Remarks by

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Chairman, Board of Governors of the Federal Reserve System

Commemorating

The Dedication of John E. Simon Hall

Washington University

St. Louis, Missouri

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I am delighted to be here this afternoon on this special occasion.

Your presence here today reflects the esteem in which you all hold John Simon, the importance of Washington University, and its constant quest to keep abreast of -- and to anticipate -- the needs of the community and the nation. The new building is, in the first instance, a place for students and scholars. That is the central aspect of what a university is all about. But a professional school, and particularly a School of Business and Public Administration, seems to me also something more. The teaching and learning have a direct application to improving the well-being of all of us, working together productively.

That's not a new thought for either the University or St. Louis. They have both long been blessed with a sense of energy and destiny since the days this city became the gateway to the West. The national reach of much of your industry is one aspect. The strength and support of the University is another.
I'm tempted to add to that the quality of your baseball.

I first came to fear that as a Brooklyn Dodgers fan in the 1940s. Then, as a Mets fan there was 1985. But 1986 will, of course, be a little different in that respect.

The fact that the John E. Simon Hall is the largest academic building on the campus of Washington University and the new cornerstone of the Hilltop community seems to me symbolic. It defines your faith in the American economic system itself and the ability of a trained citizenry to make it better.

That economic system is again showing its innate vitality. We are now well into the fourth year of economic expansion. That in itself is about as long as the average for postwar expansions. Moreover, today, more people are employed relative to the working age population than ever before.

What is more unusual is that the expansion has been sustained without any pickup in the rate of inflation. Indeed, with oil and other energy prices sharply lower, concerns about a resurgence of inflation seem to be receding, rather than the opposite.
That has helped set the stage for strong increases in both bond and stock prices, and interest rates have returned to their lowest level in many years.

I am a cautious central banker. I get a little suspicious when there is so much ebullience in financial markets. But that is welcome to the extent it reflects well-founded confidence in longer-run prospects. Many have set out the evidence to support that view. To be sure, growth in recent quarters has been less vigorous than had been generally expected. But after 3-1/2 years the signs that in the past have signalled the onset of cyclical downturns are still generally absent.

With only a few prominent exceptions, industry appears to have inventories under control. Pressures on productive capacity by and large are limited or non-existent. Wage restraint in many industries and lower commodity prices have kept costs under control. As the period of low inflation is prolonged -- as we become accustomed to more stable prices -- the chances of sustaining stability seem to me to improve. It can become a habit.
In that context, the prospects for extending the expansion also have probably been enhanced, by recent developments in the world financial and energy markets and on the budgetary front.

Our massive and rising trade deficit has been one obvious and serious flaw in an otherwise strong economic advance. Manufacturing industry, open to foreign competition, has simply not shared in this phase of economic expansion, tending to retard growth generally. But, with the foreign exchange value of the dollar falling by some 30 percent over the past year, the international competitive position of American industry is now improving. Inevitably, such a depreciation in the dollar also has inflationary risks. But the sharp break in oil prices is providing an important offset to higher import prices. And the lower prices for gasoline and other fuels will over time in the process release real purchasing power that American consumers will spend for other goods and services.
Rising stock prices and lower interest rates also reduce costs of capital and should also help to support further growth. And, if we carry through on the expressed intention to cut the budget deficit significantly year by year, a potential source of renewed pressure on interest rates as the economy grows more rapidly would be alleviated.

Both economic theory and common sense suggest that these forces, in combination, could help provide a solid base for sustained growth with greater price stability.

So there is a lot to cheer about.

But I also get paid to worry. Central bankers have a reputation. We have a haunting fear that someone, someplace may be happy. There is plenty that could go wrong if we collectively let down our guard -- if we forget the effort that was necessary to deal with accelerating inflation; if we fall into the trap of stagflation -- an ugly word for an ugly situation -- or if we fail to deal with points of pressure and strain, here and abroad, in our financial system and in the real economy.
Then we will not have earned all the confidence that financial markets are displaying.

Take the case of lower oil prices that has engendered so much optimism in most parts of the economy. I say "most parts" advisedly, because it is also obvious that sizable parts of the country heavily dependent on energy exploration and development have been catapulted into recession-like conditions. The oil companies are slashing capital spending plans and laying off workers. The effects on foreign energy producers undoubtedly are as acute, and their imports -- our exports -- will be further reduced. New questions have been raised about the pressures on some financial institutions. By contrast, the higher spending expected to flow from the increased purchasing power of American consumers and augmented cash flow of oil-consuming businesses may take awhile to materialize.

That is one reason the incoming economic data have been so mixed. On the positive side, employment continues to rise briskly; housing activity is surging in response to the sharp declines in
mortgage rates; and consumer spending generally has been well-maintained. But other indicators of activity -- including business investment -- are much less favorable.

There has plainly been overbuilding of offices in a number of areas, spurred in part by the generosity of tax benefits. Agricultural production has been growing world wide, and prices have been under downward pressure, threatening important parts of our farm economy despite its vaunted efficiency. And the relatively recent depreciation of the dollar is only one factor, important as it is, in our prospects for trade.

As we try to sort out these cross currents in the economic scene, several points stand out, each indicating unresolved, or only partly resolved, problems. Failure to deal with them effectively could undercut our growth, our stability, or both.

The first of those questions revolves around our trade problems and relative rates of economic growth, here and abroad. During most of this expansion, domestic demand growth in the U.S. has been
outstripping the increase in what we produce by a sizable margin. The difference between growth in our demand and our output is a reflection of the enormous increase in imports and our rising trade and current account deficits. We have created about 11 million jobs in just over three years in the United States, but we have also turned to importing, net, more than 3 percent of our gross national product, equivalent to a current account deficit of almost $150 billion by the end of 1985. That process has, in effect, created export opportunities and stimulated job creation elsewhere. The irony is that, even so, new jobs in Europe and Japan have lagged far behind ours, and their rate of GNP growth has been slower.

That process of the U.S. acting as motor for the world economy cannot be sustained indefinitely. The trade and current account deficits become both politically and economically intolerable. Protectionist pressures have been stronger than at any time during the postwar period, threatening to undercut the liberal trading order upon which the prosperity of all countries depends.
Meanwhile, we have become utterly dependent upon a need to borrow abroad to cover the massive current account deficit. That is never a comfortable position, however strong the country.

We have been fortunate that funds from abroad have flowed so freely to the United States in recent years. Partly, that has reflected relatively high interest rates. But it has also reflected to a considerable extent widespread confidence in our economic prospects and in our political stability. And the availability of that foreign money has helped keep interest rates lower than would otherwise be possible at a time when we have been borrowing much more than we save.

Fortunate as we have been, it is clearly not healthy for the largest and richest country in the world -- in its own interest or that of others -- to run so large a trade deficit, to use up so significant a fraction of the world's savings to finance that deficit, and incidentally to count on foreign funds to help finance, directly or indirectly, our budget deficit as well. Our
lending abroad has practically stopped. We have become a debtor nation. Our competitive edge and investment in manufacturing had eroded.

The recent depreciation of the dollar can help deal with the competitive problem. But, however necessary, a depreciating currency is hardly a free ride. Over time, it carries an inflationary potential, and can undercut the confidence that is necessary to attract capital. As our trade balance does improve, as we hope and expect, we will no longer need to borrow abroad. That, in itself, would be healthy, but it also implies that we will need to find some other way to finance our domestic needs.

There is, in my judgment, really only one practical option in dealing with that problem. Economic history gives little basis for counting on a great increase in the rate of domestic savings. We want to maintain high levels of business investment and housing that absorb large amounts of those savings. The remaining option is to cut our budget deficit which, today, diverts so much of our savings potential.
That is why so much is at stake in the perennial budgetary debate in Washington. The impetus generated by the Gramm-Rudman-Hollings legislation needs to be maintained. Just the expectation of cuts in future budget deficits, and correspondingly lower claims on world savings, seems to have contributed to a decline in interest rates since last summer, especially long-term rates. We must ensure that those expectations of future cuts in our budget deficit are not disappointed.

But, important as they are, exchange rates and action on the budget deficit cannot be the entire answer to our external imbalance. We also need to look toward strong and growing markets abroad, particularly among our main trading partners in Japan and Europe. Therein lies a major continuing question. Unlike recent years, when those countries have had growing exports to the United States, they will need to rely on more "home grown" expansion.

Looking at the industrial countries as a group, there has been some progress in that direction, particularly when measured
against the turmoil and instabilities of the 1970s and the start of this decade. By dint of hard and continuing effort, virtually all of them have made remarkable progress against inflation. In Germany and Japan, it is possible consumer prices will be essentially stable this year. Employment is now growing almost everywhere.

In that sense, there is a good foundation upon which to build. But it's also plain that unemployment is still far too high in most other industrial countries, averaging more than 10 percent in Europe. Even so, economic growth has been less than earlier in the postwar period, and the appreciation of their currencies, to the extent it restrains their exports, acts as a further restraining influence on their economic activity.

The case for greater domestically led expansion seems particularly strong in Japan, given its enormous trade surpluses and high level of domestic saving. Japan is the second largest economy. By every economic characteristic, it should also be able -- in its own interest -- to help lead the world toward
more open markets rather than feeding protectionist instincts in the United States and elsewhere. Happily, there are increasing signs that need is recognized by the Japanese Government itself.

But in my judgment, it is also late in the day for action.

A second area of continuing concern also reflects a difficult situation abroad. A number of developing countries in Latin America and elsewhere are plagued by heavy debt burdens, in large part to international banks here and abroad, but also to governments and international institutions. Clearly, it is in our interest that those debts be serviced in an orderly manner, and it is even more basically in their interest.

Little in the economic world is more precious than creditworthiness, because trade and growth are ultimately dependent on the availability of credit, for a nation as for an individual. And it is equally true that heavy debt burdens can be managed effectively only in a context of growth -- growth in one's own economy and growth in the markets in which one's products must be sold. Indeed, no part of the world would reap greater
benefits from sustained expansion in the industrial world, from more open trade, and from lower interest rates than the middle-income countries of the developing world. But, to take advantage of that more benign economic climate abroad, they will also need to be prepared to take full advantage of those markets.

By and large, the heavily indebted countries achieved exceptional growth records in the 1970s and early 1980s. But in a large number of instances, that growth entailed very heavy borrowing from abroad. Too much of that foreign capital, rather than contributing to additional investment and efficiency, supported consumption or simply replaced a chronic outflow of their own savings. It cannot be entirely coincidental that countries that did manage to create a hospitable environment for investment and to effectively utilize the savings of their own citizens -- the Koreas, the Taiwans, the Singapores, the Malaysias -- are those that, in the 1980s, have been able to manage their debts most easily and have continued to grow.
I cannot help but be encouraged by the sense that many of the most important leaders of Latin America -- and today they are democratically elected leaders -- have spoken out forcefully about the need for structural change -- for more competition to spur efficiency, for more private initiative and investment, and less governmental and bureaucratic domination of their economies, and for more "openness," at home as well as in trade.

I know there is a long distance from recognition of a problem and from generalized statements of intent to practical policy changes -- changes that mean a departure from deeply embedded ways of doing business and domestic political traditions. I also know that even in the best of circumstances, sustained growth by developing countries will require some margin of external financial support. The more certain that necessary external support, the easier it should be for the borrowing countries to marshal the will and the effort to make the fundamental policy changes needed at home. And the clearer and more effective
the policy measures, the easier it will be to obtain the needed external support from international financial institutions.

Recognition of those interlocking needs for discipline and structural change at home and for a margin of external financial support provides the essence of a solution. It is precisely that framework that was set out by Secretary Baker last October at the World Bank and IMF meetings in Seoul as the basis for a constructive approach toward the debt problem.

That approach does not imply a simple cookbook with common recipes for each country. Reality is too complex for that -- each country has unique problems and potential, its own political traditions, and different needs. But there are common elements.

The World Bank and regional development banks will need to step up their lending sharply in support of promising policy changes. Those institutions are financially capable of responding to the need. Moreover, the exposed commercial banks, as in the past, have a key part to play in restructuring existing loans.
and providing some margin of new money in support of well-conceived economic programs that, over time, will enhance the creditworthiness of the borrowers.

Years of good growth -- growth that can be sustained without the kind of massive injections of new money characteristic of the 1970s and early 1980s -- would be the best possible environment for solving the debt problem. It would, at one and the same time, reduce the interest burdens of the borrowers, relative to the size of their own economies, and reduce the exposure of banks, relative to their capital and assets.

The challenge is clear. Each part of the overall effort -- by borrowers, by international institutions, and by banks -- is essential to the success of the whole. And it would be unrealistic to anticipate that any part could proceed for long without the support of the others.

All of that implies a very large cooperative effort. Can a large number of banks from many countries, with different exposures and particular interests, develop a common approach
responsive to the needs and reflecting their basic community of interest? Can the borrowing countries themselves develop policies that will first of all command the confidence of their own citizens, stop capital flight, and build sustained growth? Can the international institutions effectively encourage and assist that process, acting in the interest of world development and growth?

It's obviously a tall order -- but neither are we starting with a blank piece of paper, building from scratch. We have by now a lot of experience in dealing with the debt problem, and some concrete successes. I think the answer to these questions is yes.

The basic concepts incorporated in Secretary Baker's initiative are widely accepted. Indeed, the approach was reconfirmed by the financial leaders of the world at international meetings in Washington last week. The major banks from around the world have voiced their support for the initiative, while the World
Bank is proceeding actively to approve loan programs to help finance structural adjustment initiated by the borrowing countries.

Much more, however, must be done. And it must be done not just in the context of lower interest rates, which clearly are helpful, but also lower oil prices, which, for the developing world, are hardly an unmitigated blessing.

There are, of course, winners and losers from the decline in oil prices. But the impact is not really symmetrical. There is no real offset or balance to the failure of a major borrower to maintain continuity in debt service from moderate improvement for others.

Mexico, our neighbor to the south and a major oil producer, obviously faces the greatest challenge. I do not underestimate the difficulties. That country has for several years been engaged in a difficult adjustment effort, and large sectors of the population have seen living standards eroded. At present oil prices, Mexico, in terms of government revenues alone, is losing something like 4
percent of its GNP. And that comes on top of other adverse budget trends last year.

At the same time -- and I want to emphasize this -- I see nothing in the situation created by the new oil prices that undermines the basic validity of the approach I have outlined. It only makes more pointed the need to combine stabilization measures with structural reform -- more open, competitive economies; a more hospitable climate for investment, domestic and foreign; and for restoring and reinforcing confidence in their prospects. In that context, financing external needs should remain feasible, within the capacity of private and official international institutions.

In the last analysis, those complementary approaches need need to be grounded in the perceived interest of the borrowing countries themselves and of the creditor. Solutions cannot be imposed by fiat from outside, by the United States, or by anyone else. What we can do collectively is to find the common ground among the parties at interest, just as was done when the
debt crisis first broke in 1986. That search for common ground and complementarity in actions is where the U.S. can play a helpful role. It is the basis for all our conversations with the debtor countries and creditors alike.

In the context of this overall, joint approach to the debt problem, the external financing needs, even taking account of the oil shock, seem to me manageable, and probably manageable within the context of the overall amounts of new bank credit and the multilateral lending effort set out by Secretary Baker six months ago. Naturally, some countries may require somewhat more financing than was contemplated earlier; others, however, benefit from both lower oil prices and interest rates and will need less.

One further point. The progress in the world economy can be undermined by political as well as economic strains. Huge trade deficits, excessive borrowing, inability to deal with the pressures of debt in the developing world, and inadequate growth are all prime breeding grounds for political frustration. Surely, precisely the wrong response would be to permit those frustrations
to boil over in shortsighted actions -- protectionism, defaults, and inflation. Those approaches could only undermine cooperation, reverse the progress that has been achieved, and set back prospects for growth for years to come.

Those dangers have been repeatedly recognized by the responsible leaders in almost every country. By and large, the temptations have been resisted. But we must not neglect the larger task of dealing with the economic imbalances at their source, and do so with a sense of urgency.

No doubt there is a human tendency to look to the other fellow, or to the other country, to do its part, and hope that's enough. No doubt, the needed measures are also politically difficult. But there is also no doubt that, if we are to be successful, it will have to be a joint effort, with recognition of the complementary roles for all the leading countries.

In the end, the success of that effort, like so much else, will depend on progress in a number of directions. The prospect for sustaining growth and working toward lower interest rates
in the United States and elsewhere rests in large part on whether there is a willingness to work together. Within the United States, as our trade balance improves and we borrow less from abroad, we need complementary action to reduce our budget deficit in the United States. That, among other things, will also reduce the risk of renewed inflation.

Other industrial countries need to help carry the torch of growth. Those in the strongest external position can, by opening markets, help us all resist the siren song of protectionism. All of that, more certainly than any intervention in exchange markets, would help ensure a better international balance and well-aligned exchange rates.

This is not just a time of opportunity, but of danger as well. We cannot expect perfection in the timing and execution of every policy -- the world is too uncertain, and our abilities too frail, for that.

But we do not need perfection. What we do need is a strong sense of the right direction -- and I think we have that.
We need to realize how the actions of each country fit into a coherent whole -- and I think we are gaining that.

And, of course, we need practical action. That's sometimes the hardest part. But there is too much at stake to fail to carry through.

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