



FOR RELEASE ON DELIVERY
MONDAY, DECEMBER 28, 1981
9:00 A.M. EST

THE FEDERAL RESERVE AND INTEREST RATES

Remarks by

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

at a roundtable on

"Monetary Policy and the International Impact of Interest Rates"

at the annual meeting of the

American Economic Association

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In this discussion of monetary policy and the international impact of interest rates, the topic assigned to me is "The Federal Reserve and Interest Rates." In this context, two recent episodes come to mind that it might be useful to explore. One is the recent discussion of the prospective U.S. budget deficit, and its international repercussions. The other relates to the period of high interest rates earlier this year, when it was frequently alleged that the United States was responsible for high interest rates in the rest of the world. I would like to exemplify what I have to say on my topic by reference to these two episodes.

The Federal Budget Deficit and Its International Ramifications

The federal government is now widely expected to have a very large deficit not only in 1982 but quite possibly also in 1983 and 1984. The

financial markets have not responded well to this prospect. It has been argued by distinguished economists, however, that the pressures exerted by our deficits on U.S. capital markets and interest rates have been exaggerated. We live in a world of international capital markets. We can borrow abroad. By distributing some of the financing of our deficits among other countries, it has been argued, we can reduce our own burdens.

In examining this proposition, I must begin by noting that in a sense we may find ourselves borrowing abroad whether we want to or not. It is not a question of whether we issue government securities here or abroad, in dollars or in foreign currencies. The international balance-of-payments adjustment mechanism, of which international capital markets are a part, will indeed tend to distribute the borrowing around. Our own monetary and other policies, assuming the deficit to be given, will, of course, play a role in this. But in assessing whether the outcome is favorable for the United States, and how it affects the rest of the world, we need to understand how the international borrowing process works.

A country borrows abroad, i.e., is a net importer of goods and services, when it has a deficit in its current account. When more goods and services are imported than are exported, the country is obtaining real resources, i.e., real capital, from abroad. It does not matter whether the country's government, or its private sector, has issued securities abroad, or has issued securities in foreign currencies. So long as such issuance does not lead to a current account deficit, the country cannot be engaged in net borrowing abroad. If, in response to such borrowing, a certain number of dollars has flowed in an equal number of dollars must have flowed out through

capital exports, whether or not we know in detail through what channels this happened. To put it in simplest terms, under a system of floating exchange rates and in the absence of intervention, a foreign investor who has no dollar assets can acquire such only if he can find a holder of dollar assets who is willing to acquire the foreigner's foreign currency assets unless the current account goes into deficit. If the country started out with a current account surplus or deficit, these effects must be viewed in terms of changes in that position.

How, then, would the U.S. government borrow abroad, and how would the necessary move toward current-account deficit come into existence? Borrowing abroad in dollars makes little sense. National capital markets are highly integrated today. The world market for dollar securities is like a big bathtub. One cannot, by bailing water out at one end and pouring it back at the other, make its level at either end different.

Thus, the question comes down to borrowing in foreign currency, say in D-marks. Assets in different currencies are not perfect substitutes. Interest rates in different currencies can differ, not only in nominal terms (they may do that because of different rates of inflation) but also in real terms. Nevertheless, the economic sequence of events, stripped of currency complications and superficial differences, is not greatly different whether the U.S. government finances its deficit in dollars or in some other currency.

Suppose first that the deficit is financed in dollar-denominated debt, it being immaterial whether the securities are issued in the United States or abroad. U.S. interest rates will tend to go up, and the more rapidly the more successfully the Federal Reserve avoids monetization of

the deficit. Monetization of the deficit would not avoid the rise in interest rates, since eventually it would lead to higher inflation and even more quickly to higher inflation expectations. Higher interest rates, other things equal, cause the dollar to appreciate. An appreciating dollar, after some temporary J-curve effect perhaps, would generate a current-account deficit (or shift the current balance in that direction from whatever surplus or deficit we start out). The United States then would be importing capital.

Alternatively, suppose the U.S. government borrowed abroad in D-marks. Assume also a two-country and two-currency world. This would tend to raise D-mark interest rates and to that extent strengthen the D-mark. However, the U.S. government would have to convert the D-mark received by selling it in the exchange market to get the dollars needed to finance its operations. In the absence of German intervention to take the operation out of the market, that would tend to depress the D-mark. The net effect is to raise the dollar and the U.S. current account would move toward deficit.

To complete the picture, let us look briefly at German interest rates as they would evolve in the case of dollar and D-mark borrowing respectively. In the case of dollar borrowing, dollar interest rates rise relative to D-mark interest rates. The D-mark depreciates. The German side can offset that depreciation by adopting appropriate policies, for instance raising real interest rates. In the latter instance, there would have been a transmission of rising interest rates from the United States to Germany.

In the case of D-mark borrowing, D-mark interest rates will rise reflecting the greater volume of D-mark securities investors must hold. Dollar interest rates will rise less than if all the borrowing were done in the United States.

It may be somewhat perplexing to see, in both examples, assuming unchanged German policies, the development of a U.S. current-account deficit associated with a rise in the dollar. Ordinarily, one thinks of countries with rising current-account deficits as having weak currencies. But in the case we are examining, the causal sequence, of course, is reversed. We are not observing the independent development of a deficit that then pulls the currency down. We are looking at an appreciating currency that causes a deficit. So long as net foreign borrowing is maintained, the dollar will remain strong. If it were to drop, the deficit would disappear and net capital imports ipso facto come to an end.

What benefit would foreign borrowing provide for the United States? It is obvious that the relative magnitudes of historical swings in the current account and prospective swings in the budget deficits differ drastically for the United States. The U.S. current-account deficit increased by a record \$18-1/2 billion between 1976 and 1977 (from a surplus of \$4.4 billion in 1976 to a deficit of \$14.1 billion in 1977), substantially less than the projected increase in the U.S. budget deficit. Current-account deficits of the kind we have seen so far obviously would not make much of a dent on the financing of \$100 billion budget deficits. It boggles the mind to think of the kind of current-account deficits (even if we started out with some surplus) needed to shift a significant part of the financing of such budget deficits abroad. Likewise, it is difficult to visualize the rise in the dollar needed to generate these deficits, or what this rise would do to U.S. exports and to U.S. import-competing industries. Finally, although this is a value judgment, it would seem to me a serious misallocation of world resources if the United States

were to drain away the world's scarce capital resources, thereby crowding out businesses, consumers, and governments in foreign, and especially in developing, countries, in order to devote these resources principally to consumption.

Two final observations on international borrowing: As I said at the outset, a large U.S. budget deficit and the ensuing pressures on capital markets may well make the United States a capital importer, whether it intends to be or not. Second, I doubt that the processes of the international markets would allow a very large U.S. current-account deficit, once it had come into existence, to continue for any length of time without adverse repercussions on the dollar, despite favorable interest-rate differentials, which in turn would limit or eliminate the current-account deficit.

U.S. and Foreign Interest Rates

I now come to my second example of the international impact of interest rates. The dollar in 1981 has shown exceptional strength, rising to about 115 of its trade-weighted level (world trade shares weighted, 1973 = 100) from a low of about 85 in 1980. With respect to the D-mark, the rise was from a (very short-lived) low of 1.70 to a (likewise short-lived) high of 2.57, an increase of over 50 percent. Whatever the contribution of factors such as diminishing inflation expectations, a current-account surplus, and political circumstances in the United States and abroad may have been, many foreign observers have singled out the role of high U.S. interest rates as the principal cause of dollar appreciation. In turn, the rise in interest rates abroad was widely attributed to the need to limit the depreciation of

foreign currencies against the dollar. At first blush, this seems to provide an example of the international transmission of interest-rate movements that we are here discussing.

But before we accept this analysis, with the United States cast in the role of the villain, let me examine some contrary evidence. It is fragmentary and pragmatic, and in any event my intention is not to deny the case made, but to suggest that it is not the entire story. Here are some items upon which I could draw:

Item. The rise in interest rates did not occur in all parts of the industrial world. Japan experienced no increase in short-term rates and yet the yen did not experience pronounced weakness. Apparently, Japan continued to be considered as a country attractive for international funds. A strengthening current account, and a firm hand on the budget, may have had something to do with it.

Item. After the end of 1980, the interest differential between the United States and European countries ceased to widen. Nevertheless the dollar continued to rise.

Item. When U.S. short-term interest rates began to drop in May and June, interest-rate differentials also dropped. Foreign countries tended to maintain their interest rates for a while before taking advantage of a lower dollar and lower U.S. rates to reduce them. Evidently there were reasons, such as higher inflation rates, weaker current accounts, and unresolved budgetary problems, that made a restraining monetary policy desirable independently of the level of U.S. interest rates. It was only several months later that the downward movement of U.S. interest rates and of the dollar was followed by a significant decline of interest rates abroad.

This casual evidence seems to suggest that the strength of the forces powering the international diffusion of interest rates in the short term can be overrated. There apparently are other causal factors, including domestic, which induce countries to adopt policies that more or less seek to match U.S. interest rates. These domestic factors, and especially inflation, of course, may be operating in the United States as well as abroad.

Allow me to end with a more general comment on the transmission of interest rates. One could visualize a world in which both monetary and fiscal policy served as flexible and effectively managed tools. In such a world, as we know, it would be preferable to assign to fiscal policy the job of looking after domestic stability while monetary policy looked after the balance of payments, or, in a world of floating, the exchange rate. This at least would be so if monetary policy is defined in terms of interest rates rather than money-growth rates. In such a world, especially if exchange rates were fixed or if flexible rates were kept stable by deliberate policy actions, the propagation of interest-rate impulses would probably be very rapid. However, in many cases a move by one country to raise its rates might be followed by action of others to lower theirs, reflecting the rules, such as they were, of the classical gold standard.

The world in which we live is very different. Fiscal policy, in most countries, is not part of the solution, but of the problem. Monetary policy has to do both the domestic and the international job, to the extent that one can pursue two goals with one instrument. Monetary policy, moreover, largely because of the prevailing inflation, in most countries is quantity oriented rather than interest-rate oriented. Finally, because inflation rates

differ, nominal, if not real, interest rates are internationally diverse. Thus, whether interest-rate coordination can ever become a realistic goal or not, at the present time there exist more than the usual historic obstacles to it.

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