10 DOWNING STREET

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Prime Minister

Apart from avoiding mention of a specific time, the Volcker's analyses of the US position is couched in very similar terms to your own.

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Fed signals concern at twin deficit threat

BY PAUL TAYLOR IN WASHINGTON

Ir Paul Volcker, the Federal Reserve Board chairman, yesterday testified before the U.S. House of Representatives Banking, Finance and Urban Affairs Committee on the state of the U.S. economy, the prospects for continued non-inflationary growth and Fed policy. The following are excerpts from his remarks.

A year ago in appearing before you on this occasion I emphasised that after too many years of pain and instability, we had an enormous opportunity to sustain growth for years ahead in an environment of much greater price stability. Today, after a year of strong recovery, that sense of the opportunities before us has only been reinforced.

What we have not done in this past year is to face up to other hazards to our prosperity and to our stability, hazards that are new to our actual experience but which have been long identified. I am referring of course to our twin deficits: the structural deficit in our federal budget and the deficit in our external account, both at unprecedented levels and getting worse. Both of those deficits carry implications for the prospects of reducing our still historically high levels of interest rates.

So far, the strains have been masked by other factors of strength and by the rapidity of growth from the depths of recession. But with the passage of time and full recovery, the predictable effects have become more obvious. They pose a clear and present danger to the sustainability of growth and the stability of markets, domestic and international. We still have time to act—but in my judgment, not much time.

Over the past year, our needs have been increasingly met by savings from abroad in the form of net capital inflow. That money has come easily amid world economic and political uncertainty, the U.S. has been a highly attractive place to invest. But part of the attraction for investment in dollars has been relatively high interest rates. In effect, the growing capital inflow has, directly or indirectly, helped to finance the internal budget, by the same token helping to moderate the pressures of the budget deficit on the domestic financial markets.

At the same time, the flow of funds into our capital and money markets pushed the dollar higher in the exchange markets even in the face of growing trade and current account deficit—and the dollar appreciation in turn undercut our worldwide trading position further.

We simply cannot afford to become addicted to drawing on increased amounts of foreign savings to help finance our internal economy. Part of our domestic industry—that part dependent on exports or competing with imports—would be sacrificed. The stability of the dollar and our domestic financial markets would become hostage to events abroad. If the recovery is to proceed elsewhere, as we want, other countries will increasingly need their own savings. While we don't know when, at some point the process would break down.

We recognise that the battle against inflation has not yet been won—that scepticism about our ability, as a nation, to maintain progress towards stability is still evident. That is one of the reasons why longer-term interest rates have lingered so far above current inflation levels. After so many false starts in the past, the scepticism is likely to remain until we can demonstrate that, in fact, the recent improvement is not simply a temporary matter—that the Federal Reserve is not prepared to accommodate a new inflationary surge.

The doubts are reinforced by concerns that the pressures of the huge budget deficit on financial markets may, willy nilly, push us in that direction.

The desire to see interest rates lower, or to avoid increases, is natural. But attempts to accomplish that desirable end by excessive monetary growth could soon be counterproductive. By feeding concerns about inflation, the implications for interest rates themselves would be in the end be perverse—and likely sooner rather than later.

As things stand, credit markets are already faced with potential demands far in excess of our capacity to save domestically; to add renewed fears of inflation to the outlook would only be to reduce the willingness to commit funds for long periods of time and for productive investment. Inflationary policies would also discourage the continuing flow of funds from abroad upon which for the time being, we are dependent.

In setting the targets for the various monetary and credit aggregates for 1984 as a whole, the Fed Open Market Committee had to remain alert to the danger of renewed inflation as well as to the need for growth.

Certainly, a kind of demonstration that we are beginning to face up to our budgetary problems would make it easier for monetary policy to do its necessary work. And, in the larger scene, it would be tangible evidence to our own people that we can do what is necessary to seize the bright opportunities before us.

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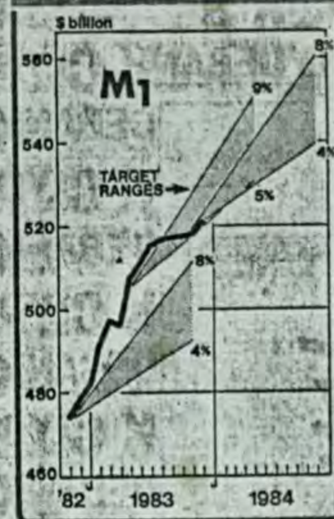

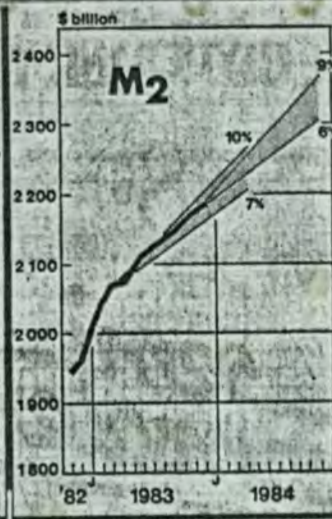

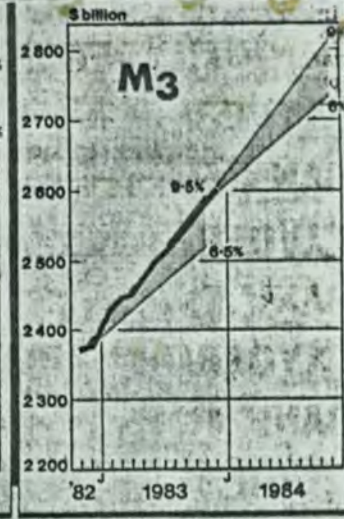

Congressional Budget Office adds voice of concern

MR RUDOLF PENNER, director of the Congressional Budget Office, warned yesterday that Federal budget deficits could soar to $326bn by 1989 if there are no changes in current budget policies, Stewart Fleming writes from Washington.

The CBO warns that the deficit could hit $267bn in 1986 and $390bn by 1989. In an anlysis of the budget outlook based on more pessimistic economic assumptions in line with the U.S. economy's 3 per cent real growth path in the 1970s but including a "moderate recession" in 1986 involving a 0.9 per cent decline in real economic output.

The CBO's figures differ widely from those which the Reagan adminstration put in its budget message to Congress. The administration projected deficits of $177bn in 1986, falling to $123bn in 1989.

The CBO warned that deficits of this magnitude are unprecedented since World War Two. Many analysts believe they could have severely depressing effects on interest and trade sensitive sectors of the economy and could lead to increased instability in overall economic activity.

Commenting on the difference between the central projection of the CBO calling for a deficit of $326bn in 1989, Mr Penner said the CBO assumption of a 3·4 per cent real growth rather than the 4 per cent the Administration assumes and less optimistic interest rates assumptions appear to account for a large part of the gap.