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On Key Economic Issues

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Introduction

Paul W. McCracken

Even with its penchant for taking the short-run view, particularly in a quadrennial year, government is confronting an awesome array of major issues about which some decisions cannot much longer be postponed. What is to be the course for the federal budget as we look down the road through the remaining years of this decade? How can we better reconcile our management of domestic economic policies with the growing significance of international economic developments for production, employment, and incomes here at home? These are questions whose answers will influence the course of the nation in the years ahead.

Participants in a session on "The Interaction of Domestic and International Economic Policy Issues" during the annual Public Policy Week in December 1983, organized and conducted by the American Enterprise Institute for Public Policy Research, prepared statements on these issues to serve as the basis for discussion in the session. Because of its basic commitment to the principle that careful, scholarly work in the world of ideas does ultimately influence policy, and will contribute to better decisions about public policies, AEI is with this volume making these statements available to an enlarged audience.

Paul W. McCracken is Edmund Ezra Day University Professor of Business Administration at the University of Michigan and chairman of the Council of Academic Advisers of the American Enterprise Institute for Public Policy Research.

Martin Feldstein

I am delighted to be here with so many good friends and distinguished economists.

Near-Term Fiscal Issues

The focus of this morning's panel is on fiscal policy issues in this decade. I will begin by commenting about the near term and in particular about the relation between fiscal policy and the pace of the recovery. I will then turn to the longer term issues of inflation, budget deficits, and fiscal incentives.

Last Friday's unemployment figures are clear evidence of the current strength of the recovery. The total unemployment rate of 8.2 percent represents much faster progress than most economists have been expecting. Other measures of economic activity also show substantial strength. Industrial production was up 14.8 percent in the first ten months of the recovery, and real GNP rose at an annual rate of 6.8 percent. November's sharp rise in employment—up more than 700,000—suggests that the fourth quarter may be another strong one.

As I noted in my testimony to the Joint Economic Committee last month, the personal tax cuts in 1982 and again this July contributed significantly to the spurt of consumer spending that has been responsible for so much of this year's recovery. It is standard textbook economics, as I also pointed out to the JEC, that the direct fiscal stimulus of the 1983 and 1984 deficits does more to raise demand than the increased real interest rates that result from deficits do to depress demand. The problem is not the near-term deficits but the prospect of the long string of deficits that would remain in the future if Congress fails to act; I will return to the long-term issue in a few minutes.

But first, I want to comment on one technical aspect of the recovery that continues to surprise many people: the strength of business fixed investment in the face of high real interest rates. Real fixed

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nonresidential investment rose 5½ percent between the fourth quarter of last year and the third quarter of 1983, an increase that has been as great as the average rise in the first three quarters of past recoveries. As I pointed out in my remarks to the Tax Foundation last week, this reflects the substantial improvement in tax depreciation rules enacted in 1981. It is a good illustration of a point that I made in academic research papers during the past several years: What matters for investment is not just the rate of interest or the profitability of investment but the difference between the net-of-tax real cost of funds and the after-tax real profitability of investment.

Similarly, the strength of the stock market in the face of very high real interest rates reflects the improved after-tax profitability that investors now expect. Indeed, one way of explaining the current level of investment is to note that the change in business tax rules has raised the value in equity markets of new physical capital (or reduced the cost of equity capital to finance new investment) and that this has stimulated businesses to increase their investment.

It is impossible to talk about the fiscal environment without discussing inflation as well because the rate of inflation substantially influences the effective tax rates on saving and investment. The high rates of inflation in the 1970s raised the effective tax rates on real personal interest income and real capital gains to more than 100 percent and substantially increased the effective tax rates on income from business investment in plant and equipment, a point that I elucidated in excruciating detail in research papers for several years. The decline in the rate of inflation from the double-digit rates of 1980 and 1981 to the current level has sharply reduced the problem of taxing artificial inflation income. Last year's *Economic Report of the President* showed that a fall in inflation from 10 percent to 4 percent raises the present value of the depreciation deductions by more than 10 percent. The improved inflation outlook thus reinforces the explicit legislative changes in providing a better fiscal climate for business investment.

The Longer Term

Although there is more that could be said about the effect of recent fiscal changes on the current economy and near-term outlook, let me turn to the longer term fiscal situation. I will touch briefly on three topics: inflation, budget deficits, and fiscal incentives.

I have already indicated the importance of inflation as an influence on the effective tax rates on saving and investment. The key determinant of inflation over the longer term is clearly monetary policy. Since I know that monetary policy is the subject of the next session on today's program, I will not say very much about it. I will only repeat what I have said many times before: that this administration and the Federal Reserve are committed to a monetary policy that will reduce inflation at the same time that the economy recovers. We are now in the fortunate position that, with appropriate policy, inflation can decline to an even lower level before the end of the decade.

I do not have to tell this group about the adverse consequences of a long string of very large budget deficits. The dynamics of national debt accumulation and the process of crowding out are well known to you all. If you have studied the projections, you also know that it would be unwise to assume that growth alone will reduce the deficit to an acceptable level.

Less well known is the fact that nearly two-thirds of the current structural deficit was inherited from the Carter administration. More specifically, the budget deficit in fiscal year 1980 was 2.3 percent of GNP. The unemployment rate in that year was 6.8 percent. This implies that the 1980 structural budget deficit, evaluated at a 6.5 percent unemployment rate, was 2.2 percent of GNP. By comparison, the current structural deficit (also evaluated at a 6.5 percent unemployment rate) is 3.4 percent of GNP. The inherited structural deficit of 2.2 percent of GNP is therefore 65 percent of the current structural deficit. Indeed, even if Congress takes no steps to reduce the deficit and the structual deficit rises to 4.2 percent of GNP in 1988 (as projected in the administration's midsession review), more than half of that deficit will have been inherited, and an additional fraction will be due to the accumulating interest on this inherited debt.

As I have emphasized many times, the president earlier this year sent to Congress a budget plan that would cut the deficit nearly in half in 1986 and to only 1.6 percent of GNP in 1988. The president's budget would thus bring the 1988 deficit share below the inherited structural deficit. To reduce the deficit, the president called for a balance of spending cuts and a contingency tax increase that could trigger on in October 1985. Unfortunately, Congress rejected the president's budget, leaving us with the risks of high real interest rates and a lopsided recovery.

We are now working hard on the 1985 budget. During the weeks ahead the president will be making his decisions about the budget for 1985 through 1989 that he will submit to Congress. I obviously cannot say anything about the 1985 budget proposals until the president has announced his decision.

Looking at the longer term fiscal environment, I think it is important to focus on the fiscal incentives that contribute to economic growth. The savings incentives that were enacted in 1981—especially the expanded eligibility for Individual Retirement Accounts and the increased limits on IRAs and Keogh accounts—have transformed our income tax into a consumption tax for the majority of American families. The new business depreciation rules and the lower rate of inflation have increased the incentive to invest in business plant and equipment. The improved tax treatment of R & D expenditures can advance the development of new technology. The lower rates of tax on capital gains can stimulate investment and risk taking. It is particularly important that these fiscal reforms be preserved and strengthened in the years ahead.

Rudolph G. Penner

One of my pet theories is that the major reason for our current political impasse over the budget is related to a fundamental ignorance on the part of the public concerning what the federal government does and how much it costs. In other words, we have a problem today because we really don't know what the public is willing to pay for. I think there is a natural tendency on the part of the ordinary voter to believe that those things the government does that he or she likes can be provided very cheaply while those things that other people like are very expensive.

So the question is, what does the federal government really do? In fact, if you look at the totals involved, a huge proportion of total expenditures is devoted to a very few broad budget categories. Indeed, if you add up defense, entitlements, and net interest, these already amounted to 79 percent of the budget in 1980. But those categories are growing so rapidly that by 1986 CBO projects that they will constitute 87 percent of the budget—given current law and CBO's economic assumptions if we assume 5 percent annual real growth in defense spending.

The word "entitlement"—and entitlement spending very roughly speaking constitutes about 50 percent of the budget—conjures up notions of means-tested programs or welfare in the minds of the public. But in fact just two programs, social security and Medicare, constituted 56 percent of entitlements in 1980 and will rise to 64 percent by 1986. The most dramatic way to show the enormous mismatch between the spending path and the tax path that we are on today is to note that just four program categories—defense, social security, Medicare, and net interest on the debt—will constitute over 70 percent of spending in 1986. More interestingly, they will be equivalent to 90 percent of receipts in that year as we project the implications of current law. The path of total spending will therefore be influenced to an

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extraordinary extent by what we do in the defense, social security, and medical areas. Of those three, really only defense and the health programs are growing very rapidly. These two seemingly very different budget categories have one thing in common that is making them so expensive. It is a very rapid rate of technological advance which, in essence, has given us a much more expensive menu to choose from in deciding where we want to go in these areas.

We can debate about how efficiently we deliver defense. We can debate about how efficiently we deliver health care. But the basic point is that, if the rate of technological change continues at current rates, the current-policy growth path would exceed GNP growth in the long run even if we deliver these things in the most efficient way possible. The consequences are most profound, particularly in the health area. We have to think about the extent to which these programs should be means-tested and about how much of these services we are willing to deliver. In other words, the debate involves questions of life and death.

The one big growth area that I have not focused on very much is net interest. That growth area draws attention to the importance of resolving the deficit problem quickly. Interest is growing at an extraordinary rate. Indeed, if you assume the policies left by the Congress in November and if you assume that the rate of interest remains constant at last September's levels, our projections show the interest bill on the debt going up by some $56 billion between 1982 and 1986. Even by the standards of today's arithmetic, that is a very large number. It exceeds the $45 billion tax increase that the Congress had in its budget resolution and that the president included in his January budget on a contingency basis for fiscal 1986. It means, of course, that any delay in resolving the budget issue is very expensive simply because the interest bill keeps increasing at a rapid rate. We do have to finance that interest bill. Indeed, the worst of all possible worlds is one in which the budget deficit gets so large that the interest bill itself begins to rise at a rate faster than we can politically reduce expenditures or raise taxes. At that point, the government would be like a private firm that goes out and borrows continually both to finance a deficit and to finance interest payments on the already existing debt. When you get into that situation, you're heading toward bankruptcy. Now the big difference between businesses and governments, of course, is that governments have a monopoly on the creation of money so that they do have a way out. When they find it too politically arduous to finance their spending with taxes, and when the interest bill makes it too burdensome to finance their spending with the issue of more debt, governments can resort to printing money. That is the story behind many of the hyperinflations in world history. It is certainly the story of modern-day Israel, whose inflation rate of over 150 percent a year is really driven by the budget deficit.

I am certainly not predicting that outcome for the United States. We are far from a situation in which the interest bill has become extraordinarily burdensome. It is certainly not high relative to that of many European countries and Israel. The interest burden is still small here, because of what appears in retrospect to be a very disciplined fiscal policy from World War II to 1974. I would say that year was the turning point. Through the earlier period, our budget deficits were small enough to make the debt-to-GNP ratio decline along a fairly steep trend. Since 1974 the ratio has gone the other way; that is to say, it has been steadily rising and, of course, in recent years rising at an accelerated rate. The mathematical conditions are in place for an interest bill explosion. It can be said with certainty that we cannot forever remain on the path that we are on today. Luckily we can remain on it for quite a long time. The actual explosion doesn't occur until time infinity. That's a long way away, but it's getting closer by the minute, and the longer we wait the more difficult it will be to correct the problem.

I'll finish by saying that I really do think we are going to do something about the deficit. I think there is a lot of concern and movement in the Congress already.

Charles L. Schultze

Before I start, let me make two brief comments about the remarks of prior speakers. I noted Rudy Penner's very perceptive point that the pace of rapid technological change may well be a major factor driving the two most rapidly expanding areas of the budget, namely, defense and medical costs. I have heard that situation described by the phrase, "Invention is the mother of necessity."

Marty Feldstein claimed that more than one-half of the out-year structural deficit was inherited by the Reagan administration from the Carter administration. Ten years ago I would have been shocked (although I am not any longer) if I had thought that the chairman of the Council of Economic Advisers in a very conservative Republican administration would find it a matter of some congratulation that his administration had taken the peak one-year high-employment deficit of the preceding administration, had "only" doubled it, and had converted it into a semipermanent structural deficit. I am indeed surprised at this defense.

I want to make a number of points about the outlook so I will have to make them very quickly. In conjunction with perhaps 90 percent of the people around this room, I think the current policy mix in this country—very large stimulative and structural budget deficits, offset by a tight monetary policy—is very harmful to the economy. But the harm is long term and subtle; it is not direct and immediate. I think we need to identify the harmful consequences of this policy correctly. Let me make the following propositions:

- The deficits are not likely to lead to inflation in the foreseeable future.
- The deficits are not likely to abort the recovery and lead to a recession.

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- The deficits will give us a high interest rate economy, with sustained aggregate recovery, with good growth in some sectors but very poor growth in the interest-sensitive sectors.
- Business investment is not likely to be absolutely depressed by this policy. Rather we will probably neutralize the beneficial investment effects of the 1981 business tax cut.
- But with the impact of high interest rates on business investment being somewhat offset by the tax incentives, then a major impact of the high interest rates has been, and is going to be for a while, a substantial penalizing of our export industries and of our import-competitive industries, thereby doing grave harm to the industrial core of the nation.
- Finally, the political argument that a tax increase to deal with this long-run deficit problem would do no good, because the Congress would devote the proceeds to higher spending, is nonsense.

Let me start with the first point—the deficit probably will not lead to inflation. By now the Federal Reserve has pretty well demonstrated, under substantial pressure and fairly difficult circumstances, that it will not accommodate the large federal budget deficit with easy money. The competition is not likely to be a competition for real resources. It is going to be a competition for credit within the framework of a relatively restrained monetary policy. It is going to be a competition for scarce financial resources. And so we will have a high interest rate recovery, but probably not a recovery which, in the near future, leads to inflation. I think the Federal Reserve's objectives are pretty firm on this. My own judgment, at least, is that they will stick by their guns even at some very substantial cost. In the very long run, given Rudy Penner's and Herb Stein's recent calculations about the cumulative impact of unchecked deficits and high interest rates on future interest payments, the Fed will come under ever greater pressure. How long the Fed can stand that I am not sure. But for the foreseeable future it is not inflation that is likely to be the problem.

Will the tension between monetary and fiscal policy abort the recovery? My answer to that again is very probably no. I know nothing which suggests that, for a long period of time at least, a recovery characterized by high deficits, tight money, and high interest rates cannot continue. Assuming that monetary policy fixes a ceiling to the growth of total aggregate demand, the federal government can get the resources it wants in two ways. It can tax sufficiently to cover expenditures, and, under the most likely patterns of taxation, consumption will be depressed to release resources to provide for the government's expenditures. Or the federal government can borrow a part of its needs and push interest rates up to the level at which nonconsumption, interest-sensitive components of GNP are depressed, and government expenditures will then come out of that sector of the economy. Either course, it seems to me, is feasible, and there is no reason to think that it is not sustainable for a relatively long period of time.

While there is no reason that high deficits and high interest rates are likely to abort the recovery, there is a world of difference in the composition of demand and output in those two scenarios. On the assumption that the deficits are not cut, then we are facing high employment deficits for roughly 4 to 5 percent of GNP into the indefinite future. Apart from the Vietnam War episode, the federal government's budget during periods of high employment in the past did not absorb more than 1 percent of GNP. In the second half of the 1980s, therefore, the federal government will be absorbing an unprecedented three to four *additional* percentage points of GNP through its borrowing, in an economy whose gross private saving is 17 to 19 percent of GNP and whose net private saving is 7 to 8 percent of GNP. What are the effects of this? There are four possible effects. *First*, the higher real interest rates might pull in more private saving. I think the record would indicate that the probability of getting very much out of this is quite low. That leaves three other possibilities, all of which involve a reduction in some nonconsumption sector of the economy. Marty Feldstein went through the reasons (and I agree with him) why business investment is not likely to bear the brunt at least for some time. What we will get, I think, is an offsetting set of forces, the incentives from the 1981 tax law competing with higher real interest rates. They should more or less tend to neutralize each other. We will indeed be wasting the supply-side consequences of the 1981 tax cut or at least part of them, but relative to other recoveries it is not likely that private business investment will be severely curtailed, at least in the next year or so.

The major effect of the current policy mix is likely to be in two other areas—housing and net exports. I do not have much to say about housing, but I can make a couple of points about net exports. The American economy in the decade of the 1970s made some very impressive adjustments to changing technology and changing world markets. In 1970, for example, the United States was a net exporter of capital goods of about $11 billion. In 1980, it was a net exporter to the tune of $47 billion. A conservative projection to 1983 mid-year would have made that a net export surplus of $65 billion. But in fact the capital goods export surplus in mid-1983 had fallen to an annual rate of $29 billion—from what would have been $60–65 billion. Just the opposite was occurring during the 1970s in the case of consumer goods. We became an increasing net importer. Our economy was making that adjustment to being more and more a net exporter of capital goods and a net importer of consumer goods. Recently, the massively overvalued dollar has impeded the necessary adjustments. Policies which penalize the most dynamic industries in our economy and which reverse those important structural adjustments which American industry had been making are bound to have some effect in slowing down long-term economic growth, even though I cannot quantify that effect.

And finally, the current policy mix is likely to have very bad political consequences—two of them. First, the obvious one is increased protectionism. Protectionist pressures seem to be mounting even as the recovery continues, and I think that is in part because of the lopsided nature of the recovery we're getting. We are doing damage to our industrial core. And second, we are feeding ammunition to those who insist that America is deindustrializing itself and that we need some kind of new industrial policy.

Finally the argument that we should not raise taxes significantly because the Congress would simply spend the proceeds misread the history of the Congress in recent years. In some of his recent speeches, Marty Feldstein has done a very nice job in documenting the fact that outside of social security, Medicare, and interest on the debt, the remainder of the federal government spending will fall (with no further cuts) from a peak of something a little over 9 percent of GNP in 1980 or 1981, to something like 6½ percent by 1986—a three percentage point drop in its share of GNP. The Congress has shown itself most willing to cooperate with the administration in bringing the deficit down. There is very little evidence that in the current climate and under current circumstances the Congress will spend a tax increase. Such an assertion just misreads history and, I think, is a cop-out.

Herbert Stein

I agree as I have been doing increasingly lately with almost everything that Charlie Schultze said, except I can't get him to stop giving the impression that monetary policy could do something to change or alleviate the consequences of deficits by pursuing a more inflationary course, but I forgive him that. The discussion that has been going on about fiscal policy—and I don't refer at all to the discussions that have been going on here this morning—but the discussion that has been going on in the country reminds me of President Reagan's story about the optimist. The optimist was the young boy who went out to the barn on Christmas morning looking for his presents. All he saw there was a huge pile of manure, and he said to himself, with grit and determination, "Well, there must be a pony in here somewhere," and he took the shovel and started digging. And I think that somewhere in this discussion of budget policy there must be a pony. The pony, as I see it, is the issue of national priorities. What we're really concerned about is how the budget affects the allocation of the national output. We have rather subordinated the stabilization and inflation or noninflationary aspects of the budget in our thinking. Especially if we are looking at the longer run issue, what the budget does is affect the way in which we use the national output.

Now, in thinking about this issue for myself, I divide the uses of the national output into four categories. One is the national defense. The second is assistance for the very poor among us. The third is provision for growth by investment in the ordinary sense and also in research and in education; and the fourth is the consumption of everybody else—the consumption of the ordinary American.

In my view of national priorities, I give high priority to sustaining and increasing the first three of these; and therefore, since we have left behind the notion that the national output is infinitely elastic, we need to hold back the fourth, which is the consumption of all others. You don't have to agree with this ranking of my priorities, and, if you

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don't, of course, you come to a different conclusion about the budget. I do think it is important to have a position about these priorities. I give very high priority to defense, partly because I think we are under severe threat and perhaps because I was frightened—I think properly—in the 1930s by our failure to give adequate attention to defense.

I give very high priority to doing something about the very poor people among us, although that is not as fashionable as it used to be. I am impressed and disturbed by the figures that show the proportion of the very poor people to be rising in this country. I think we have a national obligation to do something about that and it is in the national interest to do so. More than forty-five years ago I was greatly impressed, as many people were, by the words of my professor, Henry Simons, who said he felt that extreme differences in the distribution of income were unlovely. I think "unlovely" is too weak a word; but it indicates that there is certain kind of aesthetic judgment involved, and I admit that. If that makes me a bleeding heart, so be it.

Third, I place high priority on accelerating the growth of the economy. That is the one of these priorities about which I feel the least certain, although it's the one to which people most commonly pay obeisance. Back about 1960, I guess, Edward Denison and I wrote a paper together, at the time when the government was trying to find out what its goals were, and our conclusion was roughly that the United States was probably rich enough and was getting richer faster enough for all practical purposes. And getting richer faster wasn't what we were after. I still have some of that feeling; nevertheless, there are a lot of people in the country who think that we ought to be richer. Since we've been growing so slowly there is more ground for that thinking than there used to be. Therefore, I think the budgetary problem is how to hold down the consumption of the all-other group.

It is commonly suggested that the way to hold down the consumption of the all-other group is to increase their saving. But the saving rate in the United States does seem to be intractable, and I do not regard that policy as likely to have very great yield. This notion arises whenever we get into budgetary difficulties. I can remember the early post-war period when I was working at the Committee for Economic Development and we had this kind of budgetary problem. There are many people, especially in the retailing business, who just thought that if we would turn the sale of savings bonds over to Macy's we would solve the problem of increasing the national saving. But that didn't seem to work. Such evidence that we have indicates that saving is rather sticky. It seems to me that the way to reduce consumption of the all-other group is to reduce their disposable income, which means their after-tax and after-transfer income. We control the taxes, and we control the transfers. The purpose of taxes is to reduce consumption, and we should use them to the extent necessary for that. Obviously, different taxes will have different degrees of effectiveness per dollar in achieving the desired restraint of the consumption of middle-class Americans. That subject deserves a lot more discussion. I think we would be better off if we get away from the debate about whether one is for or against a tax increase and focus more explicitly on the issue of what kind of taxes we ought to have. Many of those who might want to argue for consumption taxes are debarred from doing that because they have a phobia about taxes of any kind and are not willing to say a good word for any kind of tax.

I think that it is important to get away from the common paternoster about expenditures—which is that deficits are bad, deficits should be reduced, but we should reduce the deficits by cutting expenditures—as if we were still, as we were three years ago, in a position to talk about the budget's consisting overwhelmingly of waste, fraud, and abuse. We have had three years of squeezing out the waste, fraud, and abuse to the extent to which a very diligent administration can do it; and we should accept the fact that there isn't an awful lot left to squeeze. Furthermore, the budget provides a lot of things that we really want and we really need in this country. Reducing the expenditure side of the budget is not a bottomless well from which we are kept from drawing water only by the ignorance and political short-sightedness of other people.

Aside from these rather heated prejudices that I have expressed, whatever you think about any of these issues, you must agree that we are in bad shape with respect to rules of fiscal policy. We have obliterated what we used to think were guides to the overall behavior of the budget. We have to recognize that "less" is not a rule of fiscal policy, that "less expenditure, less taxes" does not add up to a rule of fiscal policy, any more than "more" added up to a rule of fiscal policy in the past. We need to have some standards by which we judge what is an appropriate relation of taxes to expenditures, and I think that we are fast abandoning such standards we have had until recently. Thank you.

William Poole

As I look at today's monetary policy debates, it seems to me very clear that the main issue is essentially the same as the one that has been around for many, many years. That issue is the weight to be assigned to controlling the money stock, given all the uncertainties, relative to the weight to be assigned to controlling or cushioning interest changes. That monetary policy issue is as central today as it has been over the last several decades.

The reason that the gradually growing emphasis on money growth as the appropriate policy target has been questioned in recent debates has to do with the quite extraordinary changes in velocity over the last few years. Let me provide a quick perspective on those velocity changes. The time trend for M1 velocity estimated over the period from 1960 through 1979, a period that ends before the unusual events of recent years occurred, is about 3 percent, and for M2 about zero. How unusual has velocity behavior been in the last few years?

If we look at velocity relative to trend—velocity measured by dividing nominal GNP in a given quarter by the money stock two quarters earlier to make a crude allowance for the lags in monetary effects—we find that in late 1980 and early 1981 M1 velocity was about 4 percent above trend. By 1983, M1 velocity was somewhat more than 6 percent below trend. Thus we had a swing of 10 percent relative to trend from late 1980 to mid 1983. But it is interesting that, relative to trend, M1 velocity fell about as much from the fourth quarter of 1980 to the second quarter of 1982 as it did from the second quarter of 1982 to the second quarter of 1983. The point of all this is that the decline in velocity relative to trend was going on before the economy appeared to become so very surprisingly weak at the end of 1982.

The story is roughly the same for M2. Velocity, again measured on a two-quarter lag basis, was 6 to 8 percent above trend in 1981. It

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had fallen to 2.3 percent below trend by 1983:III. Thus M2 velocity has also experienced a swing of about 10 percent relative to the trend.

The swing in M1 velocity—and I'll concentrate now on M1, which I think is the most reliable of our monetary aggregates—from above trend to below trend occurred quite rapidly. The pattern was *qualitatively* the same as in other recessions, but the speed and the size of the decline were much larger than usual. For example, in the 1973–1975 period, also a deep recession, M1 velocity went from just about on trend at the beginning of 1973 to 4 percent below trend in the first quarter of 1975. That swing of 4 percent was much smaller than the swing of 10 percent during the most recent recession. Earlier in the postwar period other substantial velocity swings occurred, but, again, never anything so large or so fast as the one from 1980 to 1983.

It seems clear that M1 velocity is now swinging back. Unless there is a very big downside surprise in GNP growth over the next several quarters, which I certainly don't anticipate—I guess nobody anticipates "surprises"—velocity will be rising back toward the old trend.

One question, of course, is how far velocity will go. Obviously we have to be wary, but the main question is whether the evidence accumulated over the last *few years* suggests that the emphasis on money growth targets that has been growing over the last *few decades* should now be reversed.

As I insisted at the beginning of my remarks, the issue is money growth versus interest rates as the main guide to monetary policy. The case for reduced emphasis on money growth cannot be made by only examining the stability of velocity. Many of the same factors that may be disturbing the relation between money and GNP may also be disturbing the relations of interest rates to GNP. Is the relationship between the federal funds rate and GNP any more reliable than it used to be? In my view, the best bet is still for the Federal Reserve to pay primary attention to money growth as the main control instrument for monetary policy.

The case for emphasizing money growth is, I believe, reinforced by what has happened this year. In the spring, about May, the Federal Reserve began to allow money market interest rates to rise somewhat for the purpose of slowing down money growth. It is now clear that allowing rates to rise at that time was a very wise thing to do. If the Federal Reserve had not acted last spring, it seems quite clear that money growth would have been somewhat higher, whereas now it is well contained. The economy has been strong. If the Federal Reserve had not acted, interest rates almost certainly would have been higher today because there would have been greater concern in the bond market that the higher money growth coupled with a strong economy would make it essential for the Fed to act.

Interest rates rose after May into August, but are now down somewhat from their August highs. So we have a situation today in which, at least locally, we are below previous interest rate peaks and money growth is quite well contained. Indeed, the issue that concerns many now is that money growth is coming in a bit too low. The M1 measure of the money stock is near the bottom of the Fed's 5–9 percent target range.

So where do we go from here? I believe that the Federal Reserve should be absolutely and completely symmetrical in its attitudes toward money growth and interest rates. When money growth is coming in below target, the Fed should be willing to let rates fall as necessary to keep the money stock within its target range. And vice versa.

With money growth coming in low over recent months it may well be appropriate for interest rates to fall. If that seems intuitively wrong because the economy seems so strong, then the intuition needs to be redeveloped. Because of known lags in the effects of monetary changes on the economy, today's data on the real economy are irrelevant for monetary policy except insofar as they help to forecast economic activity in the future.

After growing very rapidly in the first half of the year, according to the data now available, M1 has grown at a rate of only about 2 percent over the last three months. It is unwise for two reasons that M1 be permitted to fall much below the target range 5–9 percent. First, even if we had no targets, it would be unwise to have a period of sustained money growth well below 5 percent. That would be such a substantial deceleration from the average growth rate over the past year that we would run the risk of bringing the recovery to at least a pause and maybe cutting it short altogether. The second reason is that we do have money growth targets. The targets are there for good reason, and it is important that we adjust the money stock to the targets and not the targets to the money stock.

Without question there are inflationary dangers in the present situation. From past experience, we should be wary that 1984 may be a year that is rather like 1967 or 1972 or 1977. In those years it appeared that there was substantial slack in the economy and that inflationary pressures were well controlled. As I look back, it seems to me that it was in each of those years particularly that monetary policy errors allowing money growth to run too high led in the space of a relatively few quarters to an acceleration of inflation and the undoing of what had been the beginnning of sustainable expansion at lower inflation. That is why adherence to monetary targets should be symmetrical. If money growth starts to run high, then we must be willing to accept temporarily higher interest rates.

The fiscal situation is frequently viewed as a constraint on monetary policy. Fiscal policy is a real problem, but by real I mean both important and real as opposed to nominal. Because of the indexed tax system we cannot solve fiscal problems today through inflation. Thus, the fiscal problem cannot be solved with a nominal policy instrument, the money stock, and we ought to be sure that monetary policy is not unhinged by the fiscal situation. That only means that we must be willing, if need be, to let interest rates rise in order to keep money growth well contained.

Just a couple of final comments: We have come through a very, very difficult period from 1979 to 1983. When we started in 1979 and 1980, the economy was confused. There was a great deal of uncertainty. Inflation was high, and the prospects for the economy made planning difficult for everyone. The markets just didn't know what to expect.

The uncertainty today is a good bit less, and we have substantial prospects now for sustained economic growth with stable to declining inflation. For these prospects to be realized, we must, of course, deal with the fiscal problem and avoid any sustained acceleration in money growth. But I'd much rather deal with 1984 problems than 1980 problems. We should be thankful that the economy, though scarred, has come through this difficult period whole.

Phillip Cagan

Let me extend Bill Poole's remarks, from a slightly different perspective, and review where we stand in the campaign to subdue inflation and the prospects ahead. As you know, the GNP price deflator was rising at around 10 percent per year in 1980 and early 1981, and it has decelerated in 1983 to around 4 percent per year. That deceleration is in line with the 1975–1976 episode and is somewhat larger than previous experience with recessions, which typically cut the inflation rate in half. We have now completed the first stage of disinflation. The second stage is the crucial one of continuing the disinflation process and of not allowing a resurgence of inflation as has occurred each time since the mid-1960s. The first stage is easy to initiate and hard to endure: You simply cut monetary growth and suffer through a recession and a depressed economy. The second stage is easier to endure. The economy recovers and inflationary pressures are subdued, but it is hard to maneuver through, because monetary policy must continue to exert disinflationary pressures at the same time that the economy is expanding. As we have learned, it is easy to end up after a couple of years of economic expansion with the inflation rate back where it started.

Looking ahead, most forecasts in and out of the government see an inflation rate for the next several years of 5 to 6 percent. That is based on the reasonable observation that recent rates of 3 percent in the CPI are temporarily low. Compensation per hour is running about 6 percent and may rise, and productivity will lose its cyclical resurgence and settle down to 2 percent or so. With increases in unit labor costs of 4 percent and some recovery in profits, a 5 to 6 percent inflation could well be the outcome for 1984. It may also be a good *average* of the possible outcomes for later years, but the actual rate is not going to be constant. A constant inflation rate at that level is not

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viable. Either we bring it down and hold it down to the noninflationary range below 2 percent or it will take off again.

The difficult job for monetary policy, therefore, is to maintain disinflation. Most forecasts see a nominal GNP growth in 1984 of 10 to 11 percent, of which 4½ or perhaps 5 percent is the real growth and 5½ to 6½ percent is inflation. If the inflation rate goes above 5½ percent for the full year and is rising at the end of next year, it will be difficult to turn it down thereafter. From there it will easily climb to 7 percent in 1985, and at that level the economy is again vulnerable to shocks that will bring back double-digit inflation. That is not the path we want to follow.

As I see it, we want less than 5½ percent inflation in 1984—say 4 percent, or no more than 5 percent. Usually the first year of economic recovery brings a rise in the inflation rate as demand for raw materials expands. We have not had such a rise this recovery year because of good luck for once with food and energy prices. Let us take advantage of a little good luck. It is a scarce commodity these days. A 4 to 5 percent inflation rate translates into nominal GNP growth of 7½ to 9 percent, because with a less expansive monetary policy we could well have less than 4½ percent growth in real GNP.

How does 7½ to 9 percent GNP growth translate into monetary growth? For M2 this would mean growth in the 8 percent range, assuming the trend of M2 velocity remained constant.

To gauge M1 growth, we first need a projection of its velocity. While the sharp decline in M1 velocity last year appeared mysterious and led the Fed to demote M1 as an indicator, various studies suggest that the decline in M1 velocity reflected unusually large interest-rate effects combined with the usual recession effect. The interest cost of holding money declined dramatically in 1982 as market rates fell in the second half and as interest-bearing NOW accounts became a larger part of M1. I also find that a one-time additional rise in the demand for money balances occurred in early 1982, attributable to the sharp decline in inflation, which corresponds interestingly to the one-time decline in demand for money balances in 1974 when inflation escalated.

If the studies of M1 velocity are correct, it will recover only part of its previous decline as economic activity recovers. Furthermore, the usual effect of a cyclical expansion by which rising interest differentials reduce money demand will be reduced in the future as interest-paying money balances grow—assuming, of course, that market rates do not rise sharply to their former high level. Since part of the past upward trend of M1 velocity reflected rising interest rates, the future trend of velocity should be lower.

Putting this together, I see a rise in M1 velocity of about half of real GNP growth and little further effect from changes in interest-rate differentials, on the assumption that market rates do not rise sharply. That translates into about 2 percent velocity growth in contrast to the 3 to 5 percent typical of past cyclical behavior. That projection leaves 5½ to 7 percent for M1 growth if nominal GNP is to be kept in the 7½ to 9 percent range. To play safe, M1 growth should remain at the 6 percent level, not at the upper part of the range. I believe we can rely again on M1 as a target that will be more reliable than M2 or any of the other targets that have been suggested. The 4½ to 8 percent target for M1 implied by current Fed policy will be all right if the actual growth is kept in the lower half of the range and if velocity growth remains low.

Although M1 growth has fallen to 5 percent recently, it will not be easy for the Fed to hold it down to 6 percent next year. I am mindful of the problems posed by large Treasury borrowing as business investment expands, of the international debt crisis, and of domestic inflationary pressures should the dollar weaken on foreign exchange markets. The key problem is a possible rise in interest rates that will increase velocity and require offsetting by even lower monetary growth, which in turn will temporarily push interest rates higher. On the other hand, further progress in containing inflation will help remove the inflation premium from interest rates and lower them.

Despite these problems, I am also mindful of the cost we have paid to come through the first stage of disinflation, which we do not want to incur again. Indeed, I wonder whether, if our latest disinflationary effort eventually fails, the nation will have the fortitude to start out and carry through another stage one again. The second stage of reducing inflation that we are now entering is the crucial part of the process.

Jacques de Larosière

The growth in economic interdependence among nations is one of the most significant phenomena of the postwar period. This growing interdependence, and the institutional framework in which it exists, has profound implications for how economic developments in individual countries are transmitted to their trading partners and to the world at large. Recognizing these transmission mechanisms, and harnessing them for the general good, is what international economic cooperation is all about.

In my remarks today, I want to examine in some detail the phenomenon of economic interdependence, with a view to drawing some lessons concerning policy priorities in present circumstances. I will start by giving a few figures to illustrate the nature and extent of the growth of interdependence over the postwar period. Then, I want to examine the role that the growing integration of the world economy has played in fostering economic development and expansion during this period. Lastly, I will come to some of the policy problems that arise in an increasingly integrated world and the kinds of response that they call for.

The Scope of Interdependence

Perhaps the simplest way of measuring the extent to which the world economy is becoming interdependent is by the growing share of international trade in overall economic activity. In the industrial countries, exports have risen at an average annual rate of 6 1/2 percent between 1955 and 1982, as against a rate of growth of overall output of some 3 1/2 percent. As a result, the share of exports in total output rose from an average of 8 1/2 percent in the late 1950s to 9 1/2 percent a decade later, and to 15 percent by the late 1970s.

Proportionately, the greatest increase in international exposure has taken place in those countries, especially the United States, that

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were previously least exposed. In 1955, exports accounted for just under 4 1/2 percent of U.S. gross national product (GNP); by 1980, they exceeded 10 percent. This figure, of course, conceals a much larger share of exports in particular sectors of the economy. It has been estimated, for example, that almost 20 percent of the output of U.S. manufacturing industry depends directly on export markets, while as much as half of U.S. agricultural output in 1982 was exported.

Even these impressive figures may tend to underestimate the growth in international transactions. For one thing, they do not include service transactions between countries, which have grown more rapidly than trade in goods and now account for almost a third of current account payments for the industrial countries as a group. Also, they ignore the enormous integration that has occurred in capital markets. In the twenty years or so since the major European countries and Japan achieved current account convertibility, there have been major moves toward the freeing of capital movements. The Eurocurrency market has grown from virtually nothing to one that now approximates a trillion dollars. And national financial markets have become increasingly open to large-scale capital movements both inward and outward. Reflecting this, the daily volume of foreign exchange transactions in New York has grown very rapidly in recent years and is currently estimated to be in the vicinity of $30 billion, which, at an annual rate, is more than double the size of U.S. nominal GNP.

The growing volume of international trade and capital movements has in large measure been the result of deliberate policy action. The postwar economic order embodied a conscious effort to move toward trade liberalization and to provide a payments framework that facilitated that movement. It has also been increasingly recognized that, given the existence of differences in rates of return on investment and in propensities to save across countries, a greater degree of freedom for capital movements was desirable. In particular, for those developing countries that demonstrated a potential for rapid growth, access to international capital markets was needed for this potential to be tapped. At the same time other developing countries, which in the preindependence era had been largely tied to bilateral trading relationships, were able to participate more fully in a multilateral network of trade and investment links.

The Benefits and Constraints of Interdependence

The growing integration of the international economy has been one of the principal factors underpinning the remarkable economic progress of the postwar period. Among OECD countries, the growth of output per capita over the past three decades has been much higher than anything achieved in the past. In the developing world, the rate of increase in output has averaged about 6 percent per annum over the period 1960–1980.

Trade and capital flows have contributed to the postwar prosperity in a number of ways. Tariff reductions and other measures of liberalization have encouraged greater specialization in production and a better exploitation of comparative advantage and have fostered an increase in international trade. Perhaps even more important, however, exposure to foreign products and markets has encouraged the spread of new technology and stimulated improved efficiency both in production and management. Furthermore, the opening up of capital markets has permitted a better mobilization and allocation of savings among countries. This factor has been particularly important in the striking economic progress made by the so-called newly industrialized countries.

It is noteworthy that, while most countries have shared in the economic prosperity of the past thirty years, those whose involvement in international trade and investment has grown most rapidly have performed best. Among the industrial countries, the success of export-led growth in the Federal Republic of Germany and later in Japan is well documented. Among the developing countries, a number of studies have confirmed the association between export growth and the rate of growth of real per capita income.

While the growing integration of the international economy has been an essential part of the prosperity of the postwar period, it has also created new policy problems for national authorities. The faster adaptation of production structures which trade encourages has advantages from the viewpoint of efficient resource allocation, but it has costs to companies, individuals, and regions that find their products and production methods outdated. Moreover, disturbances in foreign economies, whether caused by unexpected developments or by deliberate policy action, are more quickly and easily transmitted the more numerous are the channels of linkage. At times the costs created by economic linkages, being specific and identifiable, may seem to outweigh the benefits, which are more widely spread and less tangible. This can lead to pressures to interfere with international mechanisms in ways that carry important risks for the fabric of cooperation.

Let me, therefore, consider the nature of some linkages that operate in the international economy before going on to discuss how policy can respond to the problems that stem from interdependence.

The first and most important linkage is through trade flows. In economic sectors producing traded goods, there is bound to be a strong influence from world markets on both the volume and price of domestic output. In recent years the weakening of demand conditions in industrial country markets, and the deterioration in the terms of trade with which it has been associated, has been a major factor in the slowdown in developing-country growth. The real value of developing-country exports increased at about 7 percent per annum during 1963–1972, facilitating real economic growth at an average rate of almost 6 percent. Since 1980, the purchasing power of exports has been almost stagnant, and economic growth has averaged only 2 percent for the past three years. Now, the emerging recovery offers the prospect of a reversal of these trends. A recent analysis by the Fund staff suggests that a 1 percent change in ouput in the industrial countries would result in a 3 1/2 percent change in export receipts for developing countries.

A second linkage is through capital flows. Over the long term, capital flows respond to differences in savings propensities and investment opportunities among countries. In turn, the sustainable capital account position determines the appropriate equilibrium on current account. In the shorter run, however, capital flows can be affected by a number of factors—shifts in relative yields resulting from changes in monetary policy; political uncertainties in either lending or borrowing countries; sudden loss of creditworthiness by borrowing countries; shifts in current account positions among lending countries; and so on. We have witnessed, in the past two years or so, the combination of a number of these factors. One important result has been an abrupt reduction in the volume of voluntary commercial flows to the indebted developing countries, bringing with it the need for sharp, real adjustments among borrowing countries. Among industrial countries, there have been unexpected shifts in interest rate differentials which have contributed to substantial movements in exchange rates.

A third linkage comes from the relationship of the policy stance adopted in the major countries to the international pattern of interest rate and exchange rate relationships. I said a moment ago that international capital markets have become increasingly integrated. This means that interest rates in one financial center (after adjustment for expected capital gains and losses from exchange rate movements) cannot diverge very much from rates prevailing in other capital markets. Interest rates are importantly determined by competition (actual and potential) in the market for loanable funds, as well as by expectations concerning the future course of prices. Thus, the choice that countries make concerning the size of their fiscal deficit and the rate of monetary expansion has important implications for the policy options faced by their trading partners.

For industrial countries, these implications bear importantly on the transmission of expansionary and contractionary impulses. For developing countries, interest rate developments have additional significance because of their importance in current account developments. A one percentage point increase in U.S. dollar interest rates would, depending on the assumptions used, increase debt service payments of non-oil developing countries by about $3–4 billion. Thus, the fact that real interest rates in the United States are perhaps four percentage points higher than at a comparable stage in previous postwar cycles can be seen as representing almost a fifth of the total current account deficit of non-oil developing countries.

Policy Making in Conditions of Interdependence

Faced with the need to adjust to a changing external environment, there are two broad types of response. One is to try to reduce the vulnerability of the domestic economy to external disturbances, by seeking to insulate it against the transmission mechanisms I have just described. The other is to harness the mechanism of international cooperation to reduce the extent of such disturbances. The two approaches can, of course, be combined, with cooperative mechanisms used to exploit the advantages and reduce the disturbances that flow from interdependence, while retaining the capacity to cushion domestic economies against whatever remaining international disturbances nevertheless occur.

Whatever the stance that is adopted, however, countries cannot gain an entirely free hand in the exercise of their domestic policies. Exchange rate management, for instance, has been used by several countries in an attempt to avoid the domestic repercussions of changes in the international environment. For some this has involved exchange depreciation in an attempt to maintain competitiveness and export shares; for others it has involved exchange rate fixing to ward off inflationary pressures. In either case, however, it is clear that the result cannot be satisfactory in the absence of appropriate changes in domestic policies. Those that have pursued overexpansionary domestic policies and allowed their exchange rates to depreciate too quickly and too far have added fuel to domestic inflationary pressures. In the opposite case, where countries have sought to maintain their exchange rates at unrealistically high levels, through excessive borrowings for instance, they have caused their current external payments position to deteriorate and have triggered capital outflows. Thus, the truth of the matter is that sound domestic policies and realistic exchange rates are both central to international economic stability.

Perhaps the most troubling manifestation of the desire to shield domestic economies from outside disturbances is the revival of protectionist pressures that has been a feature of the past few years. Protectionism is a classic example of attacking the symptom of a problem at the cost of making the problem itself worse. As I noted a moment ago, the prosperity of the postwar period has been built on the steady growth of trade and the increasing international integration that it encourages. Attacking trade strikes at the roots of this prosperity. Furthermore, it may not even be effective in its direct objective of preserving jobs. To the extent that imports are held down in a protected industry, the exchange rate will tend to be stronger, thus improving the competitiveness of foreign products and undermining employment opportunities in nonprotected industries.

The desire to be shielded from international economic developments is not confined to trade, however. Recently, the view has gained ground that international lending to developing countries over the past two decades has been excessive. The opposition of certain circles in the United States to some of the measures designed to help international institutions find a solution to the present debt crisis is a case in point. Regardless of the reasons for the crisis (and the blame lies in several directions) it is in no one's interest that this problem be allowed to drift. As President Reagan remarked at the Annual Meeting of the Fund, failure to deal with the debt crisis could lead to an "economic nightmare" that would affect all countries, lenders as well as borrowers, and all sectors of the economy, industry as well as finance.

It is clear from what I have said so far that I regard cooperation and collaboration as the key to solving the difficulties that result from the growing interdependence of economies. The benefits of international economic linkages are too great to risk by a policy strategy based on insulating the domestic from the international economy.

The need for cooperation is not, by itself, controversial. What is more difficult is to know the kinds of action that will give concrete and beneficial effect to a desire to work together for mutually agreed objectives. In the remainder of my remarks, I want to focus on the cooperative policies that are required to deal with perhaps the two central issues facing the world economy at the present time. The first is how to overcome the debt crisis facing many heavily indebted developing countries. The second is how to restore sustainable and balanced growth to the world economy at large. Needless to say, the solutions to these two problems are intimately linked, although I will discuss the policy requirements separately.

The Debt Crisis

The first thing I want to say about the debt crisis is that, with appropriate policies, it can be handled and overcome. In the medium and long run, the productive capacity and potential for growth in economies such as those of Brazil, Mexico, and Argentina is more than sufficient to service their foreign debt, while regaining the momentum of domestic development.

The second key point is that the debtor countries themselves must demonstrate that they are taking the necessary steps to regain financial viability, while preserving their capacity to resume economic growth in the medium term. The fact that the balance of payments difficulties of many countries involve factors beyond their control does not mean that adjustment is not required. On the contrary, failure to adjust will compound the initial problem as it will lead to inflation, import controls, and many other consequences that undermine the efficiency of resource allocation. Effective adjustment, on the other hand, will permit the countries that undertake it to exploit the opportunities for renewed growth in output and investment that would be presented by recovery in the industrial world.

My third point concerns the need for a proper appreciation by creditors of their role in this process. It is simply not possible for borrowing countries to go from a situation in which they were absorbing $50 billion a year of net new lending from commercial banks to one where inflows are zero or negative without disastrous consequences for both current welfare and future development prospects. It is certainly true that too much was borrowed in the past in too short a time with too little consideration of the consequences. But the correct solution is not to cease all lending and let the chips fall where they may. That would provoke disproportionate economic hardship that might well lead to political instability the consequences of which could not fail to rebound on economic and financial structures in industrial countries. The task, therefore, is to achieve a smooth transition in which sufficient external financing is available to indebted countries to enable them to scale back their dependence on foreign savings in an orderly fashion, while preserving their ability to invest and grow in the medium term. This process has already proceeded a long way.

Economic Recovery in the Industrial World

This brings me to the issue of how domestic and international economic developments are linked in the process of international recovery. Economic expansion has been proceeding quite strongly in the United States and Canada since around the beginning of this year, but a number of uncertainties surround the sustainability of global recovery. In the first place, recovery is not yet sufficiently well spread geographically. Second, there are a number of factors that threaten to undermine a recovery of business fixed investment which, itself, is central to a sustainable expansion.

First, interest rates remain extremely high in relation to ongoing rates of inflation. In the seven major industrial countries, for example, average long-term interest rates were some five percentage points above the current rate of inflation in the third quarter of 1983. The comparable figures at a similar stage in the last three recoveries would be between one and two percentage points. Second, uncertainties about the future course of inflation still remain. The prospective trend of prices beyond the next couple of years depends on policies that are not in all cases clearly established and may yield to political pressures. Third, profitability in manufacturing remains at a low level, particularly in a number of industrial countries.

This is not an exhaustive list of the issues facing international policy makers. Nevertheless, it does point to a number of areas in which domestic and international policies interact. The most prominent example is the determination of interest rates in a world where international capital markets are increasingly integrated. Interest rates are influenced both by the current balance between the demand for and supply of investible funds and by perception of how this balance is likely to evolve in the future. They are also strongly influenced by inflationary expectations—and by the degree of uncertainty that surrounds these expectations.

The plain fact is that fiscal deficits in the industrial world absorb a greater proportion of private savings today than at any previous time in the postwar period; in 1982, this proportion reached almost 50 percent on average in the seven largest industrial countries. Some of this reflects the effects of the global recession. But it is also a reflection of persistent structural deficits which, failing a change in policies, threaten to continue to absorb an excessive share of private savings and, thereby, to undermine the prospects for a sustained recovery over the medium term.

Not only do such deficits keep real interest rates high because of the prospective competition for scarce savings which they represent, they add to the other sources of uncertainty that impede the process of recovery. The fear that deficits might be monetized makes it harder to foresee future price trends, and this uncertainty itself is likely to add a premium to market interest rates. Moreover, the fact that deficits vary in relative size among countries, and are moving in different directions, has implications for the pattern of exchange rates and capital movements.

It will come as no surprise that we in the Fund strongly favor early and substantial action to achieve a credible reduction in fiscal deficits over the medium term in a number of countries, particularly in the United States. This could, I believe, do more than any other single policy action to bring down interest rates, reduce uncertainty, and restore confidence in the durability of recovery.

But this would address only the most obvious current manifestation of the interaction between domestic and international economic development. In an interdependent world, the policies of all countries impinge on the global environment of their trading partners. The institutional framework in which these interactions can be discussed already exists, in embryo, in particular in the surveillance responsibilities of the International Monetary Fund and in less formal arrangements such as those engaged in by the Summit countries. The need is not for new institutions so much as for the political will to use more intensively those we already have. There is also a need to strengthen the analytical framework in which the implications of interdependence can be assessed. In this regard, the regular reviews of the economic policies of individual countries, particularly by the IMF, have contributed to a much better understanding of the international implications of national policies.

In conclusion, let me say simply that it is the utmost importance that these techniques of collaboration are developed and refined. If they are rejected in favor of autarkic solutions, then the pessimists will have been proved right, and the foundations of our present international economic system will be swept aside to the detriment of all. If, on the other hand, they can evolve fruitfully, then we shall have established the basis for resuming the momentum of progress toward a world of greater integration and greater shared prosperity.

Henry C. Wallich

I have an impressive list of topics that are affected by the federal deficit: exchange rates, capital flows,the U.S. balance of payments, and trade. I also note that we have two deficits—budget and payments, and I'm tempted to say, you name it, we have it. Let me begin by pointing out something about the federal deficit. I believe most of the things that are said about the deficit, except one. I don't believe that the deficit is very likely to bring the expansion to a halt. I don't see how, with a $200 billion deficit, there would be a recession. That would mean that the demand for funds by the Treasury would raise interest rates so high that they would stop the expansion. It would mean that the secondary effect, the derived effect, would outweigh the primary effect. I find that difficult to believe—it sounds like the philosophy test question: Can the Lord Almighty make a stone so heavy that he can't lift it? But I think the answer is clear: so long as there is a very large deficit, with a large and growing structural component, the balance of forces is on the side of expansion. The expansion is laboriously restrained by control of the monetary aggregates and by correspondingly high real interest rates.

All the other consequences that the deficit stands accused of, I think, follow. I do think that it raises interest rates. It may be that reduced-form regressions don't capture this. But simulating different levels of deficit with a model surely does capture it. The finding I have in mind is that a $100 billion reduction in the deficit would bring down long-term interest rates by 150 basis points. The reason why one does not easily find the relationship of deficits and interest rates is, of course, that the simple relationship shows high deficits associated with low interest rates. Both occur in recession. Recession raises the deficit and depresses interest rates. If one does no more than to look at these data, one seemingly finds that high deficits cause low interest rates. If one controls for the joint effects of the business cycle, one will find that interest rates are raised by the deficit.

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Higher interest rates then raise the dollar. I think that is at least very plausible. I wouldn't say, of course, that there aren't a lot of other factors raising the dollar. Among them are low inflation, as well as improved productivity and high profitability that we've achieved in this country. There is a difference in the degree of political stability. These all help the dollar. Indeed, they have sustained it in the face of what the market has now known for a year or so—that we're moving toward an enormously high current-account deficit, of the order of $80-100 billion. In the face of this deficit, the dollar hasn't budged, indeed it has been very strong.

I am not sure whether this situation is sustainable. At some future point, the massive international obligations that we incur are likely to impress, I fear, foreign markets. At the present time, our net international savings—that is, our net investment position—is somewhere between $100 billion and $200 billion, depending on how one treats the statistical discrepancy. That means that we're using up our net international assets within one or two years. I don't think that can remain without some impact on markets. If and when the market begins to pay attention to this, I would believe that the reaction can happen in a smooth and gradual way. I don't see any need for sudden and dramatic change in exchange rates. At the same time, you can never be sure. Conceivably, a movement of that kind could generate a dgeree of turbulence that could interfere with the continuing expansion. On the whole, however, it seems to me that the probability is against such movement.

I see on my topic list a question about exchange market intervention. Would intervention be an appropriate policy? Well, it depends for whom and under what conditions. Intervention works in the European monetary system. They do it every day, and it works because they back it up with some degree of monetary policy action. After a while, to be sure, when differential rates of inflation assert themselves, it ceases to work. Then there is a rate adjustment, of the kind that we have seen in the European monetary system a number of times. So we observe a certain although limited effectiveness of intervention when backed by policy action.

If you look at a country like Mexico, intervention also works. Mexico maintains its exchange rate by supplying exchange to a tightly controlled market. That is not really what one means by intervention. If finally you look at the dollar, the bulk of the evidence is that intervention has only a very temporary and slight effect. We have a big intergovernmental study which came up with that result. The main finding was, I think, that our friends abroad didn't draw a distinction between sterilized and unsterilized intervention—that is, intervention whose monetary effects were compensated by offsetting monetary action and the other kind, whose main effect comes from the monetary side effects which are not compensated.

Finally, the last question posed here: Is the dollar overvalued? Again, it depends for what purpose. In terms of the overall balance of the market, the answer clearly is no. Otherwise, the dollar wouldn't hang up there at the rates at which it hangs. Supply and demand are evenly balanced at those rates. But a large part of that supply and demand is capital movements. Flows reflecting trade and services are, on any one day, surely the smaller part. On the other hand, if you are looking at the current-account balance and ask if the dollar is overvalued, you will see a very large current-account deficit at the present level of the dollar. In part, this is because the U.S. economy is ahead of others in the expansion, but also in good part it is because of the level of the dollar. For the purposes of current-account balance, therefore, the dollar is overvalued. Whether you want current-account balance for the United States, whether you want a large deficit so that we end up borrowing abroad and so financing our budget deficit, or whether you want a surplus in the current account so that we as the richest country would be an exporter of capital, those are decisions that this country has to make. In the light of those decisions, it would arrive at a conclusion whether its currency was overvalued or not overvalued.

James Tobin

I would like to make clear that I didn't leave the Council of Economic Advisers because I disagreed with the President's policies.

As usual, I agree with most of what Henry Wallich said. We always agree on analysis; we just disagree about policy.

If you look around the world—especially at the major locomotives of the world economy—right now, you will see that the United States is unique both in the strength of recovery and in the reasons for it. I would say the reasons are very Keynesian. We followed policies of demand stimulus, and they have worked. A deliberate and dramatic change of monetary policy in the latter part of 1982 turned the economy around. The expansionary fiscal policy was inadvertent, wholly unplanned. But it provided demand-side fuel for the recovery with what turned out to be very good timing. The budget stimulated a boom in final sales, mainly for consumption, by the age-old method of cutting taxes and increasing disposable income. Anybody who calls that supply-side economics seems to have signs reversed.

I notice that meetings like this a year ago were full of hysteria about the deficit. It was going to "choke off the recovery." Now we know that it helped the recovery, for the reasons that Henry gave: namely, that the primary effects of expansionary fiscal policy are stronger than the secondary effects, especially when the Federal Reserve is fairly accommodating, as it has been this year. So we haven't suffered "crowding out" yet. You wouldn't expect to have crowding out in an economy with as much idle labor and plant on the scale as we had and still have. In such an economy the saving to finance both the deficit and increased investment is generated by putting idle resources to work and increasing the incomes, the wages, and the profits which are the sources of the saving.

I suspect that monetary policy and interest rates would have been no different if the same recovery had been generated by a spontane-

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ous private investment boom rather than by tax cuts and defense spending. The strength of the recovery is the main concern of the Federal Reserve. The Federal Open Market Committee is mainly worried, not about the sources of the recovery of demand but about how strong and fast it is and what its inflationary content is and is likely to be. Those are the considerations that led the short-term interest rates under the Fed's control to be what they are. Those rates should not be attributed to the deficits per se, as opposed to the recovery itself.

Actually, a recovery like the current expansion probably crowds *in*, as reduction of excess capacity stimulates investment. What has surprised me as well as most economists is that the economy has done so well against interest rates that are still very high in real terms. But we may now be in a stage where interest rates are more of a drag on continued recovery. The most urgent backlog demand for housing and durable goods came out of the woods as soon as the monetary stance relaxed and disposable income turned up. But less urgent demands may require the inducement of still lower interest rates. Further recovery now depends on fixed, private, nonresidential investment. That may revive for a while at present interest rates—the stock market is higher, the decline in excess capacity is by itself favorable to investment, cash flow and retained earnings are improving, and even the supply-side tax incentives may come into their own in the more clement macroeconomic environment. But probably sustained continuation of the investment needed to keep the recovery going will require a lowering of real interest rates.

In any case, I do agree with the majority of economists who believe that we need a different mixture of monetary and fiscal policy. That means reducing the structural deficit for the period after fiscal year 1985, not because deficits choke off recovery nor because they crowd out domestic investment now, but because they could crowd out when prosperity is restored. That means also, active monetary measures to reduce real interest rates and maintain aggregate demand as fiscal policy is tightened. Concern for the policy mix does not refer to the *level* of GNP sought by the policy makers—that is largely a balance between the goals of unemployment and production on the one hand and the risk of inflation on the other. The policy mix relates to the *composition* of GNP, and the objective of a tighter fiscal—easier monetary mix is to shift the composition from private and public consumption to investments in the nation's future.

In this connection, I'd like to urge that when we talk about the composition of GNP we don't succumb to cosmetics. The name of the game is not to reduce the deficit in the government budget for its own sake but to increase the allocation of resources to future-oriented uses of resources as opposed to consumption. In terms of this objective, budget corrections that reduce investment in public or human capital do no good. Neither do tax increases that impinge mainly on private investment rather than on consumption.

In altering the composition of output, I repeat, monetary policy has a responsibility equal to fiscal policy. If the federal government releases claims to the nation's resources and to its saving, those claims are not automatically replaced. The Federal Reserve has to cooperate, to make interest rates low enough to induce other claimants to use the saving that the government gives up by lowering its deficit.

Our main crowding-out problem relates to our net foreign-asset position, as Henry Wallich said. We are in effect borrowing abroad to finance domestic investment and government dissaving. The monetary side of the change in policy mix would remedy that in one of two ways: One way would be by lowering the exchange of the value of the dollar, provided we could succeed in lowering our interest rates in relation to those abroad. But I suspect that right now the major foreign central banks will not allow much narrowing of the differential between our interest rates and theirs. Their economies are all lagging behind us in recovery. They might well be glad to have the opportunity to ease their own interest rates further and keep the differential pretty much what it is. That would still improve our current account because the stimulus to their economies would increase demand for our exports. That is the second way. Either way, reduction of U.S. interest rates would help.

Among big countries like these, national monetary stimulus is not just beggar-thy-neighbor policy. It is not just a way of capturing other people's demand by depreciating the exchange rate. The United States and other "locomotive" countries really determine the world level of interest rates. It's important to get the real interest rates down world wide. For one thing, as M. de Larosière said, it is essential in solving third world debt problems, not just directly by reducing the burdens of debt service but also indirectly by the beneficial effects of world recovery on the debtors' ability to pay. Their recovery, and their ability to manage their debts, depends on recovery in the major economies of Europe, North America, and Japan.

One final remark in regard to the mix of monetary and fiscal policy: For stability of the fiscal position of this country in the long run, it is important to keep the net real interest cost as percentage of the debt lower than the trend rate of real growth of the economy. Otherwise, even if you balance the budget in all other respects, interest costs are going to rise faster than GNP. For the first time since World War II, we have a growing debt/GNP ratio. That ratio declined from 1946 to the 1970s when it leveled off. If we want to stabilize that ratio at some point in the 1980s, then we need an interest rate on debts lower than the growth rate of the economy, just as debtor countries overseas need an interest rate on their foreign debts lower than the growth rate of their exports.

I know there are practical problems in coordinating policies among sovereign powers within our government or across the seas. Two and a half years ago, I proposed a new accord between the Federal Reserve, on one side, and Congress and the administration, on the other, to bring about a better mix of monetary and fiscal policy. It is a difficult thing to bring about, but the case is even stronger today.

Richard D. Erb

I would like to concentrate on the last item on the agenda, the International Debt Situation. The IMF managing director in his speech today summed up the basic assumptions underlying the current approach to the debt problem. These assumptions are that the countries with large external debt will essentially be able to service their debt over the longer term, assuming that the world economy returns to more stable economic growth and growth rates along the lines of what were experienced in the past, and also that there would be some further downward adjustment in what seem to be very high positive real interest rates. When the world economy will reach that stage, or at least the major industrial countries, is an uncertain event at the moment, and I think a lot depends obviously on what happens to the U.S. economy.

With respect to the topics previous speakers have touched on, in particular the impact of the U.S. fiscal deficit on other economies, I find that there are among the members of the fund—at least as represented in IMF Executive Board discussions of U.S. economic policies—that there are different perspectives across countries with respect to the impact of U.S. economic developments on their economies. Let me be a little more precise about that. As the managing director said, international linkages are complex; there are trade linkages, service linkages, capital market linkages, and money market linkages. I find, for example, that those economies that are closely linked to the real sector of the U.S. economy, with high growth in their export volume and export prices dependent upon U.S. imports, are not as concerned at the moment about the high U.S. deficits which they see driving the recovery. They are concerned, however, that perhaps in a year or two, or the medium term as referred to earlier, that in some sense the large fiscal deficits will abort the recovery. So they worry more about the impact of our fiscal deficit on their economies in the distant future and see some benefit in the short run. Many of these are not that concerned about the impact of the U.S. deficits on interest rates because their capital market linkages to the dollar are not as high. For other

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countries, the relationship is a little more complicated. While they are enjoying the benefits of our high import growth, or they are enjoying the benefits of a high dollar, they're suffering in a very significant way from the consequences of high interest rates which they link to the large U.S. fiscal deficits.

So in some ways they're a little more ambivalent about the transition or the way in which the United States should achieve lower fiscal deficits and the timing of deficit reductions. Some of them, including some other industrial countries with close capital and money market linkages to the United States, would like to see an immediate and very sharp decline in the U.S. fiscal deficit. They recognize, and I think would be willing to accept the consequences for their export growth, that in the short run a sharp reduction in the fiscal deficit would result in lower real economic growth and lower U.S. import growth. In short, they come out with the judgment that the impact of a lower U.S. fiscal deficit on interest rates would give them more opportunity to pursue more expansionary policies and thus have a more favorable impact on their growth rates. As Professor Tobin said earlier, he thought other countries would allow their interest rates to come down sharply along with ours, and I think that he is right. On this issue of whether the dollar is overvalued or not—a subject which many other governments focus on—I think essentially what they're concerned about is not that the dollar is overvalued but rather they are upset with high interest rates that are, in effect, driving the dollar. I think some would like to have low U.S. interest rates and an overvalued dollar so that they could continue to enjoy some of the trade benefits of the latter.

I have trouble drawing explicit linkages between the first four items on this paper and the last one on the international debt situation in terms of drawing concrete conclusions about the *speed* with which the U.S. fiscal deficit should be reduced. I'm not quite sure what impact a sharp reduction in the U.S. fiscal deficit would have in the immediate future on the adjustments that many countries are facing. There have been very large current account shifts over the last three years from a deficit of $108 billion in 1981 for the non-oil developing countries to a deficit of around $60 billion in 1983. For the twenty major borrowing countries that account for 70 percent of total debt outstanding, the current account deficit of that group declined from about $70 billion in 1981 to around $35 billion in the present period. Many of these countries have quite large trade surpluses with their current account deficits reflecting large external interest rate payments. Thus, a sharp reduction in the U.S. fiscal deficit might reduce their interest payments but hurt their exports.

To be sure, the adjustment process is nowhere near complete in these countries. The adjustment process will not have been completed until the countries have begun to resume a normal rate of economic growth and more normal import growth and until the external financing flows are forthcoming in a more voluntary fashion than they are for many of these countries. This brings me very briefly to comment on an aspect of the IMF's activities.

I can be easy talking about this now that the quota legislation is through the Congress and the $8.4 billion is there and that the quota increase is in place. While the financing that the fund provides is extremely important in facilitating the adjustment for some of these countries—for clearly without the financing the external adjustments would be sharper for these countries than otherwise—I would also emphasize the catalytic roles the fund plays when assisting countries. For example, the fund plays a catalytic role when it assists government officials in a country design the policy changes necessary to restore external balance and economic growth. The fund usually plays a catalytic role in assisting the country obtain external financing from official and commercial sources.

Regarding its catalytic roles, the power of the IMF is often exaggerated. There seems to be a perception that the IMF can force governments to do something or that it can force commercial banks to lend or that the IMF in some way has the ability to really twist arms. Now in many ways the IMF has a great deal of power or influence, but I would refer to that as its powers of persuasion. It exercises these powers by spelling out the realities of the adjustment problems to each of the parties including the governments in the countries that must be making the economic adjustments in response to the shift in their external financing. It also spells out the realities to external sources of finance about what different levels of finance mean in terms of the adjustment problems that individual countries face.

At times I like to refer to this catalytic process as the IMF playing the role of a referee in a multilateral game of chicken, because, in a sense, that's what it is. Each party wants to make the minimum amount of adjustment. The countries that must adjust their economic policies in response to the decline in external financing obviously don't like the domestic implications of having to adjust to a lower import growth. And in the interim period, commercial banks often don't like the idea of putting large scale resources into these countries while the uncertainties surrounding the adjustment process remain so high. Central banks and the BIS do not like to be asked to put in short-term money or bridging money; and yet, as the realities are spelled out to them, if they do not put in that bridging money, the short-run consequences can be very serious. In fact, you almost get an economic implosion in a country if external financing suddenly dries up. Without some immediate response in external financing, the deterioration in the country situation feeds on itself. If it can't import, it can't produce exports; and if it can't export, its financing problem becomes worse, and it continues on a downward spiral. So, in many cases the first step in the adjustment process—which is a step I think most countries are already through and beyond—is the step of stopping the downward spiral and re-establishing some confidence so at least the country may begin to turn around its balance of payment situation.

But, once that first step is taken, then there is the need for a follow-on financing, and here again the fund tries to spell out to export credit agencies, bilateral aid donors, multilateral development institutions as well as commercial banks the kinds and magnitudes of resources that are needed in different countries and the implications for that country and the country's adjustment if those resources are not provided. I would say that an additional source of confidence is given by the fund to supervisors of commercial banks that indeed the system will get through the current crisis without a major collapse.

In effect, the phase or the process that most countries are going through now is getting the new financing to carry them through this year and beginning to reverse the internal deterioration and laying the basis for economic growth. In some countries that adjustment process started earlier in 1981 and very early 1982, and they are much further ahead in the adjustment. Eastern European countries, for example, were the first to get into serious problems, and I think they will be among the first to get out. Mexico responded much more quickly, and I think will come out of its problem more quickly than Brazil. But there are not any unique steps in the process. It's an organic process, a continual process of adjustment. A fund program is not something that's approved one day and is completed after one year or two years but a continual process of monitoring where the fund plays its central catalytic roles within the country as well as with external sources of financing.

Thomas D. Willett

I would like to briefly summarize the results of a number of studies we are doing for an AEI project on exchange rates, trade, and the U.S. economy, as they relate to the issues that were laid out for this session.[1]

One of the first points which I think should be made, although it is perhaps trivial to this group, is that international developments are important for the U.S. economy. They do not dominate the U.S. economy the way some global monetarists would argue, but they are quite significant. In some recent empirical work which will be forthcoming in the *American Economic Review,* both Ronald McKinnon at Stanford and Art Warga at Claremont have found that a 10 percent change in the exchange rate of the dollar tends to be associated the following year with about a 2½ percent change in nominal income relative to M1 growth. This is a fairly significant impact of exchange rate changes on the domestic economy.

McKinnon and I differ rather fundamentally in the interpretation. He argues that this is international currency substitution. My work in other areas suggests that currency substitution is significant statistically but economically is not terribly important. I tend to interpret these results as being consistent with more traditional analysis. Disturbances other than currency substitution cause changes in the exchange rate, which have the traditional feedback effects on the prices of traded goods and Keynesian trade balance effects that stimulate aggregate demand and velocity. But for whatever reason, we do find quite significant effects. We cannot afford to ignore the international

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1. These studies will appear in a volume being edited by Sven Arndt, Richard Sweeney, and Thomas Willett on *Exchange Rates, Trade, and the U.S. Economy* for the American Enterprise Institute in collaboration with the Claremont Center for Economic Policy Studies. (Preliminary versions of the studies summarized here are available as *Claremont Working Papers* from the Claremont Center for Economic Policy Studies, 205 East Harper Hall, The Claremont Colleges, Claremont, California 91711.

sector in domestic policy making even if we are unconcerned about international policy cooperation, as I don't think we should be.

A second major point is that contrary to what seems to be the popular impression, the international sector is not always a destabilizing element. It seems that we pay attention to the international sector only when it is doing something wrong. However, if we go back and look at the postwar experience of our international sector in terms of real income effects, the changes in our net export position have had a marginally stabilizing effect on the level of U.S. economic activity rather than a destabilizing effect. This goes back to our standard theory of open economy macroeconomics. Internal disturbances tend to be spread out over the international economy just as external disturbances tend to be imported. Moving from fixed to flexible exchange rates influences these relationships, but with high capital mobility the difference is not as much as a typical textbook would have implied ten or twenty years ago.

Moreover, as Gottfried Haberler always reminds us, we need to look at both sides of the coin. International developments have both output and price effect. The strong appreciation of the dollar in recent years did tend to deepen the recession, but it also had a very substantial favorable impact on the rate of inflation in the United States. I think this has a political significance far beyond its direct economic significance. A number of times in the past we have followed stop-go policies in which we started disinflationary policies and then gave up because the public did not see that we were making sufficient progress. I think the speed with which inflation has come down has increased the credibility of our disinflationary policies and helped to build broader support to carry through with the disinflation process.

Now, let me turn to another set of issues—Why is the dollar so strong? Is it too strong? And, if it is, what should we do about it? It has become commonplace to refer to the dollar today as being overvalued. Almost everyone agrees the dollar is overvalued. The only thing that tends to exceed that consensus is the frequency with which people don't say what they mean when they talk about the dollar being overvalued. I would like to distinguish among several different senses of the term and talk a little bit about what the evidence seems to say as to whether the dollar is overvalued or not on each score.

One way in which the dollar could be overvalued is that we do not have a market clearing price. Foreign beggar-thy-neighbor policies could be artificially propping up the dollar to get trade advantages abroad. This is often alleged, particularly in the case of Japan, but it is much harder to document. There clearly is a good deal of official intervention, but the vast majority of this period seems to be leaning against the wind in both directions. Thus, I think it is hard to support the argument that the dollar is substantially overvalued at the present time as a result of foreign exchange rate manipulation. There may be some element of this in particular currencies, but that is not a major part of the overall high value of the dollar.

A second sense in which the dollar could be overvalued is that private speculation is not stabilizing, that the market has not been working efficiently. The dollar has been pushed up beyond what can be explained by reasonably based expectations about underlying demand and supply developments. What is the evidence on this possibility? We can approach it in two different ways. One is to try to directly estimate what an equilibrium exchange rate is. That is incredibly difficult to do. The other and more common approach is to undertake the types of technical efficiency testing that people have done on the stock market to see to what extent one finds speculative inefficiency in the foreign exchange market. Here the results are mixed. We do not find as strong evidence for efficiency in the foreign exchange market as we do in the stock market. The work surveyed at the Federal Reserve Board and other places as part of the international intervention study set up at the Versailles Economic Summit came to this conclusion, and recent work Dick Sweeney has been doing at Claremont finds essentially the same type of results. The market tends not to be grossly inefficient. The set of initial hypotheses that we would have very predictable bandwagon type destabilizing swings in exchange rates has not taken place. On the other hand, there are many disturbing signs of various types of at least marginal inefficiency so that one cannot safely argue by analogy that because we have a lot of evidence that domestic financial markets are very efficient, the foreign exchange markets are so also. We found some disquieting anomalies there, so the possibility of some exchange market inefficiency has to be taken as a serious hypothesis. In my own view, we can point to some particular episodes in which I think it is a quite credible hypothesis; however, I don't think it applies in substantial degree to the United States dollar today.

A third sense in which we can have an overvalued dollar is that even with an efficient market we could have a current market equilibrium rate that is above the longer run equilibrium rate. Particularly because of analysis by Rudigev Downbusch, we now understand that in the world with high capital mobility, real interest rate changes may have a magnified effect on the foreign exchange market. To equalize the incentives of interest rate differentials plus speculative expectations to put money into one country or another, a monetary policy change that causes a temporary change in domestic interest rates may have an overshooting effect on exchange rates. It has been frequently argued that such overshooting explained a great deal of the substantial appreciation of the dollar associated with Reaganomics. We did have tight monetary policy and a very large and rapid appreciation of the dollar. However, again, I don't think this explanation of exchange rate overshooting as contrasted to the longer run effects of tighter monetary policy explains very much of the current strength of the dollar. For one thing, had this been the main explanation, then *ceterus paribus*, the dollar would have begun to fall back again rather substantially. Instead, it has continued to strengthen. And if it were due to interest rate related overshooting, we should observe this in the pattern of forward exchange rates. But forward exchange rates did not follow the predictions that this explanation would imply. Empirical work for our project that I've done with two of my former graduate students, Aida der Hovanessian at Chemical Bank and Waseem Kahn at First Interstate, does not find a strong systematic relationship between interest rates and exchange rates overshooting. The relationship between interest rate and exchange rate changes is highly variable and depends importantly on whether the change in nominal interest rates is due to changing inflationary expectations or expected real rates.

A fourth type of overvaluation is a specifically normative value judgment. The dollar is too high relative to particular structural objectives that one may have. As Henry Wallich mentioned earlier, the dollar may be overvalued in terms of objectives for the current account.

If one sees that the dollar is overvalued by so much in a newspaper article and it doesn't say what the measure of overvaluation was, your best guess is that somebody made a purchasing power parity calculation. We now have overwhelming evidence that PPP, however measured, is not a very good guide to exchange rate analysis, either positively or normatively. It doesn't predict terribly well. There is no reason to expect that you would not have equilibrium changes in the real exchange rate. Real factors do matter in exchange rate determination. The implicit assumption in PPP calculations of a constant real exchange rate is unwarranted. Work for our project by Charles Piggott at the San Francisco Federal Reserve and Dick Sweeney does not find that deviations from PPP tend to be strongly self-reversing, as is hypothesized by many of the popular exchange rate models. There may be a little bit of a weak tendency, but you can't make a lot of money betting that changes from PPP are going to be systematically reversed. Real exchange rate changes are important. I think there are two main reasons for the substantial real appreciation of the dollar. One is the change in monetary policy. This has caused a substantial appreciation in real as well as nominal exchange rates. When one takes into account that uncertainty effects, moving toward a lower expected average rate of inflation, will reduce uncertainty and should strengthen the relative attractiveness of the dollar, this should cause a real appreciation over and above what one would get from expected future PPP calculations.

Quantitatively perhaps even more important, I think, are the effects of the large, expected budget deficits pointed to by Henry Wallich. Take, for example, one of the more sophisticated calculations of what the equilibrium value of the dollar should be which was recently made by a member of our group here today, John Williamson. He calculated that in the first part of 1983, the dollar was overvalued on the order of 18 percent. He was very careful, however, as many people are not, to explain what he meant by overvaluation of the dollar. He explicitly excluded from his concept of fundamental equilibrium rate any effects from the structural budget on the normative grounds that it was undesirable. If we take his calculations and adjust them for plausible assumptions about the expected budget deficit, it is very easy to reach a conclusion that the dollar is not overvalued at all in a market sense. Just by way of illustration, take projections of budget deficits equal to $150–200 billion and assume 25 or 30 percent of this is financed from abroad (a percentage not out of line with recent experiences). Then the capital inflow and corresponding required change in the trade deficit would be on the order of $40–50 billion. Assuming normal range of elasticity estimates for the foreign exchange market, one can calculate the range of equilibrium exchange rate change this would bring about. One does not need to be an extreme elasticity pessimist to calculate a required change of 15 to 20 percent change in the dollar. You can get a very large effect from the foreign financing of budget deficits that can explain a very substantial part of the high value of the dollar.

What should we do about it? My own preference would be to see a lower structural budget deficit and consequently a lower dollar and more competitive export sector. I think that would be better for our own economy and for the world economy. In the absence of bringing down the structural budget deficit, however, my recommendation would be to do nothing. As Henry Wallich mentioned, most work supports his conclusion that there can be a role for official intervention in the foreign exchange market, but that its scope for positive effects is both limited in duration and in the types of circumstances to which the rationales for intervention apply. I don't think an attempt to force down the dollar by a substantial amount by official intervention would be successful.

I will close with just one word of optimism. One of the reasons that many people are concerned with the high value of the dollar is the stimulus this gives to protectionist pressures. I think this is a very real consideration. However, some of the preliminary empirical work that Susan Geigenbaum and I have been doing for the project suggests that while the effects of trade deficits and the value of the dollar on protectionist pressures are not trivial, they are dominated by the effects of the state of the domestic economy. There is some basis for optimism that a sustained recovery will reduce protectionist pressures even if the dollar does remain strong and our trade balance weak.

Alan A. Walters

The first point that strikes me in the discussion is that the high potential deficits of the United States are the most serious economic problem, not just for the United States, but for the free world. The deficit gives rise to great difficulties in foreign lands, partly because of the high interest rates that it generates, partly because of the same political difficulties that were encountered in an earlier period when there was a relatively small deficit. DeGaulle complained bitterly about the United States printing dollars, handing them over to France, and running away with its produce and its industries. The same sort of complaints are going to occur again. I agree, we have got quite a different set of interest rates from those low rates in the 1960s and 1970s. Nevertheless it is going to give rise to a serious exacerbation of the political problems of the Alliance.

The second point I'd like to take up is Jim Tobin's argument. He said that the present recovery was generated by the increase of the federal deficit. And the reason for other countries not recovering is that they haven't increased their deficit. My reading of statistics of other countries gives me quite the opposite point of view. Italy, I have just heard, is trying to get its deficit down to 15 percent of its gross domestic product. Yet Italy has been suffering a considerable decline in activity. Germany, of course, has had a very serious budget deficit problem and few signs of recovery. Holland has an enormous deficit problem and the highest level of unemployment in Europe. The Republic of Ireland also has a public sector deficit on the order of 16 percent of the GDP and very severe problems in a slump. And so I can go on and on.

The third point is that this recovery was predicted accurately by monetarists. Karl Brunner and I were talking about the future of the economy in the third quarter of 1982. The argument was that the big

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increase in money supply from July 1982 would be followed in six to nine months time by a very rapid rate of recovery of the economy. And, of course, this occurred more or less on schedule. I should also point out that one of the odd men out here is the British recovery. From early in 1981 that has been associated with consistently *smaller* and *smaller* budget deficits. At the same time, from 1981 monetary policy became less restrictive. A tighter fiscal policy combined with an easier monetary policy gave us another opportunity to compare the relative effects. Clearly monetary policy dominated since the recovery began in 1981. So I do not interpret the virtues of budget deficits in quite the same way as Jim Tobin does. But let me come back to one of the issues I was going to talk about—that is, the effect of the budget deficit on the height of the dollar. I don't think that there is very much doubt about this. It increases real interest rates and has an effect on the dollar. This causes enormous difficulties in Europe, leading to the suggestion that there should be massive coordinated intervention by the United States, Germany, and Japan. I agree entirely with Tom Willett that, so far as we can see, sterilized intervention has no lasting effect whatsoever. The intervention which is done in the European Monetary System is, alas, disastrous, as EMS remains, in my view, substantially a very severe and a very important failure to the sort of exchange control mechanism that many people have been promoting. I'll talk about that later.

Deficits exacerbate the international debt problem. The management of the debt problem by the United States and the international financial community was one outlined at lunch today by Mr. de Larosière. In the short run, it seems to me, we can do very little except broadly keep the financing at a minimal level and encourage the countries to pursue sensible reformist policies. And it is a moot point whether the fund is not insisting on too much, but I leave that aside. I think the broad policy in the short run is correct. But I have very serious misgivings about the *long run* effects.

The real difficulties, I think, come later. The international community has not been very sensible in handling its international liquidity problems. You recall that for many years there was talk of a dollar problem which was described unequivocally as a dollar *shortage*. And then, abracadabra, there came a dollar *glut*. Yet the mechanisms for dealing with the dollar shortage continued to operate through the dollar glut. There was great alarmist talk about an international liquidity shortage in the 1950s which ran on into the 1960s. The international community eventually designed an instrument, the SDR, to augment liquidity. The first SDRs were issued in 1970 and again in 1971 and 1972. The issues coincided with the biggest mushrooming of private liquidity the world has ever seen. The SDR issues added fuel to the inflationary fires of the 1970s. For very good bureaucratic reasons, the international wheels turn very slowly. We are always inventing solutions to the problems of a decade ago.

Now I'm afraid that something similar is going to happen with respect to the debt problem. The approach now is to provide *permanent* liquidity to the IMF, and this will appear in the credit arrangements and the general arrangements to borrow. There it will remain after the debt problem is only history. The present crisis is mainly a problem of liquidity (excluding the Polish problem which is really *not* one of mere liquidity). The great debtors, such as Brazil and Mexico, have substantial resources, which, if they allowed them to be sold to foreigners, could easily be used to pay off their debts. But for various chauvinistic reasons they will not do this. Consequently, the debt problem will have to be alleviated by the general process of structural adjustment internally, which means essentially a considerable reduction in the budgeting and monetary laxity that they have practiced so long.

I am concerned primarily because once this liquidity problem is out of the way, the IMF total liquidity (and total world liquidity) will have been considerably increased in order to deal with this transition problem. The liquidity won't go away (except insofar as the override to the quotas is reduced). The liquidity will just hang around and be the basis for another outburst of inflation.

The second difficulty is that there has been a very considerable increase in the availability of IMF liquidity, considered as a total relative to world exports from 1960 to 1982.

Third, there is the "moral hazard" problem. If you are insured and can have access to subsidized funds, then it makes you much less cautious than if you did not have such access. Insurance makes us all somewhat less cautious than we would otherwise be. Suppose, for instance, we insure against theft. Then, it is less important to make sure that the padlock fits or the windows are tightly shut, and so on. If you have 120 percent theft insurance, you can almost put a welcome mat out for the thief's catlike tread. Now, I'm not suggesting we've quite got to that position, but there *is* an element of that in the existing situation.

A very good paper by Roland Vaubel (The Heritage Lectures 21) pointed out that the number of countries that consistently reschedule is a very small fraction of the total. He showed that some 80 percent of the rescheduling was accounted for by twenty countries. And the number of countries in the IMF is now about 150. This suggests that accidents are not entirely accidental. There's an element of design in it which is not entirely the will of the Almighty. It may be the consequence of local decision making as distinct from celestial dispensation.

There's one other domestic aspect of the debt issue which I think is rather important—the effect on the balance sheets of American banks. American banks carry this third world debt in their portfolio valued at 100 cents to the dollar. In order to maintain the fiction that it is worth 100 cents to the dollar, they relend money to make sure the country pays its interest before ninety days is up. Then that loan can continue to be counted as a performing loan. This seems to be strange behavior. And I think it would be much better if first, as any normal prudential banking supervision system would require, these banks sell off part of this loan, perhaps only a small fraction (say 2 percent—a trivial amount) to the nonbank private sector. This would give rise to a market for that debt in the nonbank private sector. Such markets exist for bonds. Mexican bonds trade in London, and we have seen Zambian bonds traded when there was a Zambian debt problem. Some three years ago the debts of Turkey were trading at about a 40-50 percent discount.

Now, if we had these markets in this debt, we could then see what these loans were really worth. I want to make it clear, I'm not suggesting that we *force* a market. To sell 2 percent is trivial (perhaps 1 percent would be enough to start the market going). There are already substantial markets in bank debt. Most are covert, between one bank and another. It is time for the banks to come out of the closet.

It seems to me that this has a lot of advantages, because a country like Mexico, for instance, could then decide whether to buy back its debt at its discounted value. It is much more attractive buying it back at say 70 cents or 80 cents to the dollar than 100 cents to the dollar. This could induce Mexico, for example, to sell off some of its oil leases (as the People's Republic of China has recently done) for the Western oil companies to exploit.

This opens a Pandora's Box or what I'm sure Mr. Erb would call a can of worms. But nevertheless, let's see what the worms look like, let's see their color, and let's at least face the reality and not pretend. Then we shall not be deluded by fantastic values in the accounts of banks. And there are the advantages of a market for all to profit from.

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On Key Economic Issues

The statements published in this book were delivered at a session on "The Interaction of Domestic and International Economic Policy Issues" during the American Enterprise Institute's seventh annual Public Policy Week. Among the opinions offered by the discussants—who include seven present or former members of the Council of Economic Advisers (including four chairmen), the managing director and the U.S. executive director of the International Monetary Fund, the director of the Congressional Budget Office, a Nobel laureate, a governor of the Federal Reserve, and a former economic adviser to the British prime minister—are the following:

"The worst of all possible worlds is one in which the budget deficit gets so large that the interest bill itself begins to rise at a rate faster than we can politically reduce expenditures or raise taxes."

"The fear that deficits might be monetized makes it harder to foresee future price trends, and this uncertainty itself is likely to add a premium to market interest rates."

"We are now in the fortunate position that, with appropriate policy, inflation can decline to an even lower level before the end of the decade."

"The benefits of international economic linkages are too great to risk by a policy of strategy based on insulating the domestic from the international economy."

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