For release on delivery
1 p.m. C.S.T. (2 p.m. E.S.T.)
Saturday, March 30, 1985

Remarks by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

XIII American-German Biennial Conference

Dallas, Texas

March 30, 1985

It is not just a routine remark for me to say I'm glad to be back, at least for a day, at this Biennial Conference. There are old friends from both sides of the Atlantic that have labored long and effectively to enhance and preserve German-American relations. Maybe more important, there are, as well, younger people ready to carry the work forward.

The American Council on Germany and the Atlantik-Brucke are, in themselves, small organizations, and the Biennial Conference one among many meetings. But their importance lies in being catalysts for something much larger. They are a part of the common cause -- the "gemeinsame Sache" -- that has inspired the relations between our two great nations over the postwar era.

That common cause is built on a solid foundation -- a mutual respect through the years for the basic principles of market-oriented economies, of freedom of trade and capital movements, of stability, and of democracy and of the interdependence of our security.

But however strong, common foundations do not automatically result in harmonious architecture or understanding relationships among different households. That takes constant nurturing and effort. And that was the role the American Council and the Atlantik Brucke undertook some 30 and more years ago. Under the inspired leadership of John McCloy and Chris Emmett on the American side, and with Konrad Adenauer helping to inspire the work of some eminent and thoughtful Germans, a real impact could be made at a critical time. The founders were wise enough to recognize that, for all the antagonisms and distortions of war, the foundation was there, and that an edifice of productive cooperation could be rebuilt -- that indeed it would be an essential to peace and prosperity more generally.

How accurate their perception was!

Of course, the specific challenge then seemed quite different. America appeared as a kind of colossus standing astride a largely shattered world economy -- and also a strong beacon of hope to younger Germans looking toward finally building a stable democracy from the ruins of the past. For our part, farsighted men saw that our own prosperity and security could not be pursued in isolation, but only as a part of an Atlantic world in which a rebuilt Germany would naturally have to play a large role. In that context, there was a natural impetus among some key leaders of good will on both sides to reach out and work together -- to put aside all the anger and divisive forces.

I suppose the celebration of John McCloy's 90th birthday symbolizes the passage of that era.

Germany has long since fully recovered economically. The plant of democracy is strongly rooted -- and with it some of the diversions and uncertainties characteristic of democracies everywhere. Moreover, Germany plays a key role of leadership in the European Community that, economically, is as large or larger than the United States. So other preoccupations, internal and external, political and economic, have quite naturally sprung up that can dilute the trans-Atlantic tie.

Among a new generation in both countries, without the fresh and personal memory of war and destruction, the strong imperative to work together may not be so instinctive. We both have other concerns -- not necessarily inconsistent with close trans-Atlantic relationships -- but perhaps turning more of our energies to other priorities.

Nonetheless, the foundation of common economic and political philosophies remains, and with it the common cause. As I see it, the American Council and the Atlantik Brucke have a special responsibility to help maintain the flame -- keeping the lines of communication and cooperation open among leaders, supporting contact and educational exchanges among new generations, and helping to identify and deal with points of friction as they emerge. In some ways, the job may be more difficult today than in the aftermath of war precisely because, on the surface, it may no longer seem so urgent -- it's too easy to take a basic cooperation for granted. But the fact is the relationship needs constant attention lest we inadvertently drift apart.

In the area of economic policy, a high degree of understanding between the United States and the Federal Republic has been -- and I think remains -- natural because the basic market orientation of both countries has been so strong, and because of our mutual concerns about economic and price stability. Certainly, I can testify that relationships between our central banks and finance ministries are easy, personal, and more or less continuous -- the old diplomatic phrase of "frank and full discussions" carries no ambiguous connotation in describing those contacts.

Naturally, economic performance has not always met our aspirations. Our fall from grace in the United States on the stability front during the 1970's was more marked than in Germany, and the weakness of the dollar at the time complicated the job of economic management in Germany. In these past few years, as we have struggled with some success to restore price stability, I sense German officials have been consistently supportive of the priority necessary for that effort. They have been so, even as the recovery and then soaring strength of the dollar again complicated German monetary management. I suppose that welcome support for our efforts is instinctive for a country whose central bank, at its creation, received a special charge as "guardian of the currency" in recognition of the fundamental priority for stability in a well-functioning economy.

Today, we can observe in the industrialized world as a whole a pattern of converging price performance at a relatively low level of inflation. I know a lot remains to be done. But for the first time since the 1960's there has been clear progress toward the holy grail of stability — the internal stability that, we have told each other constantly, is the prerequisite for more stable exchange rates and for sustained and balanced growth.

I don't have to recite to you all the evidence that those fruits have been elusive. So far as exchange rates are concerned, the morning paper -- or, if you are a modern-day executive, your computer screen -- reports more volatility, not less.

On the American side, after a deep recession, we have indeed had vigorous economic expansion -- among the strongest in our postwar history. In two years, employment has increased by some 7½ million, and the unemployment rate has dropped by 2½ percent; more of our population is at work than ever before. Business investment has surged higher, and productivity trends have shown some signs of improvement from the poor record of the 1970's.

On the other side of the Atlantic, in contrast, Germany has found it difficult to generate new jobs despite some evident recovery in economic activity. And that pattern has been typical of Europe generally, with unemployment hovering around a postwar high of 20 million, even though most countries have benefitted from strong markets in the United States. In Japan, growth has been faster, and unemployment remains low. But even more than in Europe, much of the expansionary impetus has come from abroad.

That contrast in recent performance has, as you know, fed and reinforced a striking change in psychology and attitudes toward the outlook in Europe and the United States -- Euro-pessimism on the one hand, and renewed confidence and optimism in the United States on the other. And that contrast in attitudes amplified the extraordinarily strong rise in the dollar over most of the past two years, even in the face of sharply rising trade and current account deficits.

The contrast in attitudes is, of course, more than an economic phenomenon. But an economist observing the history of the postwar period can, I think, raise some questions as to whether the swing in sentiment has not been overdone.

My own education and experience in international finance began in the 1950's, during the days of the so-called "dollar shortage." And I well recall that, no sooner had we digested and half begun to believe all those learned treatises explaining why the demand for dollars would remain virtually inexhaustible, the facts and the perception changed. At the beginning of the 1960's, the Deutsche mark was revalued slightly upwards, and that was just the harbinger of a strong trend toward appreciation. Instead of dollar shortages, we soon began analyzing the "dollar overhang," and elaborate plans were spawned for funding or consolidating "excess" dollar holdings abroad. And in the 1970's, Germans could too glibly talk of the decay -- der Verfall -- of the dollar.

Well, only a few years later, the dollar was born again -- and we have heard much more talk of "super dollar" than of decay. Dollar assets have been described as the most attractive of all investments, seemingly oblivious of prevailing rates of exchange or the fact that we have been swinging fast from being the world's largest creditor to being its largest debtor nation.

Any central banker is inclined to like a strong currency -- particularly one that reflects internal strength. I am no exception in that respect. There have indeed been solid reasons for the recovery of the dollar from the morass of the 1970's. But I am also more than a little skeptical of the notion that Germany, and Europe as a whole, are somehow trapped in structural rigidities that doom it to slow growth and leave little or no room for policy maneuver -- or that the United States can safely relax in the glow of a strong cyclical expansion.

It's hard for me to forget, for instance, that through the 1970's the German economy was characterized by considerably faster growth in productivity than the United States, that "guest workers" were needed, that German industry was and remains highly competitive in international markets. Certainly, Germany has for a long time maintained a better record on price stability than its trading partners. And it's equally hard to be oblivious to the fact that the rising trade deficit in the United States is now undercutting our expansion and incentives to invest domestically over a wide range of manufacturing industries.

The current volatility of exchange rates mirrors an unsettled nature of expectations -- the sense that something is out of kilter, despite all the progress made toward containing inflation here and elsewhere and toward restoring growth. And certain facts seem to me to underline that uneasiness.

There is the still widening gap in our trade accounts, which has increased by some $100 billion since 1982, hardly a sustainable trend. Our interest rates are still extraordinarily high, by world standards or those of our own experience. Abroad, unemployment has been stuck at high rates, and much of the expansionary impulse has been derived from the United States, rather than "home grown."

But I also believe that we all have made a lot of progress toward our mutual goals of growth and stability, and we can build on it. What needs still to be done, here and abroad, seems to me both reasonably clear and well within our economic and political capacity to implement, so long as we work together.

None of you will be surprised to hear me say that decisive action to narrow the Federal budget deficit in the United States ranks first on the list of needed actions -- and that we should achieve as much of that as possible by reining in expenditure growth. The simple fact is that we have an enormous gap between what we save internally and the demands we place on those savings. So long as we face the need to finance huge deficits, now approximating $200 billion, on top of business investment and housing needs, that disequilibrium will remain. And, one way or another, the economy will be distorted.

So far, we have been able to bridge the savings-investment gap with surprising ease by drawing on savings from abroad in unprecedented quantities, amounting to fully a quarter of our net domestic needs for investment and deficit financing. But that capital inflow, in turn, implies an equally large and rising current account deficit. Sectors of the American economy exposed to international competition -- that is, much of industry, mining, and agriculture -- are paying a heavy price. Surely, a process of sharply rising international indebtedness and a weakening competitive position is not sustainable indefinitely.

Right now, we have no satisfactory alternative to prolonging the capital inflow because neither the budget deficit nor the trade deficit will disappear overnight. That will require us to maintain a strong sense of confidence in our ability to maintain growth in a framework of stability. In that respect, there is a particularly heavy burden on monetary policy. Certainly it is not an environment in which we can neglect the effort to nurture greater price stability, upon which confidence depends. In such circumstances, to yield to any temptation to try to substitute money creation for a shortfall in real savings would be to aggravate the problem.

Instead, we have to close the budget gap. If that takes time, as it must, to fully implement, it is within our ability to take decisive action to set us on a clear path toward that goal. The critical time, for the economy and for the political calendar, is now.

Out of sheer frustration, as things now stand, pressures are building in the United States for protectionistic measures, even among industries and segments of the labor movement that traditionally have supported liberal trading policies. Such a response would deal with symptoms, not causes. In the end, like inflationary policies, protectionism would only complicate the problem. It does not deal with the underlying imbalance between our capacity to generate internal savings and the demands we place upon those savings.

So long as that basic imbalance remains, we perhaps could, in theory, shift the pressure points from one sector of the economy to another. Suppose, for instance, we somehow succeeded in reducing the trade deficit by the brute force of controls, or by depreciating the currency. Then, by definition, the net inflow of capital would also decline. Other sectors of the economy dependent, directly or indirectly, on that flow of capital would be sharply impacted -- with housing potentially the most vulnerable. And it's also evident that any purely economic analysis of that kind of "trade-off" can not capture the crushing effects of the largest and strongest economy in the world leading us all into the trading equivalent of mutually assured destruction.

Those protectionist pressures are rightly being resisted by the Administration and, more or less successfully so far, in the Congress. But I suspect that political resistance can be well sustained only to the extent our trading partners -- especially in the industrialized world, but in developing nations as well -- resist protectionist pressures within their own countries, and those in exceptionally strong trading positions -- such as Japan -- must find the will and the means to move toward liberalization.

Germany has, of course, been in the forefront of that effort through the years. There, it may not be so much a question of more liberalization, but of taking continuing leadership in the mutual effort to encourage others to emulate its example. The torch of further liberalization through international negotiations needs to be held high; Germany has strongly supported that initiative.

Such negotiations may well be a labor of years. But, in this instance, as in so many others, a good offense -- a clear sense of constructive goals and steady effort toward those goals -- may be our best defense.

In other respects, there are strong positive aspects of our recent performance, and these may have implications for others.

Certainly, Germany, like other countries, does have important structural rigidities that impede new business formation and innovation, impair labor markets, and inhibit growth. Those rigidities need to be dealt with. It takes time. An outsider can offer little in the way of detailed prescriptions for another economy with its own social and political traditions. But we can and do welcome the clear recognition and emphasis on those structural problems in a country whose example and efforts are so important for the whole of Europe.

One wonders whether that necessary process can be integrated with, and indeed supported by, some changes in emphasis in more general economic policy. Germany through recent decades has achieved a remarkable record of price stability. Notably, that record has been well maintained even in the face of the sharp depreciation of the DM against the dollar, which has been reflected in rising costs for oil and some other imports. Moreover, substantial progress has been made in containing a relatively large budget deficit that arose in earlier years.

No central banker -- certainly not this one -- has anything but support and admiration for those efforts.

At the same time -- looking ahead -- there are some nagging questions.

For more than two years, growth in the United States has, directly and indirectly, provided the principal impetus for the world economy. The United States accounts for some 40 percent of the GNP of all OECD countries. But in 1983 and 1984, the growth of demand in the United States accounted directly for some 70 percent of OECD growth, and indirectly presumably for more. While our output, measured by the GNP, rose by more than 12 percent over those two years, some $140 billion of demand generated in the United States flowed abroad. That demand created exports, jobs, and GNP elsewhere than in this country. Indeed, for some countries, growth in exports to the United States has been the most important single factor providing stimulus to their economies.

For awhile, that pattern has brought benefits to both sides -- growth abroad, and useful products and resistance to inflation in the United States. But huge and widening trade imbalances are not a secure foundation for sustaining growth or containing inflation either here or abroad. And the prospect now is that, after two years of extraordinary growth, the pattern of expansion in the United States may be less ebullient. Indeed, as I indicated earlier, import penetration has itself reached the point of discouraging some domestic production and investment.

Fortunately, in Germany and elsewhere in the industrialized world, a growth trend now seems to be reasonably well established. Yet, that growth, in the eyes of most observers, official and non-official, does not seem to be strong enough in Europe to reduce appreciably the historically high levels of unemployment. Moreover, unlike in 1983 and 1984, the impetus from the United States is likely to be diminishing.

Meanwhile, in Germany, as in the United Kingdom -- and in stark contrast to the United States -- the structural budget position appears to have reached balance or surplus. In other words, the recorded budget deficits now are a reflection of a period of slow growth and higher-than-normal unemployment, rather than a basically divergent trend of revenues and expenditures. Viewed from this distance, one wonders whether, in all the circumstances, the past efforts have not now won for the authorities a degree of fiscal flexibility that could be usefully employed, for instance, in improving incentives and otherwise promoting economic efficiency and structural adjustment. I know that some planning for tax reduction has been on the German agenda.

Should the DM stabilize -- or its appreciation relative to the dollar of recent days persist -- one source of upward cost-price pressures in Germany would end. A natural consequence could be that the monetary authorities, too, might find themselves with more maneuvering room, to be usefully employed if needed to encourage growth, without jeopardizing prospects for stability.

I realize all of that would be much easier in an environment in which the United States is not itself drawing so heavily on world savings, an environment in which we could enhance the possibilities of sustaining lower interest rates consistent with further progress toward price stability. That is, of course, why action on our budget deficit is so crucial to the whole effort.

I need hardly belabor the fact that success in the United States, in Europe, and in Japan in providing growing and open markets will also be critical to the efforts of much of the developing world to struggle out from under its heavy burden of debt. After more than two years of successfully coping with the immediate debt crisis, some lessons seem clear in that respect.

The major borrowing countries do have the potential for balancing their external accounts -- or at the very least sharply reducing the need for new bank lending -- and at the same time restoring growth. Mexico, Brazil, and Venezuela have gone a long way in that direction already, showing the way to others. Success over time will, in my judgment, require not only self discipline but also steps to liberalize their own economies. They must be made more flexible, efficient, and competitive and more attractive for private investment, whether by their own citizens or from abroad.

It's not easy for any of us to break out of past patterns. Constructive new measures in developing countries will be introduced and sustained only as their leaders can offer people realistic hopes that the efforts will pay off. And that "pay off," in the end, will be dependent on our efforts in the industrialized world as well as theirs -- our success in sustaining our own growth, in maintaining open markets, and achieving reasonable interest rates. No IMF programs, and no series of bank financings or refinancings, important and imaginative as they can be, can substitute for those fundamentals.

Nor can we really expect the volatility in exchange markets -- with all its connotations of uncertainty and unsettlement -- to subside in any lasting way without addressing the elements in our policies that give rise to economic imbalances. As I emphasized at the start, the cornerstone of that effort lies in the progress toward price stability among the leading countries. In that respect, the omens are better than for many years. But taken alone, that progress may not be enough to assure a stable international system.

Indeed, our experience with floating exchange rates over the past 15 years has not, to my mind, been totally reassuring -- certainly not when measured against the expectations of many. The floating system has, of course, been justified on the strongest of all grounds -- that, after all, in its way, it has worked, when no other arrangement seemed practically feasible. But the amount of volatility has been large, and so far has not decreased.

If we can achieve better balance in our growth, and sustain that growth in a context of greater price stability, then we should also have the basic "environmental" conditions for exchange rate stability. If spontaneous market forces then do not develop a more stable exchange rate system, I believe we have a further challenge for our cooperation efforts -- the challenge to think hard about ways that governments and central banks can better encourage that result.

Inevitably, relationships among the dollar and the mark (in its role as a national currency and as a central part of the ECU) are pivotal to any wider stability. And certainly, the exchange rate today is too important an economic variable to ignore in our policy making. It is simply another aspect of the interdependent nature of our economic relationship, the health of which is of significance to far more than our two countries.

That needed economic cooperation can flourish only in the larger context of sympathetic understanding reaching to all levels of society in our two great democracies.

In both countries there are competing and compelling demands for attention elsewhere, internally and abroad. To a degree, that's natural and inevitable. The unique atmosphere of intensity and urgency that led to the formation of the American Council and the Atlantik Brucke -- and that underlay the broader constructive effort to rebuild our political ties and a shattered economy -- is no longer present. But the need to maintain the strong ties of communication and understanding that originated in that period remain.

The function of meetings of this kind, and the work of the American Council and the Atlantik Brucke, is to attend to that continuing need. I wish you every success, because nothing seems to me more certain than that the relationship between our two countries will remain central to our peace and prosperity.

* * * * * * * * * * * * *