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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Senate Foreign Relations Committee

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I am pleased to discuss with you this morning the role of the United States in the global economy. That role, of course, has many dimensions, and I can only touch upon a few of them this morning -- specifically on the relationships between our expansion and growth in the world generally, certain aspects of trade and exchange rate policy, and the problem of developing country debt.

As you know, we have enjoyed a strong recovery for more than two years, with the real Gross National Product rising by some 12-1/2 percent from the fourth quarter of 1982 to the fourth quarter of 1984.

GNP is a measure of production. Throughout this period, domestic demand has increased faster than the GNP. In essence, a significant fraction of demand currently generated here -- more than 2-1/2 percent -- is now flowing abroad, providing stimulus to production overseas. Put another way, U.S. purchases of goods and services have increased by about 15 percent over the past two years, as compared to the 12-1/2 percent increase in production.

With strong stimulus absent in the rest of the world, the growth of demand in the United States represented 70 percent of the total growth of demand in the OECD area from 1982 to 1984, even though we accounted for only 40 percent of OECD GNP in 1982. Moreover, countries outside the OECD area, including importantly many countries in Latin America, have similarly benefitted from the vigor of U.S. recovery.

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The difference in economic performance over this period has been starkly evident in employment figures. In the United States, jobs increased by 7 million since the end of 1982. In contrast, there has been virtually no increase in employment in the rest of the OECD area as a whole, and in many of those countries unemployment rates have continued to fluctuate around their post-World War II highs.

At the same time, the growth and relative dynamism of the American economy have helped attract a flow of funds from abroad, strengthening the dollar even as our external trade and current accounts have moved into deep deficit. 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. The strength of the dollar and the ready availability of goods from abroad have also been potent factors restraining price increases for manufactured goods in the United States.

From one perspective, those results are gratifying for us, and our trading partners have benefitted as well. But there are, of course, serious flaws -- flaws that unless dealt with constructively, will undermine all the progress. Strains and distortions are evident, for instance, in pressures on our farmers, miners, and producers of heavy capital equipment. There have been exceptionally high levels of unemployment in many

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other industrialized countries, and, looking ahead, too few signs of significant improvement in that respect. Moreover, the financial position of the heavily indebted developing countries remains vulnerable. Those difficulties feed back on prospects for our exports and our financial system. Interest rates remain high relative both to historical experience and to recent rates of inflation.

Those strains have specific causes and potential remedies. But it is also true they are all aggravated by underlying imbalances in our trade and budgetary accounts. U.S. trade and overall current account deficits reached levels of almost $110 billion and $100 billion, respectively, during 1984. Such deficits seemed almost unimaginable a few years ago, yet the present prospect is that those external deficits could rise still further. And it is not a coincidence that those external deficits are accompanied by internal budget deficits of unprecedented size during a period of prosperity, deficits that, according to both Administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy U.S. economic growth.

Economic analysis and common sense coincide in telling us that the budgetary and trade deficits of the magnitude we are running are not sustainable indefinitely 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

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essential to a strong currency and to prospects for lower interest rates. But the hard fact is that we have come to rely on that foreign borrowing to finance the combination of a budget deficit and the private investment demands generated by a growing economy. The largest and richest economy in the world has perforce been required for the time being to draw on savings that might otherwise have been invested abroad. Indeed, the inflow of savings from abroad is equal to something on the order of 15 percent of net savings (or about 8 percent of gross savings) in all other OECD countries combined. And, the related exchange rate pressures, trade imbalances and financial strains generate political as well as economic pressures toward economic nationalism and protectionism.

It seems to me essential that those pressures be resisted. There are powerful reasons why such an approach is not in our economic interest whatever the response abroad.

For instance, we have encouraged developing countries to adopt policies that will enable them to service their debts, to enhance over time their productive capacity, and to 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.

Even if we could somehow shield developing countries from broad protectionist measures -- and it is not clear that

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in practice we could do so -- there are other high economic costs from widespread protectionism. 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. Other things equal, protectionist measures that actually had the effect of appreciably reducing some imports would presumably be reflected in still further upward pressures on the dollar, hurting exporters and industries not protected.

Beyond those specifics there are potentially much more damaging risks of a breakdown in a world trading order built up so laboriously after the chaos of the 1930s.

Consider, for example, the proposals now being discussed 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 addresing the trade deficit.

One attraction is that an import surcharge effectively taxes foreign exporters as well as domestic residents. But it is also clear that any benefits, either for trade or for the budget, would be temporary. More lasting favorable consequences of the proposals would be derived not from the temporary surcharge but from the accompanying budget measures.

I would question whether the imposition of a surcharge makes those accompanying measures easier, or more difficult,

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to enact. In any event, so attractive a tax to the United States 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, wouldn't others find almost irresistible temptations to emulate our example? Would not that eliminate any net benefits and also have destructive implications for world trade -- upon which our hard-pressed farmers, among others, are so dependent?

At a more fundamental level, we cannot logically take actions to reduce our trade deficit and at the same time welcome the associated capital inflows from abroad. The trade deficit and our capital inflow are two sides of the same coin. Unless we reduce our budget deficit, success in improving our trade balance, and thus reducing the capital inflow, will only threaten stronger pressures on our domestic financial markets, jeopardizing housing and investment.

In essence, a lasting solution to the problem of our external imbalance rests on simultaneously restoring internal financial equilibrium. I know of no approach to that problem that promises success other than straightforward measures to reduce our budget deficit over time. Approaches that obscure that basic need will, in the end, be counterproductive.

I do not want in any way to suggest that, important as action with respect to the budget deficit is, that approach

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will somehow deal with all the problems of the global economy. In particular, other industrial countries have clear responsibility and opportunity to take actions themselves to enhance their economic prospects. The importance of policies to deal with structural rigidities in their economies has often been noted. Moreover, in some important countries where inflationary pressures have been successfully contained, and where credible long-term anti-inflationary monetary policies are firmly in place, there may be scope for action to stimulate their growth by constructive measures to speed tax reductions or otherwise.

Certainly, much remains to be done to restore sustainable growth patterns in much of the developing world. Over the past two years or more, a number of the more advanced and largest developing countries, particularly in Latin America, have made serious efforts to implement appropriate adjustment programs in conjunction with IMF and private financing arrangements. Clear progress -- in some cases, spectacular progress -- has been made in eliminating or narrowing external imbalances. Mexico and Venezuela in Latin America, and Yugoslavia and Hungary in Eastern Europe, have produced current account surpluses. Brazil's current account deficit was essentially eliminated last year. Happily, most of those countries have also managed to restore a measure of domestic growth. All of that progress was facilitated by access to foreign markets, most importantly in the United States.

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In some instances, the progress in adjustment has encouraged and justified longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico, Venezuela and Ecuador, and serious negotiations are underway with Brazil and Yugoslavia.

However, these signs of progress do not mean that the "debt problem" is behind us -- or that, more broadly, the borrowing countries are firmly on a path of sustained strong growth in a context of political and economic stability. Indeed, some of the more fundamental adjustments necessary to that end are still absent, or only partially in place. Inflation, for instance, remains disturbingly high in many of the countries, and in some is still rising to new peaks. Spontaneous new investment by either domestic firms or from abroad has often been slow to develop, reflecting in considerable part concern in some countries about the role for private investment and the degree of controls and market distortions. Moreover, on the more purely financial side, cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required despite the protracted and tedious nature of the process. Rather than impatience, the need remains for energetic and constructive approaches to the longer-term problems faced by individual countries.

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I will conclude with a few words about the dollar. Few if any anticipated the degree of strength that the dollar has displayed persistently for some time, nor can it fully be explained by such factors as relative interest rates or differences in inflation rates. No doubt, relative confidence in our economic prospects, in our political stability, and in our business climate have played a part, as has a sharp diminution in our bank lending abroad. At the same time, the widening gap in our trade position suggests that our basic competitive position cannot support so high a dollar indefinitely.

The policy question is what measures can be taken to encourage a reasonably competitive equilibrium over time. I suggest that the general approach I have alluded to today would work in that direction.

Credible measures to reduce the U.S. budget deficit would alleviate one source of inflationary concern and encourage lower real interest rates than would otherwise be the case. In that environment, some other important industrial countries might find it easier to undertake more stimulative policies at home. If they managed at the same time to deal more effectively with some structural rigidities, the perceived contrast between the opportunities in the U.S. economy and the relative sluggishness of European economies could constructively be diminished. If developing countries could reduce inflation and restore more confidence in their own business climate, their own citizens would then employ more of their savings

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in their own countries, and funds could again be attracted in greater volume from the United States or elsewhere.

At times, forceful official intervention in exchange markets could have a useful role to play. But that role has to be complementary and subsidiary to more basic measures to have lasting impact. That is why measures to deal with the fundamental imbalances in our own financial requirements are so important.

Over the near term, prospects for the economic performance of the United States, and to a lesser extent the rest of the world, appear to be favorable. We want to build sensibly on those strengths and to deal in a lasting way with the imbalances. Purely symptomatic treatment is not adequate -- and, in the form of protectionism, will be counterproductive. The more basic approaches necessarily take time, and we have let too much time pass already. But fortunately we can still proceed from a position of strength. I trust we will make the most of the opportunity before us.

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