

COMING OUT OF THE RECESSION:
THE AMERICAN ECONOMY IN 1984

Remarks by
Paul A. Volcker
Chairman
Federal Reserve Board

EXECUTIVE DINNER FORUM
WHARTON ENTREPRENEURIAL CENTER
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PAUL A. VOLCKER

When I thought about entrepreneurship, I thought that it was probably a field full of happy people, and Dr. Shils, Director of the WEC, has confirmed that. I was struck by a comment I heard a few months ago. Someone said, "Central bankers are like Puritans. They have a haunting fear that someone, someplace, may be happy." When I look around at all the doubts, uncertainties and anxieties expressed in the world today, particularly in our financial markets, I have a sense that we may not be alone in wondering whether anyone is happy.

What struck me as a bit strange and peculiar about this phenomenon recently, is that it has come after a period of 15 or 18 months when things have indeed gone exceptionally well. Everything during this period, at least on the surface, has turned out better than anyone could have projected a year or more ago. Production is up by about 20%, and employment is up by about 5 million people, which is tremendous by world standards. We have real incomes rising, which shouldn't be so unusual, but two consecutive years of an increase in real income is unusual in terms of our economic performance in the 1970's, which is a reflection of how dismal they really were. Productivity has been increasing. Prices have risen at the lowest rate in more than a decade, and despite all the concern, have remained in that channel in recent months. Profits, measured in real terms and relative to the GNP, (adjusted for distortions of inventory evaluation and depreciation allowances) after a little more than a year of recovery, are about as high as they were at any time during the 1970's, which was not a brilliant decade for profits. I'm not suggesting that our current position is "it" and that it's the end of the street, but it's interesting to see how far we've come up during this recovery.

So, you may be inclined to ask-- what are we worried about? I must confess that part of my job is worrying and I do think that there is something to worry about. I think that we are still feeling, in a fundamental way, some scars of a long inflationary period,

which stretched out over 15 years and culminated in the greatest inflation in all of our history, including the war years. That period has certainly had a deep effect on the psychology and behavior patterns of consumers and business. It's something they are not going to forget about in just a few years of progress, particularly when that progress is incomplete.

We've achieved a lower inflation rate, the lowest rate in some time, but still, it's not zero. It's a legitimate question to ask— what will happen when the recovery proceeds? We haven't passed the test of maintaining control over inflation during a period of prosperity. Can we live with prosperity, in that sense?

I also think that this past decade, filled with uncertainties due to rising inflation and exceptional instability in our financial markets and the economy, has left people with an insecure feeling about where we are headed. Can we have faith that whatever sense of stability has been restored will last against the experience of earlier years?

I also think that there are some alarm bells ringing quite clearly on the international side. We have maintained a strong dollar in the face of increasing trade problems. I guess this offers an interesting insight into how the rest of the world thinks, because part of the strength of the dollar comes from a feeling that the U.S. is a safe and profitable place for your money relative to what's going on elsewhere. By historical standards, and by relative standards compared with other countries around the world, we've had extremely high levels of interest rates. That has, of course, helped pull in a lot of money from abroad, so that the dollar has been strong and remained strong in the face of an increasing trade deficit.

Capital inflow, in the short run, has been important for two reasons. It has financed the trade deficit and also helped finance internal economic growth. This year, capital inflows from abroad are likely to supplement domestic sources of savings, net, by about 25%. To put it another way, capital inflows will amount to more than 2% of the GNP this year. That percentage is without precedent so far as I know. In terms of

reliance on capital inflows from abroad, our net savings rate of all savings comes to 8% or less of the GNP.

One can legitimately ask, where would the level of interest rates be in the U.S. if we didn't benefit from that capital inflow? Here, we can see it has some definite advantages in the short run. But another little question comes up, as with all economic questions: how long can you count on that lasting in the face of a large, growing and debilitating trade deficit? I think this situation is making us increasingly vulnerable to a change in psychology due to economic imbalances associated with that trade deficit.

This interrelated problem of the dollar, the trade deficit, and interest rates has a large bearing on another international problem — the international debt. It's a problem that has gained public attention fairly recently, but which has been managed one way or another for the last couple of years. There is a great feeling of alarm, and I think is justified. These debts are legion, to a point that failure to manage them would create serious doubts about the underpinnings of the entire international financial system. Thus far, the challenge has been met and there has been a great deal of progress in some areas, but I would not even begin to suggest that the problem is over. In my mind, it is a problem that has to be treated on a country-by-country basis. In some areas, like Mexico, some real progress has been made, but if you look at the other end of Latin America, at Argentina for example, you can see it's still in a very early stage of progress. All the problems impact on one another. By far, the largest threat to the management and solution of the international debt would be a decided increase in interest rates. These debts are mainly denominated in dollars and are floating rate instruments. Therefore, there is nothing that can change the external financial position of the indebted countries faster than a major change in interest rates. Conversely, if interest rates went down, that would be of immense benefit to the indebted countries.

In reviewing these problems, it becomes clear that the solutions lie mainly in the area of public policy. It's no secret to you that I think many of these problems revolve

around the budgetary deficit which is running between 5% and 6% of the GNP. We have been relying on capital inflows from abroad to finance, not only the deficit, but also domestic investment: housing, inventories, and all the rest. Domestic generation of savings is running between 7% and 8% of GNP, and when you subtract 5% from that 7% or 8%, there isn't a very large percentage left for financing business expansion. Although these internal pressures have been kept in hand by capital inflows from abroad, I don't think it's safe to count on this continuing, especially when you're the largest and richest country in the world. The inevitable results are higher interest rates and imbalances in the economy, particularly in the foreign trade picture. And beyond these types of identifiable effects, there's a psychological uncertainty, which I mentioned earlier. For understandable reasons, it seems unreal to large sectors of the American public that we can expect to maintain anti-inflationary policies, control of the money supply, and responsible monetary policies when we have to finance that kind of continuing deficit year after year. The issue is not whether we can or can't, but whether it affects expectations, financial markets, and other things.

I'd like to turn to monetary policy just briefly. I think it is essential in this situation that we maintain our progress against inflation and sustain a policy that avoids excessive growth in money and credit. As for the dictates of the Federal Reserve, I want to stress that it is a cooperative endeavor, conducted by an open institution in American society. When you debate this issue, you come back to the point that we've gone through a lot of pain and difficulty because of inflation. At this incomplete stage of the recovery cycle, it would not serve the long-term growth, stability, and sustainability of the American economy to throw away the progress we have made. This progress is certainly not made impossible by the deficits, as many people think, but neither is it made painless, more certain, or easier in terms of its financial market effects.

In the last quarter you've observed at least modest increases in interest rates. Let me observe too, that during this quarter there was exceptionally fast growth in economic

activity: business credit, as far as bank credit is concerned, expanded at a rate of nearly 15%; consumer credit accelerated at a rate of about 20%; and mortgage credit continued a fairly rapid growth in the area of 12%. At the same time, government indebtedness rose at a rate of about 20%. It's hard to believe that one can squeeze in all that credit expansion without having some impact on interest rates when the economy is growing as fast as it is. To put it another way, we can influence and indeed, over a period of time, control credit expansion and the money supply, but there is nothing monetary policy can do to generate savings.

A final point that I would like to touch upon in terms of public policy goes directly to the international area and the issue of protectionism. Our improved performance with respect to price stability has no doubt been strongly influenced by the availability of imports from abroad. The strength of the dollar has contributed to imports coming in at highly competitive prices. Given that performance of our trade balance, there are increasing pressures toward shutting this off, in whole or in part, through protectionist measures. It seems to me at present that we can't afford this "luxury" (hardly a description of protectionism) if we expect to continue to generate growth in a context of price stability, and to generate the confident flow of funds that we need from abroad.

Success, in the end, will depend upon the private attitudes of the American public, particularly those of business and labor. There's another side to the issue of improved productivity. It's not clear from all the figures, despite anecdotal evidence from business, whether the improved productivity we're seeing now is the kind that will carry through into a long-term and more rapid improvement. At the end of the 1970's, it was hard to say if we were having any trend growth in productivity at all. I think, now, that we probably are, but it has been a cyclical growth. Recent data is not encouraging, that is if the data is good, but this is always the problem with statistics measured against a background of a still rapidly growing economy. While the trend may be improving, it's still not certain whether we're anywhere near the 2 1/2% rate of productivity growth

which we took for granted two years ago. How that growth interacts with wages will have a lot to do with our success in keeping the economy going in a balanced way with no overheating.

Wage performance to date has been about as good, by which I mean as low, as one could have expected. So far, as the economy has grown, there has been no tendency in the aggregate data to show any real acceleration of the wage bill. But we are now getting into a much more critical phase as profits, and executive compensation, go up. And, with pressures on capacity in a number of areas of the country, can that performance be sustained in the period ahead? In the end, while I say that a low wage increase is a good thing, I only say that against a background of productivity growth that will bring an increase in real wages. This is essentially what the economy is all about. We have had that increase in real wages, while nominal wage increases have been going down lately. The great substantive test of the economy's performance this year seems to me to have been in the automobile industry late in the summer, and that was not unrelated to the protectionism problem.

Private attitudes, certainly, are going to rest fundamentally on assessments of what is going on with respect to public policy. I would emphasize that our problems are not insoluble in that sense, but this is not the same as saying that the political process will produce adequate results. We are seeing some guarded progress on the deficit side which is expressed, in my world, in fairly long-term perspectives. I don't know where we got into the habit of announcing tax programs in terms of three years, or reduction programs in terms of five years. I guess they sound bigger that way, but when you reduce them to single year effects, they look somewhat less impressive. The problem now is that this \$150 billion plus deficit reduction program, which I support and urge upon Congress, will begin to take effect in a \$15-20 billion amount a year from now. Only in 1987, not too far from the next presidential election, will we have the full force effect on the budgetary situation. I think we can find it in ourselves to do what is necessary

and, in the end, I think it's very important that we accept the fact that we had better do it and get on with it.

Thank you.

Q.: In a year like this one, when you have these very heavy inflationary trends in the economy, how does the political scene with the upcoming presidential election affect your problem of keeping things under control?

A.: The Federal Reserve System was designed quite wisely to give us a certain insulation from those sorts of anxieties and pressures. All I can say is that we do our best to try to discharge our responsibilities, not oblivious to what's going on, but insulated from those kinds of pressures to which you allude. We swim in the midst of them, but with respect for the fact that we have a structure which impels us to try to evaluate what the long-term needs require.

Q.: I heard today that the leading indicators dropped for the first time in 19 months. Is this the leading edge of the credit crunch that the large federal deficits are bound to generate?

A.: I don't think so. You speak about a credit crunch that will lead to a decline in the leading indicators. There are many factors that go into the interest rate picture. One is the speed of general credit growth, which is not interrelated with the speed of the economy. In and of itself, you wouldn't expect a slower rate of economic growth to produce more pressures on interest rates. Looking at that factor alone, you would expect less pressure. I am most familiar with monetary figures, and let me say that, after all the turmoil we've gone through in recent years, you shouldn't

be too beguiled by the ups and downs in the short run. The statistics are just not that good, particularly when you've gone through a period of wide swings in the economy which I think these figures indicate. It's hard to believe, if you take them literally, that retail sales were as weak as the figures said in December when all the retailers were reporting great sales, that there was a boom in January and a renewed weakness in March. I really doubt that the underlying economy has been as unstable as these statistics tell us. I just want to give you a word of warning— it would not be unnatural at this stage to see some slowdown in the rate of growth in economic activity. You always have to consider these things and make the best judgment analysis you can. We've had expansion for more than 15 months now, and as past expansion records show, they usually slow down before now. I can't be sure if that is the case now, but I'd be interested in some of your comments. The less formal evidence doesn't really suggest a big change in the tone of business activity recently. We'll just analyze what comes in over the next few months and see what it means.

Q.: In the 1970's, we saw the prime rate go from 5 1/2% to 21 1/2%. As I recall, the releases from Washington said that this was necessary to keep the dollar strong. When the prime rate went from 21 1/2% to 11%, the dollar became stronger than ever. I'd like to know first, how do you account for that, and second, is it in the long-term interest of the U.S. to have the dollar as strong as it is?

A.: Your opening remarks are a perfect illustration that nothing in the world of economics depends on one variable. I do think that interest rates have an impact on inflow and the dollar, but they are not the only influence. When interest rates were declining, for example, our competitor position was growing relatively stronger. You also have to look at what was going on abroad, and interest rates

abroad were indeed declining. I think, at the time, there was also an underlying confidence that the U.S. would continue to grow, which was partly because inflation was going down. That helped to motivate capital inflow and strengthen the dollar. You touch upon a delicate question when you ask about the dollar. Central bankers in general, myself in particular, like a strong dollar. I won't pronounce an appropriate amount for the dollar, but I wouldn't want to see a cascading decline of the kind we had in the 1970's, for a variety of reasons: it would have an inflationary impact and it would affect our domestic financial markets. Neither of these would be conducive to a sustained recovery.

To some degree, I think we have to earn our way out of our deficit trade position by a better inflation performance. To some extent, our trade performance has been influenced by the fact that we are growing much more rapidly than our customers and suppliers are growing. If business activity picks up in Europe, Japan, and elsewhere, that trend will change to some degree, but it won't correct the trade imbalance in the short run. Finally, these adjustments taking place in Latin America have had considerable success in some cases and this has improved their current account, but it has been largely at our expense. We are their most important trading partner, yet, between 1980 and now, our trade performance with Latin America has declined by about \$25 billion. As they regain health though, you don't want this situation to reverse itself in a hurry. It has stopped getting worse at this point and it's beginning to improve modestly.

Q: I was surprised not to hear any negative response when you spoke about protectionism, its influence, and how it relates to inflation. I think you will find people here who will argue that savings on imports are not passed on to the consumer.

A.: Let me say that this is a complicated area. You can always find a particular case where an industry can claim, with some coloration of the facts, that there are temporary factors at work. Indeed, there can be some unfairness in policies abroad that may justify temporary protectionist measures. I think at this point what we have to do is look at some of the bigger protectionist measures, like the Japanese and the auto agreement. Whatever justification there may have been originally, here we have an agreement that seemed, at least in the short run, to be of benefit to American labor by restraining an active source of competition. I don't think there is much doubt that the level of Japanese car prices in the U.S. is approximately two thousand dollars higher than it otherwise would be, and it's hard to believe that this fact doesn't have an influence on the pricing practices of American manufacturers, as well as on attitudes toward productivity, efficiency, wage bargaining, etc.