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Statement by
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Member, Board of Governors of the Federal Reserve System
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Subcommittee on
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Committee on Foreign Affairs
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I welcome this opportunity to discuss the important issues relating to U.S. trade and current account deficits. I will begin with some thoughts on the basic factors at work, to provide a framework within which to consider the desirability of various possible actions in terms of their contributions to non-inflationary economic growth as well as to reductions in our external deficits.

Causes of the External Deficits

It is customary to analyze changes in the external deficits by focusing on proximate causes, such as the growth of economic activity at home and abroad and changes in exchange rates. The cyclical behavior of the U.S. and foreign economies has been an important factor contributing both to the timing and the widening of the U.S. external deficits. The U.S. recession held down the growth of imports from the fourth quarter of 1980 until the fourth quarter of 1982 and, thus, delayed the rise in our external deficits in spite of an appreciating dollar. Since 1982, we have enjoyed a strong recovery, with output -- measured by real gross national product (GNP) -- rising by some 12-1/2 percent from the fourth quarter of 1982 to the fourth quarter of 1984. Aggregate demand -- measured by all U.S. purchases of goods and services domestic and foreign -- has increased even faster, by about 15 percent during this period, with some of this demand spilling over abroad. A significant part of the deterioration in our external accounts has therefore resulted from the strong growth in the U.S. economy.

In contrast, the growth of demand for U.S. exports had been quite weak. In major foreign industrial countries, real GNP increased only about 5 percent from the end of 1982 to the end of 1984, after virtually no growth on average the preceding two years. The slight support that this growth provided for U.S.

exports was offset to a large extent by the external financing problems of some developing countries, especially our neighbors in Latin America. As a result, the value of U.S. exports in 1984 was little changed from 1980. The Board staff estimates that about one-third of the increase in the U.S. current account deficit from the end of 1980 to the end of 1984, after abstracting from a decline in imports of oil, can be attributed to the cyclical expansion of the U.S. economy relative to that of our trading partners.

A somewhat larger portion can be related to the very substantial appreciation of the dollar. On a weighted-average basis against the currencies of other major industrial countries, the dollar has appreciated by more than 70 percent since the fourth quarter of 1980, when our current account was showing a small surplus. Some of the appreciation has reflected and contributed to our relatively good inflation performance, but even in real terms -- adjusted for changes in consumer price levels in the United States and abroad -- the weighted average value of the dollar is now nearly 60 percent higher than it was at the end of 1980, and roughly 45 percent higher than its average for the entire floating rate period.

I think it is fair to say that no one fully understands the factors that have led to the enormous appreciation of the dollar; certainly no one anticipated it. Nevertheless, it seems clear that several forces have been at work at one time or another. A rise in U.S. interest rates relative to those abroad can explain a good part of the dollar's rise, particularly in its early phases. In addition, one can point perhaps more broadly to the vigor and dynamism of the U.S. economy and its high profitability. But one cannot find much direct evidence in the statistics that international flows, such as purchases of U.S. equities or direct foreign investment, have been of a nature that might be

specially responsive to such incentives. Finally, one can point to the political and social, as well as economic, stability of the United States, which has made this country a relatively secure haven in which savers may want to keep their wealth.

History provides some support to this notion that capital movements can be a dominant influence in the determination of the dollar exchange rate. Evidence covering the periods 1919-39 and the post-war period indicates that an expansion in the United States relative to the rest of the world, while weakening the current account, strengthened the capital account sufficiently to improve the overall balance of payments by increasing desires to move funds into the United States under the old regime of fixed exchange rates, and causing the dollar to appreciate under the present regime of flexible rates.

While the strong dollar and our large external deficits reflect, in part, our improved macroeconomic performance and the greater return on financial investment in this country, in a more fundamental sense they are related to the budget deficit. When the U.S. government runs a deficit, other sectors must, on balance, finance it. Private domestic residents and state and local governments through their savings have provided part of the financing, not just of their own investment, but of the government's deficit as well. The net inflow of savings from abroad -- which is the counterpart of the current account deficit -- has (directly or indirectly) provided the remainder of the financing. This capital inflow has enabled us to have lower interest rates than we would have had otherwise, given our budget deficit.

Consequences of the Deficits and the Strong Dollar

The goal of macro-economic policy is to provide an environment for sustainable non-inflationary economic growth. The strong dollar and the external

deficits have contributed to that environment. The external deficits reflect the growth and relative dynamism of the American economy that has attracted a flow of funds from abroad. The growing net capital inflow -- now supplementing net domestic savings of individuals, businesses and state and local governments by nearly a third -- has been a critically important factor in enabling us to finance both rising investment and the enormous federal deficit at lower rates of interest than otherwise would have prevailed. Of course, it is our rising private investment that would be crowded out by higher interest rates in the absence of the net foreign capital inflow. The strength of the dollar and the ready availability of goods from abroad have also been potent factors restraining price increases in the United States.

At the same time, the strength of the U.S. economy, acting through our trade and current account balances, has provided a major and needed stimulus to the rest of the world. The support we have provided to the exports particularly of developing countries has been a critical element in the difficult process of economic adjustment that they have embarked on. Exports to the United States have helped to sustain the economies of our industrial trading partners, as well, thereby contributing to a healthier world economy.

Some have argued that the strong dollar has cost the U.S. economy something like two million jobs since 1980. But it is difficult to conclude that overall U.S. employment and output have been unduly restrained during the past two years by the large trade deficit and, more fundamentally, by the appreciation of the dollar. Employment has increased by 7 million people since the end of 1982. It would be misleading to suggest that last year's \$107 billion trade deficit could have been simply transformed into an additional \$107 billion of domestic output. Any attempt to demand that much more output from the domestic

economy -- equivalent to about 3 percent of GNP -- would likely have produced higher interest rates, run into capacity constraints, and encountered structural rigidities in the labor market. The result would not have been 3 percent more output but a significantly less favorable U.S. price performance. In the absence of the policies that have led to the capital inflow and the strong dollar, while losses of jobs from these sources would have been less, so probably would have been the creation of new jobs.

From these perspectives, the effects of the strong dollar and the external deficits are gratifying. However, strains and distortions are evident, for instance, in pressures on our farmers, miners, and producers of capital equipment. All sectors, clearly, have not shared equally in our expansion.

You have asked for my best assessment of the cumulative effects of such deficits upon the U.S. and global economies, and what consequences can be expected if annual trade deficits of the current magnitude should continue to be incurred. I do not believe that the budgetary and trade deficits of the magnitude we are running are sustainable forever, even in a framework of growth and prosperity. They imply a dependence on foreign borrowing by the United States that, left unchecked, will sooner or later undermine the confidence in our economy essential to a strong currency and prospects for lower interest rates.

If the external deficits continue, the United States will become an international debtor country on a rapidly rising scale. Our long-standing position as an international creditor has been a major support to our balance of payments so far. Thanks to the very productive character of some of our foreign assets, the United States had a surplus of investment income averaging more than \$30 billion annually during 1979-81. This has meant that we have been able to

tolerate a sizable trade deficit without incurring a deficit in the current account, which combines services and trade. This advantage is rapidly being eroded; indeed, our net investment income fell below \$20 billion in 1984. If these developments are not reversed, the United States may soon find itself in a position of where it would have to earn a surplus in the trade balance in order to cover a deficit on investment income. The longer the situation continues, the more the value of the dollar would have to fall in the long run to generate such a trade surplus.

As a final consequence, the exchange rate pressures and trade imbalances we have been experiencing are generating economic and political pressures toward protection. It is essential that these pressures be resisted. This brings me to the specific questions you have asked me to address this morning.

Evaluation of Proposals

You have asked me to evaluate various policy approaches that the Committee is considering.

One general approach -- suggested by the questions on foreign investment and import measures -- is increased protection against imports. This would be a gross mistake for many reasons. First, if protectionist measures actually had the effect of appreciably reducing some imports, they would presumably be reflected, other things equal, in still further upward pressures on the dollar. This would intensify the problems experienced by exporters, farmers, and other groups not protected. Second, quotas, new tariffs, or import surcharges all act directly to raise prices, and the problem would not be temporary if the effect would be to refuel inflationary expectations -- just at a time when so much progress has been made in changing that psychology. Third, protectionism would be particularly troublesome from the point of view of the developing countries.

We have encouraged developing countries to adopt sound adjustment policies that will enable them to service their debts, to enhance over time their productive capacity, and grow. Success is dependent upon their ability to increase exports -- and as their exports grow they will also import, from the United States and other industrialized countries. But that success will be denied if the United States and other industrial countries protect their own markets from fair competition by developing countries.

In some respects, the situation of the developing country debtors today resembles that of Germany after World War I. Heavy demands were being made upon Germany for payment of war reparations. At the same time, the countries receiving these reparations protected themselves against the imports from Germany which were the necessary means by which Germany might have paid. Default and financial restrictions were the result.

Finally, protectionist measures would almost certainly provoke retaliation. The worldwide trend toward free trade would be in danger of being reversed. A situation might result resembling that after the tariffs and other restrictions adopted around the world in the 1930s which greatly reduced world trade.

Turning to specific proposals, I would like to focus on plans for a temporary import surcharge. Those proposals are sometimes coupled with other measures to reduce our budget deficit. Such proposals are offered as a relatively painless means of raising government revenue while simultaneously addressing the trade deficit.

One attraction of an import surcharge is that it seems to tax foreign exporters as well as domestic residents. But it is also clear that any benefits, either for our current account balance or for the budget, would be temporary.

Lasting effects cannot come from a temporary surcharge. But a surcharge might make other budget measures more difficult to enact.

In any event, the surcharge would act directly to raise prices, reduce real income, lower employment, and perhaps raise the value of the dollar.

If this tax is so attractive to the United States it would certainly be attractive to others as well. Most countries have budget deficits larger than they would like, and with high unemployment would not be averse to reducing imports. If the surcharge approach is, in effect, legitimized by the United States, other countries might follow our example. That would eliminate any net benefits and also have destructive implications for world trade.

At a more fundamental level, it does not seem consistent to prepare actions to reduce our trade deficit and at the same time welcome the associated capital inflows from abroad. Unless we reduce our budget deficit, success in improving our trade balance, and thus reducing the capital inflow, will intensify pressures on our domestic financial markets, jeopardizing such interest sensitive sectors of the economy as housing and investment.

In essence, a lasting solution to the problem of our external imbalance rests on simultaneously restoring internal financial equilibrium. There is simply little choice but to take prompt action to reduce our budget deficit over time. Approaches that obscure that basic need will, in the end, not succeed.

This applies also to capital controls -- such as payments restrictions, taxes, or surcharges on incoming foreign investment dollars. If these were effective, they would only shift the impact of the nation's budget problems by pushing up interest rates and most likely the value of the dollar. However, such controls are not likely to be effective, given the integration of domestic financial markets with the Euromarket and international financial markets

generally. Participants in financial markets are sophisticated enough to find ways around any controls, as they have done in the past. Imposing capital controls in these circumstances would only serve to raise costs and undermine the efficiency of our financial markets and could jeopardize the role of the U.S. dollar as a reserve currency. The experience of the United States with the interest equalization tax and with the so called "Voluntary Credit Restraint Program" confirm this judgment.

You raised the possibility of a surcharge on oil imports. Imposing a surcharge on oil imports is similar to increasing taxes on oil consumption. This tax should be judged on its merit as an energy policy measure. A smaller tax on oil consumption could yield the same reductions in the budget and trade deficits.

You have asked, as well, whether the floating exchange rate system itself may have contributed to our problems. Swings in exchange rates over the past decade, to be sure, have been extremely wide. They have far exceeded movements needed to establish or restore equilibrium in international trade and payments. Many of these swings must be related mainly to changes in the relative outlooks for interest rates, inflation and real growth in different countries. A good part of the changes in relative economic outlooks in turn can be related to changes in monetary and fiscal policies. Given the stances of monetary and fiscal policies in the United States and abroad during the past four or five years, it is hard to believe that the Bretton Woods system of pegged exchange rates could have survived. Greater stability of exchange rates, which is greatly to be desired, must be founded, in the first place, on greater convergence of economic performance in all countries, and on policies capable of sustaining that convergence.

Finally, you raised the question of whether the dollar is overvalued. It is sometimes argued that whatever exchange rate prevails in the market at any moment balances demand and supply and therefore cannot be over or undervalued. In my view, however, it is more meaningful to interpret this question as referring to the effect of the exchange rate on key economic magnitudes, such as the trade balance or the current account, over the medium term. It seems evident that the recent value of the dollar has been clearly inconsistent with even very approximate balance in either the trade or the current account. In this sense, therefore, the dollar's current value is not sustainable over time.

Given this interpretation of our situation, the right policy prescription for dealing with the trade deficit must be to deal with the circumstance that is at the root of the high dollar. This brings me back to the need to reduce the structural deficit in our federal budget. Such action, of course, would not cure all the diverse problems encountered in the various sectors of our economy or the world economy. But a substantial adjustment of the budget toward balance is a necessary first step. It would, other things equal, lead to declines in real interest rates, a depreciation of the dollar in exchange markets, and (with some lag) a reduction in the external deficits.