THE 1984 PER JACOBSSON LECTURE

Economic Nationalism and International Interdependence

The Global Costs of National Choices

Peter G. Peterson

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FOREWORD

The 1984 Per Jacobsson Lecture, entitled "Economic Nationalism and International Interdependence: The Global Costs of National Choices," was delivered by Peter G. Peterson, at the Dorothy Betts Marvin Theatre of the George Washington University in Washington, D.C., on Sunday, September 23, 1984. Mr. Peterson is Chairman of the merchant banking firm of Peterson, Jacobs & Company.

William McChesney Martin, Chairman of the Per Jacobsson Foundation, presided over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures are sponsored by the Per Jacobsson Foundation and are held annually. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.

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Opening Remarks

William McChesney Martin

I want to welcome all of you to the twenty-first annual lecture meeting of the Per Jacobsson Foundation. This meeting today is of special significance because it marks our coming of age. And looking back, I believe that the past 21 years have been singularly successful years for the Foundation.

This is indeed a happy occasion for all of us because it gives us the oportunity for meeting old friends, for making new friends, and for exchanging ideas.

I would like to begin, as I usually do at the opening of these meetings, with a few remarks about the Foundation. The Foundation is financially sound. I know Per Jacobsson would have approved of our financial status. And we expect to remain solvent for many years to come, although we must be careful and not overextend ourselves in different directions, nor undertake more than what we can accomplish.

We have a most stimulating subject today. Before I introduce the speaker, let me mention the subject—"Economic Nationalism and International Interdependence." It is truly a thought-provoking subject and covers a wide range of ideas. I am looking forward to the lecture with a great deal of pleasure.

Per Jacobsson died 22 years ago, and this series of lectures was started in his memory to provide a forum for the discussion of international economic issues.

I also want to pay tribute to Marcus Wallenberg, one of our founders. His son Peter Wallenberg, who is on our Board, is here today. Another of our founders, Eugene Black, whom most of you know, is unable to be present but extends his warmest greetings to all of you. He continues to take a keen interest in the activities of the Foundation. We have also heard from Per Jacobsson's daughter, Erin Jucker-Fleetwood. She wrote a biography of Per Jacobsson, which we helped to publish. If any of you would like to buy a copy, it is available from the Secretariat of the Foundation.

The Per Jacobsson Foundation, of which I am Chairman, has a small but a most effective staff. Frank Southard is the President of the

Foundation. Our two Vice Presidents are Albert Gerstein and Gordon Williams. Through the courtesy of the International Monetary Fund, we receive the services of our Secretary, Joseph Lang, and our Treasurer, Michael Fitzpatrick.

I see in the audience many of the past speakers at these meetings. It is indeed a privilege to be a part of such a distinguished gathering.

Now I want to say a few words about our speaker for this afternoon. We are most fortunate to have him with us. I cannot think of anyone who is better qualified to speak on this subject in the present juncture of economic problems. It seems to me that these difficulties have been created because of overvalued currencies and fiscal irresponsibility and it is going to take a long time to resolve them. Our past lectures have been delivered by many eminent finance ministers and bankers, and today is no exception. We have a speaker who has had a most distinguished career in academia, business, and government.

He was the chief executive officer of a manufacturing concern at a very early age. He has been in merchant banking, and he has served with distinction as the U.S. Secretary of Commerce. Along with five former Secretaries of the U.S. Treasury, he is a founding member of the Bipartisan Budget Appeal, a group of 500 eminent Americans concerned with reducing the national deficit. He has received many awards for his humanitarian activities. He is truly an all-round citizen. It gives me great pleasure to present to you the Honorable Peter G. Peterson.

Economic Nationalism and International Interdependence: The Global Costs of National Choices*

Peter G. Peterson

The Lecture in Brief[1]

I. Introduction

During the decade of the 1970s, many people became aware of how badly U.S. economic performance was slipping. In trying to understand the reasons behind this slide, I joined the crowd of American Japan-watchers. I did not, however, concentrate on then popular explanations involving, say, the work ethic, labor-management cooperation, or cultural differences with Americans. Instead, my attention was drawn to fundamental economic choices and the policies that shaped them. I studied the extent to which the Japanese were saving and investing vastly more than we—in physical and human capital—both privately *and* publicly. This comparison threw into stark relief what a pro-consumption, pro-borrowing, anti-saving, and anti-investment society America had become.

As I sought to explain why we had evolved this way, my attention turned to a prime source of publicly subsidized consumption, the Social Security program. This was only one of a number of burgeoning

* This is a revised and expanded version of Mr. Peterson's oral presentation.

[1] Many people gave unstintingly of their time and judgment in helping me to prepare this lecture. For reviewing drafts and offering valuable comments, I especially thank Jason Benderly, Peter Bernstein, Mark Clark, Martin Feldstein, Steve Fenster, Larry Fox, Alan Greenspan, John Gutfreund, John Heimann, Bob Hormats, George Lamborn, Arthur Levitt, Jim Leisenring, Tony Solomon, Lee Spencer, Tony Terracciano, Dennis Weatherstone, and Richard Zecher. Members of the Institute for International Economics, including its Director, Fred Bergsten, as well as Bill Cline, Stephen Marris, and John Williamson, helped immensely. Jim Capra, David Hale, and Roger Kubarych made special contributions. Jim Sebenius played a key role throughout in developing the analysis and exposition.

entitlement programs in which benefits greatly exceeded contributions not only for the poor but for the bulk of recipients—who are in middle-income and upper-income groups. Along with sharp boosts in military spending and deep tax cuts, these entitlement programs led to exploding federal budget deficits—a form of negative savings that has drained our already shallow national savings pool into a puddle. Part I of this lecture sketches these trends and discusses why they have transformed our national investment-savings choice, which on its face looks like an economic problem of resource allocation, into a brutal problem of interest group politics.

II. The Current Boom in Investment and Consumption: Supply-Side Miracle or Marshall Plan in Reverse?

But why this national focus and worried tone before an international audience during an economic boom? The explanation for the tone is simple: what now appears as a boom masks some serious economic danger signals. And I focus on U.S. policies since they now exert such powerful influences—both positive and negative—on the rest of the world. More importantly, the apparent success of supply-side Reaganomics is prompting many other countries to ask whether they should adopt like policies. In Part II, therefore, I look at the current recovery and find a world quite different from that forecast by the 1981 supply-siders.

To be sure, there are some very bright spots: inflation, unemployment, gross investment, growth. Yet the outlook for budget deficits is unremittingly grim, despite an ample supply of rose-colored glasses ("we'll grow our way out") and well-intentioned nostrums (the Federal Reserve pumping up the money supply, a return to the gold standard, adoption of a balanced budget amendment).

In part due to the voracious federal appetite for limited credit, real interest rates remain at historically high levels. But I also focus on some far less discussed contributors to high real rates: recent tax law changes as well as financial innovations and deregulation.

Almost by accident, these changes have partially insulated the United States from some of the usual depressant effects of high interest rates. And by means of these changes, we have handily equipped ourselves to receive unpredicted and unprecedented flows of foreign capital. These flows have augmented a domestic supply of personal savings that has stagnated as a percentage of gross national product (GNP) at the level prevailing before Ronald Reagan took office. Foreign capital flooding into the dollar has pushed up its exchange value so that we are importing goods at a rate unmatched since the nineteenth century when the United States was a developing country.

Though our interest rates have depressed foreign recoveries, our imports have provided stimulus abroad. So we have helped others out of recession while they have been sending us an abundance of cheap goods and lending us their savings to pay for them. These inflows have permitted a record U.S. consumption and investment boom, have staved off a real credit crunch here, and have cut domestic inflation sharply. So it seems that we are now enjoying the best of all possible worlds—but how long can it last?

III. Sustainability of the Current Course

Foreign Debt Buildup by the United States. I first present some very new research findings suggesting that *if* the dollar remained at current levels and a series of other conditions (generally favorable to the United States) held, the 1989 current account balance of payments deficit could reach almost 5 percent of the GNP. The previous record of less than 2 percent was set during the U.S. railroad boom of the 1870s. In this chilling scenario, the United States would reverse its post-World War II position as the world's foremost creditor and would rapidly incur nearly $1 trillion of foreign debt—an amount proportional to that of the average heavily indebted developing country when the debt crisis broke out.

Pressures to inflate our way out of this massive foreign (as well as domestic) debt could become overwhelming. The foreign policy implications of a superpower slide into debtorhood are ominous. But the very magnitude of this set of adverse consequences makes it likely that the dollar will decline in value, perhaps precipitously, thus *reversing* some of the most desirable elements of the current recovery.

Protectionist Pressures. Though a flood of strong-dollar cheapened imports has dramatically reduced domestic inflation, it has put tremendous pressure on U.S. export industries, many of them long-time supporters of free trade. With trade deficits reaching $125 billion and growing along with almost 2½ million job opportunities already lost to foreign imports, we can expect a great surge of protectionist measures, especially if the growth euphoria that presently mutes such sentiment should dissipate. The threat to the world's trading system posed by the almost-certain countermeasures has its closest parallels in the 1930s.

Developing Country Debt. A further crucial question of sustainability lies in the resolution of the debt problems of developing countries. Though we have made progress on this front, I present some research on just how thin is the margin, that is, how the world's financial system is hostage to a scant few percentage point swings in growth or interest rates—at which time the debt situation of developing countries could spiral out of control.

Financial System Vulnerabilities. The final set of issues I raise concerning the sustainability of our course moves from questions of macroeconomic policy to those of microeconomic vulnerability. A sustainable recovery that depends on liquidity and credit also requires sound financial institutions. Yet as I gaze over the landscape of the private financial sector, I am struck by a number of recent dramatic episodes—think, for example, of Financial Corporation of America, Drysdale Government Securities, the Continental Illinois Bank, the Hunt brothers' silver drama, and so on—along with generalized signs of strain.

New vulnerabilities seem to be arising as deregulation unfetters the players and competition provides intense pressure for quick earnings results. Still other factors combine to add to the risk of system-threatening financial aneurisms: the globalization of financial markets; unprecedented interest and exchange rate volatility; equally unprecedented proliferation of new, sometimes poorly understood financial instruments; management, accounting, and auditing inadequacies in the face of increased competition and change; the blurring of traditional distinctions among commercial banks, thrift institutions, securities firms, and insurance companies; as well as an inherited regulatory apparatus that is increasingly the target of evasive action.

I am an enthusiast about the continuing potential of deregulation, the futures markets, and financial innovation generally; all of these represent needed responses to a changed economic environment. But for these and further changes to result in maximum benefits requires markets of unquestioned soundness. Further, privatization of rewards should not go with socialized risks—a mismatch that sometimes occurs when certain regulatory protections endure while corresponding requirements and obligations are eased. Potential trouble areas appear to involve a spaghetti bowl of regulation, disclosure, accounting, auditing, and internal management issues. I am disturbed that no one seems to have analyzed these problems as a whole. So I offer an impressionistic sketch of them—and later urge a comprehensive examination by the range of involved parties—before we suffer a crippling financial stroke and before a panicked or aroused Congress gets caught up in an orgy of legislative recriminations and counterproductive proposals.

Looking at both the microlevel and the macrolevel, I ask throughout Part III just how sustainable a course we have mapped. Some have dubbed the U.S. expansion a supply-side miracle and are considering imitating it. Yet much of our current boom in investment and consumption depends on a docile rest of the world patiently sending us its savings and cheap goods. Whether I look to our current account deficits, with growing foreign debts and a rising protectionism that threatens world trade; whether I contemplate the fragile peace on the Third World debt front; whether I monitor the impending pressures to monetize foreign and domestic debts that could again send prices skyrocketing; or whether I survey the spate of new vulnerabilities in the private financial sector—in my judgment, we are not embarked on a course that is sustainable over the long term.

IV. What Can and Should We Do?

The picture is not unremittingly gloomy. To the contrary, there have been solid accomplishments: fighting inflation, building safeguards against another oil shock, picking our way so far through the developing country debt minefield, and fostering a new venturesomeness and indispensable confidence in America.

Still, in addressing the kinds of proposals that could remedy the unsustainable elements of our current situation, I start with a word of caution. As Henry Wallich observed a dozen years ago on this platform: "Experience is the name we give to past mistakes, reform that which we give to future ones."[2]

We all seem agreed on the need for more "discipline" in the international system, but let us not accept the facile notion that injecting discipline—which is to say pain—can be simply administered by external mechanisms, be they exchange rate regimes or revamped international institutions. I shall propose some reforms that might *nudge* countries and our financial institutions toward more responsible courses. However, the stresses now present in the international economic system are fundamental—and overwhelmingly political. As tempting as the prospect is of proposing a Bretton Woods II or a new safety net for developing country debt or some other bold reforms, now is not the time. But to reduce some of the risks of our current course, I do consider a number of proposals.

Reducing Financial Vulnerabilities. I believe that *a group of foundations should support an urgent, wide-ranging private effort to understand and offer recommendations on the real nature and extent of our private sector financial vulnerabilities.* Though I do not think this should be a governmental undertaking, every effort should be made to ensure public cooperation and to have the process and results taken seriously by the executive and legislative branches. This work should be spearheaded by a group of very senior, experienced people from the public and private sectors who have been major players in the involved professions and institutions. In particular, they should be

[2] Henry C. Wallich, *The Monetary Crisis of 1971—The Lessons to Be Learned* (the 1972 Per Jacobsson Lecture, Washington: The Per Jacobsson Foundation, 1972), p. 4.

known for their integrity, deep knowledge, perspective, widespread peer respect, as well as ability to rise above parochial interests. I suggest a number of elements of a charter for such a group and urge that it get under way promptly, before this set of issues becomes dangerously politicized.

Developing Country Debt and Development. I then consider proposals for dealing with developing country debt and world development. I am not sanguine about the possibilities, mainly for reasons of political feasibility. Unless and until we substantially reduce our $175 billion budget deficits and $100 billion current account deficits, the prospects for any major new initiatives will be dim at best. Still, I see a vital role for U.S. leadership in a number of specific areas, a kind of leadership that can be reconciled with the realities of our fiscal condition.

International Discipline. Everyone agrees that more discipline is needed in the international system to restrain countries from going on borrowing and spending sprees that may inflict system-wide damage when the market belatedly but brutally reins them in. As with questions of developing country debt and development, I do not envision fundamental changes in international monetary institutions or processes that are likely to exert much restraint on large countries. Why would the United States, for example, pay much attention to them when it now ignores its own massive budget and trade deficits? Still, I look at some modest measures to improve international economic surveillance.

In particular, *I propose the creation of an external, part-time, independent review body, affiliated with the International Monetary Fund (IMF), available for testimony before governments and able to make public statements. This body would prepare annual public reports on major "surplus" and "deficit" countries.*

Understanding Capital Flows. I also recommend steps to understand the *micro*economic determinants of capital flows, in effect to learn much more about who holds what assets, and why. This knowledge is necessary to predict the real effects of possible modifications in exchange rate systems, tax codes, or regulatory mechanisms affecting, for example, the private financial sector. It is especially important to comprehend these factors before others rush to imitate U.S. policies.

As a step toward such understanding, *I recommend that a consortium of private institutions organize a major conference on the international implications of differences in national tax and regulatory policies.*

Restoring U.S. Fiscal Discipline. My most important proposals, however, deal with restoring fiscal discipline in the United States. This problem is too serious to be handled by technical fixes or clever financial moves by bankers. No, at bottom, it is a political problem of the first order and can only be solved by political mobilization. I describe the founding of the Bipartisan Budget Appeal and its expansion to a more broad-based Bipartisan Budget Coalition, whose members are gearing up for a grass roots campaign similar to the successful one launched last year by two of its members to overturn a legislative measure to withhold taxes on dividends and interest. The required effort to reduce our gargantuan deficits, however, will be much greater.

If the United States succeeds in putting its fiscal house in order, a number of complementary macroeconomic and trade measures need to be taken by the rest of the developed and developing world. In the last part of the lecture, I outline these steps and delineate the stark choice the world now faces—between an increasingly fragile and vulnerable path or one that leads to sustainable real growth and prosperity.

* * * * *

I. Introduction

As I began to prepare for this lecture, my mind turned to the historic Camp David weekend of August 13, 1971, when a group of us had gathered to deal with what to us was an unsustainable international monetary situation. Ringing in my ears was the earlier advice of my University of Chicago professor Milton Friedman—as usual, the advice was unambiguous—as to whether I should take the new job as President Nixon's assistant for International Economic Affairs. "Absolutely not," replied Milton, "with floating exchange rates, the job is unnecessary and without them the job is impossible. You are too young a person to take on a job that is both unnecessary *and* impossible."

Policymakers tended to define the world economy in *trade* terms in those days. I don't think any of us in that group ever imagined a world in which capital flows would be over ten times larger than trade flows. Haunted by what we then considered an "utterly unacceptable" predicament—a looming $2 billion merchandise deficit for 1971—and badgered by that year's protectionist proposal from the legislature, the Burke-Hartke bill, we remembered another University of Chicago dictum: "If you have no alternative, you have no problem." We felt, rightly I still think, that the fixed Bretton Woods system was not a viable alternative in a post pax-Americana world and certainly not in a world where the trade fundamentals of inflation, productivity, labor costs, and oil prices were increasingly going against us. Thus with respect to the "problem" of whether to stay with the status quo, there wasn't one.

I suppose we also sustained ourselves that August weekend with the illusion that we had found a painless, even magic adjustment. Perhaps we imagined that the repegged dollar would glide downward, almost unnoticed by our political adversaries and public alike, and that our trade balances and the jobs that go with them would be stabilized, "equilibrated." *None* of us imagined today's situation—trade deficits of over $125 billion, current account deficits approaching $100 billion, with the dollar *at the same time* approaching new daily highs.

Then came the oil shock as another sample of our failure to see what was coming. As President Nixon's traveling ambassador on such matters in early 1973, I considered myself a bit prescient for the "discovery" that oil and energy were to be the new international agenda items for the balance of the decade. I even disclosed other peoples' predictions—never risking them myself—that oil prices might reach $10 a barrel.

Thereafter, of course, we have all been involved in failures to see what was coming; we were never in doubt but often wrong. Some of us persuaded ourselves that at least 2 percent real annual increases in the price of oil were more or less ordained for the indefinite future. Others, if I may invoke the name of Milton Friedman again, were confident that this cartel, like all cartels, would collapse. When I once asked Milton about his oft-enunciated, unambiguous prediction on the imminent demise of the oil cartel, he replied with his usual equanimity, "I may be wrong on timing, but never on direction." Remembering that, I shall say some things about the direction of things—but not on their timing.

Finally, on the subject of developing country debt our record is again not blemished by success. Some have predicted six of the last three debt crises. At the same time, others have stated unequivocally that developing country debt was not a problem at all; the "market" would deal with all the recycling problems. Alas, as I read Joseph Kraft's lucid account of the emergency handling of the Mexican debt problem and the unexpected, critical role of U.S. Government institutions, I concluded that the pure market, at least as I understood it in my Chicago days, did not "solve" it.[3]

With these sobering experiences in mind, I shall try to be humble but not intimidated, to be a realist but not a Cassandra, and to indicate direction but not timing. But I should say a little more about this last point. Our political system these days seems almost incapable of focusing serious attention on the future. To me, our economic problems are fundamentally long-term ones. My lecture today is thus a good occasion to focus on the long-term sustainability of our course—and not worry too much about just when the dollar will fall or when the next recession will come.

[3] Joseph Kraft, *The Mexican Rescue* (New York: Group of Thirty, 1984).

An Early Fascination with Japan

Let me step back for a moment and take a somewhat longer view. It was not too many years ago that, if you went to an academic forum, a popular subject in America was something called "zero growth." It was never taken too seriously. Rather, it was presented as a kind of hypothetical alternative by which intellectuals could test various value systems. Well, a funny thing happened on the way to the bank. If you look at the decade of the 1970s and examine real income per American worker, you will see that we practically did it; however unintentionally, we achieved near-zero growth of 0.1 percent annually.

We Americans became adept at blaming others for our problems. The Organization of Petroleum Exporting Countries (OPEC) was the principal culprit for much of the last decade. Yet consider the case of Japan. Here was a country that imported 99½ percent of its oil, 55 percent of its food, and most of its resources. During that identical period when the United States exhibited zero income growth per worker, Japan showed a strong positive rate of real income growth as well as sharply lower levels *both* of unemployment and inflation.

Japan also showed an extraordinary trade surplus in spite of the huge deficits that it had to absorb on oil, food, and other resources. Japan increased its manufacturing goods surplus by a stunning $80 billion during that period. Furthermore, its trade balance in technology-intensive products—products that we used to dominate a short ten years ago—is now 50 percent larger than ours.

In view of this impressive record, it is not surprising that America became a nation of Japan-watchers. Many observers focused on various Japanese "ethics"—the work ethic, the quality ethic, the labor-management ethic, the savings ethic—all important intangibles, to be sure. As I watched Japan, however, I concluded that much of the explanation for Japanese success has to do with *economic fundamentals* and public policy. Theirs is one of the most pro-savings and pro-investment economies in the world while we have developed some of the world's strongest pro-consumption and pro-borrowing tendencies. In 1982, for example, installment plus mortgage debt amounted to 5.5 percent of Japan's GNP. In the United States such borrowing for consumption and housing was *almost ten times higher* as a percent of our GNP (48.2 percent). But let us look more closely at Japan's record in investment and savings.

Investment: A U.S.-Japanese Comparison

During the decade of the 1970s, the Japanese invested 9.8 percent of their GNP (net of depreciation) in new plant and equipment. During the same period, we invested only 3.4 percent of our GNP. During that time, for example, they put in place about two thirds of the world's robots. (They are still ordering over half of the robots produced in the world.)

Likewise, there has come to be a new cliché in America, the "crumbling public infrastructure." The idea has existed—and it is a myth—that Japan does not care about its public infrastructure. Let us look at the facts. During that ten-year period, Japan put 5 percent of its GNP into net new investment in public infrastructure. (This rate is over seven times ours, a paltry 0.7 percent of GNP.)[4]

Moving to an ultimately important kind of investment—human and intellectual capital—as a percentage of GNP, Japan spent at a rate 1.2 times ours on nondefense research and development; they spend roughly three times as much as we do in science training and education for their children. Many more of their high school students, for example, study calculus and computer-related subjects.

So a fundamendal theme that runs through the Japanese picture is *investment in their economic future:* in human terms, in private capital terms, and in public capital terms.

Savings: A U.S.-Japanese Comparison

To fuel this higher rate of investment, the Japanese save a great deal more than do Americans—from 1974 to 1980, for example, households there had a net savings rate amounting to 19.5 percent of their disposable income while the comparable U.S. rate during the 1970s averaged a meager 6.5 percent. In 1983, it was 5 percent and has crept up to about 6 percent so far this year.

Why do the Japanese save more? To some extent, savings is an ethic and an attitude—but only to some extent. Beyond such factors, the Japanese have a much greater *need to save.* In Japan, buying houses and durable consumer goods on credit is difficult and requires much larger downpayments. In America, the tax laws and banking system are heavily skewed toward financed consumption. For example, a Japanese family shopping for a home benefits from none of our tax advantages for mortgage interest payments (full deductibility) and property taxes. Typically they must save for at least half of the total price as a downpayment versus 10–15 percent of it in the United States.

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[4] Of course, a great deal of infrastructure which is privately financed in the United States (railways, utilities, communications, television) is publicly financed in Japan and most other countries. But even if much of what is publicly financed in Japan is privately financed here, the fact that the U.S. *private* investment rate is also below Japan's adds to the case for inadequate "public" investment here.

Further, the public and private pension systems in Japan are relatively meager, forcing workers to save more for retirement. Social Security in America—an unfunded program—is believed by many to be designed to provide every eligible retired person, regardless of need, with a stipend sufficient to cover most of life's necessities. The need to save during one's working life is weakened accordingly.

For another thing, the Japanese have consciously designed their entire system of economic *incentives* to reward savings and investment. In Japan, personal income derived from capital (i.e., from savings) is taxed lightly or not at all. The most obvious difference with respect to the United States lies in the treatment of capital gains. Japan, along with about half of all industrial countries, does not normally levy any tax on gains earned by individuals from the sale of financial assets. In addition, Japan exempts interest received from savings up to approximately $60,000 distributed among postal, bank, corporate bond, and "employee benefit trust" accounts. In the United States, such "unearned income"—a singularly perverse turn of phrase—suffered especially high taxes until recently and still enjoys relatively small tax incentives.

Unlike the United States, the Japanese directed their massive savings pool toward *industry* with a variety of incentives, including large differentials in borrowing rates between industry and consumers. George Hatsopoulos calculated that, as a result of this and related policies, the cost of capital to Japanese firms averaged half of that to U.S. firms from 1961 to 1981.[5] At least three other studies have reached qualitatively similar conclusions.[6]

In the United States, of course, the thrust of many of our policies is *consumer leverage*. Beyond the tax advantages I mentioned above, we have established an alphabet soup of federal and federally sponsored agencies to ensure high leverage to home buyers, to grant direct housing subsidies, and to guarantee loans. The amount of home loans insured and guaranteed by the federal government, astonishingly, is roughly *ten times* the sum of outstanding federal loans and guarantees for business purposes.

Now, to be sure, the Japanese taught us something important, or should have, about certain other topics, such as concepts of labor and

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[5] George N. Hatsopoulos, *High Cost of Capital: Handicap of American Industry*, study sponsored by the American Business Conference and Thermo Electron Corporation (Waltham, Massachusetts: Thermo Electron Corporation, April 1983).

[6] For an evaluation, see Philip A. Wellons, "Competitiveness in the World Economy: The Role of the U.S. Financial System," in *U.S. Competitiveness in the World Economy*, ed. by Bruce R. Scott and George C. Lodge (Boston, Massachusetts: Harvard Business School Press, 1985), pp. 358–62.

management working together. And the Japanese success was enhanced by having major trading partners, and a dominant one like the United States, that follow opposite policies, especially in terms of trade openness. But when someone is saving much more and investing three to four times as much as another in productivity-enhancing equipment and education, there is an important lesson to be learned by the laggard.

How the United States Became Addicted to Consumption

History provides some important clues to America's pro-borrowing and pro-consumption tendencies. After World War II, many of our present-day industrial competitors were redesigning their economic policies to foster investment and savings to rebuild their capital stock. At the same time, our plants and factories were intact; what we needed was strong consumer demand to keep them producing up to capacity. The keys to long-term prosperity for Americans seemed to be saving less, borrowing more, and spending heavily on domestically produced consumer goods. And we installed powerful incentives to achieve these objectives.

By the 1960s and 1970s, the belief that American economic growth would continue almost automatically became a virtual article of faith. This made possible a "we can do and afford anything" mentality, which was reflected in a dramatically expanded public sector. (A similar expansion occurred in many other member countries of the Organization for Economic Cooperation and Development—OECD.) In slightly less than three decades, public spending in the United States increased by almost 15 percentage points of the GNP. The overwhelming force behind the growth in public spending has been an explosion in transfer payments which accounted for over 9 percentage points of this increase; in fact, transfer payments soared from 4.1 percent of GNP in 1954 to a stunning 13.2 percent of GNP in 1982.

Even as a noneconomist, I realized that one cannot simultaneously consume and invest the same resources. Thus, when I tried to determine just where our vast resources were going—if not to investment—my attention turned to the consumption biases in our economy and to our *political* economy.

If we look at the overall federal budget for a moment, we can see where a good deal of this subsidized consumption takes place. The largest spending category involves programs whose benefits do not depend on recipients' incomes—the so-called nonmeans-tested entitlements programs. Thus a substantial portion of these programs' benefits go to middle-income and upper-income groups. Including Social Security, Medicare, as well as certain civil service and military pension plans, these programs return far more to their beneficiaries than was ever contributed—thus they constitute a form of welfare or subsidy for *all*. These programs accounted for over 40 percent of the federal budget outlays in 1983. They will approach some $360 billion by 1985. They have been growing at roughly 15 percent a year since the mid-1960s, compounded. Look at the great growth companies in America; you won't find a single one that has been growing for almost 20 years at a compound rate of 15 percent. The amount of money for these entitlement programs is roughly ten times as much as all companies in America spent on their research and development, which is what our political *rhetoric* calls for. We now have $7 trillion of unfunded liabilities from the largest entitlements—Social Security, Medicare, as well as military and civil service retirement—whose benefits are unrelated to financial need. That is $30,000 for every American—a huge bill we are quietly slipping to our children.

As I looked at Social Security, pension, and various other transfer programs, I was struck with how far we had moved from welfare for the poor to a form of welfare for one special interest group after another—until we ended up with a system of welfare for just about everyone. Our economy came to resemble a giant vending machine to which we spent inordinate time granting group after group privileged access, while diverting our minds from how to maintain and fill it up. The symbiotic coalitions that formed and entrenched themselves—legislative vendors and happily dependent, politically supportive recipients—have converted our national investment-savings choice, which on its face looks like an *economic* problem of resource allocation, into a brutal problem of interest group *politics*.

Enormous deficits are one product of these trends toward publicly subsidized consumption—not public investment of which there has been relatively little. And these deficits represent negative savings, which drain our already shallow national savings pool into a mere puddle.

Given my concern for the long-term health of the American economy and its need for savings and investment, it was natural that I began to focus on the political economy of deficit spending. I have been seeking to understand and find ways to alter the prevailing political equation—which shows unparalleled skill at distributing resources (pleasure) but becomes virtually paralyzed when distribution of economic sacrifice (pain) is required.

And, in preparing this lecture, I have begun more carefully to evaluate these U.S. policies in an international context—something we Americans consider all too rarely. For many of us, exchange rates are something to notice only when traveling. And too few of us have traveled much: recall the boast of Wilbur Mills, Chairman of the powerful House Ways and Means Committee, that he had never been to Europe—and this was in the early 1970s.

As I have examined the present situation, my conviction has grown that U.S. policies are hustling the world down an unsustainable path. I am led to an international analogue of the questions that have bedeviled me about controlling my own country's addiction to borrowing and consumption. Further, the international monetary system gives too much rein to countries—especially large ones like the United States—that want to go on borrowing and spending sprees. I will investigate ways that the system might restrain such courses of action *before* the market does so—with widespread and damaging effects.

But why all this ominous talk? Are we not in the midst of an unprecedented economic boom? And if we are, shouldn't others adopt the economic policies championed by the Reagan Administration—as some are now seriously considering? To answer these questions, we need to look more closely at the nature of the current expansion. Is it a supply-side miracle—or something else?

II. The Current Boom in Investment and Consumption: Supply-Side Miracle or Marshall Plan in Reverse?

To all appearances, the U.S. expansion stands out most prominently on the world economic landscape. With second quarter real GNP growth at 7.1 percent, inflation running—I should say crawling—at an annual rate of 3.3 percent (as measured by the GNP price deflator), and unemployment down almost two points from a year ago to 7.4 percent, our economy is arousing admiration and envy around the world.

With this sharp economic rebound, some supply-side economists claim vindication for their policies, that Reaganomics is an unqualified success. Are they right? To answer this question, I must first clarify just what the catch-all phrase "Reaganomics" was supposed to have meant. Though "Reaganomics" now variously refers to tax cuts, defense increases, support for anti-inflation policies at the Federal Reserve, and deregulation, I will mainly focus on the original supply-side prescription embraced by the Administration in early 1981 which primarily emphasized individual tax rate cuts. They were to have been accompanied by substantial nondefense public spending reductions. Major business tax cuts were a separate matter that Republicans, Democrats, liberals, and conservatives in the Congress virtually all decided were necessary.

A prominent administration claim in March 1981 was that deficits would not rise with the tax cut and that the budget would balance by 1984—since rapid economic growth would more than offset the effects of the tax cuts. A roughly $175 billion deficit this year eloquently refutes this claim.

As to the actual extent of our economic expansion, cumulative growth from the first quarter of 1981 to the third quarter of 1984 was forecast to have been 15.2 percent; after the economic trauma of the deepest recession since the 1930s, the economy actually grew by a total of 9.0 percent, less than two thirds the amount projected.

An explosion in personal savings was to have offset the economic consequences of any deficit. Though personal savings *as a percentage of disposable income* has risen modestly, the more relevant measure for economic purposes is personal saving *as a percentage of GNP.* This latter measure has, so far this year, remained virtually *unchanged* from the 4.2 percent level observed in 1980 before the supply-side revolution took place. This result falls a full percentage point less than the original projections. Gross business savings have indeed risen as has gross private fixed nonresidential investment—especially for short-lived structures. Still, our *net* investment rate (after depreciation or capital consumption) was only 2.8 percent of GNP in the second quarter of 1984, well below the roughly 3–4 percent net rates prevalent in the 1970s and the 4–5 percent net investment rates of the 1950s and 1960s.

Real interest rates (on three- to five-year notes) were forecasted to be at 3.3 percent for the third quarter of this year; in fact, they soared to 8.1 percent—well more than *double* their projected level. Dramatic surges in productivity and competitiveness were to have given us a net export surplus of over $65 billion (1984 dollars); our $125 billion-plus trade *deficit* suggests that something must have gone awry. All this is unfortunate; there is nothing quite so sad as a beautiful theory mugged by a gang of facts.

Yet our recent growth spurt, low inflation, investment increases, and employment gains make the picture look rosy—even if the supply-side prescription may not be fully responsible. To untangle the causes, I shall first focus on a few of the warts on our economic performance—deficits and real interest rates. That clears the way for a deeper exploration of what is really behind our recent record—and a cautionary note for its would-be imitators.

There have always been good reasons to admire America, but from Ponce de Leon's "discovery" of a fountain of youth in Florida to reports of gold-paved streets in California, some of the stories need a second look. While there is much to emulate, wholesale adoption may not be desirable—certainly until we understand the causes more clearly.

The Grim U.S. Budget Outlook: Public Expression of Our Borrowing and Consumption Bias

Despite the cyclical rebound, our deficits are alarming. By fiscal year 1985 under the original Reagan plan, we were to have had revenues equal to about 19 percent of GNP—which we have achieved. On the spending side we have not achieved our goals (also 19 percent of GNP), which would have resulted in a balanced budget. Instead, spending is now at record highs, between 23.5 per cent and 24 percent of GNP. Thus, in 1984, the Government must borrow about one dollar for each five that it spends. This deficit represents 4.5–5 percent of GNP, compared with a 1–2 percent level characteristic of this point in the business cycle.

The deficits have reached the point where they feed on themselves. Interest payments on the accumulating debt will double between 1981 and 1985. The rise in interest costs alone has already offset all the nondefense spending cuts made so far during the Reagan Administration. By 1989, these interest costs are likely to reach a level over $200 billion, or a rise from 2 percent of GNP in 1980 to almost 4.2 percent of GNP in 1989. Interest alone would then consume about 20 percent of the federal budget.

Five years of $200 billion deficits would bring the national debt held by the public above $2 trillion—implying that a mere 1 percentage point rise in interest rates would add $20 billion or more annually to the deficit. The overall upward trend in U.S. debt is ominous. For over two decades, the ratio of nonfinancial sector debt to GNP in the U.S. economy stood at about 1.4. It jumped to an all-time high of 1.53 in the second quarter of 1984. This sharp increase in debt and interest payments, rather than any particular year's deficit, is really worrisome for long-term economic health.

Rose-Colored Glasses: "We'll Grow Our Way Out"

Faced with these grim projections, many among us—especially our politicians—turn to various forms of denial. In other words, if we don't have a problem, we don't need a solution. One of the most common versions of this syndrome is the assertion that we will "grow our way out of this deficit."

Unfortunately for this pair of rose-colored glasses, a fundamentally new development is not only the unprecedented size of the deficits but their size *at this point in the recovery.* A new word has been added to our fiscal vocabulary: *structural.* Heretofore, U.S. deficits have generally been cyclical phenomena, increasing during recessions and ebbing during recoveries. Now, however, they are built into our spending plans even assuming a recovery and "full" employment (6.5 percent unemployment).

For example, James Capra (Budget Consultant, Bipartisan Budget Appeal, Senior Economist at Shearson Lehman/American Express, and an uncannily accurate forecaster) estimates that the budget deficit will grow from about $185 billion in 1985 to over $200 billion for the remainder of the decade, reaching $237 billion in 1989. His 1989 deficit forecast is somewhat below that of the Congressional Budget Office and above that projected by the Administration. Capra's estimate is not based on pessimistic assumptions: in his calculations, real GNP grows at between a 3 and 3½ percent rate throughout the rest of the 1980s, undiminished by another recession, inflation hovers around 5 percent, and short-term interest rates fall from current levels to about 9 percent.

In line with economic forecasting practice, none of the usual deficit projections include a recession at any time over the next five years. Yet suppose that the economy slips into a year-long recession starting in the third quarter of 1985, with real GNP falling 2 percent from peak to trough. Even with a 6 percent real growth snapback over the next two years, the deficit would soar into the $250–300 billion range by the end of the decade. Beyond its cyclical effects, such spillage of additional red ink would add to the deficit's structural component; the rise in public debt caused by the recession-induced deficits would impose permanently higher interest costs that recovery would not erase.

The "grow our way out" scenario requires that unremitting, robust growth pull us out of the deficit hole. To reach a deficit of "only" $30 billion by 1989, we would need to combine real growth rates of just under 6 percent for seven consecutive years; unemployment would have to fall to 2 percent, inflation to 3.5 percent, and interest rates to 5 percent. If you believe that will happen, I have several Brooklyn Bridges I might sell you.[7]

In fact, we simply do not have the physical resources to "grow" out of the deficit problem. Trying to do so would really mean trying

[7] I assume that Martin Feldstein, President Reagan's former head of the Council of Economic Advisers (CEA), would *not* be among the likely buyers. After a detailed analysis, he had the temerity to write in the 1984 *Economic Report of the President* (p. 36) that a "prudent policy at this point must assume that economic growth alone will not eliminate these deficits." After Feldstein's departure and with the subsequent vocal reassertion of the Administration's view that at some point the "lines will meet" (revenues heading north equaling expenditures) due to growth, I was intrigued to read CEA member William Niskanen's comment in the *Washington Post* (November 11, 1984, p. G4): "But the people [in this town] who are saying that we can grow our way out of the problem, they are saying that we do not need to make any hard choices. I wish I believed that, but I don't." Ring up another "no sale" for the Bridge.

to *inflate* our way out. And since investors have learned their inflationary lessons, interest rates would soar—and recession would be inevitable. So what other painless prescriptions are offered? Beyond an ample supply of denials that there is a problem, there are always nostrums.

Nostrum No. 1: The Federal Reserve Should Loosen Up

Some liberals, and surprisingly, others usurping the mantle of fiscal conservatism, have found what they think is a painless escape route. If only, they suggest, the Federal Reserve would really loosen up, the deficit problem would sort itself out. In effect, they have been saying that we should combine the loosest fiscal policy in history with a loose monetary policy. Should this ever happen, the financial markets would speak on the tape—instantly, globally, unambiguously. Then, some of those now suggesting monetary stimulus, regardless of the state of fiscal policy, might blame the markets for the message received. That would be like the familiar fat man blaming his obesity on the waiter or perhaps on the bathroom scale.

Nostrum No. 2: Going for the Gold

Yet another painless cure for our fiscal excess involves going for the gold in this year of the Olympics. We on Wall Street have an inelegantly named—for this distinguished group at least—"smell test" for propositions of this sort: if it's too good to be true, it probably is.

I have tried to follow the writings and teachings of our gold disciples, some of whom have intimate access in very high places. What is the thrust of some of their claims? They promise something of an economic Nirvana—the longest sustained boom without inflation since the Industrial Revolution began. They tantalize us with visions of real income growth at 8 percent for four years or so, a full decade thereafter of economic growth averaging 6 percent annually, 50-year to 100-year bonds at 3–5 percent interest, an extraordinary surge in investment, an end to the deficit problem that would not require spending cuts; the solution would come from economic growth and an interest rate decline. In fact, the gradually developing budget surplus would reduce the national debt. And all this by the stroke of the constitutional pen. This approach seems even better than a simple "grow your way out" nostrum. Or is this a monetary Olympics that we should boycott?

To be effective, the gold standard needs to bring about a psychological sea change. Yet, would markets believe it? We have gone off the gold standard before as have others like the United Kingdom. Trying to return irrevocably to it would be, as Herbert Stein suggested, like "trying to put toothpaste back into the tube." With our extravagant record in fiscal policy, would you bet your assets on this proposition that would supposedly bring about instant and permanent economic discipline?

Like so many other alleged painless cures, without political will for the monetary and fiscal discipline needed to stay on the gold standard, we would undoubtedly recant. And we would be worse off for having invested the attempt with national credibility.

With the political will to abide by the fiscal regimen implied by the gold standard we would not need the standard in the first place. Indeed, inside the Trojan horse that promises us a golden age hangs an inescapably painful price tag in fiscal discipline. But if we were willing to pay the necessary price, we could do much better than gold in a world full of changes and surprises. The yellow metal is a blunt instrument. And gold is too volatile a commodity on which to base our money supply.

Nostrum No. 3: A Balanced Budget Amendment

The heavenly twin of the gold standard—the balanced budget amendment—suffers from a similar problem, though its proponents have focused on exactly the right problem—lack of fiscal responsibility. Still, with the political will and discipline, we really wouldn't need the amendment and could employ more refined economic tools; yet without the requisite will, we would undoubtedly embark on all sorts of evasive measures (off-budget, nonaccountable items) and break artificial rules that would melt in the face of our political indiscipline.

Moreover, urgent fiscal action is needed *now*. It would be a tragic waste if the considerable energies, goodwill, and talents of the balanced budgeteers did not also focus on the ongoing fiscal hemorrhage. Waiting for a constitutional convention could divert our attention from our current critical predicament, losing precious time and the rare opportunity to act now during an economic upswing.

And a final word on all these nostrums: their proponents wax eloquent on the pleasures of successful economic policy. They are tellingly silent, however, on the *means* through which their remedies would have to act—that is, by imposing significant fiscal pain as the growth in consumption is cut back dramatically—in order to make possible more consumption in the future as we enter an age of sustained growth.

To me the resurgence of these and similar nostrums is a manifestation of a much larger split among those of us who used to be called "fiscal conservatives." One camp has formed around the politics of optimism, growth, and pleasure. Painful subjects such as specific spending cuts or taxes are pronounced "unnecessary"—and when that assertion is blatantly unsupportable, "Camp Happiness" just brushes the objections aside, conjuring up visions of all gains and no pains. Its members also have a series of names for the other camp—the "gloom and doomers," the "nay sayers," the "pessimists," the "malaise-mongers." Somehow, those of us who hold a deep concern for the future and focus on painful problems to be solved have managed to end up tagged with the politics of despair, limitation, and pain.

Interest Rates in the Recovery: The Real Story

But let us return to the nature of the current recovery and consider the case of interest rates. When the current Administration took office in January 1981, 30-year treasury bonds had a *negative* 0.1 percent real rate. (The "real rate" is derived by taking a 12.1 percent nominal rate less the 12.2 percent three-month moving average of the consumer price index—CPI.[8]) In August 1984, by contrast, 30-year real rates had soared to a positive 9.9 percent level by the same measure. The yield in U.S. bonds has exceeded that on U.K. bonds for only the third time this century. In the 1970s, there was often a 500 basis point gap the other way. In fact, our bond yields are now higher than the French as well; only Italy among the OECD countries tops us on that score.

High Deficits, High Real Interest Rates

The expectation of continuing high deficits has undoubtedly pushed up U.S. rates relative to those in other major financial centers. As markets have become convinced that the Federal Reserve was unwilling to finance these deficits through the printing press, inflationary expectations—and hence their effects on nominal interest rates—have undoubtedly moderated.

Some argue that a more decisive lowering of inflation expectations will occur and that this will cause a major interest rate drop. But we have had nine months of uninterrupted good news about inflation, and long-term interest rates in September 1984 have still averaged 1.5 percentage points higher than in January.[9] To me this is evidence not of high inflation expectations abnormally pumping up interest rates,

[8] Of course, expected inflation may not be well captured by the current CPI—despite its widespread use and familiarity as a measure. Still, the conclusion that real interest rates are abnormally high holds with virtually any measure of expected inflation. For a sophisticated discussion of high real interest rates and their transmission abroad, see Robert E. Cumby and Frederic S. Mishkin, "The International Linkage of Real Interest Rates: The European-U.S. Connection," Working Paper No. 1423 (Cambridge, Massachusetts: National Bureau of Economic Research, August 1984).

[9] The late October 1984 bond market rally, impressive as it was, has only brought the average yield on long-term treasury bonds for October back to January levels.

but of high *real interest rate* expectations. To my mind, the severe and continuing public-private clash for credit—and fear of such a clash in the future—bears a major responsibility for high real interest rates. In 1983, federal deficits claimed some 65 percent of the net savings in America (including the foreign capital inflow which has recently eased the usual, nearly zero-sum contest between public and private credit allocation).[10] No wonder that the scramble for the scant remaining funds pushes up real interest rates.

Tax and Regulatory Changes—Hidden Contributors to High Real Rates

A second, far less well-known set of factors has affected real interest rates in the United States. In particular, recent tax and regulatory changes have improved rates of return on real assets and corporate investments relative to interest-bearing financial assets; *thus, financial assets require a higher return—by perhaps 3 percent—to be in equilibrium with real asset returns.* These effects were quite unintended, almost by-products of other policies. But let us consider them in some detail.

According to preliminary calculations by Jason Benderly of Kidder, Peabody, Inc., the overall effective tax rate for U.S. corporations on real investment dropped from an average of about 65 percent in the decade before 1981 to about 45 percent afterward. The effective rate is a function of the statutory corporate rate, overstated profits due to historical cost depreciation coupled with high inflation, as well as dividend and capital gains taxes. This drop in effective tax rates occurred in part because of changed U.S. depreciation laws and lower inflation. For the period 1976 through 1980, there was, on average, a $13 billion gap in the United States between economic depreciation and tax depreciation for nonfinancial corporate business, according to the Commerce Department. By the third quarter of 1984, depreciation tax law changes and lower inflation had transformed this tax write-off shortfall into a $58.6 billion surplus. The swing in cash flow to businesses is over $70 billion. Since real aftertax returns on investments have improved with the tax law changes, U.S. businesses have been willing to pay higher interest rates. The upsurge in cash flow has meant that they have had more funds to do so.

[10] Traditionally, the public sector share of funds raised in the credit markets starts high early in a recovery and declines as private demands increase. For example, in 1975, the first year of a recovery similar to our current one, the public share of all credit raised was 46.2 percent. It declined to 30.8 percent and 21.6 percent over the next two years. The current recovery has seen a much higher, sustained public share of all credit raised, resulting in real interest rate pressures.

Disconnecting the Old U.S. Circuit Breaker for High Interest Rates

Further, financial deregulation has meant that savings and loan associations, thrift institutions, and small banks could bid aggressively for funds at higher levels of interest rates than was possible before. Prior to 1978, the United States had a fairly rigid system of controls on retail deposit rates in banking and in the thrift industry. As a result, rising interest rates would result in market disintermediation from mortgage lending institutions. In turn, this produced slumps in home building activity—followed by much of the rest of the economy—without the Federal Reserve pushing interest rates to high and unknown levels. Many economists, especially on Wall Street, maintain that these regulations acted as a kind of informal circuit breaker on the economy. No longer.

Still further changes have reinforced the U.S. tolerance for higher interest rates. Financial innovations have become legion; for example, three years ago, variable rate mortgages accounted for only 5 percent of U.S. mortgage lending; now they comprise two thirds of all new mortgages. These new instruments often carry large interest rate concessions in the early years of the loan, making home builders initially less sensitive to increases in long-term interest rates. (Of course, this renders buyers vulnerable to higher-than-expected debt service charges in later years—with uncertain economic and political ramifications.) Thrift institutions now also aggressively promote new types of credit instruments and are changing their approach to risk management (more on this phenomenon later).

For individuals, tax rate changes have actually not quite offset the bracket creep of the late 1970s.[11] Full deductibility of interest—unique in the United States among developed countries—leaves strong tax incentives to borrow in order to lighten the individual's tax burden. Thus, particularly with a fresh recovery, a much larger rise in real interest rates in 1982 and 1983 than occurred would probably have been required to suppress U.S. consumer demand.

Taken together, these changes permitted strong demand to continue in the United States despite real interest rate levels that are enormously high by historical and global standards. It seems that the United States, quite by accident, has equipped itself to weather high interest rates relatively better than other industrial countries and thus, to become a large and persistent capital importer.

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[11] In fiscal year 1984, the GNP share for individual income tax collections exceeded the share of fiscal year 1981, the highest figure in the postwar era.

High U.S. Interest Rates and Other Countries

Ironically, over the last few years, other OECD countries have been attempting to lay the foundations for sustained long-term growth by following *restrictive* fiscal policies aimed at bringing domestic inflation and hence interest rates down. Structural budget deficits in OECD countries have been sharply reduced generally and have even moved into surplus in the United Kingdom and the Federal Republic of Germany. As you know, high U.S. interest rates tend to hold up rates across the whole OECD area as other governments have tried to defend their currencies from further erosion against the dollar. Thus, domestic demand elsewhere in the world has been slowed by the U.S. combination of tight fiscal policies and high real interest rates.

Balancing this depressant effect, though, the United States as an indomitable importer has stimulated economies around the world. (As one high U.S. official asked me, not entirely tongue-in-cheek, "What other country would voluntarily run such huge trade deficits, just to help the rest of the world?") In 1970, the United States absorbed 17 percent of the manufactures imported by OECD countries, whereas in 1984 its share approached 23 percent, and is undoubtedly higher now. In this trade sense, the United States has been a locomotive.

Yet some in Europe, despite significant export gains to the United States over 1983 (e.g., 20.5 percent for the United Kingdom, 39.2 percent for France, and 39.8 percent for the Federal Republic of Germany), fear they could eventually lose a great deal by their enormous capital flows to the United States. Of course, this kind of apprehension is far less among East Asian countries and areas such as Japan, Taiwan (that has roughly a $9 billion trade surplus with the United States—almost one third of Japan's), or Hong Kong (whose exports to the United States have doubled since early 1983). During January–July 1984, for instance, Korea, Singapore, Hong Kong, and Taiwan as a group exported 74 percent more to the United States than they did in 1981.

Thus, although different countries react to high U.S. interest rates in different ways, virtually all of them have helped America out in a manner that almost no one predicted: by sending us their savings. To see why, we must return our focus to the U.S. economy and the behavior of savings and investment in response to Reaganomics.

U.S. Investment No Longer Equals U.S. Savings

With substantial business tax cuts and the present recovery, real investment for the first six quarters of the recovery has risen to record postwar levels for a comparable stage in the business cycle. We have seen a 26 percent increase in business investment over this period of which nearly two thirds of the total went for equipment rather than longer-lived structures (such as new plants). Compare that figure with the next highest level of 23.3 percent in 1949 and 5.6 percent for the 1975 recovery.

Gross business investment at 11.6 percent of GNP this year compares to a 9.5 percent share 20 years ago. But the picture is mixed. Money is now being spent on equipment with a shorter expected life than that purchased during the investment surge of the 1960s. The shorter the useful life, the larger the annual charge for depreciation. The larger the depreciation charge, the higher that the level of *new* investment must go just to maintain a given capital stock level. If we adjust both GNP and gross fixed business investment for depreciation, our *net* investment rate is quite low, registering a scant 2.8 percent of GNP in the second quarter of this year. This net investment rate is up for recent years but well below the usual pace of the 1950 to 1980 period.

Still, this investment boom, taken by itself, is most welcome news. The great problem in the U.S. economy today, however, is that our policy changes have succeeded in boosting investment but not domestic personal savings. As I noted earlier, the original Administration plans predicted that a savings boom was to have financed the investment surge. Despite this supply-side presumption of a strong savings burst from tax cuts, however, personal savings have hovered near 4 percent of GNP since the third quarter of 1983 (when the last installment of the Reagan tax cuts were made). This is about equal to the 4.2 percent of personal savings to GNP ratio seen in 1980 and about 15 percent less than was forecast in the original Reagan budget.

Besides, the tax cuts that Congress enacted—in what we Americans call the "Christmas tree" phenomenon—ended up by giving far more to individuals than originally proposed by the Administration. Over the five years, 1981 through 1986, the tax cuts contained in the President's February 1984 proposal were projected to reduce revenues from what they would have been by a cumulative total of $718.2 billion. The projected revenue loss had the following composition: $553.9 billion (77.1 percent) from the individual rate cuts and $164.3 billion (22.9 percent) from the accelerated cost recovery system. Then the House struck further blows for the individual. First came liberalized Individual Retirement Accounts, then estate taxes, then charitable contributions, then in an act of coalition unity, they added tax indexing, without a single day's hearings. Leasing provisions, repealed in 1982, were a House add on. The Senate agreed to these changes and added some cuts of their own. After such a hard month's work, everybody went home for August vacation. The rest of us can only be thankful they did not "work" a month longer.

It may be, as Governor Jerry Brown says, that "there is no constituency in America for fiscal responsibility"—but there certainly is support for tax cuts. To constituent-sensitive legislators, the term "positive sum game" would be weak relative to what happened in 1981. That feeding frenzy on the tax code appeared more like a "maximum" sum game, with each player trying to increase the total package of cuts. *If left intact through 1989, that is, without the two intervening tax increases, the 1981 tax changes would have reduced revenues by a stunning 6 percent of GNP—from 23 percent to 17 percent of GNP!*

Even though the personal savings rate has stagnated, business savings have gone up—not as part of original supply-side program—but largely from business tax law changes originating in Congress. Still, net of mammoth public dissaving (deficits), *the overall rise in domestic savings as a percent of GNP was 2 percentage points short of the strong rise in investment.*

Consider the consequences of this situation. If the United States had been a closed economy, interest rates would have had to shoot up by enough to cut back the surge in net investment demand by more than a third. When I ask my economist friends to estimate *how much* interest rates would have had to have risen, they typically draw in their breath, refuse, or mutter something about 20 percent levels or certainly an increase of at least several percentage points.

This real interest rate differential in favor of the United States—combined with slow growth and misfortune in other economies, badly squeezed profit margins abroad, relative political stability here, and the general feeling America was indeed standing tall—all led to the unprecedented and unpredicted result that the capital inflows to the United States are now between 2 percent and 3 percent of GNP—just, of course, balancing the current account deficit.

For example, much capital is coming from Japan, which in effect is lending us its savings to purchase its goods. As David Hale observed, this relationship between the United States and Japan resembles that of a certain kind of old married couple: one spouse likes to spend and the other likes to save. It is questionable how long the affair can last. But for the time being, it is a happy and complementary relationship—if a bit neurotic.

In short, the real rate of return on dollar securities has been given a special boost by the enormous projected deficits—that now threaten to absorb more than half of future domestically generated net U.S. savings. Real interest rates must rise to balance the supply and demand of funds. This can happen by discouraging investment or attracting capital from abroad. So far, roughly $100 billion of foreign funds have flowed in—enough to finance more than half the budget deficit, or 40 percent of all net investment in the United States.

The U.S. Consumption and Investment Boom Depends on the Rest of the World

So now it seems that the United States is enjoying the best of all worlds. We have strong growth, low inflation, increasing investment, and declining unemployment. But let us look again. As is the case in many things, we may be buying current pleasure by inflicting pain on future generations.

We now see the curious situation in which the American standard of living and investment (expenditures) are up by 15.0 percent in constant dollars between the recession trough in the fourth quarter of 1982 and the third quarter of 1984, while the output of American workers (GNP) rose by only about three fourths of that amount, or 11.6 percent.

The huge trade deficit—*the functional equivalent of a second recession in the export sector*—has helped to keep domestic wages and other costs and prices low. The price level has been held down directly by foreign manufactured goods made cheap by the strong dollar and indirectly by the pressure of these goods on import-competing domestic producers. For example, wage demands have significantly moderated. The strong dollar coupled with high interest rates has also depressed dollar-denominated world commodity prices. Finally, in the absence of a massive 3 percent of GNP increase in imported goods, we would already have exceeded a domestic capacity utilization level of 86 percent—which is where inflation generally begins to take off. All told, the price level reduction has amounted to perhaps 5 percentage points over the last three years, or 1½ percent to 2 percent a year. But domestic "core" inflation is higher than the current CPI. It is not irrelevant to observe that *nontradable* components of the CPI are up 6 percent this year.

To sum up, America is enjoying growth from its own expansionary fiscal policies, and importing anti-inflation gains from other countries. Viewed another way, a conservative administration promised us a high savings economy. Instead, we have a Latin American style boom, financed by foreign borrowing and an overvalued dollar.

Some call this a "Marshall Plan in reverse." But it is an imperfect analogy. In the 1960s, with an overvalued dollar, de Gaulle used to chide us about buying up the rest of the world cheap. And we had a current account surplus! Those policies—in which the United States made *real investments* abroad—produced *future income* to sustain us. This time we are mainly incurring *debt*. This year, the United States has funded its $100 billion current account deficit with $8 billion in direct investment, $13 billion in equity and long bond purchases, and the rest by short-term instruments. The predominance of these so-called hot dollar investments, which can quickly be moved, mean that a loss of confidence by foreign investors could quickly turn into a run on the dollar.

Put differently, in the 1960s we invested in the rest of the world's economy through our capital account; now we are stimulating it through our current account. Of course, the large current account deficit is the counterpart of our capital inflows—which permit an investment boom without restraining our rate of consumption (now at a postwar high of about 66 percent of GNP). In this sense, our current account deficit functions like an emergency spare tank of fuel—it permits us to roar forward, at least for a while.

No one predicted—most certainly not Arthur Laffer, the more ardent supply-siders, or the other architects of Reaganomics—that the United States would become a major capital importer. Had the United States been a closed economy, George Bush's memorable (to everyone but him) "voodoo economics" label would have been apt for the President's remarkable combination of unprecedented peacetime defense increases, a domestic investment boom, and 1981 tax cuts totaling $750 billion over five years. The only way these inherent contradictions could be resolved was through a mechanism predicted by very few and little understood until recently—massive imports of foreign capital.

In Switzerland, a foreign critic of our economic policies recounted an analogy between Christopher Columbus and our recovery. Columbus didn't know where he was going, where he was when he got there, or where he had been when he came back. The only thing he was sure of was that the trip had been paid for with foreign money.

Some have said that our present policies have given "beggar thy neighbor" new meaning—on capital rather than trade. Of course, we do not have to beg—others seem thrilled to send their money here.

Other countries used to say that we sneezed and the rest of the world got pneumonia. Now it might be said we caught a very bad cold and the rest of the world is sending us cough syrup—for temporary relief of the symptoms.

To sum up, it will be some time before we understand the full implications of the Reagan experiment. Yet one thing is already clear: *the more that other countries imitate "Reaganomics"—especially the tax and deregulation policies that aim to attract or hold capital—the more difficult it will be for the United States to keep importing the volume of capital it now counts on.* The real test of this policy will be how the expansion finishes—throughout the world—not how it started.

III. Is the Current Course Sustainable?

What happens if we keep sailing this sea of foreign red ink? Can this course be sustained? I think there are serious grounds for doubt in several areas.

Are These Current Account Deficits Sustainable or How Soon Would We Attain Third-World Debtor Status?

Stephen Marris of the Institute for International Economics recently investigated a question that has tantalized me: the potential growth of U.S. foreign indebtedness if we hold to our present course. Even with U.S. growth slowing to 3 percent a year, real growth elsewhere picking up to a sustained pace of 3½ percent annually, and with exports to debtor developing countries rising normally again in relation to GNP growth, Marris's preliminary results show that with the dollar at its present level, *the U.S. current account deficit could reach $250 billion by 1989 and approach 5 percent of the GNP.* (Already it is approaching 2½ percent of GNP, the previous record of about 1½ percent of GNP having occurred during the 1870s railroad boom, which was heavily financed by European capital.)

In this chilling scenario, the United States would rapidly reverse its post-World War I position as a world creditor. It would then enjoy the dubious distinction of being the world's largest debtor nation. By 1989 *America would have foreign debts on the order of one trillion dollars.* This would be some *ten times Mexico's present debt* and larger than the debtor position of all the non-oil developing countries taken together. What a remarkable reversal for the United States, which until two years ago was a net creditor of nearly $200 billion!

Of course, the United States is a much bigger economy than the developing country comparisons I have made. It is interesting, therefore, to guess at how a sharp-penciled IMF analyst might assess the situation. I hesitate to ask whether we could then qualify for an IMF program for loan assistance if the analyst considered some traditional indicators:

(1) The *current account deficit as a percentage of exports of goods and services.* For the 25 major developing country borrowers this indicator rose to a peak of 24 percent in 1982, the year the debt crisis came to a head in Mexico; following the major and painful adjustments there, it is expected to drop below 10 percent this year. For the United States, this indicator, which measures the *speed* at which a country is going into debt *had already risen to 25 percent by the second quarter of this year, and would rise to 50 percent by 1989.*

(2) Excluding direct investment, the U.S. *debt-to-export ratio would rise to 180–200 percent by 1989.* If U.S. private (nonbank) assets were also excluded, the ratio would be a great deal higher. On this latter definition, the debt-to-export ratio of the 25 largest developing country debtors reached a peak of 194 percent in 1983—and, indeed, banks often take the 200 percent figure as a warning signal.

(3) *Net interest payments by the United States on this debt would*

rise close to 20 percent of exports, about the same level as for the 25 major developing country borrowers this year.

What these figures suggest is that, given this scenario, the 1989 external debt indicators for America would look just about as bad, if not worse, than those for the average heavily indebted developing country when the debt crisis broke out (although not, it should be added, as bad for some individual debtors such as Mexico, Brazil, and Argentina).

Per Jacobsson once said that central banks can print money, but they cannot print capital. One of my fears is that, given the painful political choices it would present, pressures to monetize this debt could mount to irresistible levels. This could easily set off a vicious round of world inflation with all of its consequences for the long-term investment climate, interest rates, and growth. After the brutal sacrifices many have made during recent years to contain inflation, such an outcome would be a tragedy.

But arriving at such a foreign debt position is certainly *not a prediction*. It is a projection *if* we should stay the current course. But is this a possibility? Can we continue? Pray not.

In financial or economic terms, will foreign investors continue to have an indispensable level of confidence in the United States, particularly given the increasing dollar saturation of foreign portfolios that Alan Greenspan has analyzed? The creditworthiness of the U.S. Government—hence, its ability to borrow—is unlikely soon to be called into question. Moreover, the United States does enjoy the special privilege of borrowing in its own (reserve) currency—meaning that the perceived threat of outright debt repudiation is remote. But it is much easier to inflate your way out of a crushing debt—an option that dollar-debtors Brazil and Mexico, for example, do not have (for that matter, along with nonreserve-currency countries like France or Italy). As U.S. domestic and foreign debts climb, though, so may concern that America will resort to that time-honored monetary "escape" route: inflation.

As these fears and dollar exchange rate risks grow, will we have to pay ever higher interest rate differentials to hold the dollar at the current levels, perhaps jeopardizing our recovery and those of others? Or will we face the other grim possibility of a sharp dollar fall that drives up the inflation rate we have worked so hard to keep low? Or, as C. Fred Bergsten has pointed out, could we for a while be subject to the so-called double whammy, a huge trade deficit enduring from past dollar overevaluation along with rising inflation and interest rates?

How much should we be willing to bet that we avoid these disasters and enjoy the hoped-for "soft landing?"—wherein the budget deficit, interest rates, the dollar, and the trade deficit all *smoothly* settle to levels more compatible with sustainable real growth?

We are now consuming and investing more than we produce, with other nations lending us the difference. To the extent that this foreign flow slows down, we will have to produce more and consume and invest less—something our public has not been told and certainly does not expect.

Next, what about the *foreign policy effects* of those kinds of sustained current account deficits? Have we ever had a situation where a genuine world power—indeed a superpower—was also the world's largest debtor, not a creditor? What would be the effects on our flexibility and capacity to project our political presence? Would "reverse leverage" become the new foreign policy fear?

And finally, is there not a *moral issue* here that we must face, even if we financial people are not often accused of being preoccupied with such issues? How can we justify continuing to import so much savings that are desperately needed elsewhere?

I have been touting myself as a "concept man," looking into the long-term future. I therefore have the luxury of neglecting details like timing. Many Cassandras have been drowned betting against the dollar. Yet, when Paul Volcker talks, I listen. On the question of how long a country like the United States can continue to import capital equivalent to 2–3 percent of its GNP, Mr. Volcker, not noted for overstatement, said, "That pace does not seem sustainable over a long term."

I think our foreign friends should ponder other questions before rushing to mimic our economic policies. For example, how transferable is our experience? And just how much, ironically, does U.S. success critically rely on others *not* adopting similar policies?

Are These Trade Deficits Sustainable or When Will Protectionist Flames Engulf Us?

The dollar began its meteoric rise in 1980. Even after allowing for relatively lower inflation in the United States than abroad, *the dollar has appreciated some 60 percent in real value against a weighted average of other currencies.* If a lucky American is buying, this powerful dollar now goes 60 percent further abroad. But for the 60 to 70 percent of American companies that have international competitors, the overpriced dollar functions like a tax on exports and an equivalent subsidy on imports. No wonder the trade balance is bright red. No wonder the export sector is bleeding. No wonder protectionist flames will soon rise higher—unless we do something.

The aggregate figures are stunning. Current forecasts for the trade deficit exceed $125 billion for 1984. In July 1984, imports exceeded exports by over 60 percent. To *find the highest import/export ratio prior to 1984, one has to go back 112 years to 1872, when imports exceeded exports by 40 percent.*

Let's talk about where the jobs are located. That, of course, is where we will find the politics of trade and ultimately feel the pressures of protectionism. Job loss is intimately tied up with the manufactured goods part of the trade balance. We have seen an almost unprecedented swing—from a $20 billion surplus in 1980 to a deficit of $80 billion in 1984, just in this one part of our trade accounts. Such a swing of $100 billion—about 3 percent of the GNP and costing over 2½ million job opportunities—has greatly aggravated the sharpness and suddenness of the already difficult industrial adjustment problem.

It is true that, to date, the decline in aggregate unemployment has offset the export job loss. But there are distributional problems; the jobs lost because of trade are not the same as the jobs added because of the recovery. This time the large swing in the manufactured goods balance has caught many industries other than the traditional textile, automobile, and steel industries. These other "victims" in turn have been among the traditional supporters of a reasonably open trading system.

Consider the example of Caterpillar Tractor. This fine company has seen its considerable productivity gains overwhelmed by an exchange rate which so favors Komatsu tractors that Caterpillar can now simply not compete in many world markets. The Nixon Administration made famous the political litmus test, "How does it play in Peoria?" In an industrial sense, Caterpillar *is* Peoria. When I was Secretary of Commerce in 1972 and 1973, this company contributed nearly $2 billion to a positive U.S. balance of payments! Just one company! By itself! By 1981 it exported $3.5 billion worth of its product. Last year, the figure shrank to $1.6 billion. Export-related jobs plummeted from about 31,000 to 16,000 over this period. It is estimated that at least twice this number of Caterpillar supplier jobs were also lost. *Thus, between 1981 and 1983, one company alone accounted for a loss of over 45,000 job opportunities.* Caterpillar profits also slid over this time from $579 million to a $345 million loss. Of course, some of the drop came from the international slump and some from price reductions. But the exchange rate millstone around Caterpillar's neck made a bad situation infinitely worse. In sum, as the trade situation worsens, it plays very badly in Peoria and, indeed, in the many Peorias of this country.

An artificially expensive dollar pounds a wide variety of other industries. Of course, the overpriced dollar is not the only contributing factor. The debt crises of the developing countries, economic stagnation, and general instability caused a $21 billion reduction in U.S. exports to Latin America alone. And faster growth in the United States than elsewhere—the "growth gap"—results in higher U.S. imports. But it is worth noting that some of the same factors that have contributed to dollar overvaluation (i.e., budget deficits and high interest rates) have contributed to the debt predicament and slower growth in the rest of the world; the causal factors are hardly independent.

The recent testimony of Lawrence Fox, Vice President for International Economic Affairs at the National Association of Manufacturers, offers sectoral perspectives on the U.S. trade debacle through June 1984. Compared with the previous year, capital goods imports increased by 38 percent, automotive products by 35 percent, and consumer goods by 24 percent. Import shares of capital goods outlays have also increased from 18 percent to 25 percent in less than two years.

Fox noted that the recovery-stimulated capital investment is increasingly being sourced abroad—making it difficult for this market share to be recaptured by U.S. firms. Thus the capital equipment investment boom we are so proud of in this country is heavily a boon for foreign manufacturers.

As to our traditional strength in high-technology areas, Fox calculated that, relative to 1983, imports of computer and office machines increased at a 50 percent annual rate through June 1984, while electrical machinery and parts, including semiconductors, rose by 38 percent and telecommunications equipment (excluding consumer products such as television sets and videocassette recorders) increased 30 percent. As a result, the annual rate of the surplus in computers and office machines fell by one third to $3.6 billion, while 1984 deficits in electrical machinery and nonconsumer telecommunications equipment increased substantially.

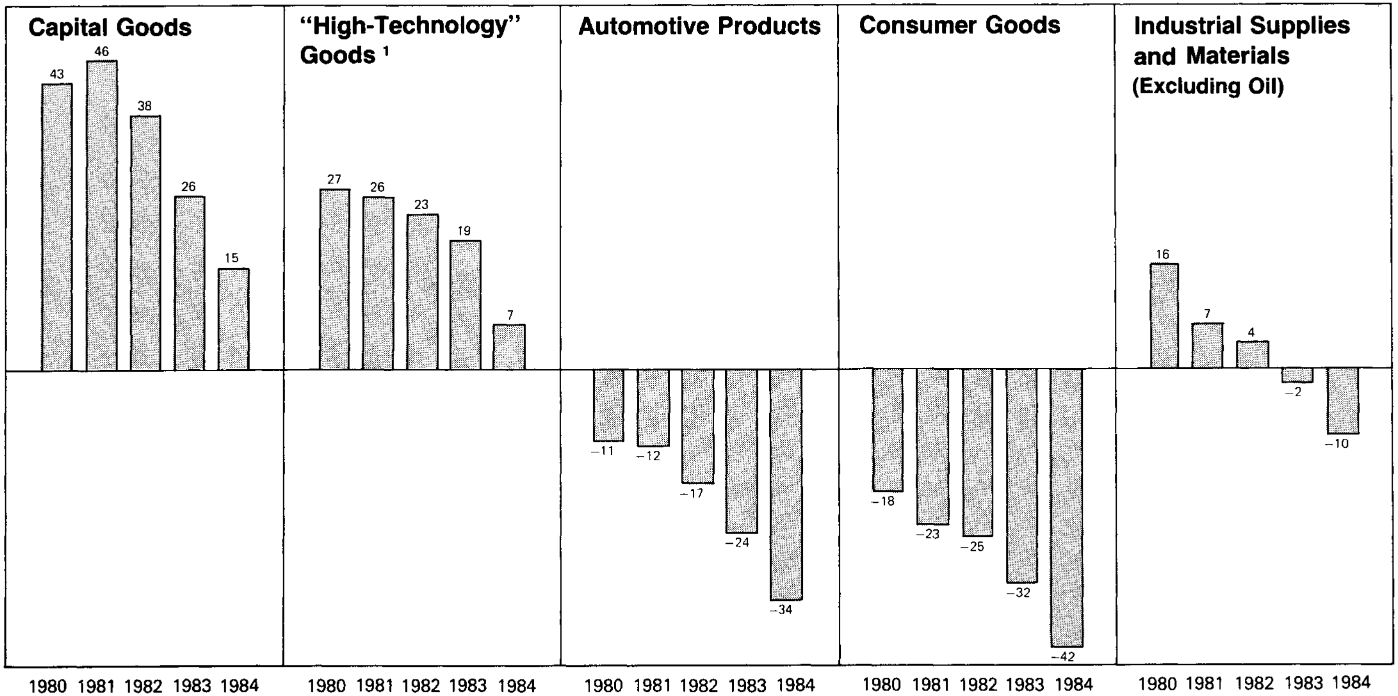
The sectoral trade balance changes are even more dramatic if comparisons are made on a yearly basis since 1980, as the National Association of Manufacturers has done in the following chart:

The most notable conclusion to be drawn from the chart is that no sector has escaped a precipitous decline in the trade balance since the dollar's surge in value: the capital goods surplus is down by two thirds; the high-technology surplus has been cut by almost three fourths; the automotive deficit has increased threefold; the consumer goods deficit has increased by almost 250 percent.

Further, as a consequence of the overpriced dollar, many American companies are concluding that it is impossible to compete, and an increasing number of them are setting up overseas manufacturing plants. (For example, I do not know of a single major chemical plant built in the United States over the last four years.) This is no runaway plant mentality; it is a cruel choice, exacerbated by our deficits, that confronts U.S. firms. Many of these companies now feeling forced to

Major Sectoral Balances in U.S. Manufactures Trade, January–June 1984, at Annual Rate

(In billions of U.S. dollars; imports f.a.s. or customs value)



Source: National Association of Manufacturers, *Trade & Industry*, Vol. II, No. 13, September 21, 1984; data based on U.S. Department of Commerce, *Highlights of U.S. Export and Import Trade*.

[1] High-technology goods as defined by U.S. Commerce Department, Definition No. 3.

look abroad have traditionally been among the most effective lobbyists on behalf of limiting protectionist trade barriers. How long will these severe distortions and dislocations on our industrial landscape be sustainable if these executives now feel their basic businesses threatened by our exchange rates? Will these industries continue to fight protectionism?

Next, consider the geographic dimensions of this predicament. The Commerce Department has compiled a list of states with the highest ratios (per 1,000) of workers in export-related employment. After California, the list includes Ohio, New York, Pennsylvania, Illinois, and Michigan, with Massachusetts, New Jersey, and Indiana not far behind. Given the present and projected job loss in these areas—and how critical they are to Democrats given Ronald Reagan's Southern and Western strength—the result by the 1986 elections could be a great surge of protectionist rhetoric and political commitments—particularly if growth has substantially slowed or if we are in any kind of recession. Without the growth euphoria that presently mutes such protectionist calls, the pressures could prove irresistible.

In fact, they are already being felt. According to data quoted by Robert Z. Lawrence of the Brookings Institution, the percentage of U.S. manufactured goods protected by nontariff restrictions such as quotas and other import barriers soared from 20 percent in 1980 to 35 percent in 1983. It is undoubtedly worse now.

Developing Country Debt—Sustainable Burden or World Time Bomb?

There is one key, longer-term question concerning Third World debt: *Is it a case of illiquidity or insolvency*? Calculations by William Cline of the Institute for International Economics suggest that it is a temporary illiquidity problem that will improve *so long as* OECD growth averages 2½ percent or above, interest rates do not rise above the London interbank offered rate (LIBOR) at 12.75 percent, protectionism is held in check, the dollar doesn't rise, and a few other conditions hold (on inflation rates and oil prices).

I asked Bill Cline to crank up his computers and tell me *how thin the margin is*. We are, after all, betting the survival of the world financial system and the health of developing countries on improvement in the debt situation. Cline calculates that with 1–1.5 percent OECD growth, the LIBOR at 15 percent, and no correction in the dollar, developing country debt spirals seriously out of control. Even with LIBOR dropping to 10–11 percent by 1986, if growth falls to a 1 to 1½ percent rate, creditworthiness would decline. With 2 percent OECD growth and 14.5 percent interest, the debtor countries would again fail to make improvements in creditworthiness. This, of course, would delay a return to normal market recovery and could have some serious psychological effects.

Indeed, this is a thin margin, particularly since there are no major facilities in place for such a crisis. And it gives interdependence an urgent meaning—the developing country debt crisis hangs on how well we do in the North—with growth, with open markets, and with avoiding an interest rate escalation.

* * *

To sum up, there are those ready to dub the U.S. expansion a simple supply-side miracle. Yet our investment and consumption boom also relies on a docile rest of the world patiently sending us their cheap goods and savings. Though this is now tonic, we must ask how sustainable a course we have set. Whether we look to current account deficits, with growing foreign debts and a rising protectionism that threatens world trade; whether we contemplate the fragile peace on the Third World debt front and ponder how the world's financial system is hostage to a scant few percentage point changes in growth or interest rates; or whether we monitor the growing pressures to monetize domestic and foreign debts that could send prices out of control again; in my judgment, this is not a sustainable course for the long term. The risks are simply not consistent with the world we want to inhabit and pass on—a world of low inflation, open trading, and a strong U.S. foreign policy. But if we turn our gaze from these familiar macro concerns, there are problems at the microlevel as well. I speak of a spate of potential new vulnerabilities in the private financial sector.

New Vulnerability to Aneurisms in the Private Financial Sector?

A sustainable recovery that depends on liquidity and credit also requires a sound financial sector. Yet as I scan the landscape of private financial institutions, I am struck by signs of strain and vulnerability.

Among certain banks, I see an overdependence on volatile funding sources and dangerously uncertain loan portfolios. Among banks in general, for this stage in the economic recovery, there has not been the improvement normally expected in balance sheets and rates of nonperforming loans. There are very low price-earnings ratios, depressed stock price levels in relation to book values, and consequent trouble in raising equity capital.

As deregulation proceeds apace, the thrift industry still languishes in intensive care with continuing doses of public capital assistance virtually inevitable. Major players in the insurance and securities sectors also show stresses. Newer, smaller players dealing with novel, high-stakes financial instruments raise questions not simply about their own exposure but about risks to the rest of the system.

Sources of Strain

Some of these troubles have "normal" economic roots such as bad times for energy, agriculture, or mining loans. But as I survey the situation, it seems to me that new vulnerabilities are arising in the financial sector as deregulation unfetters the players and competition provides intense pressure for quick earnings results.

Still other factors combine to add to the risk of financial aneurisms: the globalization of financial markets; unprecedented interest and exchange rate volatility; equally unprecedented proliferation of new, and sometimes poorly understood financial instruments; management, accounting, and auditing inadequacies in the face of increased competition and change; as well as the blurring of distinctions among traditionally separate types of financial institutions and more frequent attempts to evade the spirit of banking and securities laws.

Just think of recent dramatic episodes—the Financial Corporation of America, the Continental Illinois Bank, the Hunt brothers' silver drama, Drysdale Government Securities, Banco Ambrosiano, Johnson Matthey, and Schroeder Munchenmeyer—to mention a few that have become familiar. But these and similar dramas may not only involve privately borne pain as the price of lost bets on immense private rewards. To the contrary, some of them suggest the potential for high costs to the soundness of the financial system—which all dollar holders want and need in the same way that we need clean water and unpolluted air.

The high and volatile inflation of the 1970s and 1980s was a major source of interest and exchange rate volatility that intensified the strains on major parts of the financial regulatory system. For example, high rates played a major role in ending Regulation Q interest rate ceilings. These same economic factors have also greatly increased the financial risk faced by financial institutions and by their customers. This greater risk has increased the demand for new "risk management" instruments, such as financial futures, options, and swaps. None of these instruments existed in 1971 and most were introduced in the past five years. In themselves, they represent commendable developments.

I am frankly enthusiastic about such developments and the continuing potential of deregulation. They are needed and valuable responses to a changed economic environment. I supported them then—for example, Lehman Brothers was among the key backers of Rule 415 allowing shelf registration of securities—and I remain committed to the approach.

But for these changes to result in the maximum benefit requires a marketplace of unquestioned soundness. Presumably, deregulation of the private rewards should imply deregulation of the private risks—a condition that is not always met if certain regulatory protections endure while corresponding requirements and obligations are eased. Some of the unfortunate financial episodes I mentioned above seem to have their roots in just such conditions. And, as Anthony Solomon recently stated, "the blurring of distinctions among commercial banks, thrifts, securities firms, and insurance companies is unleashing waves of new competition. These waves are swamping a regulatory structure designed to preserve comfortable distinctions among them. As a result, the nation's banking and securities laws have become constant targets for evasion."[12]

I do not pretend to understand the full extent, nature, and causes of these potential trouble areas. What *is* clear to me, though, is that they do not respect familiar professional and institutional boundaries; in fact, there seems to be a rat's nest of regulation, disclosure, accounting, auditing, and internal management issues.

Indeed, a fundamental difficulty has become clearer to me in preparing this lecture: though many people sense the seriousness of the problem as a whole, no one seems to have described and gathered convincing data on it. So I can only impressionistically sketch some of its dimensions and implications. I will conclude with a proposal for an urgent and comprehensive examination by the gamut of involved parties—*before* we suffer a crippling financial stroke and before a panicked or aroused Congress gets caught up in an orgy of legislative recriminations and iatrogenic proposals.

Privatized Profits, Socialized Costs

Some thrift and other institutions now respond to their new freedom in liability management by aggressively promoting new types of credit instruments, such as variable rate mortgages. Some of these innovations have been lifesavers for a sick industry. They were a needed response to a world of stagflation, higher and more volatile interest rates, and increased competition for funds. Yet under intense competitive pressure, certain thrift institutions are now changing their whole approach to risk management, taking greater gambles with interest rate mismatches and credit quality in order to generate loan volume and higher fees.

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[12] Anthony M. Solomon, remarks to the National Bankers Association on October 17, 1984, reproduced in *Quarterly Review*, Federal Reserve Bank of New York, Autumn 1984, p. 2.

There is nothing wrong with taking risks to reap rewards. Problems can arise, however, when financial deregulation combined with cheap, fixed-price deposit insurance invites managements to pursue high-risk, high-growth strategies, while, at the same time, promising safe funds to their depositors. If enough goes wrong, the taxpayer can foot part of the bill—for an amount that at some point could exceed shareholder losses. Private sector companies, of course, should price insurance in terms of risk.

Consider, for example, the growth of the well-known Financial Corporation of America (FCA). In six years, it mushroomed from a $1 billion to a $32 billion institution. In 1983, FCA wrote 25 percent of the savings and loan industry mortgages in California and nearly 10 percent of those in the country as a whole. FCA's deposits, of course, were heavily insured. FCA pursued much higher risk policies than comparable institutions in terms of loan quality and interest rate mismatches in order to generate lending volume, trading profits, and fee income.

Before action by the Securities and Exchange Commission (SEC) in July 1984—objecting to their treatment of forward commitments and requiring a restatement in the second quarter from earnings of $75.3 million for the first six months of 1984 to a $79.6 million *loss*—FCA grew to be the twelfth largest financial institution in the United States and was poised to become one of the top ten. Its apparent success was also starting to produce imitators elsewhere in the system.

I recently read a hundred-plus page report on this single institution.[13] The securities analyst who gave it to me had it filed under "Crazy Accounting." Just the section headings go a long way toward explaining some of the problems: "There are Earnings and Then There are Earnings," "Then There's Mortgage Banking Income and There's Banking Income," and " 'Core' Earnings Per Share."

FCA's business challenge was how to deal with an interest rate mismatch that was an outcome of its unprecedented expansion; in 1983 each percentage point rise in interest rates apparently would cost FCA $143 million in pretax earnings. Thus, FCA was betting very heavily on a decline in interest rates. Another problem was asset quality; by September 1983, almost 19 percent of the loans made in 1980 had soured. Tremendous growth, however, can hide problem assets. "If you double in size every year, at any point in time, the ratio of problem assets to toal assets can be very small," noted the securities analyst to whose report I was referred.

[13] See "FCA" Research Briefs, Sanford C. Bernstein & Co., Inc. (New York), January 10, 1984 and February 14, 1984. See also Christopher R. O'Dea, "Straddling the Gap at FCA," in *Intermarket* (Chicago), Vol. 1, No. 3, August 1984, p. 10.

Fee income was becoming a larger component of revenues. And FCA would take the present value of the entire ten years of such income up front, even if the loans went uncollected. Such noncash income was added to FCA's net worth, appearing as "deferred charges and other assets" on the balance sheet—a category amounting to nearly $100 million in 1983.

If FCA's potential depositors generally had had a better idea of the company's true position, it might have been forced to grow more slowly. (Of course with deposits insured and FCA paying higher interest rates relative to competitors, why should depositors have cared about its true position? The obvious counter to this point, though, is the exodus of some depositors that occurred as the company's predicament became widely known after the SEC action.) If FCA had grown more slowly to begin with, however, there might have been fewer bad loans on its books with a correspondingly smaller potential liability for the Federal Savings and Loan Insurance Corporation (FSLIC). And I seriously doubt whether FCA would have pursued this strategy if it had had to pay insurance rates appropriate to the magnitude and type of risks it was incurring.

Such an example suggests how new business practices as well as accounting and supervisory problems in a changed regulatory environment can create considerable potential for public safety nets to be abused, for companies to "grow" rapidly with the help of government's deposit insurance subsidy, for firms to act aggressively even when monetary policy is designed to slow down credit expansion, and for some managements to take high risks in order to become too big to go bust.

Federal Home Loan Bank Board (FHLBB) Chairman Edwin Gray, after referring to many savings and loan association "daredevils dancing on a high wire," recently said that despite annual premium contributions of nearly $1 billion, the ratio of FSLIC liquid reserves to total liabilities of the thrift system is "worsening steadily." He said, "What we face, then, is a situation where deposit and asset growth in the industry are spiraling upward at a dizzying pace which, all too often, is unrelated to [net worth] and which isn't even faintly related to the level or magnitude of reserves on hand" at the FSLIC. Industry sources estimate that 5 percent to 10 percent of the nation's 3,100 savings and loan associations have embarked on a risky strategy of rapid growth through speculative loans and investments.[14] Can we sustain such a trend in which we privatize profits but potentially socialize the costs?

Of course, one logical response to this unbalanced situation would be to abandon the public provision of deposit insurance. Occasionally

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[14] See *Wall Street Journal*, October 31, 1984, p. 4.

I hear that this would be feasible at roughly current insurance rates, since, for example, the FSLIC, has a surplus or "profit." Few serious observers, however, believe that these systemic risks could be laid off on the private market at anything like current premiums. If we were to rely on the kind of market discipline implied by more risk-sensitive premiums or the actions of uninsured depositors, there would be a corresponding need for greater market access to detailed information on operations. And depositor reactions to even preliminary signs of weakness could themselves exacerbate funding problems, potentially adding to system instability. Under the various forms of market discipline, moreover, some rate of failure would have to be regarded as normal.

In short, while I believe that modifications to the deposit insurance system should be considered, they need to be very carefully thought through. But simply imagining the reactions of people in Nebraska to the headline that deposits were no longer to be federally insured instantly convinces me that this reform route would now involve a plunge off the cliff of political feasibility. So, for now, I assume something like the present insurance system will remain and that other approaches to the problems should be investigated (such as lower coverage thresholds, increased premiums, restrictions on types of business activities for thrift institutions even to qualify for deposit insurance coverage, or different insurance rates, perhaps with private coinsurance, to reflect the risks inherent in different kinds of businesses).

High Leverage, Wobbly Dominoes, New Products, and Unfamiliar Risks

There has been rapid growth on Wall Street of variously regulated or unregulated trading entities which convert tiny equity stakes into huge balance sheet leverage via the proliferation of new products involving futures, options, and forward commitments. Thus, as we have seen, big plays by small players can generate large tremors in the system. As interest rate volatility has increased, the risk of large trading losses at these unregulated institutions, old or new, has also risen. And the "domino effect" among this unruled and unruly set of players—some of whom have very few chips—carries a potential threat to the whole system, whether the domino falls in Chicago, New York, or Singapore. Let the buyer—and public—beware.

There is plenty of blame to be shared. In some cases, the regulators have not been sufficiently diligent on matters of bread and butter oversight. Similarly with some of the exchanges. In other cases, the accounting and auditing professions have seen products and practices get too far ahead of their expertise. In still other cases, the players themselves have either been loose, disingenuous, or outright dishonest in their accounting and disclosure practices.

As a society, we are not merely content to accumulate a large mountain of debt; we also want to trade it actively in secondary markets and through products that did not exist five or ten years ago. Indeed, after creating a major new secondary market in mortgage securities during recent years, some firms are now investigating the creation of a secondary market in car loans, presumably to be followed by options on car loans, undoubtedly to be followed by futures on car loans, and options on the futures. Even if we do not go that far, current options, such as those on financial futures and Standard and Poor indices—now a major component of Chicago Board Options Exchange volume—involve a kind of unknown "leverage on leverage." There is nothing intrinsically wrong with such instruments, but we are developing such a wide range of new products that it is highly questionable if we—including investors, managers, accountants, auditors, and regulators—really understand the attendant risks of their imprudent use.

How Accountants and Auditors Can Go Wrong: Auditing the Auditors

Our accounting profession should help depositors, investors, and regulators determine the real *quality* of earnings and of the institutions behind them. As recently as three years ago, for instance, most thrift industry balance sheets and income statements in this country were more readily comparable than they appear today. In part this is due to the evolution of their business mix, in part to the accounting treatment of fee income, asset values, loan delinquencies, and so on.

With respect to the profusion of new and more arcane financial instruments, partners in major accounting and auditing firms have indicated to me privately that they do not always have the expertise to monitor and audit firms in these industries, and barely even understand some of the recent and most exotic financial instruments.[15]

The stock market judgment of the accounting presentation and solidity of the "earnings" of major commercial banks (as well as of their economic prospects) is certainly harsh—they are now generally

[15] I was disturbed to read recently that a major auditing firm agreed to pay Marsh & McLennan Companies almost $20 million to settle a shareholder suit charging that the auditors had failed to detect government bond trading that led to a $165 million loss. This follows an almost $50 million settlement by the same firm with Chase Manhattan over the Drysdale affair. Of course, such huge and painful losses—the personal liabilities of such firms' partners—will likely do more than any conceivable commission report or public policy action to correct the problems.

selling at less than half book value and at remarkably low price-earnings ratios. And this price-earnings pressure comes precisely at the wrong time—just when banks need favorable access to equity markets.

Those closest to performing an informed surveillance function in some cases are securities analysts. This was true, for example, in the case of FCA. However good they may be, of course, securities analysts do not act as even informal checks on all institutions; for example, they do not generally follow mutual savings and loan associations, mutual insurance companies, private investment banks, or trading organizations.

Thus, the accounting profession faces some major challenges. Its members should be encouraged to accelerate their review of the changes now occurring in the financial system and to develop a new set of uniform accounting standards for reporting their effects clearly, consistently, and sensibly from an economic point of view. Of course, the Financial Accounting Standards Board (FASB) has in many areas appropriately defined how earnings from various transactions are to be handled, what prudent reserves are for various businesses, and how to compute them.

Likewise, experienced managements and auditing firms have elsewhere given considerable thought to how frequently which kinds of audits should be carried out. From personal experience, though, I know that the outside audits of some rather volatile businesses in investment banking are only done annually—when a system-threatening storm can blow up in hours, days, or weeks. Further, auditing firms clearly need to determine where to find and train the professional talent to understand and audit trading in some of the more exotic financial instruments.

But there is a larger point. Good management practice—both within the firm and in choosing what other firms to deal with and on what terms—is probably the most important defense against financial troubles. There is an obvious need to bolster the quality of management information systems and internal controls at many firms. The functioning, quality, and output of these management systems might then be a focus, where appropriate, for any closer regulatory monitoring and supervision.

Regulation Here and There

We have seen that the thrift industry faces serious business challenges such as the quality of its investment portfolios and the extent of the mismatch between its assets and liabilities. The industry needs independent assessment, not simply of accounting and auditing procedures, but also of the regulatory oversight processes. Many observers subscribe to the view that there is a mixed pattern of regulatory and auditing oversight, in which the commercial banks are subjected to higher standards than the thrift institutions, and most certainly than investment banks and other related firms.

As to commercial banking, the regulatory apparatus is characterized by splintered authority and overlapping jurisdictions. It is essentially a historical holdover from a time when primary concern was with the potential concentration of economic power.

Sometimes the results seem odd. For example, a national bank would be examined by the Comptroller of the Currency, while a holding company would be examined by the Federal Reserve. If a savings and loan association is part of a public holding company, it is subject to SEC accounting and disclosure requirements. If it is a mutual, however, then there are few disclosure requirements and regulatory accounting applies. For commercial banks, there can be the choice of a state versus a national charter and, at the federal level, what combination of regulators will exercise oversight—the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), or the Comptroller of the Currency. In all cases, though, the Federal Reserve examines bank holding companies.

From the standpoint of public policy, this set of choices can lead to unhealthy "forum shopping" where a bank seeks to change its charter after a "bad" experience with one regulatory body. The signal example of this phenomenon came with the Butcher banks in Tennessee a few years ago, which, when facing an imminent "cease and desist" order from the Comptroller of the Currency, wriggled out of it by having their national charter converted to a state one *within 24 hours*. Anthony Solomon recently pointed out the troubling incidence of state bank supervisors, who may feel budgetary strains and pressures to help attract jobs into their areas through "liberal" banking regulations and less stringent oversight.[16] Thus the danger looms of regulation approaching the least common denominator.

As to investment banks, my own perception is that their regulation and auditing is less comprehensive and rigorous than for other sectors of the financial services industry. It has been rather common practice for investment banking firms to set up nonguaranteed subsidiaries or specialty trading firms with very limited capital—but that take astoundingly large positions. (Commercial banks can do the same thing.) And the products of the major investment banking firms are so diverse and

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[16] Anthony M. Solomon, remarks to the National Bankers Association on October 17, 1984, reproduced in *Quarterly Review*, Federal Reserve Bank of New York, Autumn 1984, p. 5.

complex and their product line subject to such different types and levels of regulation that I doubt that regulatory overseers take a sufficiently comprehensive view of *aggregate* capital adequacy.

As to the smaller and newer firms in the financial community that specialize in some of the more exotic products—options, futures, forward commitments, and the like—their capital bases are often shockingly small given the volume of their trading. This, in turn, puts a major burden on the relevant clearinghouses and exchanges to be sure, for example, that they mark their positions to market, that they follow margins rules, and that they generally act in responsible and disciplined ways.

Clearing organizations probably function adequately as long as market movements do not show large discontinuities. Yet problems of capital sufficiency may loom in turbulent times, particularly for the smaller players. These problems, in turn, may be transmitted to other players in the system (e.g., letters of credit used to back client's unhedged futures positions may cause the issuing bank's liability to skyrocket).

Wall Street firms, of course, may have different kinds of capital bases, depending on their lines of business. The New York Stock Exchange (as well as, for example, the Commodity Futures Trading Commission) has a fairly sensible method of aggregating different sorts of needed capital by applying different discounts or "haircuts." For example, unlike cash, commercial paper is discounted at one rate, common stocks at another, puts and calls at still another, and so on. Thus, the New York Stock Exchange has very specific rules whereby it builds up the aggregate capital requirements for member firms on a business-by-business basis, though even here certain types of operations can be segregated in subsidiaries that are beyond the reach of the Exchange's rules. The practices of other exchanges vary considerably.

There is also a great deal of variation among the various exchanges in the degree and quality of surveillance. For example, some see the Chicago Mercantile Exchange as especially rigorous in applying marking to market and margin rules. There are also obvious differences between countries in their surveillance and supervision of financial markets.

Strange Accounting and Regulatory Mixtures

I am a believer in the deregulation of financial institutions. Yet we now face an ungainly transition in which new freedoms can interact with old restrictions and protections to produce anomalous results.

For example, regulators are pressing commercial banks to increase capital in a general attempt to strengthen these institutions. Yet sometimes banks can simultaneously remove items from both sides of their balance sheets—thus appearing to bolster their reserve ratios. Experts tell me of all kinds of ingenious ways—of structuring receivables, deposit floats, etc.—for making such off-balance-sheet moves and, incidentally, lowering their deposit insurance costs. (Many of these—like collateralized mortgage obligations—have their origins in financial market deregulation and consequent innovation.) The rub is that these off-balance-sheet items may be de facto protected by deposit insurance—even if "invisible" for regulatory calculation of reserve ratios.

A similar disconnection between new freedom and old regulatory and accounting treatment can be found in the case of some thrift institutions which sometimes act as traders. In the FCA case, it was buying and selling loans—though there are plenty of other trading vehicles (e.g., Government National Mortgage Association (GNMA) "dollar rolls" involving forward commitments to buy). When markets are good, the players in these games may realize the gains from what in effect are trading accounts; when times turn bad, however, these assets can be carried at historical cost. Of course, the philosophical rationale for historical cost treatment of thrift assets was their practice—by no means extinct—of holding loans to maturity. But practice has generally evolved—and with the change should come compatible regulation and accounting.

Financial regulators clearly need to think through, and in some cases, re-think their oversight philosophies and practices. For example, the notion of "primary capital" should be re-examined in an era where banks follow varied strategies of asset diversification, where different assets have different risk profiles. Regulators need to look beyond the relationship of "capital" to total assets and focus more on capital versus risk assets. Moreover, banks have very different patterns of funding. Some, such as the Continental Illinois bank, get up to 80 percent of their funds from money "wholesalers," while others obtain a much larger portion from "retail" sources. Obviously, bank vulnerabilities can vary greatly depending on the sources, maturities, concentration, and diversification of their funding sources.

Some regulations are clearly outdated and may be counterproductive. For example, the regulations restricting bank branches arguably contributed significantly to increased dependence of Continental Illinois on "purchased" money and altered the nature of its vulnerabilities.

But all these examples suggest a central point: our current regulatory apparatus may not be up to the tasks posed by the new era of financial deregulation, innovation, global markets, and rapid technological change. As part of the process of injecting discipline into the system, this area needs review and re-thinking. This task, however, should not be thought of as a purely governmental function. Others' input should be sought, and the effort should be meshed with complementary work on accounting and audits.

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I have sketched some dimensions of the problem of new micro vulnerabilities in the private financial sector: regulatory, disclosure, accounting, auditing, management. My sketch, however, is impressionistic, even idiosyncratic. I am aware that other explanations can be proffered for each of the examples I have cited. Some have ascribed the troubles of Continental Illinois to garden variety mismanagement and bad lending; some say that Drysdale looks like old-fashioned fraud made easy by lax controls elsewhere; circumstances may even vindicate FCA as a model for survival in the hard-pressed thrift industry. But to my eye, there are too many such known examples, too many glimmerings of others, and too many glimpses of underlying structural causes—especially by comparison with other industries I know—for me to rest easy. I am deeply troubled that nowhere could I find a comprehensive description of the kinds, interrelations, or magnitudes of the risks we now face in this area, risks that may transform themselves into ugly realities if we continue with the other elements of our generally unsustainable fiscal course. As such, I will propose an urgent effort to understand our predicament and to fashion a coordinated response. A world whose hope now lies in a credit-based recovery cannot risk aneurisms in its financial institutions.

IV. What Can and Should We Do?

The Positive Side of the Story

My objective here today is to call them as I see them, pointing out the paradoxes, the contradictions, and the dangers with which we are confronted. But I set out to be fair and objective. And a fair assessment of the outlook is not entirely gloomy, far from it. We have unique problems to overcome, but we also have unique opportunities for achieving growth and prosperity that would benefit all nations and that would last. That promising vision is one for which many people yearn, especially the young. Whether in this country or elsewhere, the young among us want to believe that ambition, hard work, new ideas, and enterprise will pay off for them personally and for their countries. And there are elements in place now that will help them reach their aspirations for better and more secure lives.

First, beyond the contribution of the deficit-swollen dollar, we have brought down the inflation rate in this country and in the world generally. We have learned that you do not inflate your way to growth, only into stagnation and disappointment. Most emphatically, Paul Volcker and his colleagues at the Federal Reserve, by leading the attack on inflation and refusing to bend to those who might undermine it, have earned our special respect and thanks. And the Reagan Administration put its weight behind the effort. It is an accomplishment that they can all take pride in, along with what they have done in furthering the progress begun by others in deregulating important industries and thereby promoting healthy price competition that combats inflation.

Second, we have put in place some safeguards against another debilitating oil shock, in the form of price decontrol and development of new supply sources. We have innoculated ourselves to a significant degree against a new shock, though more remains to be done.

Third, we have pulled together so far to manage the developing country debt crisis in a way that, with further sustained effort, promises over time to restore tolerable rates of growth as well as basic creditworthiness. In part, our success to date came about because all participants contributed something to the adjustment process; that is, the necessary pain was broadly shared. Like any such process, everything does not always go smoothly. But authorities of the creditor countries have shown diligence and understanding, commercial banks have met their responsibilities, and most importantly, debtor countries have endured economic hardships that few industrial countries would have been able politically to withstand. The IMF and the World Bank have played different roles in the process. But it is hard to conceive how the crisis atmosphere could have been reduced as much as it has without them. In the longer run, however, world markets must be further opened to developing country exports if progress made to date is to be sustained.

Fourth, we now understand far better that one of the keys to real economic growth is to unleash the talents and energy of individuals and to provide the incentives that will inspire strong investment. What is clear is that investment is a bet on the future, and people will not make that bet without confidence. Without doubt, there has been an impressive rebuilding of business confidence in this country in recent years. And here the Reagan Administration has been at its best, sensing the desire of people in this country to want to believe in the future, to set up new businesses, and to try out new ideas. I have added to the new business statistics myself and I will tell you that it is exhilarating.

Obviously, we recognize that every country has its own cultural and institutional setting, its traditions and its biases. But however one goes about organizing an economy, there must be policies that mobilize individual initiative and bolster confidence. Countries ignore that fact at their peril. Nothing symbolizes the disregard of this more disastrously than the billions of dollars of flight capital that have seriously aggravated the debt crisis of developing countries. But the lessons are being learned and positive change is occurring.

Yet, as much as I am optimistic about the potential for lasting growth with low inflation and a wide distribution of the benefits, I have no illusions about the urgency for removing the hurdles still in our way and for reducing what are unacceptable risks of failure. In the United States, these are hurdles of inadequate savings, of outrageous budget deficits, of fragility in our financial markets, and of huge imbalances in our trade accounts. Abroad, they are the hurdles of outdated technologies, heavy taxation, crippling regulation, rigid labor markets, barriers to mobility, uncertain profitability, and other inefficiencies and distortions. They are formidable hurdles. They test our competence and our will.

I do not like grandiose schemes and have none to offer up today. I do not even have a short-run package of coordinated measures that can excite the economic departments of the institutions gathered here. But I do have a group of proposals that can help put us on a more sustainable world economic course.

Proposal to Reduce Our Vulnerability to Aneurisms in the Private Financial Sector

To reduce the risk of financial aneurisms, we need first to better understand the real nature and extent of the problems. We must have a clear sense of the whole. A diverse set of people with significant operating experience will be needed from the various institutions and professions to address the interrelated mass of regulatory, disclosure, accounting, auditing, and management questions.

A Public or Private Effort?

Should such an effort take the form of a Presidential or other high-level public commission? Or should it be a private effort? As I see it, a Presidential commission or the equivalent would have great visibility, status, and drawing power. The example of the President's Commission on Financial Structure and Regulation (Hunt Commission) near the beginning of the last decade comes to mind.[17] Yet, for the kind of

[17] In this context, mention should be made of the report of a task force chaired by Vice President George Bush, dealing mainly with regulatory duplication and overlap for commercial banks and thrift institutions. See *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services* (Washington: Government Printing Office, July 1984).

effort I envision, there could be significant drawbacks to this route. Members of Congress—especially from the opposition party and, in particular, the chairmen of the relevant committees and subcommittees—could be counted on to vigorously press demands for involvement and influence, often for partisan political reasons. Moreover, there could be a great deal of unproductive bureaucratic footwork, with much attention paid, say, to not stepping on the toes of the Federal Reserve or offending other institutional or agency sensibilities. And it would be hard for an official body to give the appropriate emphasis to any real dangers or inadequacies it found; powerful pressure would be brought not to make any pronouncements, however justified, that might "undermine confidence."

In my judgment, therefore, a private, foundation-supported effort would be best suited to the urgently needed task of understanding the whole problem and fashioning solutions. I have in mind foundation support of between $1–2 million over a 12-month to 24-month period. Senior participants would normally be expected to donate their time and to offer, as appropriate, in-kind assistance from their institutions. As the effort is designed and launched, it should be reviewed with the Secretary of the Treasury, the relevant Congressional chairmen, along with other executive and legislative branch officials to elicit maximum cooperation. The idea should be for the Government to commit itself in advance to serious consideration of the results (through hearings, interagency processes, and the like).

The Proposed Commission: Its Composition, Procedures, and Tasks

First, a small group of wise and experienced men and women should seek quickly to clarify the real problem areas and issues for more intense and detailed consideration by special subcommittees and task forces. In effect, this group would be charged with devising a charter for its subsequent work. The group should be composed of very senior, experienced people from the major involved professions and institutions. They should be known for their integrity, deep knowledge, perspective, widespread peer respect, as well as unquestioned ability to rise above parochial interest. For this latter reason, people who have very recently retired or moved to qualitatively different pursuits would be especially suitable.

I can think of a number of people—should I say paragons?—who could fill such roles admirably. The participants might come from any number of positions: a former chairman of the Federal Reserve; head of a major Federal Reserve Bank; Comptroller of the Currency; senior partners in an investment bank, law, or accounting firm; senior executives of a commercial bank, thrift institution, insurance company, pension fund, or trading house; professors of economics or finance; top figures in a public interest organization; former heads of the FDIC, FSLIC, FHLBB, or a key state regulatory agency; senior executives of a stock, commodity, or option exchange; prominent members of the FASB; and the like.

Their first task to devise a draft charter would be a demanding one. Undoubtedly, the charter should provide considerable latitude to examine new, critical areas. Undoubtedly, unanticipated connections among the various parts of the problem should be expected to emerge as the work progresses. But at least three tasks would be key to a successful charter: hammering out the right questions, setting the appropriate scope, and defining the problems in a way amenable to being answered in a relatively short time.

As the group makes progress on its charter, it should begin to identify the most knowledgeable, experienced, and expert men and women for subcommittees and task forces. Most likely, these would be people at relatively high working levels. Several sectors should be represented: commercial, merchant, and investment banks, thrift institutions, trading houses, clearing and surveillance organizations, insurance companies, pension funds, different exchanges, financial industry associations, major law and audit firms, federal and state regulatory bodies, relevant academic disciplines, as well as the investing and otherwise affected public.

Broad Elements of the Commission's Charter

There is no way we can turn the clock back to the old days of financial regulation nor would we want, for example, a restoration of rigid and noncompetitive deposit yields to subsidize minimally competitive mortgage lending institutions. But we are still faced with a number of major practical and philosophical questions about how to maintain proper checks and balances in the regulation of the whole financial system. At a minimum, though, there is an urgent need for in-depth sectoral reviews of the sources of likely financial vulnerabilities and trouble spots. At the same time, the commission should take a comprehensive look across the financial services industry to map the key connections that often are overlooked by groups whose preoccupation is with their own areas, institutions, or professions.

I have come on some of these immensely complicated and sensitive issues too recently to have a clear view of the underlying issues and problems. I feel presumptuous in suggesting even some of the most basic questions that the group should address. Yet such questions are worth asking since different answers lead down qualitatively different paths. For example:

(1) Should the design of deposit insurance aim to *prevent* risk or to *price* it appropriately (recognizing how difficult and potentially awkward this would be *within* any given line of business)? That is, do we want to prevent *all* financial institution failures—at least all "large" ones—or are we willing to countenance a "normal" failure rate consistent with efficient pricing of risk? The more general version of this question is whether we should design our regulatory system to be proactive—that is, to act to *prevent* the abusive and expensive situation? Or do we want our regulators to set ground rules and procedures aimed at fostering desirable conduct—but mainly limit their intervention to swift and sure *punishment* after the fact—one hopes, thereby, deterring undesirable actions? Or where is the right balance?

(2) Should regulation be cast according to the kind of instrument, transaction, industry segment, institution, type of risk, geographic area, or some other categories?

(3) What approach should we adopt to the *coordination* of regulation and supervision, especially where transactions cross political borders? Should we consider expanding the focus of the Basle Committee on Banking Regulations and Supervisory Practices (Cooke Committee)?

(4) When should we tilt our bank and thrift supervision toward the stockholder and investor—implying considerable public disclosure—and when toward the depositor—implying less public disclosure to permit time for quietly correcting problems and preventing self-fulfilling "runs" or other instabilities?

More Specific Elements of the Commission's Charter

Obviously, I cannot say in advance what the more specific questions will be. But I am virtually certain of a number of such questions that the charter would contain. Let me suggest several areas:

(1) *Adequacy of Private Action.* Financial institutions shocked by the magnitude of some of the losses of recent years have set up increasingly strong self-defense systems. We see this, for example, in efforts to set up bilateral limits on interbank and international payment clearing systems. That is all to the good. From a policy standpoint, however, the question is: Are these self-policing, self-protective efforts adequate? The other side of the coin involves whether private actions may lead to overly *restrictive* practices that could, say, cause credit to dry up to developing countries.

(2) *Regulatory Unevenness.* Where are there potentially dangerous gaps in the regulatory structure? Where do jurisdictions overlap, or is

authority fragmented to bad effect? Where are regulations outmoded or counterproductive?

(3) *Deregulation.* For commercial banks, two subjects for scrutiny might be geographic expansion (interstate banking) and product expansion (particularly into the areas of securities products, insurance, and real estate). Much material is available on these issues as a result of the failed legislation on these banking issues in 1984. For other financial institutions and players, the group should assess the extent, consequences, and future of deregulation.

(4) *Risk Management Instruments.* As noted, financial futures, options, swaps, and related products are now widely used. These instruments can be powerful tools in improving financial risk management. The issues are how these instruments have improved such management and how they have affected the overall safety and performance of the financial system. What changes in their use or in the practices of those who use them might be desirable?

(5) *Regulations on Capital Structure and Other Areas.* After the onset of the international debt crisis in 1982 and the severe industrial dislocation of the recession, banks and their regulators have moved in various ways to strengthen capital structure and safety. Primary and total capital ratios are rising as a result of regulatory pressures and the business judgments of bankers. The commission should pay special attention to the effects of these capital structure changes, with particular emphasis on changes that will enhance bank safety. The group should then focus on the aggregate capital requirements for nonbank financial institutions—both as to their adequacy and needed qualitative changes. Similar attention should go to regulations on disclosure, marking to market, and margin requirements for the range of involved players.

(6) *The Purposes and Effects of Deposit Insurance.* As John Heimann has cogently argued, we must clarify whether the real purpose of deposit insurance should be to protect the depositors, the banks, or the financial system. Most experts now agree that our current insurance system does not price risk adequately and thus may induce undesirable and disproportionately risky business decisions. This issue is in principle separate from the issue of who pays for the insurance, but obviously the two are closely related. There are good economic reasons to strive for a system that deals effectively with both issues: one that correctly prices insurance and that at the same time shifts the full burden of paying for the insurance to the private sector beneficiaries of a safe depository system. Thus far, of course, there has been no cost to the taxpayer; the FDIC enjoys a comfortable, approximately $17 billion surplus, though the FSLIC is flashing a warning light. So, our challenge is to permit sufficient scope for competition while preventing abuse of the public sector safety net

which implicitly underpins the financial system. We have to balance the privatization of profits with the potential socialization of risks. To do this, we must clarify the real functions we want the system to serve.

(7) *Accounting and Auditing Inadequacies.* Where are the real problems with current standards and techniques of auditing and accounting? Changes in technology, markets, financial instruments, and regulation have made it more urgent than ever for our accountants to provide us with accurate, economically sensible portraits of firms. And questions of the frequency, coverage, and methods both of internal and external auditing should be raised and posed to the profession. (Of course, the minds and energies of any auditing firm partners who are saddled with out-of-court settlements for inadequate performance are likely to be "wonderfully concentrated" on these problems, certainly more so than any commission report might stimulate.)

Prompt Private Action Needed Now

The regulatory process is not without its very special constituencies or clients. For example, some would argue that a regulatory agency's most important clients are the chairmen of the relevant Congressional committees. Those chairmen, of course, are not immune to the potential political rewards of publicized hearings on alleged new abuses and of the crying "need" for new regulations. This phenomenon underscores one of the reasons why we should strive for early preventive treatment of vulnerabilities and weaknesses in the system.

If the private sector in cooperation with the relevant regulators seizes the initiative, it can take effective steps to prevent or minimize the kind of financial episodes that could cost innocent taxpayers and stockholders dearly and excite the Congress to pass counterproductive, excessive, and even vindictive legislation.

That is one primary reason why it is important for the private sector to take significant initiatives now, to look at itself critically, and to set up its own mechanisms to prevent damaging episodes from occurring. The result should be safer, more efficient, and truly freer markets in which investors and the public at large will have justifiable confidence.

But what I would *not* like to do is delay this process until some new series of financial traumas at the microlevel presses against the already-extensive vulnerabilities at the macrolevel.

I have sounded the call for a searching investigation into key elements of our financial system. I have done so on the basis of what I freely admit to be an impressionistic view of the possible perils and their causes. It is hardly beyond the realm of possibility that the group might look carefully at the symptoms, pronounce them not serious, reaffirm existing countermeasures, and, with a few undramatic but sensible suggestions, give their blessings. Frankly, that would greatly please and relieve me—along with, I suspect, many members of Congress and the public alike. Equally frankly, however, I do not expect such a soothing conclusion. But far better a jolting diagnosis and early treatment than blithe assurances of good health and "never mind those little palpitations, that odd lump, the brief dizzy spells—none of them is too serious and each probably has a routine explanation."

Developing Country Debt and Development

It is always enormously tempting on a special occasion of this kind to float some major new proposals to stabilize the Third World debt predicament, to promote world development, or the like. I shall resist that temptation. To be sure, some of the reasons that I won't set forth major proposals on developing country debt, for example, are substantive—that certain candidate proposals are unnecessary, that others are undesirable, and even counterproductive.

But an overarching reason for not adding to the pile of such proposals already advanced is that most of them are simply politically infeasible, given the current context of budgetary restraint and domestic preoccupation. For example, the enormous difference between what most of our political leaders *know* we should do about our fiscal crisis and what they are *willing* to do is a measure of the lack of political will to exert discipline for our own direct benefit. There is an analogous difference between what we suspect we *should* do internationally and our actions in that realm. The melancholy example of America's recent stance toward supporting global development efforts and related institutions needs little elaboration.

Squaring the Circle: Domestic Politics of International Development Initiatives

On this set of issues, perhaps more than anywhere else, our $175 billion budget deficits and our $100 billion current account deficits conflict with obvious needs and my personal desire for strong U.S. support of international institutions. In these circumstances, whatever we do will have to be more symbolic and psychological than financial.

To illustrate the difference between how domestic and international economic issues play politically, consider the following three actions: (1) recent cost of living increases that could have cost some $5 billion beyond the Social Security Commission recommendations were adopted in the flash of a press conference; (2) next, we saw the virtual forgiveness of $600–700 million in farmer loans; and yet (3) recently, the United

States refused to go along with the level of financing for the Seventh Replenishment of the International Development Association originally agreed by all the other donor countries—which still would have represented a substantial cut in the program in real terms. Moreover, the increment above the amount finally agreed would have entailed an authorization of a mere $250 million a year to the United States over three years—a commitment whose benefits would have been multiplied by the contributions of others and which would have generated direct benefits for the United States.

International Economic Illiteracy in America

This asymmetric political situation points up the dire need for public awareness and education about the developing countries—their problems as well as their vital linkages with developed nations. For example, the decline in U.S. exports to Latin America *alone*, as a result of financial instability and economic stagnation, has cost the United States an estimated half-million jobs. Yet now, I fear, the Third World is what we in the Nixon Administration would have called a MEGO subject—for Mine Eyes Glaze Over. In a recent poll, aid to developing countries ranked fourteenth out of 14 choices in popular priorities—the next least popular being that all-time American favorite: pay increases for public officials.

Another manifestation of such attitudes was evident when Katherine Graham—Chairman of the Board of the *Washington Post* and one of the most powerful women in America—and I went to testify about the results of the deliberations of the Independent Commission on International Development Issues (Brandt Commission) on North-South issues. Out of some 30 members, only 4 attended, including the two subcommittee chairmen who had called the hearings. American attitudes on this subject remind me of the philosophy professor who asked his class, "Which is worse, ignorance or apathy?" A sleepy student in the back row responded, "I don't know and I don't care."

Leadership in an Era of Constraint

Given these obvious domestic problems and constraints, it is critical to reconcile the need for U.S. leadership and support with the realities of our fiscal condition.

Certainly, we can encourage more active roles by some of our allies who now enjoy balance of payments surpluses (Japan among others). Further, we should pledge that we will join them later when we can.

Certainly, we can support efforts that do not require significant new commitments that add items to the federal budget.

Certainly, we can offer special encouragement to developing countries that have adopted sensible domestic policies (*not* indiscriminate subsidies, price controls, overvalued currencies, counterproductive taxes, and the like).

Certainly, we can support schemes (like a General Agreement on Tariffs and Trade—GATT—for investment) that encourage private investment in developing nations.

Certainly, we can encourage advanced developing countries to become fuller members of the GATT—enjoying a real voice in the negotiations—and with a mutually beneficial opening of their markets.

Our financial resources may be temporarily constrained but this should *not* preclude us from being a positive force for constructive change. In this spirit, let us hope that Secretary Regan's recent proposal for an extended session of the Joint Development Committee of the IMF and the World Bank will be used to good effect.

More International Discipline—at the Margin

Everyone says that more "discipline" is needed in the international economic system—but by what means? This talk reminds me of Senator Long's "don't tax him, don't tax me, tax that fellow behind the tree."

There is an asymmetry in the way our international institutions impose discipline on large developed countries and small developing countries, between "surplus" countries and "deficit" countries. And you can see it plainly in the numbers: of 35 or so countries with IMF programs, not one of them is an industrial country.

For the weaker countries, there is need for money; their markets are exposed; and their economic problems are aired in public. There are identifiable carrots and sticks. Thus, real leverage exists.

There is a wholly different set of conditions with respect to key industrial countries. Leverage, at least most of the time, does not come through money—they don't need it. Nor does it derive from rules—they will break them. Thus, large countries can go out on a very long leash before the market reins them in. All this is not only very damaging to them but can be to others and to the system.

Is there anything that can be done? Formal sanctions are now out of the question, given the size and political power of the target countries. And just think about it. If the largest budget and trade deficits in U.S. history—along with a Republican president and the pressure of much of the business community—cannot goad the United States into a more disciplined stance, it is hardly realistic to imagine that the United States would pay much attention to the criticism of some international institution or process. Indeed, the international monetary institutions seem a pint-sized master with a very flimsy leash, while, for the purpose of this metaphor, America is a very big dog.

But should we not at least explore how various measures can modestly increase public and political understanding thereby adding to pressures for more discipline?

Better Surveillance: A Proposal for an IMF-Based Review Board

I was troubled in preparing this lecture at how difficult it was to come up with the tough questions and objective analyses concerning the sustainability of our current course. Where were our official bodies with their expert staffs and computers? Why were their reports so bland? Shouldn't they be putting the crucial hard questions more openly on the public agenda?

For example, earlier this year, a report which could have been titled "Deficit Apologia," came from the U.S. Treasury purporting to cast serious doubt on any links between deficits, interest rates, and exchange rates. With all due respect, one might ask why there has been no serious public review of it, since *privately* virtually every official body acknowledges that the links are real and strong, though certainly there is not a simple one-for-one connection. On this issue, it would seem, the political and bureaucratic tensions are so high that technical debate is stifled. Professional criticism is rejected as mere partisanship.

I am familiar with the processes on consultation and various forms of surveillance under the IMF Articles of Agreement. In my view and in those of others with whom I have spoken, these processes tend to be rather meaningless for large countries. Frank and controversial treatment of tough issues is almost exclusively private; public discussion implies that the message will be bland, supportive, and invariably polite.

For industrial countries in surplus or deficit positions, even internal reports generally need agreement of the subject country. This fact alone makes it unsurprising that published results tend to be watered down when large countries are involved.

In many ways, this regrettable state of affairs is understandable. It is inherently difficult for the IMF to challenge the policies of a country such as my own, which, after all, is the largest shareholder, supplies the Deputy Managing Director, and houses the institutions in our capital city.

Might one suggest, therefore, that we explore preparing annual reports and audits of major surplus and deficit countries and making them public? Imagine an external, part-time, independent review body—affiliated with the IMF—whose experience, eminence, integrity and, yes, courage, were exemplary. Imagine that its members were available for public testimony and other public statements. Could we find such wise and saintly people? We would all agree, for example, that the U.S. Congress needs to gain a better understanding of the way the American economy affects and is affected by the world economy. Why shouldn't these external auditors testify on the Hill? Could reports and testimony by them help nudge America and other countries toward needed discipline, if only at the margin?

New Exchange Rate Systems?

There is a certain appeal to considering alternative exchange rate systems, especially when we focus on the questions about the current one (e.g., wide currency fluctuations that now add costly uncertainties to investment and planning). What should we do about it? My gut feeling is that the starting point for improvement in the system must be greater recognition that having a sensible pattern of exchange rates is an important objective of economic policy. This is especially true for attitudes in my own country.

It has not been that long since President Nixon's colorful comment about the lira and the volumes it spoke about the state of international economic policymaking in America. Contrast this state of knowledge with that represented by a Giscard d'Estaing, a Ted Heath, or a Helmut Schmidt.

Another stumbling block lies with the perceptions of the American public. A "stronger" dollar is always good, a weaker dollar is always bad. Should we come up with a dysphemism (the opposite of a euphemism)? An overexpensive dollar? A high-priced dollar? Costly? Inflated? Overpriced?

Until Americans come to understand even these elementary ideas better, I am doubtful about new rules for exchange rates and the discipline they require. And in any case, as long as the dollar is apparently so far out of alignment—and the budget is so far out of balance—it is extremely unlikely that we can consider an overhaul of the exchange rate system.

We should, nevertheless, go on looking at the options. Experience with the European Monetary System (EMS) suggests that a more fixed rate system can reinforce internal discipline at least in some member countries that enjoy otherwise special relationships among themselves. It deserves more study. So also do a number of key concepts that would underlie any new, presumably "stickier" monetary system. For example, could we even agree on the meaning of "extended market misalignment?" This notion would be an oxymoron at Chicago, where I was presumably educated.

This brief discussion of modified exchange rate systems and surveillance strongly suggests to me how limited—though real—the potential is for internationally imposed discipline, especially as compared with improved fiscal practices at home. Of these latter possibilities I shall soon have more to say.

Who Holds What, Why: A Proposal for Better Understanding of the Determinants of Capital Flows

While there is frequent discussion about the need for greater exchange rate stability and surveillance, it will be difficult to even forecast currency changes until we develop a better understanding of capital flows in the world economy today. The architects of Bretton Woods did not think much of private capital flows. Yet, as we each know, capital flows now dominate trade flows, which have been analyzed in exhaustive detail. Thus, while we have a *general* understanding of the factors that drive capital flows—political stability, economic flexibility, resource endowment, and the standard macroeconomic variables—our knowledge remains inadequate. Our focus in the past has been too macro—but the microside is crucial to understand capital flows. As Martin Feldstein recently said to me, "We simply do not know too much about *who* holds *what* assets and *why*."

As recent U.S. experience illustrates, we are generally quite ignorant of how tax and regulatory policy changes can affect even the *macro*-economy. At home, budget forecasters failed to understand either the limited impact of these new policies on personal savings or their potent effects on new investment. Only recently have analysts and governments become aware of how the 1981 tax bill in the United States seemed to increase this country's equilibrium level of real interest rates, with all that implies for capital flows, exchange rates, and debt-servicing costs of developing countries. Indeed, the history of the 1981 tax bill illustrates once again that one of the first principles of all forecasting should be "the law of unintended consequences."

There are great fights about particular questions, such as the unitary tax or bearer bonds. But as we consider making these or more general tax and regulatory changes or as others contemplate similar actions under conditions of equal ignorance, we need a better intellectual compass.

For example, I hear too many suggestions from around the world that some variation or response to the U.S. tax policies should be made before any of us have understood their real effects or whether they would really draw capital flows. The savings war that could result from such moves could be even more deadly than a trade war. To prevent this, perhaps what we need to work toward is what Roger Kubarych has dubbed a kind of informal "GATT for taxes."

To even begin to do better, we must have a detailed and careful investigation of the *micro*economic underpinnings of capital flows—the role of tax policy, financial regulation, and *most important, business profitability—in driving money from one region or country to another.* This does not merely mean asking one or two economic research institutes to publish more econometric studies on the relationship between monetary policy, interest rates, and exchange rates. Beyond economists, we need input from people in business, industry, and finance. As a first step, I can imagine developing the global equivalent of a company's statement of "sources and uses of funds"—except that the global analysis would trace savings, investment, and consumption flows. Then causal factors might be much easier to isolate.

As this research develops, it would be worthwhile *to organize a major conference on the international implications of differences in national tax and regulatory policies. The extreme sensitivity of the topic suggests that a consortium of private institutions would be better suited than governments for the task.* We need investigation, not negotiation.

Restoring Fiscal Discipline in the United States

Surely we can agree that a failure to correct the U.S. budget deficit is to play a mug's game. I don't know when and neither does anyone else, but all the numbers I have seen point to one conclusion: the present course is unsustainable. The deficits get too big, the interest costs feed on themselves, the financing requirements become too great, and the probability of retaining the confidence of the world's investors inevitably becomes smaller and smaller. When confidence erodes, the results will not be neat and tidy. The dollar could plunge. Interest rates could soar. And the awful prospect of simultaneous increases in inflation, interest rates, unemployment, and protectionism could become a harsh reality. Given our starting point—a world struggling to rebuild stability and a set of debtor countries seeking to rebuild their creditworthiness—the implications are intolerable.

But I can visualize an outcome of even more troubling consequences. Suppose fiscal inaction drags on here, and pressures build up in a Europe increasingly envious of U.S. expansion—despite our imbalances and risks—to ditch fiscal responsibility and go all out for growth. In these circumstances, as the world lurches to new imbalances and new uncertainties in financial markets, I can tell you now what doomsdayers will be talking about: interest rate wars, savings wars, tax wars, and every other sort of beggar-thy-neighbor, narrowly nationalistic policy. Whatever the exact outcome, it will be economic war, not peace, and the very word "stability" will sound archaic.

The Political Economy of U.S. Deficits

But there's another tack, a real alternative, that begins with restoring fiscal discipline in the United States. Whatever good or bad the Reagan fiscal policy causes in economic terms, it has opened up a political debate that this country has needed for some time. It is making us rethink traditional assumptions about spending and tax policies. It is forcing us to make up our minds about what we want government to do, what not, and who should pay for it. Sometimes democracies need a push, so may be we had to have such a radical experiment to shake up conventional thinking.

Yet the experiment has also left us at a dangerous impasse. The issue is not just a technical one for budget experts. It is not just a court drama played out by members of Congress and White House chieftains. It is not just a financial topic to engage the banker or the businessman. It truly affects everybody. When you get down to it, as a French observer said, as a seemingly technical issue assumes *real* importance it ceases to be an economic issue and becomes a political one.

My experience with the Bipartisan Budget Appeal and its evolution convinces me that those of us in the business and financial communities who are disturbed by the specter of huge deficits cannot assume that conventional political mechanisms will suffice.

We can't blame our representatives for representing us. We have spent the postwar years building political constituencies around each of the huge publicly subsidized consumption programs and subsidies. When it comes to distributing even modest pain among these groups, like modifying cost of living adjustment (COLA) clauses, we have to design bipartisan Social Security commissions that take months to come up with answers while the President and Speaker of the House both think they have to hide behind these mechanisms and their results for the sake of their political lives.

The recipients of these entitlement programs are well organized; some estimate that there are 35 to 40 organizations that boast a combined membership of 35 million to 40 million. But what is important is their lobbying power. I once went to see the very conservative Congressman Kent Hance from Texas to discuss the passage of tax indexing without corresponding efforts to cap COLA indexing. He buzzed his assistant and said, "Would you please bring in for Mr. Peterson the letters, wires, and telephone messages against putting a cap on social security COLA index kickers?" She gasped and replied, "All of them?" She then came in with a huge armful of letters that expressed various levels of outrage that Congress would even consider touching the system. Then he said, "Please bring in all the letters that ask us to reform the COLA indexing system." At that point I knew that I had been had: she replied, "But Congressman, we *never* get any letters like that."

I have an image that helps me understand the politicians' point of view. You may remember the Saul Steinberg painting of the New Yorker's view of the world. It appeals to us New Yorkers because of its special brand of provincialism and arrogance. The tallest buildings on Ninth Avenue dominated; even the Hudson River was a bit off in the distance; far away there were the tiny hills called the Rockies and a little pond called the Pacific Ocean, and a few dots called China and Japan.

What if Steinberg painted a *political* map of America as viewed through the eyes of a member of Congress? In my judgment, the special interests or entitlement groups would be the huge skyscrapers dominating the scene. The constituency for fiscal responsibility—and most certainly the young—would be tiny dots on the horizon, like Japan in the geographical version.

In private, many politicians will tell you that we must do something about capping the COLA indexing on entitlements. Publicly, however, they're terrified at the thought of confronting any powerful entitlement group, such as the Gray Panthers, the Association of Retired Persons, and the various federal pensioner groups, over a modest reduction in even the rate of growth of these transfer payments.

Changing the U.S. Political Equation

To change the politician's view of the world, a new kind of effort is required. It means uncovering, nurturing, and mobilizing latent grass roots public support for fiscal responsibility. That type of broad consensus building is not accomplished by lectures to audiences full of believers. It means taking the case to the public, presenting the facts, answering the questions, directly countering the outlandish claims, and exposing the rationalizations of the deficit apostles and special interests. The goal: millions of postcards, letters, phone calls to demand that the government get on with it. It is an educational effort, but it is more. It takes personal commitment and it must be an important priority of every business and financial leader concerned with the risk of fiscal paralysis.

Along with five former Treasury Secretaries, I helped to found the Bipartisan Budget Appeal. It quickly expanded to include over 600 former public officials; heads of universities and foundations; managing partners of accounting, law, and investment banking firms; and chief executive officers of over 400 major companies. Though our efforts helped to raise the salience of the deficit issue, we needed to activate people at the grass roots level more effectively. Thus, the Budget

Appeal recently joined forces with over 30 trade organizations—including the American Bankers Association, the U.S. League of Savings Institutions, the National Association of Realtors, the Mortgage Bankers Association, the National Council of Savings Institutions, the National Association of Home Builders, as well as the Menswear Retailers of America, the National Grange, the National Forest Products Association, and on and on.

These diverse groups have pledged to urge their members, supporters, depositors, home builders, buyers, and so on to express their deep concern over the deficit and their strong support for a fairly specific deficit-reduction program involving entitlements, defense, and consumption-based taxes.

These groups also firmly agree that the strong current recovery provides an ideal climate for making the tough but imperative fiscal policy choices. In fact, action within the next six to nine months or so is urgent—and may be our only realistic chance. For example, if and when the current recovery permanently slows, powerful voices will then argue it is economically unwise to cut spending and raise taxes. Politically, the President has about nine months to deliver the deficit reduction baby—before cautions and rationalizations about the 1986 elections grow in volume. And after those nine months, the President's growing lame duck status will render serious deficit actions increasingly difficult.

Last year, *just two* of the Bipartisan Coalition's members (representing banks and savings institutions) mounted grass roots campaigns against an interest and dividend withholding measure strongly supported by Congressional leaders and the Administration. Ronald Reagan, Howard Baker, Robert Dole, Tip O'Neil, Dan Rostenkowski, and Jim Jones backed this bill. A 23 million card and letter deluge—not to mention a shower of powerful phone calls—drowned their support and the measure was dropped.

One of my fondest hopes is that the new Bipartisan Budget Coalition can help unleash a similarly effective torrent—soon—on Washington with the message that the deficits must decline. I have no doubt that when—and only when—the public gets fired up, the legislature will respond. Then the transient euphoria that has surrounded us will dissolve and the sobering-up process will start.

So we are really engaged in a struggle—or perhaps it's a race—between the willingness of the world's financial markets to sustain our massive twin deficits—budget and current account—and the capacity of our overwhelmingly *political* economy to act decisively before we crash into one wall or another. This has not been the ordinary sequence for decisive political action in our country. Typically the crash comes before any decisive action.

The Role of the Rest of the World

But suppose this country does what is needed and does it soon, before the financial markets terrifyingly seize up and compel action.

What should other nations do in response to a new-found fiscal responsibility in the United States? A noneconomist, of all people, should not have any country-by-country assignments to hand out. But I do know that passively sitting back would not be adequate; other countries should actively promote real growth. And, as the United States shifts away from huge trade deficits, today's trade surplus areas, Japan and Europe, must further open their markets to the products of the developing countries, especially those burdened with punishing levels of debt. Those countries' exports—particularly to other major OECD countries—are now too low. To retain old trade barriers would seriously dilute the global benefits of a U.S. return to fiscal balance. The world would and should judge it harshly.

Naturally, the developing countries have to strengthen their ability to export. They cannot hide behind excuses or artificial subsidies that simply inflame protectionist counterreactions. They cannot drag their feet. But they must, for example, adopt sensible exchange rate policies—in short, they should simply follow through on the kind of adjustment efforts already embodied in agreed IMF stabilization programs.

V. A Choice of Two Worlds

We know that the current drift of policy results in a rosy immediate situation but riddles the system with huge long-term risks. And we know that we cannot agree on any changes in our policy course that will be painless for all concerned. If there were no pain, we would have passed the hurdles already.

Consider this question: *Why not sit down together to agree on what we cannot let happen?* If we do that, we will easily identify the crucial present problems: how to avoid another sharp, prolonged recession, another outburst of accelerating inflation, or the devastating combination of both at once. Make no mistake about it, under current circumstances those outcomes would rend the fabric of relationships among countries that binds the global system together. So let the United States get its fiscal house in order and let the rest of the world take the complementary steps needed to ensure a sustainable course for all. That is our challenge.

In the broadest sense, we face two windows, each opening on a different kind of world. One is the window of opportunity. The other is the window of vulnerability. The first looks out on a world of growing prosperity and peaceful trade among nations, a stable environment with stable financial markets, a more certain world than what we have now. In this world, the United States would play its traditional role of leadership and cooperation. The second window looks out on a world of erratic growth and restricted trade, an unstable environment with volatile markets and fragile institutions; in short, a more dangerous world than we have now.

The window of opportunity is open but will not be open indefinitely. We can choose to take advantage of that opening and move toward a more secure future. But if we fail to act and miss that opportunity, then the window will close, and it may stay closed for a very long time. We will then be left with the scene beyond the window of vulnerability, a weak landscape littered with the remnants of wishful thinking and failed ideologies.

To me, the choice is clear. Let us seize the opportunity before it is too late.

Questions and Answers

Following the formal presentation, Mr. Peterson answered written questions from the audience.

MR. PETERSON: *Why is this not the time for major reform?*

Perhaps some of us are too close to the political situation in this country, but I think that given the euphoria that now exists, the view that we are on a very good economic path, and the general lack of sophistication of the effect of our country's policies on other countries, it is unlikely that our political system would subject itself to the discipline implied by most major reform concepts. Under our system, we are marvelous at distributing pleasure, at distributing benefits, yet we are perfectly awful at distributing pain. Even correcting our own gaping $200 billion deficits seems to demand unacceptable changes. Thus I really doubt that our leaders would choose to try to subject the country to significant internationally mandated changes.

What would you ask the Third World countries to do to be positive?

I talked for a long time but a subject I did not have a chance to talk about was the incredibly important role of private investment in developing countries and how to encourage it.

I see my friend Abdlatif Al-Hamad from Kuwait is here in the audience. He will remember the following incident. At a Brandt Commission session in Leeds Castle on the question of transferring real resources to developing countries, with Ted Heath in the chair, some of us fiscal conservatives were trying to argue that certain proposals for setting up a brand new institution at the United Nations in order to handle such transfers did not seem appropriate. Close to midnight, I asked one of the proponents of such an institution, "Tell me, sir, if you had to choose, which would you choose, a transfer of power or a transfer of resources?" There was a long, long pause in the discussion. I said, "You know, you remind me of one of the great sight gags in American television: the skinflint, tightwad Jack Benny"—whom some of you will recall—"appears on stage. A robber has a gun on Jack Benny's back. The robber says to him, 'Which will it be—your money or your life?' Jack Benny pauses interminably. And then the robber asks again, 'Which will it be—your money or your life?' Finally, Jack Benny says, 'I'm thinking, I'm thinking.' "

I would think one of the things that the Third World countries have to consider doing—in the context of such areas as GATT for foreign investments—is to ask themselves how flexible they are willing to be to reduce significantly the risks to private capital investment so that investors can get their equity out and so that it is seen as both a profitable and stable investment for them.

In the context you describe, how do you value the current efforts to create issues targeted to foreign investors by the U.S. Treasury?

I knew this question would come up and I was hoping it would not.

I suppose the argument that is presented by those who favor such issues is that they are such an incredible investment that we are doing everyone a favor by giving foreign investors the opportunity to invest in this country.

I come back to my basic point. This country has got to decide whether it can create a national consensus around more savings and more capital *of its own*. One of the planks of the Bipartisan Budget Appeal is big spending cuts but also a consumption-based tax in this country so that we can shift the system more toward savings and investment. I do not want to be in a position where we must depend on foreign savings as a way of keeping this economy going. It is a diversion.

If the political will is missing to reduce the deficit, why not vote the constitutional amendment the President has requested to prohibit deficits?

First of all, I want our foreign friends to understand that there are balanced budget amendments and there are balanced budget amendments. Some are highly rigid, specific, and would result in the worst kinds of macroeconomic policy. Others are quite flexible—for example, under some of them the country could run a deficit with a 60 percent vote of the Congress. I think that the *form* of the amendment, therefore, is very important.

One of my concerns with the balanced budget amendments, as they are presented to the American people, is that they would be *constitutional* amendments. By definition, to enact one would probably take two to three years of active lobbying and four to nine years before it took effect. What I have been trying to say today, interminably, I am sure, is that it is urgent that the country move *now* on the deficit. I do not want to give us the out that in several years maybe we *may* have a constitutional amendment.

My second concern is that the notion of a constitutional amendment tends to obfuscate the fundamental issue that we have got to find the political will to distribute pain and burdens fairly across our society.

If we have not achieved that political will in this country, I suspect that any kind of amendment could be easily subverted, given legendary skill and creativity of lawmakers and administrative agencies in finding ways to spend money. For example, items now part of the budget could be shifted by various accounting devices to off-budget status. So once again we come to the issue of will and discipline and the absolute need for a grass roots lobby out there demanding real change.

Why would it be easier for your external auditors to carry out the surveillance function that the IMF is not allowed to perform on major countries?

I think the essential reason is that any private group on the outside has a degree of freedom, independence, and autonomy that people who know who their bosses are cannot possibly have. One of the great traditions of this country is its private sector. And there are a lot of people in this country who carry great weight—some of them in this room. Absent such a potent group of international auditors—drawn from the likes of some of those in this room—I think it is very likely that an international institution, looking for large resources from its major stockholders, would still feel serious constraints in engaging actively in the public dialogue.

When the IMF was set up, we had hopes that the rich and poor countries would both agree to accept discipline. After 25 years of its existence, discipline especially in the richest countries still remains where it was. They would like to discipline others but not themselves. Is this easy to change?

That is an easy one. No. I have never known anyone who liked discipline, particularly when they consider themselves powerful.

Thank you all very much.

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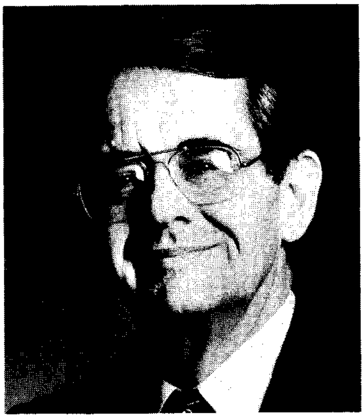
MR. MARTIN: Thank you very much for a most stimulating address. You have certainly justified our confidence in asking you to come here this afternoon. I would like to close this meeting by saying that we are most appreciative of the facilities that the George Washington University has made available to us. We also appreciate the help we have received from the staff of the University in making these arrangements. Thank you all for joining us this afternoon.

Biography



Currently the Chairman of the merchant banking firm of Peterson, Jacobs & Company, Peter G. Peterson has had a distinguished and varied career in both the private sector and public life. He has served the United States as Ambassador, Secretary of Commerce, Chairman of the National Commission on Productivity, and Chairman of the Quadrennial Commission on Executive, Legislative and Judicial Salaries. He was a member of the Independent Commission on International Development Issues (Brandt Commission) dealing with the relationships between the industrial and developing countries.

In his business career, Mr. Peterson has been President and Chief Executive Officer of Bell & Howell and Chairman of Lehman Brothers Kuhn Loeb. He is a Director of General Foods Corporation, RCA Corporation, Minnesota Mining & Manufacturing Co., Federated Department Stores, Inc., Black & Decker Manufacturing Company, and the Continental Group, Inc.

Mr. Peterson is a founding member of the Bipartisan Budget Appeal; Chairman of the Institute for International Economics; Trustee of the Committee for Economic Development, the Japan Society, and the Museum of Modern Art; Director of the National Bureau of Economic Research; and Treasurer of the Council on Foreign Relations.

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