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Remarks of

Alan Greenspan
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before

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This evening I would like to examine with you two of the most important issues of U.S. economic policy. The first is the extraordinarily large U.S. current account deficit that has emerged in recent years, largely mirrored by current account surpluses among several of our major trading partners. The second issue is our large federal budget deficit, which has come to be closely associated in many people's minds with our external deficit.

These two deficits differ somewhat in terms of their long-term sustainability. Government budget deficits can, and indeed in many countries often do, persist for very long periods, though frequently with adverse consequences for their economies. In the United States we have run a federal government deficit for 24 of the last 25 years.

Persistent external deficits, on the other hand, typically occur in countries only during their development stages. The sustainability of the U.S. current account deficit is questionable, in part, because of its large magnitude relative to total world trade. In 1987, our current account deficit of $161 billion amounted to almost 7 percent of world trade.

The sustainability of the U.S. current account deficit is also questionable because it must be financed. Foreigners must be willing to take our paper in exchange for the deficit in our trade in goods and services. By definition, the deficit must be associated with an increasing stock of foreign claims on domestic residents, and/or a reduction in the stock of domestic claims on foreign residents. Although the rate of increase of U.S. claims on foreigners has declined in recent years, it is still positive; claims are still rising. Therefore, the increase in foreigners' claims in the United States has been even greater than the total U.S. current account deficit. These foreign acquisitions of dollar assets incidentally include net purchases of Treasury issues, U.S. corporate bonds, stocks in U.S. companies, and direct investments, as well as net borrowings from foreigners channeled through banking offices located in the United States.

Accordingly, to finance our large external deficit foreign investors must be willing to add each year the requisite amount of additional dollar-denominated assets to their wealth portfolios. As the stock of dollar claims increases relative to assets denominated in other currencies, foreign investors may require additional incentives to accumulate the increased supply of these assets. A safer political environment for assets, convenience, and liquidity have in the past enhanced foreign inclinations to expand dollar asset holdings at any given set of interest and exchange rates. Whether these factors will be enough in the future without a significant reduction in the rate at which dollar assets are piling up in foreign portfolios is the crucial question. A failure to achieve a substantial reduction in our current account deficit risks changes in market incentives--higher interest yields and/or a cheaper foreign currency price for the assets.

We have already had a significant decline of the dollar. This currency depreciation will drive the current account deficit down as exports are stimulated and imports are restrained. But while these self-correcting forces will work over a time, the period may be long and unpredictable; the adjustment process is likely to be exacerbated by the volatility of exchange markets in response to perceived shifts in macro-economic policies and performances at home and abroad.

The preferences of market investors for dollar assets could be shaken by a variety of factors. The enactment of protectionist trade legislation, which might be construed as a step toward capital controls, could be one such factor; another might be increased concern about the future purchasing power of the dollar. Should investors lose confidence in the dollar for any reason, the inevitable consequence would be an attempted shedding of dollar assets and a corresponding drop in the value of the dollar and an increase in interest rates on dollar-denominated assets. If a contraction in U.S. economic activity were to follow as a consequence, it would likely improve our merchandise trade balance as the demand for imports fell. However, the rise in dollar interest payments to foreigners as a result of the interest rate increases would tend to offset the effects of this development on the current account. Accordingly any such improvement in the current account would surely be temporary, and therefore not in the longer-run interests of either the United States specifically or the world economy in general. Thus, the smooth re-equilibration of the U.S. current account depends critically on the evolution of expectations of international investors.

The depreciation of the dollar since 1985 coupled with improvements in productivity and wage restraint have begun to reduce the U.S. current account deficit but only recently. Imports as a share of our domestic demand continued to increase markedly as dollar prices on goods imported into the United States declined throughout 1985 and into the summer of 1986 despite the fall in the dollar.

The behavior of aggregate import prices reflected the decline in oil prices and the lagged effects of the dollar's earlier appreciation. Foreign producers had allowed profit margins on goods sold into the United States to rise to very high levels during the period of strong dollar appreciation. As the dollar strengthened, they delayed in implementing lower dollar prices. Conversely, as the dollar declined in value, foreign producers showed a strong and persistent inclination to hold the line on dollar prices and absorb the rise in their costs of production, measured in dollars, by reducing their profit margins. In addition, many foreign suppliers have evidently shielded their export profit margins from exchange rate changes by cost reduction efforts that helped them remain competitive with U.S. manufacturers.

Import prices also remained depressed in the face of highly visible declines of the dollar in terms of the Japanese yen and the major European currencies because a large proportion of our imports are from Canada and the newly industrialized countries of Asia. Exchange rates of the currencies of those countries have remained relatively stable against the U.S. dollar.

Since mid-1986, however, import prices have risen at more than a 7 percent annual rate, roughly twice the overall rate of domestic price increases. As a result, the import share of domestic demand is flattening out, and only recently may have begun to contract. With the decline in the dollar and substantial efforts to contain costs, U.S. export prices denominated in the currencies of our customers have become increasingly competitive, with the result that export volumes have soared since early 1986. In as much as export prices denominated in dollars have been essentially unchanged over the past two years, increases in export volumes have translated into a gain of almost 40 percent in nominal terms, from an average of about $18 billion a month during the first quarter of 1986 to an average of more than $26 billion a month in March and April of this year.

As a consequence, the trade deficit in dollar terms is contracting at a moderate pace. I expect this to continue, though the month-to-month changes probably will be erratic.

Thus, the main success we have had to date in reducing our current account deficit has resulted from the major expansion in the volume of our exports. This heavy reliance on our export sector raises the natural question of whether we may be running into supply bottlenecks in specific export-oriented industries. Or more generally, is the projected increase in the physical volume of exports and the likely shift from foreign to domestic production sources in the next year capable of being fulfilled from domestic facilities? The delayed effects of the passthrough of last year's decline of the dollar will not be felt until well into 1989.

The figures on industrial production and capacity utilization that are published by the Federal Reserve do not permit a simple answer to that question. The best evidence of whether supply bottlenecks are developing will surely be found in information on lead times on orders for materials. There does not as yet appear to be any evidence that we are seeing significant increases in order lead times for broad categories of goods produced in the United States. This suggests that we are not as yet experiencing any major supply-side constraints. To be sure, a number of products--for example, flat rolled steel sheet, petrochemical feedstocks, and caustic soda--are reported to be in short supply. But average lead times for production materials generally have moved up only moderately since late 1985 and have essentially, though perhaps temporarily, stabilized during the past 5 months. However, such data do not represent conclusive evidence as to whether we are approaching deliverability constraints. The situation will have to be monitored carefully if we are to avoid an acceleration in inflation and if we are to continue to count on an expansion in export volumes to bring about a further narrowing of our external deficit.

The uncertainty of the extent of domestic capacity availability to meet export expansion and import displacement over the next year resulting from the dollar's depreciation through last year raises obvious questions of whether further declines in the dollar in the near term can contribute materially to the adjustment process. If, in fact, the developing trends in physical volume cannot be appreciably improved over the next year, further declines in the dollar, assuming they get passed through to import prices, would only raise the nominal trade deficit to levels above what would otherwise prevail. Hence, I find no adjustment benefit to be derived from a further fall in the dollar, and indeed a further decline could actually do harm to our external position.

Thus, although an improvement in our current account deficit is clearly underway, the ultimate extent and pace of that improvement are still far from certain. They depend on developments in exchange markets and in economic policies here and abroad. Moreover, our knowledge of the underlying relationships that have evolved in recent years is limited. In light of the importance of international markets to our overall growth prospects, the critical policy question concerns whether measures are appropriate to ensure that the adjustment process continues smoothly and in a manner conducive to long-term growth and stability not only for the United States but for our trading partners as well.

In order to understand what should be done, it is useful to recall that a current account deficit is identically equal to an excess of domestic investment over domestic saving, where saving includes both public and private saving. The traditional adjustment process for bringing domestic saving and investment into better alignment relies on higher interest rates to close the gap. In fact, the rise in long-term interest rates in 1987 and more recently probably reflected the need for the market adjustment process to be supported by above-normal real interest rates when domestic demand is strong and excess capacity limited. In as much as physical investment is generally more sensitive to interest rates than saving, in this type of adjustment process, and under these conditions, the current account deficit would be reduced largely at the expense of domestic investment in plant, equipment, and housing.

If the investment rate in the United States were unusually large relative to the rates of our trading partners, then there would be less cause for concern. However, since World War II, U.S. saving and investment rates have been consistently below those of our major trading partners. Thus, an adjustment process that results in a lowering of U.S. investment spending at a time when an increase in productive capacity appears to be necessary is far from an optimal outcome.

Therefore, it would seem desirable to seek progress on the other component of the investment-saving imbalance--that is, raising the domestic saving rate. Policy can be directed at raising domestic saving directly by lowering public dissaving--that is, by reducing the budget deficit. Such a policy would permit a lowering of our current account deficit without sacrificing productive private investment.

Reducing our federal budget deficit would be the most important step we can take to further the adjustment process even though it will not automatically and immediately lead to a reduction in our current account deficit. The reason is that while a reduction in the budget deficit will remove effective demand from the U.S. economy, and restrain the demand for imports, the likely reduction in real interest rates in the United States that would accompany a significant reduction in our budget deficit would presumably stimulate an expansion in domestic investment, and in particular the demand for capital goods, some of which would be imported. Concurrently a reduced government deficit might actually improve the confidence of foreigners investing in the United States, thereby raising the exchange value of the dollar and delay somewhat the improvement in the current account deficit.

It is probably the case that the sharp increase in the budget deficit in the early 1980s raised real dollar interest rates both absolutely and relative to real rates on major competing currencies. This, in conjunction with other forces, moved the dollar's foreign exchange value higher, which in turn engendered the trade deficit. This is not a simple reversible process. In today's environment we can expect a sharp decline in the budget deficit to assist the restoration of international balance only with a lag. Moreover, it is only when any bulge in domestic capital outlays following the fall in real interest rates contracts that a fall in imports and the trade deficit would ensue.

The real merit in reducing our budget deficit is not that it will provide a quick cure to our current account deficit, but rather that it will eventually do so by addressing the fundamental issue of inadequate domestic saving. The inadequacy of our domestic saving rate, certainly relative to our major trading partners, suggests that the United States ought to be running a federal budget surplus to augment the supply of domestic savings.

While the United States currently is not saving as high a proportion of its national output as other industrialized nations, it does not follow that this is the natural or long-term situation. It is not something irreversibly embodied in our culture. Indeed, if that were the case, an obvious question would arise, namely: how did the United States become the world's pre-eminent economy, with one of the highest standards of living, when we save and invest at lower rates than most other countries?

The answer rests largely on the fact that historically we have not always been a low-saving society. In fact, during the period following the Civil War, in which the United States was rapidly becoming the most productive economic power in the world, our saving and investment rates, as conventionally measured, were much higher than those in Europe and Japan. For example, between 1870 and 1910 the domestic saving rate in the United States averaged about 19 percent of GNP. The best estimate for the Japanese saving rate during that period is 14 percent of GNP, or 5 percentage points below the U.S. rate. The comparable figure for Germany is less than 15 percent, which is still more than 4 percentage points below the U.S. rate.

The shift toward a relatively and absolutely low U.S. saving rate began during the Great Depression when the dramatic decline in the U.S. saving rate was not matched by a similar decline in Europe and Japan. After World War II the saving propensities of Germany and Japan rose to record levels, while that of the United States stabilized at a level slightly below its pre-Depression average. Throughout most of the post-war period the saving rate of the United States has been lower than those of all other major industrial countries, and at least partly as a consequence these countries have improved their competitiveness relative to the United States.

To a large extent, higher saving rates abroad were associated with the process of recovery from the devastation of World War II and a closing of the gap in living standards with the United States. While there is some evidence that saving and investment rates in these countries have been declining since the early 1970s, the United States still remains the lowest saver among the major industrial countries, and our saving rate has dropped even further during the past five years.

This brief review of economic history does not suggest that the United States must go on forever as a consuming nation, saving little, investing little, with a diminished long-run level of productive capacity relative to those of other industrial nations and a heavy reliance on foreign savings.

In particular, the United States needs to contribute to a better balance of world saving and investment by removing the continuous dependence on foreign savings as the counterpart to our large current account deficit. Ideally, this dependence would be reduced by a higher propensity to save by U.S. residents. Pending such a restoration of the private saving rate in the United States, a programmed federal budget surplus may be needed to augment total savings.

Given the current situation with large federal outlays on a variety of popular domestic programs, that kind of policy objective can only be achieved over a multi-year time horizon. Moreover, considering the very large magnitude of global current account imbalances, it is clear that any successful attempt by the United States to redress its external situation must involve cooperative policies with our trading partners both in the industrial world and in the developing world, whose debt problems are also part and parcel of the global adjustment process.

Fortunately, I can report that I am reasonably hopeful, by the normally conservative standards of central bankers, about the prospects for success. Since I moved from the private to the public sector, I have been impressed by the extraordinary desire on the part of those involved in the economic policy process to reduce saving and investment imbalances and to achieve sustained growth in the world economy. If enthusiasm and dedication are any evidence of potential for success, one cannot but come away being hopeful about the long-term outlook. Nevertheless, we all must do our part, and some of the decisions, needless to say, will not be easy.