

## **An Economy On Thin Ice**

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The U.S. expansion appears on track. Europe and Japan may lack exuberance, but their economies are at least on the plus side. China and India -- with close to 40 percent of the world's population -- have sustained growth at rates that not so long ago would have seemed, if not impossible, highly improbable.

Yet, under the placid surface, there are disturbing trends: huge imbalances, disequilibria, risks -- call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot. What really concerns me is that there seems to be so little willingness or capacity to do much about it.

We sit here absorbed in a debate about how to maintain Social Security -- and, more important, Medicare -- when the baby boomers retire. But right now, those same boomers are spending like there's no tomorrow. If we can believe the numbers, personal savings in the United States have practically disappeared.

To be sure, businesses have begun to rebuild their financial reserves. But in the space of a few years, the federal deficit has come to offset that source of national savings.

We are buying a lot of housing at rising prices, but home ownership has become a vehicle for borrowing as much as a source of financial security. As a nation we are consuming and investing about 6 percent more than we are producing.

What holds it all together is a massive and growing flow of capital from abroad, running to more than \$2 billion every working day, and growing. There is no sense of strain. As a nation we don't consciously borrow or beg. We aren't even offering attractive interest rates, nor do we have to offer our creditors protection against the risk of a declining dollar.

Most of the time, it has been private capital that has freely flowed into our markets from abroad -- where better to invest in an uncertain world, the refrain has gone, than the United States?

More recently, we've become more dependent on foreign central banks, particularly in China and Japan and elsewhere in East Asia.

It's all quite comfortable for us. We fill our shops and our garages with goods from abroad, and the competition has been a powerful restraint on our internal prices. It's surely helped keep interest rates exceptionally low despite our vanishing savings and rapid growth.

And it's comfortable for our trading partners and for those supplying the capital. Some, such as China, depend heavily on our expanding domestic markets. And for the most part, the central banks of the

emerging world have been willing to hold more and more dollars, which are, after all, the closest thing the world has to a truly international currency.

The difficulty is that this seemingly comfortable pattern can't go on indefinitely. I don't know of any country that has managed to consume and invest 6 percent more than it produces for long. The United States is absorbing about 80 percent of the net flow of international capital. And at some point, both central banks and private institutions will have their fill of dollars.

I don't know whether change will come with a bang or a whimper, whether sooner or later. But as things stand, it is more likely than not that it will be financial crises rather than policy foresight that will force the change.

It's not that it is so difficult intellectually to set out a scenario for a "soft landing" and sustained growth. There is a wide area of agreement among establishment economists about a textbook pretty picture: China and other continental Asian economies should permit and encourage a substantial exchange rate appreciation against the dollar. Japan and Europe should work promptly and aggressively toward domestic stimulus and deal more effectively and speedily with structural obstacles to growth. And the United States, by some combination of measures, should forcibly increase its rate of internal saving, thereby reducing its import demand.

But can we, with any degree of confidence today, look forward to any one of these policies being put in place any time soon, much less a combination of all?

The answer is no. So I think we are skating on increasingly thin ice. On the present trajectory, the deficits and imbalances will increase. At some point, the sense of confidence in capital markets that today so benignly supports the flow of funds to the United States and the growing world economy could fade. Then some event, or combination of events, could come along to disturb markets, with damaging volatility in both exchange markets and interest rates. We had a taste of that in the stagflation of the 1970s -- a volatile and depressed dollar, inflationary pressures, a sudden increase in interest rates and a couple of big recessions.

The clear lesson I draw is that there is a high premium on doing what we can to minimize the risks and to ensure that there is time for orderly adjustment. I'm not suggesting anything unorthodox or arcane. What is required is a willingness to act now -- and next year, and the following year, and to act even when, on the surface, everything seems so placid and favorable.

What I am talking about really boils down to the oldest lesson of economic policy: a strong sense of monetary and fiscal discipline. This is not a time for ideological intransigence and partisan posturing on the budget at the expense of the deficit rising still higher. Surely we would all be better off if other countries did their part. But their failures must not deflect us from what we can do, in our own self-interest.

A wise observer of the economic scene once commented that "what can be left to later, usually is -- and then, alas, it's too late." I don't want to let that stand as the epitaph of what has been an unparalleled period of success for the American economy and of enormous potential for the world at large.

*The writer was chairman of the Federal Reserve from 1979 to 1987. This article is adapted from a speech in February at an economic summit sponsored by the Stanford Institute for Economic Policy Research.*