

Facing Up to the Twin Deficits

Author(s): PAUL A. VOLCKER

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Facing Up to the Twin Deficits

Unprecedented budget and trade deficits pose a clear danger to U.S. growth and stability. Unless we close the gaps, we risk becoming the world's largest debtor nation.

A year ago, in appearing before the House Banking Committee to discuss the Federal Reserve's monetary policy for the year ahead, I emphasized that, after too many years of pain and instability, we had an enormous opportunity to sustain growth for years to come in an environment of much greater price stability. Today, after a year of strong recovery, that sense of the opportunities before us has only been reinforced.

The simple fact is that the economy moved ahead faster, and unemployment dropped more sharply, than we or most others thought at all probable. At the same time, the inflation rate dropped further, to the point that producer prices were almost unchanged over the year as a whole and consumer prices rose by less than at any time over the past decade. The fact that we were able to combine strong growth with good price performance is what is so encouraging. It is the key to lasting success.

With job opportunities, real incomes, and profits all

rising, so has the sense of optimism among both families and businesses. That widely shared impression is confirmed statistically in the results of "attitudinal" indices that attempt to measure confidence, expectations, and buying plans—they are mostly at the highest, or near the highest, levels in many years.

I realize that improvement must be measured from where we started. There was a lot of room to grow, and the early stages of recovery typically see rapid growth and less price pressure. Any satisfaction with what has been happening has to be tempered by the knowledge that there is still a considerable way to go to reach satisfactory levels of employment and before we can claim to have restored reasonable price stability. In particular, should inflationary trends and fears again take hold, prospects for the lower interest rates and orderly credit markets we need to support investment and productivity growth would be shattered.

I hardly need to remind you that inflation has tended

PAUL A. VOLCKER was Chairman of the Board of Governors of the Federal Reserve System when this article appeared in *Challenge*, March-April 1984. It was excerpted from his bi-annual statement on Federal Reserve policy to the House Committee on Banking, Finance, and Urban Affairs, delivered on February 7, 1984.

to worsen during periods of cyclical expansion. But that need not be inevitable. Out of hard experience, I believe we can shape disciplined policies—indeed, we have already gone a long way toward shaping policies and attitudes—to deal with the threat.

What we have not done in this past year is face up to other hazards to our prosperity and to our stability, hazards that are new to our actual experience but which have been long identified. I am referring, of course, to our twin deficits: the structural deficit in our federal budget and the deficit in our external accounts, both at unprecedented levels and getting worse. Both of these deficits carry implications for the prospects of reducing our still historically high levels of interest rates.

So far, the strains have been masked by other factors of strength and by the rapidity of growth from the depths of recession. But with the passage of time and with full recovery, the predictable effects have become more obvious. They pose a clear and present danger to the sustainability of growth and the stability of markets, domestic and international. We still have time to act—but in my judgment, not much time.

Sources of strength

I can summarize briefly why I think the developments of the past year are, in key respects, so promising—why, potentially, what has been going on can be not “just another” cyclical recovery, but the start of a long process of growth and renewed stability.

Looking back, it is now apparent that the trend of productivity growth had practically stopped in the late 1970s. But productivity began to increase again during the recession and rose rapidly during most of last year. One or two years do not make a new trend, and relatively good productivity growth is typical of the early stages of recovery. But the evidence, quantitative and qualitative, suggests that something more than cyclical forces are at work in important areas of the economy. Under the pressure of adversity—and with the seemingly “easy pickings” of speculative and inflationary gains diminishing—management and labor alike have turned their efforts and their imagination toward ways to increase efficiency and curtail overhead.

That, together with growing markets, accounted for the speed of the rebound in total profits and improvement in profit margins last year from long-depressed levels, even as prices for many goods and services tended to stabilize. The cash flow of businesses has been further reinforced by the liberal treatment of de-

preciation and other tax changes enacted in recent years, and after-tax economic profits, only a year after recession, are approaching the highest levels of the 1970s relative to GNP. Strong expansion in some types of investment during 1983—particularly electronic equipment, where technological change has been so rapid—carries promise for future productivity.

We should not claim too much. Profits remain well below rates typical of the prosperous 1960s. Recent employment increases, while highly welcome in themselves, have been so large relative to output growth that they raise some questions about whether rapid productivity growth is being maintained. Long-lived investment—new plant for expansion of capacity—still lags. High interest rates, the uncertainty bred by years of disappointment, and strong competition from abroad have all restrained heavy investment. Already, a few industries are close to, or even at, sustainable capacity. But, on balance, the evidence and the omens are more favorable than for several years.

That is certainly true of the longer-term outlook for costs and prices. I am well aware that slack markets and excessive unemployment, the appreciating dollar together with the ready availability of goods from abroad, and the decline in world oil prices all helped account for the rapidity of the drop in the general inflation rate and the degree to which cost pressures have subsided. To that extent, progress toward stability has had a sizable “one-time,” or cyclical, component. But we also now have a clear opportunity to “build in” that improvement—the best opportunity in many years.

As the increase in average wages and salaries, which account for some two-thirds of all costs, has declined in nominal terms, the *real* income of the average worker has increased. That reverses the pattern as inflation accelerated during much of the 1970s, when escalating wages often lagged behind more rapidly rising prices. The more favorable pattern should be assisted by greater stability in energy prices, where the outlook (barring political turmoil) appears favorable, and by stronger productivity growth. With real wages again rising on average and with prices more stable, the logic points toward much more moderate new wage contracts than became the norm in the inflationary 1970s. The competitive pressures associated with the process of deregulation in some important industries have also been a factor working to contain costs and prices, and, happily, we can begin to see some signs of more restrained cost increases in areas,

such as medical care and education, that have been slow to reflect the disinflationary process.

To the extent that we can build confidence in the outlook for more stable prices, the process could, potentially, feed on itself. Incentives for speculation in commodities, and for speculative excesses, would be greatly reduced and possibilities for another burst in oil prices diminished. It could provide the best possible environment for declines in nominal and real interest rates over time, and interest rates are themselves an element of costs. Lower interest rates could, in turn, be a powerful factor supporting and encouraging housing and the business investment that we need to maintain economic momentum and to support productivity growth.

The twin deficits

Nonetheless, as I suggested earlier, the prospects for sustained growth and stability must remain conditional. There is another, and bleaker, reality. We are faced with two deficits—in our budget and in our international accounts—unprecedented in magnitude. Those twin deficits have multiple causes, but they are not unrelated. Left untended, each, rather than improving, will tend to cumulate on itself, until finally they will undercut all that has been achieved with so much effort and so much pain.

Looking back, the rising budget deficit provided a large and growing stimulus to purchasing power as we emerged from recession. It helped account for the vigor of consumption in the face of historically high interest rates. The other side of the coin is that financing the deficit last year amounted to three-quarters of our net new domestic savings. That was tolerable—we obviously have tolerated it—for a limited period of time when other demands on those savings were limited. Business inventories actually declined on balance last year, and housing and business investment were recovering from recession lows.

Even then, deficits were a factor keeping interest rates higher than otherwise, and the implications become much more serious as the economy grows closer to its potential. The hard fact is that for many years we have succeeded in saving (net of depreciation) only some 7 to 9 percent of our GNP. Despite the efforts to raise it, the domestic savings rate remains within that range now and foreseeably. If the budgetary deficit absorbs amounts equal to 5 percent or more of the GNP as the economy grows—and that is the present

prospect for the “current services” or “base line” budget—not much of our domestic savings will be left over for the investment we need.

Over the past year, our needs have been increasingly met by savings from abroad in the form of a net capital inflow. That money has come easily; amid world economic and political uncertainty, the United States has been a highly attractive place to invest. But part of the attraction for investment in dollars has been relatively high interest rates. In effect, the growing capital inflow has, directly or indirectly, helped to finance the internal budget, by the same token helping to moderate the pressures of the budget deficit on the domestic financial markets. At the same time, the flow of funds into our capital and money markets pushed the dollar higher in the exchange markets even in the face of a growing trade and current account deficit—and the dollar appreciation in turn undercut our worldwide trading position further.

We simply can't have it both ways—on the one hand, look abroad for increasing help in financing the credits related to our budget deficit, our housing, and our investment, and on the other hand, expect to narrow the growing gap in our trade accounts. At the end of the day, the counterpart of a net capital inflow is a net deficit on our current account—trade and services—with other countries.

Most forecasts suggest that we, as a nation, will have to borrow abroad (net) about 2 percent or more of our GNP this year to meet projected domestic needs. That pace does not appear sustainable over a long period. Faced at some point with a reduction in the net flow of capital from abroad, the burden of financing the budget deficit would then be thrown back more fully on domestic sources of savings. If our federal financing needs remain so high, housing and investment will be squeezed harder.

The largest international debtor?

I must also point out that, in the same way that the interest costs of this year's deficit add to next year's requirements—and compound over many years thereafter—the interest and dividend payments related to the net capital inflow build up future charges against the current account of the balance of payments. Skepticism about our ability to account accurately and fully for all the flows of funds into or out of the country is justified; it is nonetheless ominous that the recorded net investment position of the United States overseas,

built up gradually over the entire postwar period, will in the space of only three years—1983, 1984, and 1985—be reversed. If the data at all reflect reality, the largest and richest economy in the world is on the verge of becoming a net debtor internationally, and will soon become the largest.

Looking at the same development from another angle, it is the exporter and those competing directly with imports that have not shared at all proportionately in the recovery. Developments in the fourth quarter illustrate the point. There has been much comment about the slowing in the rate of GNP growth to a rate of about 4.5 percent. But, judging from the preliminary figures, domestic demands were quite well maintained, increasing at a rate of almost 7 percent. Much of that increased demand flowed abroad, adding to income and production elsewhere. It was domestic production, not demand, that grew appreciably more slowly.

For a time, as with the budget deficit, that kind of discrepancy is tolerable. Indeed, from one point of view, it has provided a welcome impetus toward stimulating the growth process in other countries of the industrialized world, and the strength of our markets assisted the external adjustments necessary in the developing world. We can also take pride in the fact that others find the United States an attractive place to invest; good performance and policies can help sustain those flows.

But we simply can't afford to become addicted to drawing on increasing amounts of foreign savings to help finance our internal economy. Part of our domestic industry—that part dependent on exports or competing with imports—would be sacrificed. The stability of the dollar and our domestic financial markets would become hostage to events abroad. If recovery is to proceed elsewhere, as we want, other countries will increasingly need their own savings. While we don't know when, at some point the process would break down.

The implications for monetary policy

In the abstract, the ultimate objective of monetary policy is simple to state and widely agreed: to provide just enough money to finance sustainable growth—and not so much as to feed inflation. Toward that end, the Federal Open Market Committee (FOMC) in February essentially reaffirmed the ranges for money and credit growth tentatively established in July of last

year. The target ranges for M3 and for nonfinancial debt were lowered by 0.5 percent from the 1983 ranges to 6 to 9 and 8 to 11 percent, respectively, as tentatively set in July. The M2 range was reduced by 1 percent from the 1983 range, to 6 to 9 percent. That is 0.5 percent lower than anticipated in July, reflecting in part technical considerations bearing on the appropriate relationships among the broader aggregates. The M1 range was set at 4 to 8 percent, 1 percent lower than during the second half of 1983, as had been anticipated.

In the concrete, issues abound. Some of them are more or less technical: how we define and measure money and its relationship to the nominal GNP. These questions are dealt with in our formal report describing our decisions on the targets. I want to concentrate here on some broader implications of the current situation for the conduct of monetary policy.

There is no instrument of monetary policy that, in any direct or immediate sense, can earmark money only for expansion and not for inflation, or vice versa. The distribution of any given nominal growth of the GNP between real growth and inflation is a product of many factors—the flexibility and competitiveness of product and labor markets, the exchange rate, and internal or external shocks (such as the oil crises of the 1970s). Expectations and attitudes developed out of past experience are critically important.

In that respect we have not inherited a sense of stability. Quite to the contrary, the legacy of the 1970s was deeply ingrained patterns of behavior—in pricing, in wage bargaining, in interest rates, and in financial practices generally—built on the assumption of continuing, and accelerating, inflation. Starving an inflation of the money needed to sustain it is a difficult process in the best of circumstances; it was doubly so when the continuing inflationary momentum was so strong.

Now, after a great deal of pain and dislocation, attitudes have changed. There is a sense of greater restraint in pricing and wage behavior, a greater recognition of the need to improve efficiency, less alarm (at least for the short run) over the outlook for prices, and relative confidence by others in the outlook for the United States. In this setting, we can assume that, within limits, more of any given growth in the money supply will finance real activity and less rising prices than would have been the case when the inflationary momentum was high.

But we also recognize that the battle against infla-

tion has not yet been won—that skepticism about our ability, as a nation, to maintain progress toward stability is still evident. That is one of the reasons why longer-term interest rates have lingered so far above current inflation levels. After so many false starts in the past, the skepticism is likely to remain until we can demonstrate that, in fact, the recent improvement is not simply a temporary matter—that the Federal Reserve is not prepared to accommodate a new inflationary surge as the economy grows. The doubts are reinforced by concerns that the pressures of the huge budget deficit on financial markets may, willy-nilly, push us in that direction, as has happened in so many countries.

The wrong way to lower interest rates

The desire to see interest rates lower, or to avoid increases, is natural. But attempts to accomplish that desirable end by excessive monetary growth would soon be counterproductive. By feeding concerns about inflation, the implications for interest rates themselves would in the end be perverse—and likely sooner rather than later. As things stand, credit markets are already faced with potential demands far in excess of our capacity to save domestically; to add renewed fears of inflation to the outlook would only be to reduce the willingness to commit funds for long periods of time and for productive investment. Inflationary policies would also discourage the continuing flow of funds from abroad, upon which, for the time being, we are dependent. In the last analysis, willingness to provide those funds freely at current or lower interest rates is dependent on confidence in our stability and in our economic management. Depreciation of the dollar externally as a result of inflationary policies will not, in the end, help our exporters, or those competing with imports, because that depreciation would be accompanied by inflated domestic costs.

In a real sense, the greatest contribution that the Federal Reserve itself can make to our lasting prosperity is to foster the expectation—and the reality—that we can sustain the hard-won gains against inflation and build upon them.

In my judgment, against a background of more stable prices, interest rates are indeed too high for the long-term health of the United States or the world economy. I have repeatedly expressed the view that, as we maintain the progress against inflation, interest rates should decline—and they should stay lower.

Much is at stake. We will need more industrial capacity, and relatively soon. Even after the sharp declines in interest rates from earlier peaks, many thrift institutions and businesses remain in marginal profit positions and with weakened financial structures; lower rates would bring much faster progress in repairing the damage. The cooperative efforts of borrowers, banks, and the governments and central banks of the industrialized world have managed to contain the strains on the international financial system, but the pressures are still strongly evident. Both economic growth and lower interest rates are needed as part of more fundamental solutions.

But wish and desire are not the same thing as reality; we have to deal with the situation as it is. In setting the targets for the various monetary and credit aggregates for 1984 as a whole, the FOMC had to remain alert to the danger of renewed inflation as well as to the need for growth. It also decided that, operationally, it would for the time being be appropriate to maintain essentially the same degree of restraint on the reserve positions of depository institutions that has prevailed since last autumn. That judgment reflects the fact that growth in the various measures of money and credit now appears broadly consistent with objectives, that the momentum of economic expansion remains strong, and inflationary tendencies contained. That operational judgment will, of course, be reviewed constantly in the weeks and months ahead.

Those decisions will reflect continuing appraisals of the rate of growth of money and credit, interpreted in the light of all the evidence about economic activity, prices, domestic and international financial markets, and other relevant considerations. All those factors will, in turn, be affected by other public and private policies. In that context, it is the strength of economic activity, the demand pressures on the credit markets, and the willingness of others to invest in the United States that will influence the course of interest rates.

In approaching our own operational decisions, the actual and prospective size of the budget deficit inevitably complicates the environment within which we work. By feeding consumer purchasing power, by heightening skepticism about our ability to control the money supply and contain inflation, by claiming a disproportionate share of available funds, and by increasing our dependence on foreign capital, monetary policy must carry more of the burden of maintaining stability, and its flexibility, to some degree, is constrained.

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Toward a positive solution

Monetary policy is only one part of an economic program. It is an essential part, but success is dependent on a coherent whole.

If a sense of discipline is to be maintained, those of us responsible for public policy must be able to demonstrate that inflation will not again get the upper hand; that productivity and restraint will be rewarded, not penalized in favor of those seeking inflationary or speculative gain.

The contribution that monetary and other policies make to that environment is critical. As the expansion proceeds, and as some of the temporary factors restraining prices recede, we as a nation simply cannot afford to permit inflation to attain a new momentum. Our monetary policies are, and in my judgment must continue to be, geared to avoid that danger.

But for all the progress and promise, something is out of kilter.

Our common sense tells us that enormous and potentially rising budget deficits, and the high and rising deficits in our trade accounts, are wrong—they can not be indefinitely prolonged.

We can, of course, sit back and wait a while longer, hoping for the best.

I certainly have some understanding of the difficulties of achieving a consensus on difficult budgetary choices when a sense of immediate crisis is lacking—when for the moment things seem to be going so well. But I also know that to wait too long would be to take risks with the American economy.

It is already late. The stakes are large. Markets have a mind of their own; they have never waited on the convenience of kings or Congressmen—or elections.

The time to take the initiative is now, when we can influence markets constructively—when we can demonstrate that we are in control of our own financial destiny. Real progress toward reducing the budget deficit is needed to clear away the dangers.

I sense a fresh opportunity in the proposals of the President for a joint effort to attack the deficit—for a sizable "down payment" on what is ultimately needed.

Certainly, that kind of demonstration that we are beginning to face up to our budgetary problem would make it easier for monetary policy to do its necessary work. And, in the larger scene, it would be tangible evidence to our own people that we can do what is necessary to seize the bright opportunities before us.