

For release on delivery
8:00 p.m. E.D.T.
April 28, 1983

Remarks by

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before the

Forex Association of North America

New York, New York

April 28, 1983

I am pleased to be here tonight as the guest of the Forex Association of North America on your 25th anniversary. Your members are primarily traders in foreign exchange. I have been told by some economists that, by their standards, your markets are highly efficient and you are blessed with near "perfect foresight." Their standard, I believe, is whether they could forecast better with an econometric model. My only response is that they ought to raise their sights!

Obviously, we have lived through a period of extraordinarily unstable markets -- certainly foreign exchange and other financial markets, but also markets for basic commodities and goods and services. It may be an exhilarating "game" for a young trader, but there is substantial room for doubt as to its benefits to the economy as a whole. I suspect you fundamentally share my belief that we need a stable economic environment at home and abroad if we are to enjoy a sustained period of non-inflationary growth in this country. That stability is, of course, the basic aim of Federal Reserve policy.

You will understand, I am sure, that to my taste, the fashionable emphasis on Federal Reserve policy as the dominant force for good or evil in the world economy has been enormously exaggerated. I realize high interest rates -- and maybe even more, sharp swings in interest rates -- have had a large influence on international capital flows and exchange rates. Other countries, as

a result, have sometimes been faced with sharpened dilemmas in the conduct of their own economic policies. Of course, those same capital flows and exchange rate movements have been troublesome to the United States itself.

I don't want to debate or defend every aspect of U.S. macro-economic policy; obviously the United States (as other countries) could, in concept, have had a better policy mix. But the real source of the instability, and the basic reason for the monetary policy approach adopted by the United States and its difficulty, seems to me straightforward; it is no secret to foreign exchange traders, and the problems have not been unique to the United States.

The point of departure for policy was that, after the deteriorating performance of the 1970's, a base for economic growth and financial and exchange rate stability could not be restored without dealing with inflation. I believe there was a public consensus that the job needed to be done -- a willingness to take and support strong measures. That was true because there was widespread concern that an already unsatisfactory situation -- a rising trend of prices and unemployment over more than a decade and declining growth in productivity -- could deteriorate further in an alarming way.

For one reason or another, the burden of dealing with inflation fell heavily to monetary policy. The technique chosen

was not very subtle -- restraint, as consistent as we could make it, on growth of money and credit.

Progress toward disinflation at first was slow -- almost invisible. There was enormous skepticism whether the inflationary tide could be turned at all. There were strong expectations about future price increases built into wage and price behavior. Growing budget deficits added to credit market pressures and fed the doubts about the future. Economic rigidities slowed adjustment, and as a result strong pressure on credit markets and interest rates persisted longer than anticipated. But for a long while there was little room for modifying policy in response to domestic or international concerns. The danger was that the wrong "signals" would only increase the risk that the whole process of restoring stability -- domestically or internationally -- would be longer delayed or even aborted.

I would point out that a number of other major industrial countries had come to more or less the same conclusion -- that the domestic inflation problem demanded priority. The point was in fact urged by the IMF and accepted at successive summit meetings. There was a common recognition that the prospects for future stability of any international system -- the possibility of restoring stability to exchange rates, low interest rates, and sustained growth -- would ultimately depend on the success of measures to restore domestic

stability in the leading countries, and most of all in the United States.

Now we can see clear progress in terms of declining inflation rates. But, we also have to recognize that stabilizing prices at a time of the most severe recession in 40 years is in no sense "victory." The real achievement will only be found in a non-inflationary economic expansion. And in that environment, we can repair and strengthen the strained fabric of international finance and trade.

From a U.S. perspective, I believe there are substantial grounds for optimism. Basic cost trends -- particularly wage increases -- have been substantially moderated. Productivity seems to be picking up once again. A recovery has started. Forces are in place to keep it going for a while, even though the expansion so far is still limited and uneven. Barring political upset in the Middle East, the risks of a third round of large oil price increases in a relevant time horizon have been dissipated. I realize interest rates remain very high by any historic standard. But continuation of the progress against inflation should, over time, provide a base for further declines to help sustain the recovery. While there are exceptions, a number of industrial countries seem to be somewhat similarly placed.

Such an environment should be conducive to recovery of world investment, growth of productivity, less financial

and economic pressure on the developing world -- and potentially to more stable exchange rates. But, there are, of course, hazards and risks as well. They won't disappear without strong effort, and the solutions will test the strength of our own resolve and of international cooperation.

The most obvious risk to sustained, non-inflationary expansion lies in our own budgetary situation. National budgets are, of course, preeminently the bread and butter of domestic politics, as well as of national economic policy. For the past two and a half years, the debates in the Congress have been dominated by the issue. The resolution of that debate is going to have a great deal to do not only with interest rate and economic prospects in the United States but also with the growth of the world economy -- and the stability of the monetary system -- in the years ahead.

The outline of the problem is familiar enough, and I won't linger over it. The potential for a continuing clash in the marketplace as growth in the private economy generates more private credit demands -- a clash that would be reflected in continuing abnormally high interest rates and doubtful prospects for investment and housing -- is clear enough. One aspect has not had enough attention: the pressure on our credit markets tends to attract capital from abroad, with continuing consequences for dollar exchange rates, for distorting our trade and competitive position, and for the balance of world saving and investment.

The problem cannot be solved by monetary policy. We must not be put in the position of validating inflation through excessive money creation -- that couldn't work for long in easing market pressures, and the effect would be to sacrifice our painful progress against inflation. But the alternative of seeing the private sector squeezed for credit is hardly inviting, either.

In the midst of recession, with inflation and private credit demands both declining, interest rates could drop substantially, as we have seen. But the circumstances will be different as the recovery proceeds. Prolonged huge budget deficits impair the prospects for lower interest rates, even in the face of lower inflation, and mean that monetary policy will need to continue to carry the burden of efforts to maintain the progress toward stability.

Fundamentally, policies aimed at domestic stability should not be at odds with stability in the international monetary system. Quite the contrary: as central bankers have argued ad nauseam, the stability of the international monetary system as a whole, and of exchange rates, within it, must rest on the stability of its component parts -- the main national economies, and most of all, the stability of the dollar internally.

However, restating that general truth does not dispose of the issue. The restoration of domestic stability is itself a difficult process with external repercussions; as we have seen, the process

is further complicated when the balance between fiscal and monetary policy is less than ideal.

We know exchange rates have fluctuated widely throughout much of the "floating era." While some or most of the major swings have had a rationale in terms of divergences in inflation rates, competitive positions, or "structural" changes, the extent and timing of some of the changes have, even in retrospect, been difficult to explain. Looking ahead, the question remains as to how we can provide greater assurance that, as the disinflationary process proceeds, exchange rates will in fact be more stable.

We can take the view of not arguing with the wisdom of the market -- that what happens, happens, and shouldn't be second-guessed by officials and bureaucrats with biases of their own -- or that exchange rate fluctuations are of secondary importance. But responsible officials do have an obligation to ask to what extent we can work more effectively to dampen extreme exchange rate swings that, by common agreement, seem far out of keeping with underlying needs and trends.

One means often suggested of working toward greater stability would be to intervene directly in a more coordinated way in the exchange markets. Fashions in that respect have changed from time to time in the United States, in Japan, and in various European countries. Philosophical and practical differences in that respect led to a decision at the Versailles Economic Summit to study the

issue together; that study is in the final stages of review. I don't want to anticipate the conclusion that will be reached, but I do believe it is fair to say that evidence as well as experience suggests that intervention is a limited tool that cannot, itself, alter major market forces.

However, my own belief is that we can hold out some prospect of damping extreme exchange rate movements in a context of greater domestic stability if we recognize the implications for domestic policies and their "mix" in the leading countries. The objective will certainly need to be defined and pursued with appropriate modesty, recognizing the large limitations on our ability to determine the "right" exchange rate and on the tools at our disposal. We should be skeptical about our ability to judge the "right" exchange rate -- even an appropriate "zone." But from time to time it may be possible to reach a consensus on when exchange rates seem clearly "wrong" -- at levels that are unsustainable and mutually damaging to our economic objectives.

To be successful in achieving greater exchange rate stability, market participants will have to be convinced that nations seriously include such stability among their policy objectives. Stating the point that way illustrates the basic difficulty -- in the past, when points of conflict arose, the exchange rate objective has often seemed to give way to so-called domestic objectives.

Over time, however, the objectives of domestic and exchange rate stability should broadly coincide. We have by now plenty of evidence that extreme and prolonged swings in exchange rates can themselves be damaging to domestic objectives, and changes in exchange rates provide evidence about the state of expectations and the degree of domestic economic pressure. More often than not, I suspect that a policy response to wide movements in exchange rates will turn out to be appropriate on domestic grounds as well. In other words, exchange rate movements can help "tell us" something useful, and we should be prepared to listen, accepting that the "discipline" of exchange rates can at times reinforce the domestic objective of stability. To take U.S. experience as an example, the tightening of domestic policy in late 1978, and again in 1979, had important international "ingredient," but was certainly in the direction consistent with domestic needs.

At the same time, we need to recognize the limitations on our ability to assess or enforce an "appropriate" exchange rate. Exchange rates are inherently two-sided, and action to stabilize them often depends upon cooperative action. National views on what is an "appropriate" exchange rate may, and often do, differ. Experience with fixed exchange rates clearly indicates that there will be strong differences on who takes the burden of policy action to maintain the exchange rate. As recent European events demonstrate again, that is a matter of strong domestic economic and

political sensitivity. It was reasoning along these lines that led to the decision to float in the first place -- to in a sense, leave it to the market to resolve the matter.

My conclusion is that, if we are not too ambitious, we can constructively do something to help stabilize exchange rates within the general framework of the floating system. As inflationary forces recede here and abroad, and as confidence increases in our ability to keep inflation under control, nations should be in a position to accept in the formulation and execution of monetary policy, and in the fiscal-monetary policy mix, a degree of discipline implicit in the desirability of greater exchange rate stability. It is in that broader framework that intervention may, at times, have a modest but useful subsidiary role to play -- and I welcome the discussions among the leading countries in an effort to reach a better consensus on the point.

Stability in the international system, as well as prospects for orderly expansion will more immediately depend on our continuing collective ability to cope with the strains on international and credit markets growing out of the heavy indebtedness of a number of important developing countries. The problems of Latin America and several East European countries are familiar to all of you. Financial constraints have abruptly halted growth and potentially placed severe strains on their economic and political structures. While we can, in time of need, provide strong

and effective support to our banking system, our economy and our credit markets could not be fully insulated from the repercussions of intensified international financial strains.

I believe real progress is being made in dealing with those problems. But we should not delude ourselves into believing that containment of the problem is equivalent to a solution. There is a sense in which the purely financial manipulations -- the provision of new money by the commercial banks and the "bridging" credits by central banks, the various "standstills" and rescheduled loans -- are stopgaps. We have rapidly moved from a market-driven system of lending to many developing countries to highly organized lending programs -- hardly a satisfactory situation. Nor is any return to "normalcy," in that respect, imminent. For their part, the borrowing countries, whatever their mood today, are not likely to find the present situation tolerable indefinitely.

All of this is a situation ready-made for spawning paper plans for some kind of grand reorganization of international lending. It's a game anyone with a little knowledge and a little imagination is tempted to play. You start by setting out some broad conception of who will lend how much, for how many years, at what interest rate, in accord with some preconceived notion as to how much money the borrowers can reasonably afford to pay, how much governments will be willing to provide, and how much the banks

should lose. Then, presumably, everyone is asked to "stand still" while a grand negotiation of terms proceeds.

I have to say that, while I admire their ingenuity, those across-the-board plans seem to me impractical. The world isn't going to stand still, and the vision of a negotiated across-the-board solution will be counter-productive if it diverts attention from the practical, immediate problems. In the United States, as you know, there is strong resistance to Congressional approval of U.S. participation in the enlargement of the resources of the IMF and the General Arrangements to Borrow (GAB), even though that institution has been long established and strongly supported by the United States through the years. I detect no probability of a favorable and timely response to a request for sizable new budget outlays to, as it would inevitably be put, "bailout" banks and "foreigners." I doubt that prospect would be all that much better in other countries.

There are other inherent problems. If public funds or private concessions could be negotiated on a generalized basis, there would be strong pressures to extend those benefits as a matter of simple equity to virtually all developing country borrowers; a system that provided relief only to those least prudent in the past could hardly be defended. In the wake of such negotiations, a return to "normal," in the sense of developing countries restoring their access to new private credit, would be hard to foresee. In

the end their long-run growth prospects could be inadvertently damaged by the application of such generalized programs of debt forgiveness.

Plainly, the problem cannot just be "papered over." But I believe the present approach is not simply one of buying time, and is consistent with more fundamental solutions. First, for their part, the major borrowers do have to adjust their economies -- internally and externally -- to restore a base for growth. It can be a harsh process, but that process is eased, not made more difficult, by cooperation with the IMF, the World Bank, and private creditors -- all of which will and do provide support when they have grounds for confidence that progress is being made. We can potentially, with the enlargement of the resources of the Fund and imaginative World Bank participation, provide more time and resources for the borrowing countries to do their part. Second, the adjustment efforts of the borrowers -- to be successful within a realistic time period -- do need to be complemented by growth and by lower interest rates in the developed world. I have already indicated some grounds for encouragement on that score -- though we have a ways to go to make that promise a reality.

In the light of the threat to stability and prosperity from international financial pressures, we can take some satisfaction from the fact that the situation has called forth a strong international cooperative effort. There was no "rule book,"

no pre-agreed approach or single international institution exactly suited to the job. But the fact is the IMF and the BIS, national governments and central banks of the Group of Ten, borrowing countries and the lending banks, all quickly recognized the nature of the problem and the common interest in working together to contain it. That is international cooperation in the flesh.

I was asked recently, as part of a survey of monetary officials, whether I sensed that international economic cooperation had in fact declined over the past 10 or 15 years. What people mean by cooperation is highly subjective, and I doubt my answer was enlightening to the inquirers. But, the question intrigues me, and I have tried it out on my colleagues at home and abroad. What surprised me -- and may console you -- is that in my informal survey a number of officials actually on the firing line throughout this past decade, in the United States and Europe, responded quite positively. In the face of severe challenge from technological change, from economic and political "shocks," and from the sense of more difficult and complicated domestic problems, they were inclined to see more willingness to consult in a meaningful way. They felt we are now more open and candid with each other, that we exchange more information -- and collect more of it together -- and that we are at least as willing as before to recognize joint problems and consider joint solutions. Implicit or explicit in that view was the idea that mutual recognition of the desirability, where possible,

of looking to "market" solutions can itself be a constructive act of cooperation.

For you, caught up in the crush and urgency of minute-by-minute decision-making, trying to make sense of the flow of orders and the latest flash on your computer screens, that all may seem abstract and distant. But my own conviction is that when the spirit is willing, we can in fact find our way toward greater economic and financial stability. The aim is not to deprive you of your joy or your livelihood. Rather we want to provide you with long and lazy afternoons of placid trading -- a calm characteristic of a stable international financial system.