OUR TWIN DEFICITS

Remarks by

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SUMMARY

1. The U.S. economy is at the center of a tug of war between two deficits -- the budget deficit, which expands demand, and the trade deficit, which drains demand abroad.

2. The trade deficit has been gaining on the budget deficit and has slowed the economy.

3. The outlook for the dollar is the major uncertainty overhanging the American economy. A strong dollar hurts American trade, but facilitates the inflow of foreign capital.

4. The best approach to reducing the trade problem is to reduce the budget deficit, thereby reducing the need for importing foreign capital.

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The title of your session -- "Coping with Hard Times" -- shows how in a large economy like ours different sectors can have very different experience. I can fairly say that the American economy in general is not experiencing "hard times." There are, however, some sectors that are not doing well -- farmers, some heavy industries, exporters and import-competiting industries. You are not alone.

A Tale of Two Deficits

Looking at the economy generally, it clearly today is being subjected to a tug of war of two powerful forces -- the budget deficit, and the trade deficit. The budget deficit has enormously increased demand in the economy, simply by giving the taxpayer more purchasing power. This force has been propelling the economy for two-and-a-half years. Meanwhile, the trade deficit has been building up slowly as our imports advanced while exports remained feeble. Draining away purchasing power from the domestic economy, the trade deficit has been nibbling at the expansionary force of the budget deficit.
At $120 billion projected for 1985, the trade deficit is still substantially smaller than the unified budget deficit of $210 billion.

But aside from the fact that a simple dollar comparison is not entirely valid, the trade deficit now has revealed itself as having a leverage over the rest of the economy that the budget deficit does not seem to have. The trade deficit seems to affect adversely the inducement and ability to invest in additional plant and equipment. It does so by hitting with particular force at the manufacturing sector, contributing to a virtual stagnation of industrial production since the summer of 1984. In good part as a result, the rate of business investment, which in 1984 grew in real terms at the spectacular rate of 20 percent, has slowed down to 3-1/2 percent during the first quarter of this year. The trade deficit slows investment not only by holding down industrial production, but also by curbing business profits, through intensified foreign competition. The slow growth of corporate profits makes the point.

The budget deficit does not have the same leverage over business investment. By stimulating consumer purchases, it does indirectly stimulate investment. Moreover, a moderate part of the budget deficit is the result, not of consumer tax cuts and general increases in government expenditures, but of the tax benefits made available to business through accelerated depreciation and investment tax credits. But the budget drives up interest rates, although these have come down substantially from their peaks. The net result is before our eyes -- business investment has slowed substantially. Recent surveys, to be sure, seem to indicate that other factors will tend to raise investment again.
Other Factors in Good Balance

Apart from the shifting balance of these two deficits -- the internal and the external -- the economy at the present time does not exhibit the type of imbalances typical of late stages of an expansion. We are now well into the third year of the present expansion, but the typical imbalances in the housing, investment, and other sectors do not yet seem to have developed. In our private enterprise economy, business cycles are entirely normal. They can be ridden out if the imbalances have not been allowed to become excessive as a result of government efforts to keep the economy expanding when its natural expansive forces have temporarily spent themselves.

The consumer is doing quite well and seems capable of carrying his important share in a continued expansion. Real income has been rising. The ratio of consumer debt to income, to be sure, has expanded considerably and is roughly equal to its past peak. But the consumer's assets are in good shape, with the value of common stocks substantially higher than a year ago, other financial assets advancing rapidly, and the value of homes growing moderately although much less so than during the 1970's. The consumer's views of the state of the economy and of his own present and prospective finances are good, although below their peak during the first half of 1984.

Business inventories are in reasonably good shape. A slight accumulation that occurred in the latter part of 1984 has been brought to a halt, and the inventory position in most industries has been improved. The housing sector has maintained a brisk pace with housing starts at 1.8 million in 1984 and at an annual rate of 1.9 million during April. It has
turned in this performance despite a historically high level of interest rates, particularly after adjustment for the much reduced rate of inflation. This seeming ability to live with relatively high interest rates, however, may to some extent reflect the benefit of the usually lower initial rates on adjustable-rate mortgages, now accounting for about two-fifths of total loans closed. Moreover, the homeowner may be more sensitive than in the past to any subsequent movement in interest rates.

The ability of the homeowner to live with historically high interest rates raises a question whether business investment has suffered from these rates, or whether the recent slowing has been the consequence of other possibly quite temporary factors. In examining the behavior of business fixed investment, it needs to be recognized, for instance, that its character has been somewhat unbalanced. Increases have been most pronounced in office equipment and in business-owned automobiles. This is good enough to generate purchasing power, but it does not contribute much to the productivity of the industrial sector. The big new investments that typically occur in the core of manufacturing during the course of an expansion such as this one have not yet materialized, even though output of heavy industrial machinery has been strong. Moreover, while the rate of business fixed investment as a share of GNP has beaten previous records, at least until its recent slowdown, it has done so only if the depreciation factor is ignored. Because so much of the investment has been in relatively short-lived assets, depreciation will be considerably higher. Even so, the increase in the capital stock after allowance for depreciation has been equal to that of past recoveries.

Inflation has behaved relatively well, if one can speak of 4-5 percent inflation in those terms. For the longer run, that rate is, of course, still much too high to avoid distortions and disincentives in the economy. In any
event, inflation has not so far shown the kind of acceleration that has been typical of late stages of the expansion. The same has been true of most wages, at least until recently. In some sectors, wages have been picking up over the last two quarters. Meanwhile, unit labor costs, which are a combination of wages (and fringes) and productivity gains, have increased quite sharply as a result of the poor productivity performance of the last three quarters.

The Wild Card

Looming in the background of all these trends in our economy is a risk element that we have never experienced in the past -- the unpredictable dollar. The dollar has risen very high, in part at least because of the interest-rate effects of the budget deficit. In turn, the high dollar has been responsible, although by no means exclusively, for our trade deficit. The counterpart of that trade deficit, or more correctly the current-account deficit (which includes services), has been an identical volume of capital imports. More goods and services have come in than have gone out. In real terms that means an increase in real resources, i.e., in real capital. This has been manifested by increased foreign holdings of American securities, bank deposits, factories, and real estate. The capital inflow, though it reflects the painful fact of a large external deficit, has been beneficial to the extent that it has helped to hold down interest rates. The budget deficit has in that sense been partly financed abroad.

The near-term future of the dollar is unpredictable. In the long run, the present level seems unsustainable because it would imply the accumulation of an ever-mounting foreign debt by the United States. It is useless to
argue that the United States was a debtor country before World War I with no adverse consequences. In those days, the country borrowed abroad to build railroads and factories. Today we borrow to finance a budget deficit, i.e., in effect for consumption. But today, the current-account deficit of a single year does not add dramatically to our net international liabilities, because the world's holdings of dollar assets already are enormous (as are our claims on the rest of the world). The short-term impact of the current-account deficit, therefore, is uncertain. Nobody can tell when foreign investors will begin to be concerned that they may have too large a stake in the dollar and so become reluctant to keep financing us. A decline of the dollar would, with a lag, reduce the trade deficit which in one sense would be a blessing. But it would also reduce the capital inflow and that, other things equal, would tend to raise interest rates. Nobody can say when this will happen, and, if it does, in what form. It is a threat hanging over our economy that we must do what we can to lift. Reducing the budget deficit is the most promising approach.

What Deficits Can We Sustain?

The amounts by which our internal and external deficits have to be reduced may not be quite as large as the present levels of these deficits seem to indicate. In other words, some level of deficit, both in the budget and in the current account, would probably be sustainable although far from desirable. The external deficit is in part the result of an excessively high dollar, but in part also the consequence of sluggishness abroad. Recovery abroad can and should do part of the job of redressing our trade balance. So long as that does not happen, the rest of the world is as dependent on
the stimulus it gets from our imports of their goods as the United States is on our imports of their capital. If the rest of the world does recover, the magnitude of the current-account adjustment that would have to come through dollar depreciation would be much smaller.

The budget deficit, too, may not be in need of quite so dramatic a fiscal effort as its present magnitude of $210 billion seems to imply. In principle, it would, of course, be desirable for the government to make no drains at all on our nation's savings flow, which is scanty enough as it is. Ideally, the government might even contribute to the savings flow by running surpluses which the private sector would invest. That is how the American economy operated during the 1920's, when public debt was being reduced steadily, and why the economy grew so fast during those years.

But that presupposes that the private sector is willing to absorb savings into investment on a large scale. It would imply a very favorable investment climate, in which investors could take full advantage of low interest rates, with confidence in price and exchange-rate stability, with a moderate tax system, a moderate degree of regulation, and markets free of rigidities imposed by government, labor, or uncompetitive business practices. One may doubt that such a blessed condition prevails today, even after a great deal has been done through deregulation and better business tax treatment. If, by some stroke of a magical pen, the budget deficit were eliminated, the economy would experience a deficiency of aggregate demand of the order of 5 percent. If a second stroke of that pen also eliminated the external deficit, to be sure, the economy would lose resources it now borrows abroad of the order of 3 percent of GNP.
To make up for that, domestic production would have to rise by that 3 percent, leaving a deficiency of aggregate demand of 2 percent of GNP. Could the economy increase its investment by so large an amount, assuming that consumption simply stays at its old level in relation to GNP? It would mean raising investment by about 2 percentage points of GNP which takes it well beyond its normal relationship to GNP. Interest rates, to be sure, would fall if the government stops borrowing. But whether that would stimulate investment sufficiently and how long it would take are big ifs. If these very rough numbers are even approximately meaningful, they would seem to suggest that in the current context some government deficit of one or two percent of GNP might be needed in order to lift purchasing power to a level at which the economy would be operating close to potential.

**Stabilizing the Ratio of Public Debt to GNP**

A different approach to the question of an acceptable budget deficit would look at the ratio of public debt to GNP. Presumably a debt constantly rising in relation to GNP would not be acceptable because ultimately it would push us into inflation.

The current level of the public debt -- excluding debt held by government accounts -- is $1.3 trillion. Assuming nominal GNP growth of 7 percent, of which 3 percent is real growth and 4 percent is inflation, the debt-to-GNP ratio would remain roughly constant even if the federal government ran a budget deficit of $100 billion. In real terms, 3 percent growth of both GNP and debt would allow an inflation-adjusted deficit of about $45 billion.
To be sure, a constant debt/GNP ratio is not a very good guide because it seems to say that the higher the debt already is in relation to GNP, the more it can be increased each year without raising the debt/GNP ratio. A high ratio means simply that the point at which inflationary pressures might begin, owing to the burden of interest payments in the budget, is that much nearer.

These numbers suggest, nevertheless, that the United States could tolerate a sizable budget deficit — provided the government is prepared to take that much saving away from the private sector and possibly from productive investment. If the private sector in any event could not find productive use for the money even if interest rates were lower and the functioning of markets improved, no immediate damage would be done by even a high budget deficit. Indeed, the deficit would be needed in order to keep the economy from sinking into recession. However, a continuously high budget deficit would also mean that the United States had become resigned to low investment, low productivity gains, and low growth. It would be a sad day for the economy if that happened.

At the present time, the budget deficit obviously is too high in the sense that it causes us to borrow heavily abroad as well as at home. A reduction of the budget deficit, as I have noted, would lower interest rates, probably lower the dollar, and so reduce the trade deficit and capital imports. Investment would also benefit from lower interest rates.

Nobody can evaluate the possible interaction of all these forces and their ultimate effect on the American economy. The magnitude of the effects is uncertain, their timing very uncertain, even the direction in which a given effect might go is not sure. For instance, a reduction in the budget deficit, while reducing interest rates, might so improve the international
image of the United States that the dollar might go up instead of down. Various kinds of scenarios could be developed. Soft landings seem entirely possible but by no means assured. The key variables always are the budget deficit and the dollar.

Timing uncertainties are very marked. Financial-market effects, on interest rates and on the dollar, normally take place more rapidly than goods-market effects, such as on trade balance and investment. Anticipations may play a role and further speed up financial developments. Alternatively, if government lacks credibility, the desired responses of interest rates and exchange rates may be long delayed.

The main driving force of these possible interactions is the assumption of a major cut in the budget deficit. In an alternative and less benign scenario, the deficit is not reduced significantly, interest rates in consequence do not fall, but the dollar drops because foreign investors change their attitude toward investment in a country that seemingly cannot get its house in order. In that case, the trade deficit and capital imports would still go down, but interest rates would tend to rise. The net effect on GNP of an improved trade balance and deteriorating investment could go either way. The unpredictable dollar, therefore, plays the role of a wild card in this game.

Movements in the dollar also change the rate of inflation. A well-known econometric estimate says that a 10 percent drop in the dollar raises the price level by a little over 1-1/2 percent in three years, i.e., raises the rate of inflation by slightly more than a half percent per year. When the dollar was going up, the United States benefitted by a lower rate of inflation. On the way down, it will lose.
The Role of the Price of Oil

Let me conclude with a word about the role of oil in this picture. Foreign countries have often complained that a rise in the dollar and consequent fall in their currencies has added to their own inflationary pressures. That case has been made particularly with respect to the price of oil. Because oil prices are quoted in dollars the case often has sounded persuasive and indeed is by no means invalid. Nevertheless, the argument ignores that the demand for oil is a world demand and that the supply price, to the extent that it is at all sensitive to demand, is also determined in the world market rather than in the United States. The tendency of the world oil price to weaken as the dollar went up reflects, among other things, the fact that the price of oil in other currencies rose, reducing the amount demanded. If the dollar declines, a constant dollar price for oil will mean cheaper oil in other currencies and, accordingly, a greater demand. Both on the way up and on the way down, the movement in the dollar price of oil, other things equal, is likely to be less than that of the dollar itself.

Finally, I would note that domestically in the ups and downs of inflation, the great role played by the price of oil has often been overlooked. Directly and indirectly, movements in the oil price that were imposed upon the United States by forces from abroad have contributed strongly, first to the acceleration of inflation, more recently to its slowing. A near tenfold increase in the price of perhaps the most important single commodity in the world over less than a decade was bound to have major price effects, quite aside from monetary policy, budget deficits, wage push, and occasional crop failures. Movements in this price have influenced the location of industry,
the pattern of production, the rate of productivity growth, and the solvency of many enterprises and even banks.

Today it is customary to say that people made serious mistakes in investing in oil, that they should have had better foresight, and that many investors, producers, and bankers are now paying a penalty for these errors. I would like to think back to the time when those decisions were made. It was not only a time of speculation, but a time of perceived national emergency, characterized by deep concern about how the world economy would continue to function in the face of what was widely seen as an oncoming oil crisis. Mistakes have been made, and penalties are being paid, but I remember well that many of those unfortunate decisions at the time were widely hailed as serving to protect the national economy. Perfect judgment is not possible, either in the oil business, or in forecasting the dollar, GNP, and all the rest. All we can do is to try to do better next time.

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