The Legacy of Dr Volcker

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WHAT WOULD BE your reaction if IBM were to offer over three full percentage points higher interest on its bonds than does ESM Government Securities, Inc.?

Your first reaction would probably be that the Treasurer of IBM has gone mad. You might then want to rush to lend IBM your money before they change treasurers. But yet again, you might be a little scared. What can be wrong with IBM if it is offering three percent more than ESM? The whole thing would surely be a bit destabilizing . Yet that's exactly what the US Government has been doing.

During the past year, the US Government has been borrowing medium-term money at an average rate of 12.4 percent. At the same time, the major European countries and Japan have been borrowing medium term, in their own currencies, at an average rate of 9.25 percent. That means that the country with the strongest economy, the strongest currency, and the best credit has been paying three percent more than countries which are weaker, less stable, and have poorer credit.

Let's start by looking at developments in the US economy in the same way as we would look at IBM, if it were offering these exceptionally high yielding bonds. Yes indeed, something important has happened here in America. There has been a new Industrial Revolution. Some call it a techno-scientific revolution. Some call it the entrepreneurial revolution. Since 1965 it has created 35 million new jobs, and this despite the energy crisis, periods of extraordinary levels of inflation, 20 percent interest rates, deep recession, and everything else. It is now creating 300,000 new jobs every month. The new jobs are coming from small and medium sized businesses usually run by innovators and entrepreneurs whereas declining and mature industries are shedding about 500,000 jobs each year. In 1984, 650,000 new companies were formed against less than 20,000 which failed. This is an important change because it reduces the role and power of the mega corporations and the trade unions. It creates a polyculture of businesses, all competing one against the other. In a truly competitive economy, either you do it right or you get eliminated. Mega companies either get it right or they get taken over. Trade unions have to agree to competitive practices or unionised companies perish and trade union membership is correspondingly reduced.

According to estimates in the President's budget message and by the Congressional Budget Office, GNP in 1990 is projected to exceed five trillion dollars, which would be more than 50 percent above that for fiscal 1984. Under the current tax system, the government's tax harvest would increase by almost $450 billion.

According to Professor Paul McCracken of the University of Michigan and the American Enterprise Institute, a four percent annual growth rate is consistent with long periods of American experience and if there were this rate of growth through this decade, the government revenues would be $70 billion higher than the estimate by the Congressional Budget Office.

All that is incredibly good.

But what are the dangers, or perceived dangers, which lead a prominent American economist like C. Fred Bergsten to appear before the Confederation of British Industries in London last month and forecast what he called 'the second debt crisis'? His thesis was that there were great similarities between the debt crisis of the less developed countries in the 1970's and the forthcoming American debt crisis which he forecast. How is it possible that an eminent economist, like Mr Bergsten, could suggest in a public and international forum that the statement 'America will always be a triple A borrower' is as absurd as was the statement 'Sovereign nations do not go bankrupt'?

His case, of course, was based on the budget deficit and the trade deficit, with which you are all too familiar. The pessimists point to the fact that the budget deficit is forecast in the President's budget message at $220 billion, which is equal to five and a half percent of the fiscal year's GNP, and that to finance that deficit the US must borrow from overseas 12 to 15 percent of its total requirements. They remind us that the US has already become a debtor nation, in that its overseas liabilities now exceed its overseas assets. Additionally, they point to the growing trade deficit, which through 1984 hit almost $110 billion on a balance of payments basis. They consider that the rise in the US dollar has resulted in the loss of American competitiveness and that even its most efficient industries, including agriculture and electronic products, were in deficit in 1984, and computers and semi-conductors, taken together, are expected to be in deficit in 1985. They forecast that the current account deficit will exceed $300 billion by 1990, and that the external debt of the United States will be greater than one trillion dollars by that time. According to this scenario, America would need $100 billion annual trade surplus just to service interest on its foreign debt at a time when in fact there would be an annual trade deficit of $300 billion.

Personally, I believe that there have never been greater opportunities for growth, prosperity, and a better life than there are today. But these opportunities could be strangled by bureaucrats and politicians. Let me come back to the seemingly irrational behavior of the Treasurer who is offering unusually high yields. In the case of the US, he is Dr Paul Volcker. Obviously Dr Volcker realizes that there is a problem and he wants to solve it. But, in fact, he himself has become part of the problem. He seems to believe that the Fed can compensate for government policy and can control the economy as a whole by regulating the flow of money. That's rather like a man who believes that he can build a whole new skyscraper because he possesses a tap.

I think that well-meaning though they are, the Fed's actions have been inflationary; they have been a significant factor of the Budget deficit; they are a major contributor to the trade deficit; and they imperil world economic recovery. Let me explain.

High interest rates are inflationary because the direct or indirect cost of paying interest is part of everybody's and everything's cost. High interest rates contribute massively to the Budget deficit because the US Government is the biggest borrower. Every percentage point of interest ultimately adds $11 billion to federal interest expense. And that is based on the current level of US Treasury debt, which, of course, is increasing annually. If the US were paying interest at the same level as the major European countries and Japan, the ultimate saving to the US Government would be $33 billion per annum. That's the extra cost to the US of issuing high yielding bonds.

High interest rates have contributed substantially to the trade deficit because, obviously, with such yields all the spare cash in the world has been transferred to the US and into dollars. This has contributed to the 30 percent rise in the dollar's value since 1980 and to the consequent competitive pressures on US industry. As we all know, high yields only attract money if the credit is perceived as good. If there is any loss of confidence in that credit rating, then with the amount of hot money in the US there could be some turbulence. Ironically, these high interest rates also do some damage overseas. When the world's best borrower pays such a high rate of interest, it means that everybody else has to follow for at least part of the way. This endangers the fragile economic recovery of the remainder of the world.

As you can see, I don't believe in the solution offered by the Fed. I am also frightened by some of the other suggested remedies. There is a temptation to find soft options which deal with the symptoms and not with the causes of the problem. For instance, some people ask for intervention in the market place so as to artificially control the price of currencies. Others, who want to avoid hard decisions, call for a general freeze on government programs regardless of whether they are good or bad. That way they don't have to make choices which could alienate some of their supporters. And still others press for direct protectionist action. This could be particularly dangerous next year as one-third of the

Senate and all members of the House begin to think of their election prospects. The result of a new wave of protectionism would be to return the world to the vicious cycle of reducing competition, which ultimately leads to ossification, inflation, and recession.

It seems to me that the right solution is to allow the US economy to grow at its own pace, and I don't believe that anybody knows what that pace could be under the circumstances of the new Industrial Revolution. Furthermore, no matter how strong the US economy might be, it cannot be the sole pillar on which the world's economy is built. The best remedy for the US trade deficit is that the economies of other countries should also grow. This would supply outlets for their own industrial production, take pressure off imports into the US, and supply opportunities for US exporters.

Obviously, the ideal plan of action is to reduce government spending, to avoid tax hikes, and to hope that economic growth will sufficiently increase the government's tax harvest so that the budget deficit comes under control. Politically, that seems to be improbable. Congress will not allow the necessary cuts in government spending so the Fed won't allow the necessary rate of growth. But even with the good figures that I quoted earlier on, whereby the GNP would grow to five trillion dollars in 1990, and the government's tax harvest would increase by almost $450 billion, there would still be a greater budget deficit than that forecast for this year. Of course, that is because of the built-in government programs. So some form of compromise is necessary, even if unpleasant.

I like to believe that there is a chance of a compromise. Obviously the President cannot make concessions on military spending and taxes until Congress has agreed to substantial cuts in non-military spending. But perhaps at the end of the day, there might be agreement along the lines of $40 billion off non-military government spending; about $20 billion off military spending as a concession to obtain the remainder of the package; and some form of tax on consumption. Such a tax could raise about $30 billion per annum, with trivial effects on the level of inflation. Obviously, any tax increase should in no way diminish individual incentives or the capacity to invest. These are at the fountainhead of the new recovery.

Such a reduction in the budget deficit would enable a deep cut in interest rates. This would further and substantially reduce the budget deficit by cutting deep into the cost of government borrowing. It would allow for vigorous economic growth in the US with the consequent increase in tax harvest. It would also allow other countries to cut their interest rates and stimulate their economic growth, which could be fueled with savings no longer needed to fund the US budget deficit
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The value of the dollar would not drop sharply because the US economy would be prospering on a solid basis. Strong currencies based on sound economies are good, not bad. They are part of the virtuous cycle which leads to low inflation and high growth. The worry is when there are strong currencies which are based on trade deficits and artificially high interest rates.

As Mike Melkin said to you earlier, I sold out many of my Company's assets in Europe and invested them in America. That's because I believe in America. Your new revolution is deep and vigorous. It is indigenous to the USA because its parents are personal freedom and individual motivation, and they live here most of the time. They rarely travel. Your revolution is not only industrial, it is based on a fundamental shift in social values. You have rid yourselves of the negative ideas of the 1970's, when people doubted in the future. I pray that your great new revolution be allowed to be a shining example for the rest of the world to follow.