
Are There Reliable Adjustment Mechanisms?

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*Keynote Paper Presented at
The Third International Conference of
The Institute for Monetary and Economic Studies
Bank of Japan
Tokyo, June 3–5, 1987*

Once upon a time economics students of my generation learned the theory of international payments adjustment. We marveled at the natural mechanisms which, in principle at least, corrected the imbalances that triggered them. The subjects, even the words, still appear in modern textbooks (for example, Dornbusch (1980)), although they have been swallowed in “open economy macroeconomics,” or in what might be called “multi-national macroeconomics” were that subject advanced enough to merit a label. Both the world and the models economists build to model it are vastly more complex than students of my day were led to believe and did believe. Nevertheless, exploiting the license a keynoter has for imprecision and impressionism, I propose to review several possible adjustment mechanisms and to consider their applicability in today’s world.

I shall in the end be skeptical that there are any reliable mechanisms. This conclusion, I suspect, is widely shared—if rarely voiced—among economists, and

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especially among practitioners and policy-makers in international finance. Perhaps it is a premise of this very conference. The universal call for coordination of national macroeconomic policies betrays a strong suspicion that absent such coordination the system will not equilibrate itself. The suspicion might be that the natural, automatic mechanisms are weak or perverse, or that they are frequently obstructed and perverted by unconcerted national policies.

With "endogenous politicians," in Assar Lindbeck's phrase, it may be difficult to distinguish policy responses from market responses. Several endogenous politicians are gathering at Venice this month, and effective coordination is not likely to be one of their responses. In the old days, in contrast, the mechanisms of payments adjustment were not thought to leave much room for discretionary national policies, concerted or disparate, for good or for ill.

I shall discuss both short-run and long-run adjustments, to both nominal and real shocks. The two distinctions are interrelated; nominal shocks and adjustments are relatively more important in short runs.

I. The Necessity of International Price Adjustments

In those old days to which I referred, the major short-run adjustments to payments imbalances were thought to occur through absolute price changes in deficit and surplus countries, which spelled relative price changes between those countries. Keynesian theory added, in the international context as in the analysis of closed economies, adjustments due to variations of output and effective demand. But for reasons of which I shall remind you below, this mechanism was thought to be inadequate by itself.

Emphasis was concentrated on the adjustments of current accounts, probably because capital movements—other than official settlements and short-term trade finance—were limited by national controls and other barriers. The problem was posed like this: Suppose trade imbalance arises because of changes in comparative advantage—differential changes in tastes, technologies, resources in the trading countries—or because of disparate changes in monetary stocks or velocities. What happens to restore balance?

The oldest and simplest story was the specie flow mechanism of the gold standard, with gold essentially a common international money. Gold would flow from the deficit country to its trading partners in surplus. According to the quantity theory of money, prices would fall in the former and rise in the latter. If the shock were real, the change in the countries' relative prices would shift international demands for goods and services from surplus countries to the deficit country. These shifts would eliminate the imbalance. If the shock were permanent, the new relative prices would be permanent. Once achieved, they would sustain a new equilibrium in international

payments. This story assumes that the countries were producing different goods, imperfect substitutes.

The mechanism is essentially the same in fixed-exchange-rate system in which governments, their central banks, and private banking systems augment money supplies beyond national quantities of gold or other international media. Recall the gold exchange system or Bretton Woods. However, the links to gold or international monetary reserves are looser. Banks and individual agents can substitute local paper money, and central banks and governments can allow or engineer such substitutions. Thus countries—especially and asymmetrically, surplus countries—can postpone or avoid the local price consequences of payments imbalances. “Rules of the game” arose to strengthen the price adjustment mechanism against the capacities and incentives of nations to weaken it. But the rules were informal and frequently honored in the breach.

Banking and central banking make monetary shocks possible. The price adjustment mechanism is supposed to work for them too. A local monetary expansion, or rise in velocity for that matter, raises local prices and generates a trade deficit, which drains gold or other international reserves. The local money supply is restricted until relative international prices are restored to their unchanged equilibrium. The local price increase is mostly, but not entirely, transient. When the adjustment is complete, prices throughout the world have all been raised in the same proportion, the amount necessary to absorb the increment to world money supply due to the initial local monetary shock.

This is essentially the “monetary theory of the balance of payments,” even though its modern version was expounded for a one-good purchasing-power-parity world. (That assumption does not seem to me an attractive foundation for international payments theory. It provides no basis for international trade in the first place, except by excess “absorption” in one country and deficient absorption elsewhere. That phenomenon, as well as the neutral adjustment to monetary shock, can be treated without insisting on the “law of one price” in international trade.)

The price adjustment mechanism is also central to the correction of imbalances under floating, market-determined rates of exchange among fiat national currencies. The deficit country’s currency depreciates against the surplus countries’ currencies. The same changes in international relative prices occur in response to a real shock, possibly but not necessarily without any changes in nominal prices in the several economies. Likewise, in the case of a monetary shock, a local rise in prices robs it of any real domestic consequences, while the exchange depreciation preserves the equilibrium relation of the country’s international prices to the rest of the world.

The key to the equivalence is, of course, the assumption that nominal monetary quantities, prices, and exchange rates, are neutral; national moneys are veils; relative and absolute prices are perfectly flexible. It is hard to understand why anyone who

believes that assumption—the “classical dichotomy,” if you like—prefers one national or international monetary regime to another; cares whether adjustments of international relative prices are made, or prevented, by movements of local prices or of exchange rates; or worries about inflation and deflation.

To this, I am aware, can be voiced the objection that commodity money and fiat money differ. The equivalence just discussed would apply only to alternative regimes with fiat moneys. Under the gold standard, changes in prices of other commodities in one country or in the world do have real effects, via the relative price and production of gold. I think this is not a matter of important substance, except for gold-producing countries.

When classical or Walrasian assumptions supporting the irrelevance of nominal variables are dropped, choices among monetary regimes and international rules of the game become consequential. The case for floating rates was that changes in nominal exchange rates are the quickest and least painful way of bringing about equilibrating changes in international relative prices. The assumption is that the inertia of nominal wage and price paths allows nominal appreciations and depreciations to be real, while the same inertia slows or frustrates the same price adjustments in the fixed-parity regime. Even if discrete changes in parities can be made, they are crisis decisions inviting speculation before and after; they are usually too long delayed; they often undershoot and sometimes overshoot.

Tradeoffs there always are. Flexible rates can emit false as well as true signals. Speculative movements can change relative prices between countries when no change is basically called for, and the volatility of rates can leave traders confused about the relative prices which should enter their calculations and decisions on production, sales, and purchases. Unfortunately “variable peg” regimes, temporarily fixed rates, do not really eliminate these problems. A truly common international currency would do so, but we are far from the commonalities of institutions, laws, taxation, and politics that would make a universal money possible.

II. Obstacles to Price Adjustment Mechanisms

Under floating rates since 1973 nominal exchange rates have moved a great deal, and for the most part real exchange rates have moved with them. Nonetheless I shall argue that the major governments, the economic summit powers, are reluctant to let price adjustment mechanisms work, at any rate to work well enough to handle the tasks that now confront them. In the United States, West Germany (which calls the macroeconomic tune for the European Community and Monetary System), the United Kingdom, and Japan, governments and central banks are quite determined to stick to their nationally chosen paths of domestic price indexes.

The U.K. has for several years geared its monetary policy to hold an exchange

rate that puts moderate disinflationary pressure on its prices. Both the big surplus countries, Germany and Japan, are unwilling to deviate from macroeconomic policies that have rewarded them with actual deflation. The U. S. authorities are afraid of a further depreciation of the dollar because dollar prices of imports and other internationally traded goods would rise.

These attitudes are by no means altogether new. They stood in the way of corrective devaluations and revaluations in the Bretton Woods era. For example, in the early 1960s the U. S. was running official settlements deficits, though its current account was in surplus. The U.S. inflation rate was only 2 percent per year, and the economy was not fully employed. Germany and other surplus countries were unwilling either to let their accumulations of reserves show up in higher prices or to revalue their currencies upward. Either course could have given the U.S. a larger trade surplus to match its capital outflows and unilateral transfers. The impasse was not resolved until a less auspicious time, when the Nixon Administration ran out of patience and killed the Bretton Woods system.

An important obstacle to international price adjustment is epidemic confusion between price levels and inflation rates. Once-for-all rises in price indexes do not necessarily spell continuing inflation or acceleration of prices. These one-shot increases often come from shocks that lift particular prices, supply shocks that alter relative prices. The oil price hikes of the 1970s, of unhappy memory, are major examples. Likewise, the recent declines when cartel discipline weakened made pleasant headlines. In both cases the events were not the kind that can regularly recur year after year. The transitional rates of inflation, or of disinflation in 1986, were bound to be temporary. Nonetheless the OPEC shocks of the 1970s were opposed by monetary restriction as if they were demand-pull inflations.

In 1981–85 the U.S. enjoyed the price-lowering effects of dollar appreciation. Those effects have to be reversed to correct the U.S. trade deficit, but the domestic price index increases due to exchange depreciation scare the Federal Reserve—even though they are once-for-all, even though the upward price adjustments are in effect repayment of downward adjustments borrowed from the rest of the world in the earlier 1980s. The likely policy consequence appears to be that the dollar is to be defended by higher interest rates, holding back an already sluggish economy. One objective is to offset the increases of import prices with extra domestic disinflation. A weightier objective is to guard against the risk that exchange depreciation and higher import prices trigger a price-wage-price spiral.

The examples of the 1970s show that this is not an unreasonable concern. However, running an economy on the assumption that price indexes can never be allowed to rise, regardless of the amount of slack in the economy, regardless of how low the underlying domestic wage and price inflation rates are, is a recipe for stagnation. Moreover, central bank sensitivities to these price shocks are asymmetric.

Japan and Europe today, like the U.S. in 1981–85, accept external contributions to disinflation or deflation without engineering compensating expansionary measures. The ratchet effect is to hold down both world inflation and world expansion.

Policy stances are anticipated in the behavior of private agents. That is a lesson of experience as well as of modern economic theory. Financial markets react negatively when monthly inflation news is bad because they have learned that central banks tighten on such news. Indeed equity markets have become so obsessed by the prospect that central bank concern to prevent or arrest inflation will raise interest rates that they respond negatively to good news about real economic growth and profits, and positively to news of sluggishness and possible recession.

A principal argument for floating rates before 1971 was, as I observed above, that movements of nominal exchange rates would be, compared to movements of domestic nominal wages and prices, a quicker and less painful way of accomplishing necessary changes in international relative prices. This argument assumes, of course, that inertia in nominal wages and prices prevents or delays those adjustments at fixed exchange rates. The same inertia is expected to translate nominal exchange rate movements into effective adjustments in real exchange rates. Clearly this mechanism is disabled to the extent there are quick feedbacks from import prices (in domestic currency) into economy-wide wages and prices. Policies to avoid such feedbacks would improve the adjustment mechanism, just as policies to increase the sensitivity of local prices to market supply/demand conditions would improve the mechanism under fixed rates. Policies to stabilize wage and price paths, to avoid feedbacks from international prices, may be essential to successful devaluations or depreciations. Indexing should be minimized, and at the least exclude compensation for terms-of-trade effects. The case for incomes policies, for example, guideposts with sticks or carrots to induce compliance, is strengthened under floating rates.

III. Adjustments in Effective Demand and Absorption

International relative prices are one avenue of adjustment. Variations of output, real income, and employment are another. In the short run these arise from fluctuations in effective demand, given some inertia or stickiness in nominal wages and prices. A shock that unbalances trade lowers demand in the deficit country, and the consequent decline in incomes and output lowers imports. Likewise the positive impulse to demand in the surplus countries raises their imports. Elementary multiplier theory tells us that these adjustments are far from complete, even if monetary policy-makers accommodate them by holding interest rates constant. That is, the multiplier is much lower than the reciprocal of the marginal propensity to import. Imports are only one of the leakages from spending flows; saving and taxes are also important.

What would it take to eliminate a U.S. trade deficit of \$150 billion a year, 3 1/2 percent of GNP? Assume a marginal propensity to import of 0.25, twice the average propensity, it would take a GNP contraction of \$600 billion, 14 percent, and raise unemployment well into double digit rates. To add enough imports to erase its trade surplus, 3 percent of GNP and 20 percent of imports, Japan might need a 20 percent rise of GNP.

In medium and longer runs further equilibrating mechanisms may come into play. Current account imbalances transfer wealth from deficit to surplus countries; these transfers have both wealth and portfolio effects, some on trade and some on capital movements. Consumption stimulated by the accumulation of wealth leads the surplus country to import more. On the capital account side, the country's appetite for foreign assets diminishes, and the resulting appreciation induces some correction in the trade deficit. The reverse processes in the deficit country strengthen the adjustment.

However, current account imbalances could reflect long-lasting differences among economies in saving propensities, investment opportunities, and growth rates. In this case, there is no guarantee that they will go away, and possibly no economic reason they should. Consider the following scenario: Thrifty country J saves more than it needs for investment, that is, more than is needed to expand its capital stock given the growth of labor force and the rate of technological progress. Profligate country U, however, needs J's excess saving.

To describe their difference another way, the desired wealth/income ratio in J exceeds its desired capital/output ratio, and the difference is its wealth-owners' demand for stocks of external assets. Both domestic and foreign components of wealth will grow at J's natural rate. On the other hand, in U the desired capital/output ratio exceeds the wealth/income ratio, the excess being capital owned abroad or in effect mortgaged to foreign creditors. If capital movements are not restricted, the returns to capital in the two countries must be equal (after allowing for trend in real exchange rate) or anyway stand in such relation that they meet portfolio preferences of savers and borrowers in the two countries. This relationship determines the capital stock in the two countries. The exchange rate path is determined such that a current account imbalance provides the flows that meet the saving and portfolio demands on both sides. The currency of the more rapidly growing country will be appreciating. It is conceivable that a high-saving fast-growing country eventually owns the whole capital stocks of less thrifty and more sluggish societies, but presumably the behaviors that destine this result would eventually be altered.

Rather than continue on this abstract and speculative line, which I don't really think represents the Japan/United States situation today, I turn to the concrete problems of adjustment we face right now.

IV. The Adjustment Processes that Match Flows of Capital and Trade

The gross maladjustments of the 1980s have placed unparalleled burdens on the corrective mechanisms I have been discussing. The main sources of these burdens are first, the internationalization of wealth portfolios and asset markets, and second, the extreme, and extremely different, mixes of monetary and fiscal policies of the major countries. In the 1970s the sources of the international macroeconomic problems that beset those countries were mainly external and exogenous to them, shocks of unprecedented magnitude in peacetime. In the 1980s, the external environment has been benign; national policies and the failures of coordination are much more to blame for the generally poor economic performance of this decade.

Asset markets began to be internationalized as exchange controls and capital controls were gradually abandoned after World War II. The pace accelerated tremendously in the last decade. Communications and computer technologies facilitated international transactions and vastly lowered their costs. Multinational banks and financial enterprises multiplied. New international asset markets were born, new instruments and contracts were created, old and new national markets were linked. Deregulation of financial businesses in all countries allowed and encouraged, among other things, a burst of foreign activities. Off-shore money and credit markets in major currencies flourished. The floating exchange rate regime itself generated clients for managing positions in several currencies and countries, including speculators and arbitrageurs in cross-currency financial transactions. Finance in general became a go-go field, enlisting both the best and brightest of young technicians fresh from business schools and latter-day entrepreneurs and big-time operators; it even became an academic growth enterprise. International finance shared in the phenomenal expansion of the industry and the profession. The sun never sets on currency markets, in which the volume of transactions in New York alone is estimated to exceed \$100 billion every business day. Japanese liberalizations of portfolio investment regulations were fateful.

As we all know, a country's capital outflow (inflow) must *ex post* equal its current account surplus (deficit). Market exchange rates, interest rates, and asset values move hour by hour and day by day to convert any *ex ante* deviations from this equality to their *ex post* identity. (Official capital movements, foreign exchange purchases or sales by central banks, may on occasion be factors in this equalization. They have been substantial in recent months, evidently of the same rough magnitude as the U.S. current account deficit.) Over longer short runs other macroeconomic variables, the ones discussed above, also play important roles.

Exchange rates, interest rates, and asset values can be moved by shocks to international demands for assets in various countries and currencies, as well as by

shocks to trade and other current account items. This is the main point in discussing the current situation. Given the liquidity of financial assets in today's worldwide markets, given the intrinsic volatility of the expectations on which asset demands depend, capital account shocks can occur with much greater suddenness than changes in the determinants of trade in goods and services.

A nation's capital inflow or outflow depends positively on the expected returns on its assets relative to those in other currencies and on the expected appreciation of its exchange rate. (I remind you in passing that for an investor concerned ultimately with real returns in his or her own currency, it is the *nominal* interest differential plus the expected appreciation of the *nominal* value of the currency that matters. This reduces to concern for real returns and currency appreciation only if investors' expectations embody purchasing power parity.) The *level* of the exchange rate is much less relevant. We read in the business pages that foreign investors are buying American assets because they are bargains at the present low exchange value of the dollar. They are bargains only if the investors expect the dollar to rise. The level of the exchange rate matters only so far as its variation, like that of any asset price, alters the proportions of the portfolios of risk-averse diversifiers and induces them to shift from relatively appreciated assets.

In formulating exchange rate expectations, an investor with a long horizon will consider how the current rate differs from an equilibrium rate or path of rates. In that consideration, news about the present trade and current account imbalances is quite relevant. Anyone who thinks present U.S. current account deficits are unsustainable—presumably anyone who thinks—will have lowered his or her estimate of the future value of the dollar by observing the glacial pace of improvement of the U.S. trade position in response to the drastic dollar depreciation since mid-1985.

The list of determinants of capital account flows and stocks is different from the list of arguments a model-builder would put in functions explaining exports and imports of goods and services. For the current account, the level of the real exchange rate, in prices or labor costs, would appear, along with the national incomes of trading partners; stocks and returns on internationally held assets would determine the net flows of incomes on those assets.

Supply and demand are, Alfred Marshall taught us, some of us, blades of the same pair of scissors. Yet sometimes one blade may be the cutting edge, sometimes the other. That is the case in currency markets.

It is not too far-fetched to see the inflow of capital into dollar assets in 1981–85 as the driving force in the appreciation of the dollar. The inflow was attracted by relatively advantageous American interest rates, perhaps also by internationally contagious euphoria about the Reagan era. The inflow would have been reinforced, at least in the earlier years of the period, by the appreciation of the dollar itself. Eventually doubts of its continuation, even of its permanence, fed by ministers and

central bankers at the Plaza hotel, overtook the markets.

Meanwhile the 1981–85 appreciation, together with the strong recovery of the U.S. economy relative to the stagnation in the rest of the world, brought a trade imbalance and a U.S. current account deficit matching the capital inflow. Qualitatively the events validated economists' textbooks; quantitatively, they exceeded everybody's prior imagination.

This story is consistent with the common accusation that U.S. trade and current account deficits mirrored its outsized federal budget deficit. However, the reconciliation is more complex than the accusing pundits generally recognize. True, the budget deficit made U.S. interest rates high. But this effect occurred indirectly, through Federal Reserve monetary policy. The Fed did not raise interest rates because the Open Market Committee members were appalled by the budget numbers they read. The chain of events, I think, was more like this: Defense spending and tax cuts stimulated demand and recovery. In order to hold the expansion to a path the Fed regarded as sound and inflation-safe, the Committee kept real interest rates from falling (from their 1980–81 highs) as low as they would have been in a normal pre-Reagan recovery period. Moreover, bond markets came to expect that the deficits were chronic, not just cyclical, and would eventually either lead to inflation or collide with prosperity private demands for capital. As a result long-term bonds yielded premiums above short rates that made them especially attractive to foreign financial institutions and portfolio managers.

When pundits say that budget correction would have avoided or shut off the capital inflow and the trade deficit, they are right if they add that the Federal Reserve would have had to lower interest rates to keep the economy on the same path of GNP and employment.

Today we face quite a different adjustment problem. The choices available in 1981–83 are not on the menu in 1987–88. The trade deficit is stubborn. Perhaps the J-curve lags are longer than we thought. Most of the J-curve scenario may still be ahead of us. Exporters to the American market have been willing to cut margins in their own currencies rather than lose market shares. In "customer markets," buyers are slow to shift to lower-cost suppliers. Perhaps the long period of dollar overvaluation has crippled U.S. export and import-competing industries. Some of the effects on competitiveness are irreversible, or anyway will take a long time to overcome. (Young economists are now enchanted by the fashionable newly discovered word "hysteresis.") Evidently some underlying adverse trends in American competitiveness have proceeded apace, unrelated to but obscured by the over-valuation. Finally, the accumulation of external debt itself is reducing U.S. net investment income from the rest of the world, which will soon become negative.¹

1. I am indebted to Paul Krugman and Richard Baldwin, "The Persistence of the U.S. Trade Deficit," forthcoming in *Brookings Papers on Economic Activity*, I, 1987.

Investors and portfolio managers throughout the world have, in any case, plenty of reasons to worry about the real exchange rate necessary eventually to cut the U.S. current account deficit to sustainable size. Given a large deficit that will be with us willy-nilly for some years to come, by what adjustment will the U.S. continue to attract the capital inflows to finance it? There are several possibilities.

(1) One is that U.S. borrows from foreign governments. After all, they like their trade surpluses and do not want to see the dollar fall in a manner that will eventually threaten their exports. They seem never to have learned how to obtain prosperity and growth driven otherwise than by export demands. Nevertheless, buying up dollars is not a way out that will appeal to the governments of surplus countries indefinitely. Like the creditors of Brazil and Mexico today, they will worry about the prospects of repayment. Nor will official borrowing on a grand scale appeal to the U.S. government. Most important, this course will sooner or later turn off the private participants in the exchange markets. Their resources vastly exceed those of the governments. Once they are turned off, the dollar will fall.

(2) Second, the U.S. could "defend the dollar" by raising its interest rates to entice increasingly skeptical foreign lenders. The Federal Reserve has already moved cautiously in this direction, and is poised to do more. The consequence could be U.S. recession, which while curtailing American imports would have disastrous consequences throughout the world. Third World debtors would face both higher interest charges and diminished export markets.

(3) Third, the dollar could fall until it was low enough to convince investors that its subsequent rise would reward them for holding it. Although Paul Volcker and others are frightened of a "free fall," or "hard landing," overshooting of this kind is precisely the fantasy of rational-expectations economic theorists. Get the bad news over all at once. Markets do not seem to work that way. More likely, the fall occurs over an extended interval, during which expectations and fears of its continuation are destabilizing. No one has a rational basis for calculating the dollar's equilibrium value or the degree of overshooting that determines its floor. Nevertheless, a case can be made that, instead of trying to talk the market into supporting the dollar at its present rate, the officials of the several countries should welcome a rapid downward jump and intervene with rhetoric and money at a rate from which a rise in the dollar is credible.

Some combination of (2) and (3) seems the most probable chain of events.

The U.S. Government, as well as many unofficial commentators, have been urging Japan and Germany, the key European economy, to adopt policies to stimulate domestic demand. Given the slack in their economies and their low, even negative, inflation rates, expansionary policies are obviously desirable. They would benefit those societies themselves and the world as a whole. I have argued that the resulting increase in U.S. exports would be insufficient itself to correct the U.S. trade

deficit. Improvement in U.S. competitiveness is essential and will probably entail further dollar depreciation, as well as considerable time.

Meanwhile, expansionary policies in Japan and Europe may or may not facilitate financing of the continuing U.S. current account deficit. Fiscal stimulus, such as Japan has recently announced, would raise interest rates and diminish demands for dollar assets. Monetary expansion would help to "defend the dollar," while retarding the dollar depreciation that may eventually be necessary to correct the trade imbalance. Nevertheless, from a global viewpoint, it is desirable not to raise interest rates in major economies. An attractive compromise would be monetary accommodation of expansions in Japan and Europe, whether fiscally driven or autonomous, holding interest rates outside the U.S. at current levels.

What about that U.S. budget deficit? Isn't it the culprit? Wouldn't its removal solve the problem? As long as the U.S. current account deficit is as stubborn as it now seems, correction of the budget would not avoid the country's need for foreign credit. It would, however, remove a major internal use of the borrowed funds. Here are some round numbers: At the moment U.S. nonfederal saving is \$250 billion a year and net national borrowing (current account deficit) is \$150 billion. Together they are financing a federal deficit of \$180 billion and net private domestic investment of \$220 billion. Without a federal deficit but with the same current account deficit and foreign borrowing, the U.S. would have to raise domestic investment and/or reduce internal saving by a total of \$180 billion. How? Either by a drastic low-interest monetary policy fostering a mind-boggling investment boom, or by a recession deep enough to cut saving equally severely. (That is an over-statement, because the recession would also cut imports somewhat at the same time. Also, whatever the initial revenue and expenditure measures designed to correct the budget, some of the correction would be nullified by endogenous cyclical effects.) Anyway, the investment boom alternative seems quite unlikely, perhaps impossible. The recession alternative would be disastrous at home and abroad.

The moral is this: Substantial reduction of the federal deficit is an essential part of an ultimate solution, just as it was a major initial source of the problem. But now that the external current account deficit and the equivalent borrowing are more or less frozen into place for some years, it is not prudent to melt the budget deficit much faster than the external deficit can melt. Meanwhile it is, however, prudent to legislate a schedule of measures to be phased in gradually—in my view mainly revenue increases—that will in the end bring the budget deficit down, not to zero but to, say, 1 or 1 1/2 percent of GNP. This legislation would improve the market's view of the future of the dollar and help to attract the financing needed while the external deficit is being corrected.