International Economic Prospects: A Case Study in Mutuality

I am pleased to have the opportunity once again to address the Mid-Winter Meeting of the New York State Bankers Association. In contemplating the occasion, it struck me that this would be my fourth such appearance before this gathering, which, if nothing else, reminded me of how fast time passes in this turbulent era. For example, only a year ago I unveiled before this audience my essay on a longer-term view of the emerging financial and banking structure in the United States. In the intervening period, we have seen some decided momentum in the Congress and elsewhere toward a much needed modernization of our banking system. But, the hard fact of the matter is that progressive legislation has yet to be enacted even as the force of events here and around the world makes the case for progressive change still more compelling. Under these circumstances, I believe it is crucial that the banking industry, including all of the institutions represented in this room, lend its full support to enacting legislation along the lines of the Proxmire-Garn bill now before the Senate Banking Committee.

Legislation of this nature would not be the final word in efforts to adapt our banking and financial structure to the needs of the future, but it would be a giant step in that direction. To squander that opportunity in an effort to forge a more sweeping approach that, for example, would permit a blending of banking and commerce is, in my view, politically insensitive and substantively wrong.

As important as developments in the banking field in 1987 may have been, or may turn out to be, I suspect that with the passage of time they will earn little more than a footnote in the historians' recounting of the past year. Indeed, there have been developments in the domestic and international economy, in financial markets (and I am not merely referring to the events of mid-October), and in ongoing efforts to cope with the debt problems of the developing world that have taken on new and far-reaching dimensions over the past year that must command our attention. Accordingly, I would like to take this opportunity to share with you my thoughts on the economic situation here and abroad, with particular emphasis on the tasks that lie ahead in maintaining noninflationary growth, restoring better balance in international trade and capital flows, and working toward further gains on the LDC debt front.

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In looking first at the U.S. economy, the situation is one with both good news and bad. The good news, of course, is that we are now into the sixth year of an economic expansion. That expansion has been extraordinary, not just because of its duration, but also because it has been maintained despite very difficult

Remarks by E. Gerald Corrigan, President of the Federal Reserve Bank of New York, before the 60th Annual Mid-Winter Meeting of the New York State Bankers Association on Thursday, January 28, 1988

conditions in some regions and in some sectors of the economy and because it has been maintained without any significant rise in the underlying rate of inflation. The bad news, however, is that we have serious imbalances in the economy that simply must be dealt with if we are to sustain noninflationary growth into the next decade.

While the nature of these problems is not new, allow me as a matter of emphasis to cite several examples of things that lie at the heart of our difficulties:

- In the late 1970s, general government budget deficits in the United States consumed, on average, only about 10 percent of our net private domestic savings. By 1986, and despite large surpluses in state and local governments, overall government deficits were consuming almost two-thirds of net private domestic savings, with the federal deficit eating up an astonishing 90 percent of net private savings. While these figures fell somewhat in 1987, they remain far, far too high by any reasonable standard.

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- As recently as 1981, the United States was the world's largest net creditor nation. We are now its largest net debtor and sometime this year, our net external indebtedness will cross the $500 billion threshold. To put it differently, by the end of 1988 our net *external* indebtedness will reach or exceed the accumulated public debt of the United States from its inception through 1974.
- Since the end of 1983, nonfinancial corporate America has retired a cumulative total of almost $300 billion in equity while over the same interval corporate debt has increased by more than double that amount.
- On a global basis, the U.S. trade and current account deficits and their mirror-image, surpluses in several of our major trading partners, are of unsustainable proportions.

These examples reflect the harsh reality that for too long we in the United States have been borrowing more than we save and consuming more than we produce in an environment in which debt, deficits, and leveraging have become a way of life for government, for business, and for individuals. Fortunately, we have both the underlying economic strength and the opportunity to remedy these problems—but only if we heed the warnings of the recent past and get on with the task now.

The task that lies ahead in seeking to address the imbalances in the United States and the world economy in a context of growth is, to put it mildly, formidable. To

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illustrate what is involved, it would be useful to consider what would have to happen between now and, say, mid- to late 1991 if, over that time frame, the United States were to eliminate or largely eliminate its trade deficit—keeping in mind that even that result will leave us with a not inconsequential current account deficit. At the risk of oversimplification, and assuming no major changes in inflation, interest rates or exchange rates, achieving that result would entail something along the following lines:

- In the United States, the growth in real GNP would, for the period as a whole, have to average something like 2.5 to 3.0 percent—not an easy task in its own right But—and this is a very large "but"—there would have to be a major and sustained change in the composition of GNP growth. That is, over this entire period, the *rate* at which the U.S. economy consumes goods and services relative to GNP must *fall* if net exports are to rise, as they must if our trade deficit is to be eliminated. It is in this sense that we are facing a long period in which our standard of living must rise at a slower rate than it has in the past. To put it differently, we must make the very difficult transition from an economy paced by consumer spending to one in which export-oriented activities and investment in hard productive capital are at the cutting edge of sustainable and therefore moderate growth.

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- In the rest of the industrialized world, a growth rate in GNP of about 3 percent for the period as a whole would have to be coupled with a rise in domestic

demand in those countries to about 3.5 percent For the large surplus countries, the spread between domestic demand growth and GNP would have to be even wider. Here too, we are talking about rates and patterns of growth that are, in general, quite at odds with the experience of recent years.

- In the United States, growth in manufacturing output—both to displace imports and to provide the needed export growth—would have to average, at the very least, 4 percent in a context in which manufacturing capacity will have to rise significantly. While these results can be achieved, they will not come easily nor without clear risks of higher inflation, especially considering that we start with little slack in labor markets and with capacity constraints already in evidence in several key manufacturing industries.
- In the United States, we must achieve a reduction in the domestic savings gap about equal to the reduction in the current account deficit implied by the sharply reduced or eliminated trade deficit. Thus, the domestic saving gap must be reduced by an amount well in excess of $100 billion. That reduction can be achieved by a rise in the domestic saving rate, by a reduction in the rate of private investment, by a reduction in the budget deficit, or by some combination of all three. Since the rate of private investment is, if anything, too low, the answer is not to be found there. Similarly, while a gradual rise in the private saving rate would be most welcome, it is by no means assured. To the extent it does occur, it would be far better to see the added savings used to help finance a highly desirable increased rate of private investment. Therefore, the great bulk of the reduction in the saving gap must come from cutting the budget deficit over the next several years Sadly, and despite great effort, the details of a credible budget deficit reduction program in the needed amount are not yet in place

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- Finally, even if all of the conditions I have mentioned were realized, the external indebtedness of the United States would continue to rise, though at a slower pace, over the entire period. Indeed, under a scenario along these lines, the U.S. external indebtedness by the second half of 1991 could easily be in the area of $850 billion and still rising by the amount of the residual current account deficit remaining at that time. This means, of course, that over the period as a whole foreign investors will have to be willing to accumulate, in net terms, something like $350 billion of additional dollar-denominated assets on top of the $500 billion they will hold sometime this year. It also means that we as a nation must conduct our affairs in a manner that will command the continued confidence of our current and prospective external creditors. Current account deficits are always financed; the only question is at what price.

If the scenario I have just laid out sounds challenging, it should, because surely it is. While the numbers I've cited are broad estimates, they do give a sense of the order of magnitude of the adjustment process that lies ahead. Moreover, they reflect an adjustment process that, in some respects, leans toward a best-case scenario The key point, of course, is that even under such a scenario there is no quick and painless fix for our current economic ailments. For example, it would be nice to think that the United States could somehow manage a sufficiently rapid growth in GNP to have *both* a rise in net exports and a rate of increase in domestic demand that is in line with earlier experience. However, in my view, such an approach would carry with it the virtual certainty of renewed inflation that in the end would be highly destabilizing here and abroad. In fact, I know of no surer way to create a truly nasty recession than to fall victim to the illusion that we can inflate our problems away

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Similarly, it would be tempting to think that a further fall in the dollar would somehow make life easier. I, for one, simply don't see it that way. Indeed, in my judgment a further fall in the dollar would only serve to magnify inflationary dangers (in part by placing a further burden on the output and investment needs of the U.S. manufacturing sector), impede much needed growth prospects abroad, and complicate the task of financing our prospective current account deficits. Accordingly, the

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The point I am seeking to make is, of course, that at the end of the day we must come to grips with our underlying economic problems, not merely with the symptoms of those problems. To repeat, we simply cannot go on borrowing more than we save and consuming more than we produce, just as other countries cannot go on producing far more than they consume The issue, therefore, is not whether the necessary adjustments—including the major changes in the composition of output and spending in the United States—will take place; those adjustments will take place one way or another. The issue is whether we will have the vision, the will, and the discipline to recognize the constraints we face and to conduct our affairs in a manner that permits the necessary adjustments to occur in an orderly way and in a context of growth.

Success in maintaining noninflationary growth in the industrial world is also central to efforts to cope with the LDC debt crisis. As an extension of that, it is also true that, today as several years ago, the LDC debt situation still poses a major threat not just to the debtor countries or their creditors but to the prospects for growth and stability in the global economy and trading system.

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For reasons that are understandable, we have reached a point in the evolution of the LDC debt situation in which frustration and fatigue are very much in evidence on all fronts. However, the past five and a half years have not been without important progress: bank exposures relative to capital have been cut in half or more; growth in the LDCs, even if uneven and at subpar rates, has re-emerged; major improvements in debtor country current account and trade positions have been achieved; public sector deficits have been cut and, I might add, for the so-called "Baker 15," these deficits are not wildly out of line with our own deficit relative to GNP; and, in general, interest rate and exchange rate policies have become more realistic. Despite all of this, however, the crucial debt and debt service ratios of most of the LDCs have not improved in any material way relative to the situation at the outbreak of the debt crisis in the early 1980s.

While there are many reasons—both economic and political—why we have not seen definitive turns in the various debt ratios of the LDCs, three economic factors strike me as particularly relevant: first, for the decade of the 1980s as a whole, the LDCs have experienced a sharp and protracted deterioration in the terms of trade; second, despite slack conditions in domestic economies, inflation rates in most of these countries have remained high and in some cases alarmingly high; third, fresh financing flows from official and bank sources have, if anything, been too modest. Moreover, even when financing has become available, it often comes only after inordinately long and costly delays in the negotiation and syndication process.

Under these circumstances, the yearning for that mystical masterstroke that will put the problem behind us becomes all the more evident. I'm sorry to say, however, that such a masterstroke simply does not exist. Today, as a year ago or five years ago, there are certain fundamental prerequisites that must be a part of efforts to resolve the LDC debt problem. Those prerequisites—in addition to growth in the industrial countries as cited earlier—include, among others, the following:

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- First, growth in the debtor countries in the 5 percent range they have all experienced in the past must be attained. Needless to say, achieving such growth presupposes appropriate macro- and micro-policies on the part of the debtor countries.
- Second, the maintenance by the LDCs of businesslike relationships with their creditors, which means the timely servicing of financial obligations. In that regard, in a context in which a country has

an established track record of servicing its obligations, innovative steps such as the recently announced voluntary Mexican debt repurchase plan can play a constructive role, especially if such efforts are viewed essentially as exit-type vehicles. But here too, we must be realistic Such efforts can be a constructive step in appropriate circumstances, but no more than that. They are not, nor will they ever be, either a substitute for the willingness and ability of debtor countries to service their debts or a sustainable channel for needed financing.

- Third, a reasonably stable and predictable flow of appropriate amounts of external finance—including bank credit—to the LDCs must be maintained. Approaches to the LDC debt problem that fail to take explicit account of the need to provide new financing to the LDCs over time should be viewed with skepticism. At the extreme, a debt strategy that cannot hold out the hope of renewed debtor access to market sources of external finance is no strategy at all The object of the exercise is to restore creditworthiness and confidence, not to further impair them.

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- Fourth, strong and well-funded multilateral official institutions are a must. These institutions are central to the process not only because they can provide the added financing needed to close external financing gaps in the LDCs but also because they and they alone can be the locus of policy coordination and conditionality—a process which should become more flexible but which remains a crucial ingredient for success.
- Fifth, an appropriate degree of solidarity and commonality of purpose among private bank creditors, and especially major bank creditors, must be maintained. This means, among other things, that the advisory committee process or something like it is still needed, but that process must find ways to expedite procedures and decision making

In saying that the fundamentals have not changed, I am not suggesting that the process as a whole has been or should remain static. Clearly it has not and it cannot. Indeed, we have already seen important adaptations on all fronts, including fresh and constructive ideas from the Secretary of the Treasury, the President of the World Bank and the Managing Director of the International Monetary Fund, as well as from debtors and private creditors alike But as new ideas and approaches emerge, it seems to me that such ideas must be put to the test of how well, over time, they will serve the basic prerequisites I laid out a moment ago

I said earlier that frustration and fatigue regarding the LDC problem were understandable: they are. But defeatism is not! Success in containing and gradually reducing the debt problem is not assured but it is attainable. To achieve that success will require cooperative and complementary efforts on all sides and it will require vision To cite just one example, the case for further strengthening of bank capital and reserve positions is clear, but how that result is achieved can matter. That is, to the extent that reserving decisions by individual banks or groups of banks have the unintended effect of encouraging debtors to disregard their obligations or to abandon efforts aimed at sound policies, or to the extent that they imperil the needed flow of new money to the debtors, they can become self-fulfilling prophecies.

The theme of this address is mutuality: whether we live in Buffalo or Buenos Aires, Ticonderoga or Tokyo, Freeport or Frankfurt, we all have a mutual interest in how well each of us, and all of us, face up to the challenges of maintaining growth and stability in the national and international economy. But that mutuality cannot be used as an excuse to postpone needed initiatives at the national level or to place the blame for national problems at the doorstep of others. The essential things that need to be done—eliminate the budget deficit and the savings gap in the United States, achieve more rapid growth in domestic demand in the other industrial countries, promote growth and efficiency in the developing world, and firmly resist the seductive appeal of inflation on all fronts—happen, as I see it, to first coincide with national interests. From an international perspective, they are mutually reinforcing. But the reverse is also true. Failure on any one of these fronts will surely jeopardize prospects on all others. That is the essence of mutuality.

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