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Remarks by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

at the

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I well remember sitting here a year ago listening to Prime Minister Nakasone address this Annual Dinner on his way home from the Williamsburg Summit. He spoke with firmness, both about the possibilities of a world recovery then still in its early stages, and about Japanese intentions with respect to its economic relations with the United States and others.

Well, you won't have the benefits of a Prime Ministerial perspective tonight. But a lot has happened in the last year to bear out his foresight. Indeed, by broad measures of economic performance, developments in both the United States and Japan have at least lived up to -- and mostly exceeded -- any reasonable standards that would have been set a year ago.

In this country, the rate of economic growth over the past 18 months has actually been as great as during any comparable period in the past 30 years: 6 million more people are employed, industrial production is up by 21 percent; and the unemployment rate has dropped by more than 3 percentage

points from the peak. Moreover, the trend of costs and prices has remained more favorable than for a decade.

In Japan, growth has been more subdued than here, reversing the relative pattern vis-a-vis the United States of most of the last twenty years. But the Japanese economy did not, of course, start from a point of so much unemployment and excess capacity. And Japan has led the industrial world in combining near price stability with low levels of unemployment -- a matter that remains a great challenge for all of us.

For all of that progress, it is easy to sense widespread disquiet about where we might be headed -- whether, in fact, the favorable patterns can be sustained. These days, those familiar words of Charles Dickens -- "It was the best of times; it was the worst of times" -- come readily to mind.

As I see it, the simple fact is, after years of strain and difficulty, we have enormous opportunities before us. But there are equally obvious risks and dangers.

Opportunity and danger, we are told, make up the Chinese character for crisis, and I understand it is the same in Japanese. If we are to seize those opportunities and repel those dangers, there is a lot to do on both sides of the Pacific -- and the Atlantic as well.

Looked at from the perspective of our bilateral relations, we are faced with a familiar -- but still growing -- imbalance in our trade accounts, reaching an annual rate of about \$30 billion in favor of Japan recently. For a time, that imbalance has not been without certain benefits to both countries. Rising Japanese exports to the United States, as with other countries, have helped pull the Japanese economy into stronger growth. And Japanese competition has helped keep our inflation rate down.

But an obvious and relevant question is whether it is at all sustainable. And that question looms even larger when we look at the matter, as we should, in a world-wide perspective, not simply

as a matter of bilateral relations. The Japanese surplus with us is a large part, but still only a part, of a broader pattern of a persistent and rising Japanese trade surplus, which appears to be moving to a record level of some \$40 billion a year. At the same time, our trade appears to be headed for a deficit of well over \$100 billion. That deficit amounts to about 3 percent of our total GNP, and close to 50 percent of our total exports.

As always, "special" factors must be taken into account. The United States has absorbed the largest share of the sharp import reductions and the export increases in Latin America as those countries have necessarily had to undertake strong economic adjustment programs. With different phasing of the economic cycle, our growth over the past 18 months has been more than twice the average of other industrial countries, tending to make imports grow faster than exports. Looking ahead, those forces should diminish -- they are diminishing. But they alone cannot account for the size of the swing. We

have to recognize, and deal with, problems that will only yield to more fundamental policy adjustments.

For Japan, those old questions of achieving more open markets -- for goods and for money -- remain, even though, as Prime Minister Nakasone promised a year ago, some real progress has been made. But behind the matters of external commercial and financial policy lie other questions of economic management.

We all envy the high Japanese savings rate. But in recent years a much less familiar consequence of that high savings rate has arisen. As Japanese growth has trended lower, savings generated internally are not being absorbed domestically, even though the budget has been in sizable deficit. Instead, capital has spilled out overseas, including to the United States. As it has done so, the value of the yen externally has not seemed to reflect the strength of Japan's trade and current account, or of its economy generally.

More limited domestic sources of growth and the highly competitive exchange rate have both contributed to the rising trade surplus.

Viewed in that light, one wonders whether Japan is fully meeting its domestic potential and whether it is not now too reliant on stimulus from abroad.

In the United States, we see the other side of the coin. As the economy grows rapidly, we can't meet both our domestic investment needs and a huge government deficit from a savings rate that has remained stuck in a channel of 6-1/2 to 9-1/2 percent of the GNP for many years, with no apparent evidence of change. During this period of remarkable expansion, we have resolved the problem in a way without much precedent for us -- we have become dependent upon an extraordinary net inflow of capital from abroad. Currently that inflow is running at a rate of more than 2 percent of the GNP; it is supplementing net domestic savings by about a quarter.

We currently rely on that foreign capital, but substantial costs are involved in the process. The capital is attracted in part by the extraordinary level of dollar interest rates. While interest rates likely would be still higher without the capital inflow, those same flows have, over the past year, been reflected in a further appreciation of the dollar even as our trade and current accounts have deteriorated. In a sense, then, both our internationally exposed industries and our financial markets are held hostage to the fact that we can only cover our investment needs by drawing on large amounts of capital from abroad.

For the time being, the situation has been manageable in domestic terms. Moreover, we have provided a rapidly expanding market for developing countries faced with severe external debt servicing problems; so far the favorable effects of our economic expansion on their current accounts appear to have outweighed the negative effects of our higher level of interest rates.



Nonetheless, there are elements in the current situation that cannot be sustained indefinitely. For one thing, the enormous trade deficits breed pressures for protection from those sectors of the economy that are not sharing fully in the expansion of the U.S. recovery. In the circumstances, I can only welcome the initiative taken by the President and other national leaders in London to counter those pressures. Instead of turning inward, they have begun to prepare the ground for another round of negotiations to relax, rather than to increase, trade barriers in the future. Nevertheless, the potential obstacles to that course here and elsewhere will be great so long as the underlying imbalances are not resolved.

For the United States, as for Japan, those external imbalances are in the end, a reflection of imbalances at home between the capacity to generate domestic savings and the propensity to invest and run deficits. And the remedies seem clearer here.

To put the issue at its simplest, we cannot forever continue to invest what we would like in plant, in housing, and in inventory and cover prospective federal deficits, in amounts far larger than our domestic savings. Something has to give. We can try to increase savings -- but the record suggests that is a slow process at best. We don't want to see lower investment, least of all by means of a squeeze on financial markets, prolonged high interest rates, or a sluggish economy. The remaining alternative -- reducing the federal deficit as fast as we can -- is by all odds the safest and surest approach; I am tempted to say it is the only realistic approach, in our own interest and that of others. The efforts of the Administration and the Congress to agree on a "down payment" against future deficits during this election year represent the beginnings of a constructive response, and we will need to build upon it.

The problem is reflected and amplified by the sense of growing concern expressed by many recently about the problems of international debt. That reaction is understandable in

the light of the sensitivity of the most heavily indebted countries to dollar interest rates.

But in another sense, the heightened degree of concern is ironic, for it comes at a time when signs of progress in dealing with the debt problem have been more evident than at any time in the last two years.

This isn't the time or place to linger over all the origins of the difficulty -- the successive oil crises, overly enthusiastic borrowing and lending policies fostered in substantial part by an inflationary environment and inflationary expectations, failures to encourage more direct investment in developing countries, an undermining of confidence that led to massive capital flight from other countries, and other factors. Suffice it to say all of us, borrowing and lending countries alike, have an enormous stake in seeing to it that the problem is managed successfully, in the interest of maintaining a favorable climate for extending the current expansion and

in the longer-term interest of the economic development and trade of the borrowing countries themselves.

One dangerous temptation is to see the debt issue only as someone else's problem -- for the borrowing countries themselves or for the big international banks, or for one country as opposed to another, or for one set of banks alone. But the fact is all have a stake, directly or indirectly, and the solution requires effort over a wide front.

The success of one borrowing country in making necessary adjustments and restoring external financial stability will help another, not just by example but because they trade with, and help finance, each other. The reverse is true as well.

Taking heavily indebted developing countries in Latin America and elsewhere and Eastern Europe as a whole, the large banks around the world -- certainly including those in Japan and the U. S. -- have a broadly similar exposure, and they are all dependent on the stability of the whole international financial

system. Corrective policies, by industrialized and developing countries, by banks and by international institutions, must be mutually supporting and reinforcing.

Another temptation is to seek an "out" from the slogging, continuing process of negotiation and refinancing country by country in some sweeping new initiative to settle the problem once and for all. Those proposals seem to me based on unrealistic assumptions -- typically on an expectation that someone else will assume large new burdens. I do not sense, in that connection, any willingness on the part of the U. S. Congress, or other parliaments, to undertake massive new aid programs for countries that, in the economic hierarchy of developing countries, are among the most advanced. Lending banks understandably do not volunteer to provide large interest subsidies for, or to write down, loans that can, after all, be serviced; nor is that necessarily in the interest of countries that will be looking to international markets for credit to support growth in the years ahead. To take the other side, we also

cannot expect borrowing countries to make necessary adjustments to get their houses in order without reasonable prospects that good performance will result in continuing access to the new credit and the debt restructuring they need.

The truth is that successful management of the problem within these constraints can continue so long as certain fundamentals are respected -- continuing growth among the industrialized countries as a whole, maintenance of open markets for the products of developing countries ready to compete fairly in world markets, reasonable stability in financial markets (or better yet declining interest rates) which in turn rest on keeping inflation under control, and persistent and effective adjustment efforts by the borrowers. None of that requires perfection in every respect, and none of it will produce sudden and complete success in every case across the board. The process will take time. But it is working.

We need to guard against waves of euphoria and undue optimism that the problem is behind us because some important milestone has been passed -- such as the successful initial response to the Mexican debt crisis. But neither are there grounds for pessimism because for a few months interest rates have increased in the midst of a strong economic advance, or because one country or another has had a setback in adjustment. Nor do such developments suggest a brand new strategy must be concocted, despite the frustrations and complexities inherent in developing particular programs for particular countries. The fundamental reason for the complexity is that many countries are in fact involved, with diverse histories, needs, and capabilities. Their unique problems are not susceptible to simplistic, universal and sudden solutions. But they are susceptible to patient effort, and by now there is quite a lot of concrete evidence to that effect.

The core of that effort lies in the adjustment efforts of the borrowing countries themselves -- all else rests on the perception and the reality of their own efforts to rebuild a base for sustained growth. In most cases, as you know, those actions have been framed in cooperation with, and have received the financial support of, the International Monetary Fund, and that is a crucial ingredient in building further financial support.

In some cases, countries have reduced their budget deficits, as a share of GNP, by 5-8 percent in one year -- the equivalent of moving the U. S. budget deficit into surplus. In order to correct long-standing distortions in relative prices, they have undertaken sharp depreciation of their currencies and raised the prices of goods and services produced by the public sector. In the process, a number of countries that had grown accustomed to rapid expansion of economic activity have, perhaps inevitably, experienced a contraction. But much more positive results are appearing as well.



The combined current account deficit of the non-OPEC developing countries was almost cut in half between 1981 and 1983 -- the reduction in the deficits of those countries that have been operating under IMF-approved stabilization programs has been even larger. Some key debtor countries -- Mexico and Venezuela in Latin America, Yugoslavia and Hungary in Eastern Europe -- have actually moved into current account surplus. In others, notably Brazil, trade surpluses are exceeding expectations.

One frequently hears complaints about the size of these adjustments -- they certainly have been a factor in the enlargement of the U. S. current account deficit, and have been achieved in part by massive and unsustainable reductions in imports by the deeply indebted countries. The justification for those programs must be clear -- to lay the base for export expansion and renewed growth. And that process is now underway in some important countries, particularly those who started effective adjustment programs earlier and who have been able to take advantage of growing markets in the United States and elsewhere.

All this has set the stage for a new phase in financing programs tailored to the progress and circumstances of individual countries. The bulk of the financing has been, and will continue to be, provided by commercial banks, and is a matter for negotiation by borrowers and lenders. But I'm glad to see that, recognizing the progress made in Mexico, the banks are now prepared to enter into negotiations for a multi-year restructuring of Mexican debt on terms that both reflect the stronger credit-worthiness of that country and that can pave the way for Mexico to deal with any limited further needs for new money in the years ahead through more normal and spontaneous market processes. Other countries, while at an earlier stage, are finding needs for new money appreciably reduced.

At the other end of the spectrum, to be sure, effective adjustment programs still need to be put in place and financing is in abeyance. My point is not that it is all a simple and smooth process -- that vision is an illusion. The difficulty

is typically greatest in those countries where past policies have not engendered the confidence of their own citizens, with the result that capital sorely needed at home flowed elsewhere. Effective measures -- which in practical terms means strong measures -- must sometimes be shaped in the midst of blossoming democratic movements. That implies the need for a high degree of consensus -- no simple task even for those of us who have enjoyed stable democratic governments for many years. But democracy is also not likely to flourish in the midst of accelerating inflation and economic isolation.

What the borrowing countries seem to appreciate -- what they must appreciate to sustain the effort -- is that economic growth over a long period ahead, and prospects for political stability, are dependent on an ability to function effectively in an interdependent world. In that world, credit-worthiness and credit availability are essential to support trade and

investment, and once lost, those qualities are hard to restore. In the end, the ultimate test of a successful economic program will not be whether at a moment in time it is acceptable to the IMF or to bank lenders, but whether it in fact can restore and maintain the confidence of a nation's own citizens, and whether, as a consequence, its own savings are employed productively at home and returned from abroad.

Meanwhile, lenders need to appreciate that countries launching an adjustment effort will need financial support from abroad for a time that will not be forthcoming spontaneously -- that is by the uncoordinated action of individual banks and countries. Indeed, as debt problems first became apparent, the understandable reaction of individual lenders was to pull back abruptly, under the pressure of directors, accountants, and public opinion suddenly conscious of risks that had not been so apparent only a short while before. But experienced bankers quickly realized that that approach would guarantee

precisely the result they feared -- that borrowers would in fact be unable to repay so suddenly, that their economic futures would be jeopardized, and as a result the basic value of existing credits undermined.

By cooperation, and at times with transitional support from governments and central banks, a coordinated and constructive approach has been maintained, resting on analysis that new credits, and extension of old credits, can be justified when necessary adjustments are undertaken and long-term debt servicing capacity maintained and enhanced. That kind of approach is not new for bankers; a similar appraisal is necessary with domestic credits in difficulty. What is new is the level of complexity when hundreds of lending institutions, various governments, and international institutions are all involved with many differing interests and historical lending relationships. The one feature that tends to bind all these efforts together is a common appreciation that the success of the total effort depends on cooperation by every significant participant.

I frankly draw much more encouragement from this performance of the past and present than I do from dreams of any radically new approach, grounded more in highly generalized abstractions than in the practicalities faced by those with a financial or legislative responsibility. Nor do calls to "politicize" the issue here or elsewhere carry more promise; indeed, they carry the obvious risk of impeding a flow of private finance, now and in the future, with no obvious substitute available.

I do not minimize the real strains or, almost as important, the sense of fatigue that can set in when a large and complicated effort needs to be sustained and results take time. That is one reason why, as progress and performance justify it, it seems to me critically important to move to a new phase in which individual borrowers be able to refinance maturing debt for some period ahead at reasonable terms, permitting both borrowers and lenders to have a more certain

and stable base for planning. As the initial adjustments under the aegis of the IMF are made, the role for the World Bank and the regional development banks should become relatively more important, both in helping borrowers develop appropriate investment strategies and seeing to it that they can be appropriately financed. We should be alert to the possibilities of developing varied financing techniques, including so-called co-financing by international institutions and private lenders, methods acceptable to borrowers and lenders of protecting against surges in interest rates analogous to those used in domestic markets, and the like. All of this would represent a natural evolution, providing both a transition to "normalcy" and a basis for constructive new patterns of international lending. After all, we have learned from bitter experience that all was not right in those halcyon days of easy international lending in the 1970's.

Whether or not "crisis" in fact can be converted into opportunity will rest on the efforts of no single country,

borrower or lender alone, but on the joint efforts of many. Certainly, both the governments and banks of the United States and Japan have a key role in this process. We have, in fact, been working cooperatively, together and with others, and no bilateral frictions in other economic areas should obscure that encouraging fact.

The progress of the past is the best justification for renewed and continued international effort. At the same time, both the United States and Japan -- the two largest economic powers -- have no less important work to do at home to achieve a better balance in our own economies.

We have come too far, at too much cost, to fail to seize the opportunities now.

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