For release on delivery
10:00 A.M., E.S.T.
February 2, 1987

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

February 2, 1987

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I am pleased to appear once again before this Committee to discuss the economic situation. As you know, the Federal Reserve will be submitting its semi-annual report on monetary policy to Congress later this month. My testimony at that time will provide a full account of recent monetary developments and will report on the decisions to be made by the Federal Open Market Committee regarding money and credit targets for 1987. Therefore, in my statement today I will be emphasizing more general considerations of domestic and international economic policies.

The economy is now in the fifth year of expansion, making it among the longest. During this time about 11-1/2 million jobs have been created, and the unemployment rate has fallen more than 4 percentage points from its peak in 1982, reaching 6-3/4 percent in December. In contrast to the experience of the 1970s, real incomes of households have risen steadily in recent years. In the business sector,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

after tax profits have recovered both absolutely and relative to overall GNP. Interest rates, in contrast to the usual cyclical pattern, are lower today than when the expansion started.

These substantial economic gains were accompanied by -- and I believe fundamentally dependent upon -- consistent progress toward the objective of overall price stability. Consumer prices rose a scant 1.1 percent last year and producer prices actually declined -- a performance unrivaled since the early 1960s.

We know, of course, that that extraordinary progress reflected, in large measure, the transitory influence of the sharp drop in oil prices that occurred early last year; that movement has been partially reversed recently. Moreover, given the size of the fall in dollar exchange rates against other leading industrialized countries, increases in some important import prices are occurring. Because of those factors, we cannot reasonably expect so satisfactory a statistical result in 1987. There is, however, encouraging evidence of continuing

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

restraint on costs and in pricing behavior. Most significantly, the trend toward moderation in nominal wage and salary increases has continued in almost all sectors of the economy and productivity gains in manufacturing (if not in other sectors) have been sizable during the expansion.

My purpose, however, is not to express satisfaction or complacency over past performance. What will count is whether we can build upon and sustain that progress. And the obstacles and roadblocks are evident.

You are all too familiar with regional and sectoral disparities in performance. Manufacturing has been relatively sluggish for two years or more. Much of agriculture is depressed despite massive federal assistance. The energy industry has been hard hit. Conversely, employment in services and finance has been rapidly expanding.

Overall, it is higher levels of consumption that have been driving the economy over the past two years, while investment and domestic savings have lagged, hardly a sustainable combination.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The exuberance of financial markets and the rapid pace of debt creation have been accompanied by evident pressures on some sectors of the financial system, rising loan losses, and the risks implied by greater leveraging of many businesses.

Plainly, in their particulars, many of the strains and imbalances in our economy can be traced to specific circumstances beyond the reach of broad fiscal or monetary policies. For instance, there is a worldwide tendency toward growing surpluses of basic agricultural commodities. The sharp break in oil prices has also been an international market event. Both of those circumstances have contributed to the strains on some lending institutions. But through it all, two disturbing (and partly related) currents run strongly -- our trade and budget deficits. Those are matters that must be addressed -- indeed can only be constructively addressed -- by appropriate national policies. And if we delay, the adjustments become even more difficult, compounding the risks for the future.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The direct effects of the trade deficit are clear enough. Burgeoning imports over several years, while exports in real terms have risen much more slowly, largely account for the overall sluggishness of manufacturing. With capacity ample, that sluggishness feeds back on spending for plant and equipment.

The effects of the budget deficit, in current circumstances, may be less obvious -- after all, as many have noted, interest rates have fallen while the deficits have been so large, the huge new issues of Treasury securities have found a market, and private debt creation has been high as well. How is that possible when, to take one simple benchmark, our federal deficit has averaged about two-thirds of the net savings generated by our economy over the past four years?

In effect, the answer is that we are drawing on the savings of others -- in 1986, the net influx of foreign capital appears to have exceeded all the savings generated by individuals in the United States. That capital influx is the mirror image of the deficit in our current account -- we cannot, at one

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

and the same time, borrow abroad (net) to cover a domestic investment-savings imbalance and run a balanced current account.

In a sense we have been fortunate. We have been able to increase consumption rather rapidly, sustain overall growth and reduce inflation and interest rates even in the face of a large federal budget deficit by calling upon other nations' savings -- which they have readily provided. But the cost has been a rising trade deficit and increasing international indebtedness, strong pressures on manufacturing in the here and now, and an unsustainable pattern of economic activity for the future fraught with political as well as economic risks.

Stated simply, we are living beyond our means -- individuals, businesses, and government have collectively been spending more than we produce. That might be acceptable if we were matching the foreign borrowing with a surge in productive investment in the United States. That's been the case at times in the distant past in the United States and in other countries more recently. But we are not making that match now -- it's consumption that's been leading the economic parade.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In that context, the challenge for economic policy over the next few years is clear enough. We have to work toward better _external_ and _internal_ balance at the same time. The adjustments required are large. Given our extended position, the difficulties and risks are substantial. We don't want to achieve the needed external adjustments by recession nor can we reasonably float off our debts by rekindling inflation -- and I don't think it's realistic to think we have the option of trading one of those possibilities for the other.

That may sound like abstractions. I will be more specific.

One requirement is progress in reducing our trade deficit. That, on the face of it, will bring benefits to manufacturing in the United States. The potential is huge -- to close our $150 billion trade deficit by increased manufacturing (and I don't see any other practical avenue) implies a 15 to 20 percent increase in industrial output over the coming years above and beyond that required to support domestic growth.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

While a surge of that kind would be welcome in many respects, the challenge is to achieve it without renewed inflationary pressure in that sector. That will require continuing restraint on costs, more modernization, and in time more capacity, which in turn will require both money and real resources.

By definition, as we close the current account deficit, those funds and real resources will no longer be available from abroad. So we will have to increase our own savings or reduce other demands on savings at home. The obvious candidate -- again, as a practical matter, it must be the largest "contributor" -- is a reduction in our federal budget deficit. And, unless productivity in the economy as a whole is to dramatically increase above the recent trend of 1% or so -- and unhappily there is no solid evidence for that -- we will not be able to close the gap in trade and meet our domestic investment needs without slowing the growth in domestic consumption well below the 4% pace it has averaged during the current expansion.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In concept, all those things are "doable." They provide the outline of an appropriate economic strategy. The result would be a more balanced economy, greatly enhancing the prospects for sustained growth and greater exchange rate and financial stability.

In fact, I believe we are beginning to make progress in the required directions. But in a sense, we have so far only set the stage. Many difficult decisions lie ahead.

> In the current fiscal year, some significant progress toward reducing the extraordinary budget deficit appears to be underway. But as you well know, sustaining that progress will require still more difficult decisions this year, and for the years beyond. The Gramm-Rudman-Hollings targets have signaled your intentions, but more important than those numerical targets is specific action by the Congress to ensure that the deficit will in fact continue to decline year by year.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Without that progress, it's difficult to see how we could manage to reduce the trade deficit -- and with it the net capital flow from abroad -- without jeopardizing growth, progress toward lower interest rates, and financial and price stability at home.

The large realignment of exchange rates over the past two years should enable our industry to compete much more aggressively with other major industrialized countries. But that constructive development should not obscure the fact that a declining dollar at some point has high costs and risks as well. It generates inflationary pressures. Uncertainties about the future direction of currency values could dampen the willingness of others to place or maintain funds in the United States -- funds upon which, for the time being, we are utterly dependent to finance internal needs.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A self-generating cumulative process of currency depreciation and inflation serves no one's interest. Economic history is littered with examples of countries that acted as if currency depreciation alone could substitute for other action to restore balance and competitiveness to their economies.

That history emphasizes the need for national policy to remain strongly oriented toward maintaining greater price stability. As I indicated earlier, the good performance of the key price indices in 1986 probably can't be matched this year as we absorb higher import prices and oil prices no longer fall. But monetary policy, in particular, must remain alert to the need to avoid any sense of cumulating inflationary pressures.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Over the past year or more, as inflation has subsided and with limited economic growth, the Federal Reserve has been able to accommodate a rapid growth in money and the discount rate has been reduced on several occasions. Clearly, renewed inflationary pressures and weakness in the dollar externally would be factors limiting our flexibility. In that context, your efforts to deal with the budget deficit are even more central to the financial and economic outlook.

In the end, the efficiency, competitiveness, and salesmanship of U.S. industry, and its ability to resist cost increases, will be critical. As I indicated earlier, there are encouraging signs of improved productivity in manufacturing. As a result, profits and cash flow have been reasonably well maintained even as prices of goods have remained virtually stable.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

All that has been achieved during a period of intense competitive pressure from abroad and at a time of little growth. The challenge will be to maintain that performance as prices of competitive imports increase, as export markets improve, and as new needs for capacity arise. If not, the gains from the realignment of currencies will be frittered away.

The point has often been made that despite the longer-run benefits for the economy as a whole, recent tax changes may tend to inhibit plant and equipment spending in some industries. On the other hand, the buoyancy of the financial markets should reduce the cost of capital and provide fresh opportunities for consolidating financial resources and balance sheet strength. Those opportunities should be used constructively and not be dissipated in excessive leveraging and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

financial risk-taking that could in the end jeopardize our stability.

The burden of my comments is that there are gross distortions and imbalances in the economy that we must deal with forcibly and effectively. But we also have a lot upon which to build. The outlines of an effective approach are clear enough. Major elements of that approach are in place. But we will also need time and patience -- and they are in short supply.

For instance, the deterioration in our trade balance appears to have ended, but signs that the corner has been turned are not yet decisive. Meanwhile, the inevitable adjustments in the energy industry, in agriculture, and in commercial building are continuing to work against economic growth in many areas. In these circumstances, stronger growth in 1987, as well as more sustainable growth over time, is heavily dependent on realization of significant gains in trade.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

One temptation is to try to speed that process -- and to vent our understandable frustration about restrictive trade policies of others -- by resorting to broad-brush protectionism. But such a course, it seems to me, would invite almost certain failure. The lesson of experience is that world trade and economic activity would be depressed together. Indeed, given the greater degree of economic and financial interdependence of nations today, the risks and potential losses are all the greater.

At the same time, that very interdependence means that we cannot be successful unless other countries are taking constructive complementary actions to maintain their own growth, to keep their markets open, and to deal with legitimate complaints of unfair trading practices.

The United States and its currency are a major force in the world economy and financial system. In that context, I can readily understand the concern expressed abroad about instability in the dollar exchange markets and about the potential

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

impact on their own economies. At a time of rather sluggish growth among the main industrialized countries, abrupt further changes in the dollar could undercut business planning and investment. We in the United States obviously have nothing to gain -- and a great deal to lose -- from any interruption in growth abroad.

But it is equally obvious that the needed improvement in our trade position must be matched by others absorbing increased imports and facing stronger export competition -- logically and constructively, those changes should be borne primarily by countries with huge external surpluses. For countries that have been dependent on large export surpluses to support growth, that poses difficult adjustment problems, the mirror image of ours. In those cases, the plain need is to encourage domestic growth, while also maintaining the kind of open markets and receptivity to imports that are a necessary part of achieving better international balance in a framework of world growth. Naturally they, too, want to

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

maintain and consolidate greater price stability. But with their currencies appreciated, the opportunity to do so consistent with more rapid growth will be enhanced by cheaper and more available imports.

Sometimes, and I think unfortunately, that need for complementary adjustment abroad is framed in political terms as a request for "help" by the United States to resolve our own problems. But what is at issue is not a narrow concept of help for us or any single country; rather it is what is required to achieve, in an interdependent world, the sustainable world growth and stability we all want. In that respect, no country heavily dependent on trade is an island. Sooner or later, the necessary adjustments in trade will be made. The issue is whether they will be made in an orderly way, in a framework of open markets and growth, or with excessive currency instability or protectionism or both.

Our own responsibilities in that connection, as I have outlined, are unmistakable. But those measures inevitably

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

impact others, and a better international balance cannot be achieved, in the interests of the United States and its trading partners, without constructive complementary policies abroad.

Moreover, such responsibilities extend beyond the main industrialized countries to others, particularly in the Far East, that have achieved rapid growth largely by penetrating foreign markets open to them, most of all in the United States. To the extent some of those countries have large and growing external surpluses, the time has clearly come for them to open their markets more broadly. In doing so, the benefits of their growth to their own consumers will be enhanced, even as they contribute to easing the problems of worldwide adjustments.

I want to emphasize, too, that all these actions -- by the United States, by other industrialized countries, and by certain newly industrialized countries -- are a necessary part of achieving the healthy economic environment essential for other

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

developing countries to constructively deal with their problems. The heavily indebted countries, in particular, must be able to penetrate export markets outside of the United States.

What I have tried this morning to outline is the broad directions that I believe U.S. policy must take -- is in fact taking -- during 1987 and the years ahead. And I think there are signs as well that the need for complementary policies abroad is increasingly well understood.

Plainly, much more remains to be done. I do not underestimate the difficulties. Right now, our own growth is hesitant, and the indicators of economic activity abroad have not been entirely reassuring. The general ebullience of financial markets masks some strains and weaknesses that will need continuing attention. Despite the progress of the past, the cooperative effort to deal with the acute debt problems in Latin America by the countries themselves, by the international financial institutions, and by leading banks needs fresh impetus.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

With oil and commodity prices now stable or even rising, maintaining the sense of progress toward general price stability will be more difficult, particularly in the United States. Needed policy changes, here and abroad, even when accepted conceptually, are hard to implement with the needed vigor.

At the same time, I think we should be encouraged by the degree to which some of the needed policies are in place. There is some evidence that the needed economic adjustments are beginning. What seems to me important, as we assess progress in 1987, is not so much whether we in the United States -- at least within some reasonable range -- reach some specific rate of overall economic growth. Rather, our emphasis in policy-making should be on whether the necessary adjustments are clearly underway and will in fact be sustained.

We won't eliminate the budget deficit or the trade deficit easily or quickly and certainly not in 1987. By the same token, we cannot expect to achieve an appropriate balance in our internal savings and investment in so short a period of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

time nor sharply improve productivity. As a practical matter, a sudden spurt in growth abroad won't be a solvent for our problems.

What we collectively can do -- and what we must do -- is act with force and conviction in the necessary directions. In doing so we will lay the base for sustained noninflationary growth not just in 1987 but for years beyond.

****

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis