E. Gerald Corrigan
President, January 1985 to present

In this speech, made shortly after the stock market crash of October 1987, President Corrigan identifies imbalances in the U.S. and the world economy that contributed to financial market instability. He emphasizes that the reduction of U.S. federal budget deficits and the removal of barriers to international trade are prerequisites for adjustment, and he ends by drawing some implications for the supervision of financial markets.

Securing a More Balanced Global Economy

by E. Gerald Corrigan

Good afternoon, ladies and gentlemen; it is a pleasure for me to have this opportunity to address the Canadian Club of Toronto.

I think you will all understand that this is not the easiest of times for a central banker to be making public appearances; indeed, there is an old adage that central bankers should be seen and not heard. In these turbulent days I am inclined to the view that we should be neither seen *nor* heard. Since that is not a practical alternative, the next best thing is to be careful and measured in what we do and in what we say. Consistent with that, let me say right at the outset that I will have absolutely nothing to say this afternoon about possible near-term changes in interest rates, exchange rates, or stock prices! However, I do want to take this opportunity to provide something of a broad overview of the economic challenges that lie ahead—with particular emphasis on the adjustments which must take place over time if we are to succeed in restoring better balance in the U.S. and the world economy.

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Having said that, obviously I cannot ignore the recent period of unprecedented volatility in financial markets around the world. In the wake of these developments, there is a natural and appropriate desire to better understand what happened, why it happened, and what it implies for the future. I would not be so foolish to try to answer any of those questions at this time. I say that in part because meaningful answers will come only after the dust settles and only with the benefit of the perspective that will come with the passage of time. However, it is important that we learn all we can about exactly what happened on Monday, October 19, when the Dow fell by 500 points, including the answers to such questions as whether programmed trading or highly leveraged positions in stock futures and options played an important role in unleashing those events or

in aggravating them once the initial downward momentum developed. But to cite just one example of perspective, let us also keep in mind that stock prices in countries other than the United States where those particular institutional arrangements are far less important than they are in the United States have fallen by even greater amounts than the drop in the United States.

Let us also keep in mind that when we look carefully at the period between late August, when the Dow peaked at about 2700, and mid-October, when the Dow had reached its recent low of just above 1700, it is not easy to conclude that there was any one event or even any combination of events that can satisfactorily explain all that has happened over that interval. To be sure, from a U.S. perspective the dollar was under pressure in the exchange markets; interest rates, especially long-term rates, had risen; inflationary expectations were building; and there were signs of strains in the process of international economic policy coordination. While these developments were disturbing, individually or collectively, it is not clear that they should have been decisive, especially since over this same period economic performance was, in several crucial respects, better than earlier expectations. The U.S. budget deficit for fiscal 1987 turned out to be smaller than even the most optimistic expectations; spurred importantly by growth in exports, economic activity in the United States—including in the manufacturing sector—was stronger than expected; growth prospects abroad were no worse than earlier and, in the case of Japan, were actually better; and developments on the inflation front—while warranting careful and continuing vigilance—were in no way indicative of a significant outburst of inflation.

In short, as hard as we may look, it is by no means clear to me that we will find in these recent weeks a smoking gun or guns that can explain why stock prices plummeted so sharply and so abruptly in the United States and around the world. Let us also not lose sight of the fact that stock prices in the United States and elsewhere had reached historic heights in both absolute and relative terms in this general time frame. Indeed, the rise in stock prices during 1987 was such that even now stock prices in the United States are above their year-end 1986 levels.

Imbalances in the U.S. and the world economy

What I am suggesting, of course, is that the underlying causes of the recent financial market disturbances are not to be found in the events of the past several weeks or months but rather in the cumulative weight of events over a much longer time frame. Looked at in that light, it seems to me that the important conclusion to be drawn from recent experience is that the financial markets are sending us a message, and that message is in the form of a warning that despite a long period of satisfactory, if not quite extraordinary, economic performance, there are serious imbalances in the United States and world economy that simply must be remedied and remedied without further delay. Indeed, to the extent recent market developments have been fueled by any one thing, that thing may have been a growing doubt as to whether the policy process—domestically and internationally—was capable of mounting the necessary policy initiatives to deal with a series of problems which were certainly not new.

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

- In the late 1970s, general government budget deficits in the United States consumed, on average, only about 10 percent of our net private domestic savings. By 1986, and despite large surpluses in state and local governments, overall government deficits were consuming almost two-thirds of net private domestic savings, with the federal deficit eating up an astonishing 90 percent of net private savings. While these figures have come down somewhat this year, they remain far, far too high by any reasonable standard.
- As recently as 1981, the United States was the world's largest net creditor nation. We are now its largest net debtor and sometime in 1988 our net external indebtedness will cross the $500 billion threshold. To put it differently, by the end of 1988 our net external indebtedness will reach or exceed the accumulated public debt of the United States from its inception through 1974.
- Since the last quarter of 1983, nonfinancial corporate America has retired a cumulative total of $270 billion in equity while over the same interval corporate debt has increased by a staggering $600 billion.
- On a global basis, the U.S. trade and current account deficits, and their mirror-image surpluses in several of our major trading partners, are of unsustainable proportions.

These examples reflect the harsh reality that for too long we in the United States have been borrowing more than we save and consuming more than we produce in an environment in which debt, deficits, and leveraging have become a way of life for government, for business, and for individuals. Fortunately, we have both the underlying economic strength and the oppor-

tunity to remedy these problems—but only if we heed the warnings of the recent past and get on with the task now.

Yet, as we approach that task we must be realistic. There are no quick fixes; for example, we in the United States must recognize that for a period of time our standard of living must rise at a slower rate than would otherwise be the case. We must also be realistic in our expectations; for example, we can all look back with fondness at the interest rate environment of the 1950s and early 1960s and wish that we could quickly and easily return to such a tranquil setting. The reality, however, is that no country with our recent track record of debt, deficits, and inflation should expect such a result to emerge quickly or painlessly. Finally, let us also remain mindful of the risks and dangers on all sides. For example, there can be no doubt that the exchange rate is a crucially important variable in the current setting, but just as there are dangers with an exchange rate that is too high, there are dangers with one that is too low. Indeed, at the end of the day, there is no exchange rate which, unto itself, can solve our current problems in an orderly way.

Policy initiatives

All of that is simply a long-winded way of saying that imbalances in the U.S. economy are an important contributing force to the imbalances we see in the world economy. But the existence of these problems in the U.S. economy does not mean that the burden of adjustment lies exclusively with the United States. To the contrary, any realistic appraisal of the current situation must recognize that directly or indirectly the rest of the world has been the beneficiary of the U.S. trade deficit as output, employment, and income growth elsewhere have been supported by consumption in the United States. In other words, adjustment in the United States of necessity implies adjustment elsewhere and especially in the large surplus countries. There is no mystery to that. Nor is there any mystery in the kinds of policy initiatives that are needed to produce the necessary adjustments. Those essential policy initiatives including the following:

- We in the United States must sharply reduce and, in a relatively short period of time, eliminate our domestic savings gap. That domestic savings gap is the difference, relative to GNP, between our net domestic savings and the claims on those savings stemming from the combination of financing private investment and financing the government's deficits. In recent quarters, that savings gap has been averaging well in excess of $100 billion, or more than 3 percent of GNP. Looked at in that light, the problem with the U.S. budget deficit is not so much its size relative to GNP but rather its size relative to domestic savings.

  However, there are only three ways our savings gap can be eliminated: first, by reducing private investment which, if anything, is already too low; second, by increasing net domestic savings which, while desirable over time, simply does not seem to be in the cards in sufficient time or amounts to produce the needed result in an orderly way; and third, by reducing the financing needs of the government.

  As a practical matter, cutting the budget deficit is the only real choice we have, and even that is not really a choice but is rather a question of whether this generation pays the freight for failing to act or whether we will pass that burden on to future generations. The equivalent of a macroeconomic free lunch, like other free lunches, simply does not exist.

  One silver lining behind the cloud of recent market developments appears to be an encouraging and bipartisan willingness on the part of the political leadership in the United States to mount a fresh and vigorous attack on the budget deficit. To the extent that effort can produce a credible program of deficit reduction which, as an illustration, could roughly eliminate the domestic savings gap in an intermediate time frame, the consequences for markets and for the economic outlook should be constructive.

- We in the United States must also accept, for a period of time, a slower rise in our standard of living than would otherwise be the case. By that I mean, of course, that the rate at which the U.S. economy consumes goods and services must slow in absolute terms and in relation to GNP. To put it in slightly different terms, if real GNP growth were to average 3 percent over the next several years—a result I would consider quite satisfactory—the *only* way net exports can rise is if domestic demand is growing at a slower rate than GNP itself.

  It would be nice to think we could have a sufficiently high growth in GNP to accommodate both a rise in net exports and a rate of growth in domestic demand commensurate with historical experience. Unfortunately, it is most unlikely that such a result could emerge without running grave and, in my judgment, wholly unacceptable, risks of renewed inflationary momentum. Indeed, when one takes account of the fact that the bulk of the external adjustment in the U.S. trade deficit must come via higher exports and lower imports of manufactured

goods, there are inflationary risks inherent in even the most optimal pattern of adjustment.

- Adjustment in the United States is crucial but it must be supported by complementary developments in other countries, especially in those industrialized and newly industrialized countries that have large trade and payment surpluses. That requires that those countries must go through a period in which their domestic demand increases faster than their GNPs even as GNP growth rates are maintained at otherwise satisfactory rates. To some extent, the process is already taking hold, especially in Japan. However, without singling out any one country, a question naturally arises as to whether this process could not be further strengthened by additional stimulus—especially on the fiscal side. Indeed, in a context in which fiscal stimulus is being reduced in the United States, the case for some increased fiscal stimulus elsewhere has natural appeal. This is especially so since there are ways in which *temporary* moves on the fiscal side—which need not jeopardize longer term objectives of budget discipline and price stability—can be very helpful in the *transition* to more balanced growth in the world economy.
- The other remaining major link in this chain of needed policy initiatives is in the area of trade policy. Protectionism is simply not the answer to our economic woes. History tells us that in a blunt fashion. But just as we must strongly resist protectionist pressures in the United States, other countries must move decisively in opening their markets to imports, including imports from the United States. The recent dramatic gains in productivity in the U.S. manufacturing sector and the not unrelated surge in U.S. exports of manufactured goods suggest that U.S. firms can compete in world markets, especially in a setting in which artificial barriers to imports are being reduced around the world.

  A more open and market-driven world trading system is what we want and what we need. In that regard, the bilateral efforts between Canada and the United States to adopt a major liberalization of trading arrangements between our two countries can serve as a model to the rest of the world. I recognize, of course, that final adoption of that trade pact faces obstacles on both sides, but I sincerely hope we can quickly get on with the process of ratification, not just because it would be beneficial to both our countries but also because of the message it sends to the rest of the world.

To summarize, the nature of the imbalances in the United States and the world economy is well known. More importantly, there now seems to be a widening consensus in the United States and elsewhere as to the kinds of policy initiatives that can remedy these imbalances in an orderly way. To the extent that assessment is accurate—and I certainly believe it is—the prospects for the world economy are brighter indeed. However, the clock is also ticking; delay and procrastination in getting on with the execution of the necessary policies carry with them the clear and present danger of slippage in both economic performance and prospects. The benefits from cooperative and concerted actions are clear, but so too are the costs of inaction.

Structure and behavior of financial markets

At the risk of exhausting your patience, allow me to close with a few remarks about the implications of recent events for the structure and behavior of our financial markets and institutions. It is possible to look at the recent period of turmoil in financial markets and observe that those markets and institutions performed remarkably well under enormous strain. In one sense that is obviously true. But however true it may be, I think it would be a serious mistake to have passed through this episode and not to have learned from it. In that regard, let me briefly mention a couple of things that stand out in my mind:

- First, the financial wizardry that has been so much in vogue in recent years carries with it new and often very complex elements of risk to market participants and institutions alike. Long periods of bull markets tend to bring about a subtle but certain relaxation of standards of caution and prudence if not a tendency, at least for a few, to allow greed to be substituted for common sense. When those tendencies are coupled with technologically-driven innovations in the financial marketplace that dramatically increase the speed, volume, and complexity of transactions, new elements of risk and volatility can come into play.
- Efforts aimed at reform of national banking and financial market systems—such as those well under way here in Canada—should not be postponed or delayed. The case for progressive reform is still there but so too is the case for insisting that the process of reform be accompanied by appropriately strong supervisory arrangements.
- The global character of financial markets has been a reality for some time. But it seems to me that recent events have demonstrated just how closely intertwined those markets have become. That reality carries with it the clear and pressing need to achieve a much higher degree of harmony among nations with regard to the supervision of banking

and capital market activities. On the banking side, the G-10 central banks are well advanced in efforts to arrive at a common multilateral approach to bank capital adequacy standards for internationally active banking organizations. Hopefully, that effort can be completed in the near term since it would constitute a very important step forward in international cooperation that would make sense both on competitive and prudential grounds. But as important as it is, it is only a beginning in the larger task of seeking to adapt national standards of banking and capital market practices and supervision to what are clearly international markets.

To summarize, the current economic and financial situation in the United States and around the world should be a matter of concern to all of us. But our fate is in our own hands. We have the tools, the knowledge, and the underlying strength to forge the necessary adjustments that can permit a return to a more balanced and sustainable pattern of economic performance. That opportunity has not been lost; to the contrary, recent events may well have worked in the direction of enhancing prospects that the needed policy initiatives—nationally and internationally—will be forthcoming. Indeed, even before recent market developments, important initial elements of that transition were beginning to take hold. Building on those developments and with a renewed sense of purpose, I believe we can seize this opportunity and cooperatively manage our way through this transition in a manner that will yield a more secure and more stable future for all.