ECONOMIC OUTLOOK, THE DOLLAR
AND THE INTERNATIONAL SITUATION

REMARKS OF
JOHN J. BALLES, PRESIDENT
FEDERAL RESERVE BANK OF SAN FRANCISCO

MEETING WITH
INTERNATIONAL BANKERS ASSOCIATION

SANTA BARBARA, CALIFORNIA
NOVEMBER 18, 1983
Thank you very much for inviting me here to speak with you. Typically, I limit the scope of my talks to a review of economic developments on the domestic front, but we have been reminded in the past year that the United States has become much more integrated into the world economy and, as a result, that our economic fortune is intertwined with that of other countries. I would therefore like to take this opportunity to discuss both the business outlook for this country and the options for monetary policy within an international context.

The State of the Recovery

Let me first say that all signs still indicate that we are in the midst of a strong recovery that began in late 1982. A review of the recent business and financial news suggests that we've accomplished a great deal in clearing the economic landscape of one of our most serious problems -- inflation -- although, of course, the job is far from finished. A comparison of today's inflation rate with the peak inflation rate of 1980 is very instructive. In the summer of 1980 the twelve-month rate of increase in consumer prices was 14.8 percent. In contrast, the current twelve month rate of change is 3.8 percent -- a 60 percent reduction from 1980. The decline in the inflation rate at the wholesale level, as measured by the producer price
INDEX, IS EVEN MORE DRAMATIC -- CURRENTLY 1.4 PERCENT VERSUS
10.5 PERCENT IN 1980.

The good news about inflation is bolstered by reports on other aspects of the economy. The index of leading economic indicators has been moving upward since September 1982. Since January, it has scored a very impressive gain of 9.0 percent. Real GNP growth at 9.7 percent in the second quarter of this year was the strongest it has been in over two years. And estimates for the third quarter indicate that GNP continued to expand at a healthy 7.9 percent rate. Equally gratifying has been the progress on the job front, as the unemployment rate tumbled out of double-digit territory to 8.8 percent in October and civilian employment increased by almost 2½ million between May and October.

1983 and 1984 Outlook for Nation

At our Bank, we expect real GNP for the U.S. as a whole to grow close to 6.0 percent during 1983 and to continue to expand at about 5.0 percent in 1984. This is an expansion led and sustained by consumer spending, whose strength reflects the substantial improvement in real consumer incomes and wealth resulting from the dramatic slowdown in inflation, from last July's tax cuts, and from the sparkling stock market rally earlier this year that boosted the value of households' portfolios. In comparison, plant and equipment spending has grown only modestly in 1983 because
OF THE CURRENT HIGH LEVELS OF EXCESS PLANT CAPACITY. AND
NET EXPORTS -- THE DIFFERENCE BETWEEN EXPORTS AND IMPORTS --
HAVE ACTUALLY DECLINED BECAUSE OF THE STRONG EXCHANGE VALUE
OF THE DOLLAR.

FEDERAL DEFICITS AND HIGH REAL INTEREST RATES

THE PROXIMATE CAUSE OF THE WEAKNESS IN NET EXPORTS (AND
TO A LESSER EXTENT IN DOMESTIC INVESTMENT SPENDING) IS THE
RELATIVELY HIGH LEVEL OF REAL INTEREST RATES -- THAT IS,
INTEREST RATES ADJUSTED FOR THE RATE OF INFLATION. BUT, AS
MANY OBSERVERS HAVE POINTED OUT, THE REAL SOURCE OF THE
PROBLEM -- IN OTHER WORDS, THE CAUSE OF THESE HIGH REAL
RATES -- IS THE FEDERAL GOVERNMENT DEFICIT.

THE FISCAL 1983 DEFICIT OF $195.3 BILLION AMOUNTED TO
APPROXIMATELY 85 PERCENT OF AVAILABLE NET SAVINGS FROM THE
PRIVATE SECTOR AND THE SURPLUSES OF STATE AND LOCAL
GOVERNMENTS, AND IS FORECAST TO BE IN THAT NEIGHBORHOOD FOR
THE NEXT THREE YEARS AT LEAST. THIS OBVIOUSLY LEAVES LITTLE
ROOM FOR THE FINANCING OF PRIVATE INVESTMENT SPENDING,
INCLUDING HOUSING AND OUR NET EXPORTS. WITH A DEMAND FOR
CREDIT THAT EXCEEDS THE AVAILABLE SUPPLY, INTEREST RATES
HAVE BEEN BID UP AS THE MARKET'S WAY OF ALLOCATING CREDIT,
AND PRIVATE DEMANDS HAVE BEEN CROWDED OUT.

DEFICITS AND THE DOLLAR

AS I MENTIONED, PART OF THE CROWDING OUT HAS TAKEN THE
FORM OF A DETERIORATING FOREIGN ACCOUNT. SINCE 1980, WE
HAVE WITNESSED A DRAMATIC UPSURGE IN THE STRENGTH OF THE
U.S. dollar in comparison with foreign currencies. The dollar’s average value against major currencies appreciated 27 percent between 1980 and mid-October 1983. The real value of the dollar, i.e., the exchange rate adjusted for price trends in the U.S. and abroad, has been equally strong — marking a 28 percent gain since 1980.

The dollar’s strength is due largely to the financing requirements of the federal government, which have brought high real rates and, in their wake, a high demand for dollars to invest in the U.S. These foreign investment funds have been welcomed by many as a desirable supplement to U.S. savings, helping to finance U.S. budget deficits and to keep a lid on further U.S. interest rate increases.

However, this ignores the other side of the coin — the adverse impact of a strong U.S. dollar on the export sector. The strong U.S. dollar has appreciably reduced the competitiveness of U.S. exports in world markets and made it easier for foreign producers to sell in the United States.

The unfavorable employment and output effects resulting from dollar appreciation have led to a rising tide of protectionist sentiment in the U.S. that threatens to cause multi-lateral trade restrictions and a reduction in world trade. Several foreign governments have added their voices in protest, pointing to higher import bills that must be paid for goods priced in dollars — most notably, oil.
The high U.S. dollar has also affected the ability of some foreign countries (primarily, Germany, France, and Japan) to control their domestic monetary policy. Authorities in these countries might want to consider monetary ease and lower interest rates as one way to counter domestic recessions. But they also want to preserve the external value of their currency. Because monetary ease puts downward pressure on currency values, these central banks face a difficult trade-off.

Finally the United States, I believe, needs to address how, in effect, it is using its foreign account to finance part of its government deficits. The capital inflow from the rest of the world, caused by high interest rates here, means that the savings from other countries are being tapped to finance the federal deficit. As Chairman Paul Volcker has noted, this outcome is especially troublesome at a time when lesser developed countries face a serious capital shortage.

The LDC Debt Problem

Recent Nobel Prize winner Lawrence Klein noted the other day that most of the burden for stabilizing the economy has fallen on monetary policy because of failure to get the fiscal deficit down. The Fed, in other words, has been given the unenviable task of both continuing the fight against inflation, and keeping the current recovery on track. At the same time, this two-fold task has been made
EVEN MORE DIFFICULT BY THE ON-GOING PROBLEM THAT LESSER DEVELOPED COUNTRIES (LDCs) ARE HAVING SERVICING AND REPAYING THEIR DEBT.

Let me present some background before discussing the implications of this problem for monetary policy. According to Federal Reserve data, LDC countries, excluding OPEC NATIONS, owe approximately $575 billion to the rest of the world. Of this, about $285 billion is owed to banks world-wide, with $100 billion owed to U.S. banks. For some banks, their total foreign loan exposure exceeds their capital.

Both the U.S. and other leading creditor countries have strong safety nets under their banking systems, and can be expected to pursue appropriate monetary and fiscal policies in the case of a serious default. Nevertheless, such a default would pose unavoidable risks to financial and economic stability, both here and abroad.

In short, no one can deny the seriousness of the problem we have here. However, we now have a much better understanding of the nature of the problem which should allow us to deal with it effectively. In my view, a workable solution requires two key elements.

An indispensable first step must be determined action by major borrowing countries to reduce external deficits by cutting inflation and budget deficits and establishing realistic exchange rates and domestic interest rates. The International Monetary Fund will play an important role in
THIS STEP, BOTH HELPING DEBTOR COUNTRIES TO FASHION THESE PROGRAMS, AND MONITORING THEIR SUCCESS.

A second key element is the working out of arrangements among bank creditors to provide continuing credit so that the debtor's adjustment programs have the opportunity to work. The fact is that few countries are in a position to repay indebtedness rapidly. An orderly solution to the LDC debt problem therefore is likely to require "roll-overs" of current and future maturities, and extensions of bank credit.

The situation we face here is a classic example of what economists would call an "externalities problem". Specifically, an individual bank may perceive it is in its narrow interest to withdraw from lending. But in fact it is not, if other banks are of the same mind. As Chairman Volcker noted in Congressional testimony earlier this year, "refusal of banks to participate in such (restructuring) programs could undermine their common interest in maintaining the servicing and ultimately collectability of existing credits."

The Role of the Federal Reserve

The Federal Reserve, as well as the U.S. Exchange Stabilization Fund, has participated in providing short-term "bridging" credits in instances where immediate liquidity requirements of a debtor country clearly threatened international financial stability. These involvements have
BEEN LIMITED AND BRIEF, HOWEVER, BECAUSE A CENTRAL BANK HAS NEITHER THE CAPACITY NOR MANDATE TO SUBSTITUTE ITS CREDIT FOR PRIVATE LENDING IN SUCH SITUATIONS.


THE FEDERAL RESERVE HAS Sought TO PROMOTE THE ACHIEVEMENT OF THESE GUIDELINES, AMONG OTHER WAYS, BY INCLUDING THEM IN THE CRITERIA IT CONSIDERS FOR REGULATORY APPROVAL OF MAJOR ACQUISITIONS. A RECENT CASE IN POINT WAS THE APPLICATION OF BANKAMERICA CORPORATION TO ACQUIRE SEAFIRST CORPORATION. IN APPROVING THE APPLICATION, THE BOARD OF GOVERNORS NOTED THAT EXPANSIONS OF LARGE MULTINATIONAL BANKING ORGANIZATIONS SHOULD BE CONSISTENT WITH AN ADEQUATE CAPITAL POSITION. THUS, IN THE SEAFIRST ACQUISITION, THE BOARD SECURED A WRITTEN COMMITMENT FROM
BankAmerica Corporation indicating its intention to secure a 5 percent primary capital ratio within twelve months.

In the last few months, several observers have asked whether the same sort of conditions ought to be applied to several proposed major U.S. acquisitions by foreign banking organizations. These observers note that up to now U.S. regulatory policy has allowed such acquisitions to take place so long as the foreign bank's capital level was in line with its country peers, and as long as it agreed to maintain adequate levels of capital in its U.S. bank subsidiary. The result was a series of acquisitions of U.S. banks by foreign banks with capital levels often well below those required of U.S. banks, even after making generous allowances for different accounting practices.

In the environment where U.S. banks are being pressed to meet minimum capital requirements, it seems to me to be legitimate, both on grounds of prudence and equity, to examine whether this policy should be revised. In my opinion, this question is not going to go away and will recur with increasing frequency and insistency in the future.

Monetary Policy and the Third World

Finally let me say a little about U.S. monetary policy and the LDC debt problem. I referred earlier to some of the problems caused by high interest rates in the U.S. One point I did not mention was that interest rates on a
SIGNIFICANT PART OF LDC LOANS ARE TIED TO U.S. INTEREST RATES. THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT ESTIMATES THAT THESE FLOATING-INTEREST LOANS AVERAGED $165 BILLION IN 1982 FOR NON-OPEC DEVELOPING COUNTRIES. OF THIS AMOUNT, FOUR COUNTRIES -- ARGENTINA, BRAZIL, SOUTH KOREA AND MEXICO -- ACCOUNTED FOR $140 BILLION, OR 84 PERCENT OF THE TOTAL.

HIGH U.S. INTEREST RATES THEREFORE EXACERBATE THE LIQUIDITY PROBLEMS FACED BY THESE COUNTRIES AT A PARTICULARLY VULNERABLE TIME. ECONOMISTS ON MY STAFF HAVE ESTIMATED THAT AN INCREASE OF 100 TO 200 BASIS POINTS IN THE FEDERAL FUNDS RATE WOULD BOOST THE NET DEBT SERVICE REQUIREMENTS OF NON-OPEC DEVELOPING COUNTRIES A MINIMUM OF $1.7 TO $3.4 BILLION ON AN ANNUAL BASIS.

THE FED HAS COME UNDER PRESSURE PERIODICALLY TO ALLOW MONEY TO GROW MORE RAPIDLY, WHICH, IT IS ARGUED, WOULD HELP LDC COUNTRIES BY PUSHING DOWN INTEREST RATES HERE IN THE U.S. SUCH A POLICY, IN MY ESTIMATION, WOULD PRODUCE ONLY TEMPORARY GAINS AT BEST. IT MIGHT INITIALLY LOWER INTEREST RATES AND EASE THE DEBT SERVICE COSTS OF LESSER DEVELOPED COUNTRIES, BUT THIS TEMPORARY RESPITE ULTIMATELY WOULD BE UNDONE BY EVEN HIGHER INTEREST COSTS FOR AN EXTENDED PERIOD, AS INFLATION PICKS UP AGAIN AND INTEREST RATES RISE TO INCORPORATE A HIGHER "INFLATION PREMIUM".

IN SHORT, THERE ARE NO GROUNDS FOR BELIEVING THAT AN INFLATIONARY POLICY HERE WOULD HELP THE LDCS ANY MORE THAN
it would help us. Far from it -- the ultimate result would be harmful for everyone. At the same time, we need to recognize that a lasting solution to the LDC debt problem depends on sustaining the economic recovery, both here and in other industrialized nations. Otherwise, LDC debtor nations would face an erosion of their capacity to service debt as falling export sales cut into their foreign exchange earnings. This point is worth emphasizing because the U.S. economy is an important market for many of the major lesser developed debtor countries. It accounted, for example, for 55.1 percent of Mexico’s merchandise exports and 20.5 percent of Brazil’s in 1982.

To my mind, the best monetary policy that we can pursue is the one we have in fact been following. It consists of timely and moderate adjustments to the growth in the money aggregates to keep them on track, after allowing for changes in the rate of turnover of money. This policy has probably the best chance of maintaining a sustained non-inflationary economic expansion in the U.S. and, in turn, of helping to lay the groundwork for a long-term solution to the problems of international lending.

Conclusion

To sum up, we can be thankful for having broken both the upward spiral of inflation and the downward spiral of recession during the past year. The recovery from one of the worst recessions in recent history shows every sign of
CONTINUING, THOUGH HIGH GOVERNMENT DEFICITS CONTINUE TO RAISE CONCERNS ABOUT THE LONGER-TERM PROSPECTS FOR ECONOMIC GROWTH.

ON THE INTERNATIONAL FRONT, PROGRESS IN SOLVING THE LDC DEBT PROBLEM HAS BEEN MIXED. POLITICAL UNCERTAINTIES IN BRAZIL AND ARGENTINA MAKE IT DIFFICULT TO ASSESS AT THIS TIME THE PROSPECTS FOR RESOLUTION OF THEIR PROBLEMS. MEXICO, PERHAPS, PROVIDES THE BEST EXAMPLE OF SOME MEASURE OF SUCCESS. A DRASTIC DEVALUATION OF THE PESO STOPPED THE SERIOUS CAPITAL FLYING FROM MEXICO THAT THREATENED TO UNDO ALL OF ITS EFFORTS TO RESOLVE ITS DIFFICULTIES. AT THE SAME TIME, THE DEVALUATION TURNED THE CURRENT ACCOUNT AROUND FROM A SUBSTANTIAL DEFICIT TO A HEALTHY SURPLUS. AS A RESULT, DESPITE CONTINUING HIGH INFLATION AND A SEVERELY DEPRESSED ECONOMY, MEXICO HAS BEEN ABLE TO CONTINUE TO ATTRACT SUFFICIENT FOREIGN FUNDS TO REPAY ITS DEBTS AS THEY COME DUE.

AGAINST THE BACKGROUND OF THESE DEVELOPMENTS THE FEDERAL RESERVE'S ON-GOING STRATEGY OF PROMOTING A SUSTAINED, NON-INFLATIONARY RECOVERY OFFERS THE BEST HOPE OF ESTABLISHING A CLIMATE FAVORABLE TO THE ULTIMATE SOLUTION OF THE LDC DEBT PROBLEM.