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The Honorable Alan Greenspan
Chairman, Board of Governors
Federal Reserve System

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Introduction

Chairman

Could I have your attention please. Members of the Economic Club of New York, welcome to the 323rd meeting in the 81st year of the club. We're very pleased tonight to have on our dais our former chairman who served as Chairman of Economic Club from 1985 to 1987, Mr. Dwayne Andreas. Dwayne. (Applause)

Our guest of honor tonight should really be speaking first rather than second. He was vice-chairman of the Economic Club when he ran off to Washington to become the Chairman of the Board of Governors of the Federal Reserve System. We're so very happy to welcome back the Honorable Alan Greenspan.

The Honorable Alan Greenspan

Chairman, Board of Governors

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Thank you very much. I see that I'm going to be grilled by Henry and Dennis, and I must say that I can't wait to see how well I'm going to be able to evade. I guess I should warn you if I turn out to be particularly clear, you've probably misunderstood what I said.

In any event, this evening I would like to examine with you two of the most important issues of U.S. economic policy. The first is the extraordinarily large U.S. current account deficit that has emerged in recent years, largely mirrored by the current account surpluses among several of our major trading partners. The second issue is our large federal budget deficit which has come to be closely associated in many people's minds with our external deficit. These two deficits differ somewhat in terms of their long-term sustainability. Government budgets, government budget deficits can, and indeed in many countries often do, persist for very long periods, though frequently with adverse consequences for their economies. In the United States, as many of you know, we have run a federal government deficit for 24 of the last 25 years.

Persistent external deficits, on the other hand, typically occur in countries only during their development stages. The sustainability of the U.S. current account deficit is questionable in part because of its large magnitude relative to total world trade. In 1987, for example, our current account deficit of approximately $160 billion amounted to almost 7% of world trade.

The sustainability of the U.S. current account deficit is also questionable because it must be financed. Foreigners must be willing to take our paper in exchange for the deficit in our trade, in goods and services. By definition, the deficit must be associated with an increasing stock of foreign claims on domestic residents and/or a reduction in the stock of domestic claims on foreign residents. Although the rate of increase of U.S. claims on foreigners has declined in recent years, it is still positive. Claims are still rising. Therefore, the increase in foreign claims in the United States has been even greater than the total U.S. current account deficit. These foreign acquisitions of dollar assets incidentally include net purchases of Treasury issues, U.S. corporate bonds, stocks in U.S. companies, and direct investments as well as net borrowings from foreigners channeled through banking offices located in the United States.

Accordingly, to finance our large external deficit foreign investors must be willing to add each year the requisite amount of additional dollar-denominated assets to their wealth portfolios. As the stock of dollar claims increases relative to assets denominated in other currencies, foreign investors may require additional incentives to accumulate the increased supply of these assets.

A safer political environment for assets, convenience, and liquidity have in the past enhanced foreign inclinations to expand dollar asset holdings at any given set of interest and exchange rates. Whether these factors will be enough in the future without a significant reduction in the rate at which dollar assets are piling up in foreign portfolios is the crucial question. A failure to achieve a substantial reduction in our current account deficit risks changes in market incentives, that is, higher interest yields and/or a cheaper foreign currency price for assets.

We have already had a significant decline of the dollar. This currency depreciation will drive the current account deficit down as exports are stimulated and imports are restrained. But while these self-correcting forces will work over time, the period may be long and unpredictable. The adjustment process is likely to be exacerbated by the volatility of exchange markets in response to perceived shifts in macroeconomic policies and performances at home and abroad.

The preferences of market investors for dollar assets could be shaken by a variety of factors. The enactment of protectionist trade legislation which might be construed as a step towards capital controls could be one such factor. Another might be increased concern about the future purchasing power of the dollar. Should investors lose confidence in the dollar for any reason the inevitable consequence would be an attempted shedding of dollar assets and a corresponding drop in the value of the dollar and an increase in interest rates on dollar-denominated assets.

If a contraction in U.S. economic activity were to follow as a consequence, it would likely improve our merchandise trade balance as the demand for imports fell. However, the rise in dollar interest payments to foreigners as a result of the interest rate increases would tend to offset the effects of this development on the current account. Accordingly, any such improvement in the current account would surely be temporary and therefore not in the longer run interests of either the United States specifically or the world economy in general. Thus, the smooth re-equilibration of the U.S. current account depends critically on the evolution of expectations of international investors.

The depreciation of the dollar since 1985 coupled with improvements in productivity and wage restraint have begun to reduce the U.S. current account deficit but only recently. Imports as a share of our domestic demand continue to increase markedly as dollar prices on goods imported into the United States declined throughout 1985 and into the summer of 1986 despite the fall in the dollar.

The behavior of aggregate import prices reflected the decline in oil prices and the lagged effects of the dollar's earlier appreciation. Foreign producers had allowed profit margins on goods sold in the United States to rise to very high levels during the period of strong dollar appreciation. As the dollar strengthened, they delayed in implementing lower dollar prices. Conversely, as the dollar declined in value, foreign producers showed a strong and persistent inclination to hold the line on dollar prices and absorb the rise in their costs of production measured in dollars by reducing their profit margins.

In addition, many foreign suppliers have evidently shielded their export profit margins from exchange rate changes by cost reduction efforts that helped them remain competitive with U.S. manufacturers. Import prices also remained depressed in the face of highly visible declines of the dollar in terms of the Japanese yen and the major European currencies because a large proportion of our imports are from Canada and the newly industrialized countries of Asia. Exchange rates of the currencies of those countries have remained relatively stable against the U.S. dollar.

Since mid-1986, however, import prices have risen at more than a 7% annual rate. Roughly twice the overall rate of domestic price increases. As a result, the import share of domestic demand is flattening out and only recently may have begun to contract. With the decline in the dollar and substantial efforts to contain costs, U.S. export prices denominated in the currencies of our customers have become increasingly competitive with the result that export volumes have soared since early 1986.

Inasmuch as export prices denominated in dollars have been essentially unchanged over the past two years, increases in export volumes have translated into a gain of almost 40% in nominal terms from an average of about $18 billion a month during the first quarter of 1986 to an average of more than $26 billion a month in March and April of this year. As a consequence, the trade deficit in dollar terms is contracting at a moderate pace. I expect this to continue though the month to month changes probably will be erratic. Thus, the main success we have had to date in reducing our current account deficit has resulted from the major expansion in the volume of our exports. This heavy reliance on our export sector raises the natural question of whether we may be running into supply bottlenecks in specific export-oriented industries, or more generally, is the projected increase in the physical volume of exports and the likely shift from foreign to domestic production sources in the next year capable of being fulfilled from domestic facilities?

The delayed effects of the pass-through of last year's decline of the dollar will not be felt until well into 1989. The figures on industrial production and capacity utilization that are published by the Federal Reserve do not permit a simple answer to that question. The best evidence of whether supply bottlenecks are developing will more likely be found in information on lead times on orders for materials and equipment. There does not, as yet, appear to be any evidence that we are

seeing significant increases in order lead times for broad categories of goods produced in the United States. This suggests that we are not as yet experiencing any major supply side constraints. To be sure, a number of products, for example, flat-rolled steel sheets, petrochemical feedstocks, caustic soda, nickle, are reported to be in short supply. But average lead times for production materials generally have moved up only moderately since late 1985 and have essentially, though perhaps temporarily, stabilized during the past five months.
However, such data do not represent conclusive evidence as to whether we are approaching deliverability constraints. The situation will have to be monitored careful if we are to avoid an acceleration in inflation and if we are to continue to count on an expansion in export volumes to bring about a further narrowing of our external deficit.

The uncertainty of the extent of domestic capacity availability to meet export expansion and import displacement over the next year, resulting from the dollar's depreciation through last year raises obvious questions of whether further declines in the dollar in the near term can contribute materially to the adjustment process. If in fact, the developing trends in physical volume cannot be appreciably improved over the next year, further declines in the dollar – assuming they get passed through to import prices – would only raise the nominal trade deficit to levels above what would otherwise prevail. Hence, I find no adjustment benefit to be derived from a further fall in the dollar. And indeed a further decline could actually do harm to our external position.

Thus, although an improvement in our current account deficit is clearly underway, the ultimate extent and pace of that improvement are still far from certain. They depend on developments in exchange markets and on economic policies here and abroad. Moreover, our knowledge of the underlying relationships that have evolved in recent years is limited. In light of the importance of international markets to our overall growth prospects, the critical policy question concerns whether measures are appropriate to ensure that the adjustment process continues smoothly and in a manner conducive to long-term growth and stability, not only in the United States but for our trading partners as well.

In order to understand what should be done, it is useful to recall that a current account deficit is identically equal to an excess of domestic investment over domestic savings where savings includes both public and private savings. The traditional adjustment process for bringing domestic savings and investment into better alignment relies on higher interest rates to close the gap. In fact, the rise in long-term interest rates in 1987 and more recently probably reflected the need for the market adjustment process to be supported by above normal real interest rates when domestic demand is strong and excess capacity limited.

Inasmuch as physical investment is generally more sensitive to interest rates than saving, in this type of adjustment process and under these conditions the current account deficit would be reduced largely at the expense of domestic investment in plant, equipment, and housing. If the investment rate in the United States were unusually large relative to the rates of our trading partners, then there would be less cause for concern.

However, since World War II U.S. savings and investment rates have been consistently below those of our major trading partners. Thus, an adjustment process that results in a lowering of U.S. investment spending at a time when an increase in productive capacity appears to be necessary is far from an optimal outcome. Therefore, it would seem desirable to seek progress on the other component of the investment-saving imbalance; that is, raising the domestic savings rate.

Policy can be directed at raising domestic savings directly by lowering public dis-savings. That is, by reducing the budget deficit. Since we have tried by employing so many different vehicles in recent years which have not really succeeded, we're getting down to the point where our major capability in improving domestic savings actually results in reducing public dis-savings, that is the deficit. Such a policy would permit a lowering of our current account deficit without sacrificing productive private investment.

Reducing our federal budget deficit would be the most important step we can take to further the adjustment process even though it will not automatically and immediately lead to a reduction in our current account deficit. The reason is that while a reduction in the budget deficit will remove effective demand from the United States economy and restrain the demand for imports, the likely reduction in real interest rates in the United States that would accompany a significant reduction in our budget deficit would presumably stimulate an expansion in domestic investment and in particular the demand for capital goods, some of which would be imported.

Concurrently, a reduced government deficit might actually improve the confidence of foreigners investing in the United States thereby raising the exchange rate of the dollar and delaying somewhat the improvement in the current account deficit.

It is probably the case that the sharp increase in the budget deficit in the early 1980s raised real dollar interest rates, both absolutely and relative to real rates on major competing currencies. This in conjunction with other forces moved the dollar's foreign exchange value higher which in turn engendered the trade deficit. This is not, however, a simple reversible process. In today's environment, we can expect a decline in the budget deficit to assist the restoration of international balance only with a lag. Moreover, it is only when any bulge in domestic capital outlays following the fall in real interest rates contracts that a fall in imports and the trade deficit would ensue.

The real merit in reducing our budget deficit is not that it will provide a quick cure to our current account or trade deficit, but rather that it will eventually do so by addressing the fundamental issue of inadequate domestic savings. The inadequacy of our domestic savings rate certainly relative to our major trading partners suggests that the United States ought to be running a federal budget surplus to augment the supply of domestic savings. While the United States currently is not saving as high a proportion of its national output as other industrialized nations, it does not follow that this is the natural or long-term situation. It is not something irreversibly embodied in our culture.

Indeed, if that were the case the obvious question would arise: how did the United States become the world's preeminent economy with one of the highest standards of living when we save and invest at lower rates than most other countries? The answer rests largely on the fact that historically we have not always been a low savings society. In fact, during the period following The Civil War in which the United States was rapidly becoming the most productive economic power in the world, our saving and investment rates as conventionally measured, were much higher than those in Europe and Japan.

For example, between 1870 and 1910, the domestic savings rate in the United States averaged about 19% of GNP. The best estimate for the Japanese savings rate during that period is 14% of GNP or five percentage points below that of the United States. The comparable figure for Germany is less than 15% which is still more than four percentage points below the U.S. rate.

The shift toward a relatively and absolutely low U.S. savings rate began during The Great Depression when the dramatic decline in the U.S. savings rate was not matched by a similar decline in Europe and Japan. After World War II, the savings propensities of Germany and Japan rose to record levels while that of the United States stabilized at a level slightly below its pre-Depression average.

Throughout most of the post-War period, the savings rate of the United States has been lower than those of all other major industrial countries. And as least partly as a consequence, these countries have proved their competitiveness relative to the United States. To a large extent, higher savings rates abroad were associated with the process of recovery from the devastation of World War II and a closing of the gap in living standards with the United States. While there is some evidence that savings and investment rates in these countries have been declining since the early 1970s, the United States still remains the lowest saver among the major industrial countries and our saving rate has dropped even further during the last five years.

This brief review of economic history does not suggest that the United States must go on forever as a consuming nation, saving little, investing little, with a diminished long-run level of productive capacity relative to those of other industrial nations and a heavy reliance on foreign savings. In particular, the United States needs to contribute to a better balance of world saving and investment by removing the continuous dependence on foreign savings as the counterpart to our large current account deficit. Ideally, this dependence would be reduced by a higher propensity to save by U.S. residents. Pending such a restoration of the private savings rate in the United States, a programmed federal budget surplus may be needed to augment total savings. Given the current situation with large federal outlays on a variety of popular domestic programs, that kind of policy objective can only be achieved over a multi-year time horizon. Moreover, considering the very large magnitude of global current account imbalances, it is clear that any successful attempt by the United States to address its external situation must involve cooperative policies with our trading partners, both in the industrial world and in the developing world whose debt problems are also part and parcel of the global adjustment process.

Fortunately I can report that I am reasonably hopeful, by the normally conservative standards of central bankers, about the prospects for success. Since I moved from the private to the public sector, I've been impressed by the extraordinary desire on the part of those involved in the economic policy process to reduce saving and investment imbalances and to achieve sustained growth in the world economy. If enthusiasm and dedication are any evidence of potential for success, one cannot but come away being hopeful about the long-term outlook. Nevertheless, we all must do our part and some of the decisions, needless to say, will not be easy. Thank you very much. (Applause)

QUESTION AND ANSWER SESSION

CHAIRMAN: Thank you Dr. Greenspan for certainly a very deep and provocative message. Our distinguished questioners tonight are Henry Kaufman of Henry Kaufman and Company and Dennis Weatherstone of J.P. Morgan & Company. We'll start with Dennis on my right and they will alternate questions until about twenty to ten and we'll have a final question from each of them. So if you'll begin and then we'll go back and forth.

DENNIS WEATHERSTONE: Thank you. Mr. Chairman, I very much agree the two main problems facing us are the current account deficit and the budget deficit. It did seem this morning that we had one of those erratic months that you referred to in the trade account numbers. And I wonder whether you were surprised by the less than $10 billion deficit? And do you perhaps believe that there's an encouraging hint in the April numbers that the import rise may be flattening. The second question along with it, and you refer to it in your remarks, even though the morning trade numbers were encouraging, they continue to show very large deficits for the U.S. vis-a-vis the Asian NICs. Isn't this a problem? And what can be done about it?

THE HONORABLE ALAN GREENSPAN: The answer, I think, of necessity was I was surprised but delighted. It's been rare in the months I've been at the Federal Reserve that numbers have fallen in the right direction two months in a row so needless to say I'm not looking a gift horse in the mouth so to speak. But I think, to be realistic, we have to expect somewhere along the line that these things will bounce around. Nonetheless, when you look at them now in the context of dis-aggregating the physical volume of imports and exports and the various prices that are involved, it's fairly obvious that we are finally getting a trend that is moving. And I think it is moving now perceptibly but as implied by your remarks and mine, it's going to kick around a bit and I think that we can expect that each month will be as good as we would like. And I think probably we'll find, however, that the experience of the last several months will induce forecasters to start to revise down their projections of what they think the current account deficit will be. With respect to the issue of the NICs, South Korea, Taiwan, Singapore, etc., the problem basically is that the exchange rates there as I mentioned and I think has been an issue which most have been involved with, have tended to be far more closely aligned with the U.S. dollar and have only strengthened moderately. I think that what is going to happen, however, is that the market forces which are emerging as a consequence will likely remedy that. I mean, as you know, Taiwan has accumulated an incredible amount of asset reserves well in excess of $75 billion which puts it up in the hierarchy of major holders of assets in the world, probably number two so far as central banks are concerned. And they are having, of necessity, difficulty absorbing all of that and as a consequence they're eventually going to have to move their exchange rates up because the markets, I think, are going to force that. And I think that's perhaps the best way of having that happen. There have been obviously discussions between American representatives and those of the NICs on this issue, but there's nothing as potent as market forces to get a message across.

HENRY KAUFMAN: Mr. Chairman, I'd like to ask a warm-up question that is related to the international side. As you know, the dollar recently not only has been stable, but has gained some strength. And indeed there has been some evidence of significant intervention by some foreign central banks to counter the demand from the private sector abroad for dollars. Now are those interventions in conformity with current U.S. policy or do they pose some problems for U.S. policy? And has this recent private demand for dollars abroad influenced the formulation of Federal Reserve domestic monetary policy?

THE HONORABLE ALAN GREENSPAN: Well, obviously we are quite pleased at the extent to which exchange rates have stabilized specifically because the instability that preceded it was clearly making the international adjustment process rather difficult. In the process of day-by-day operations central banks, as you well know, tend to deal to a considerable extent in foreign currencies. For example, to take one case which you are obviously referring to, the Bundesbank, the Federal Republic central bank, has been selling what we call troop dollars and some of their interest payments which they conventionally do, because, because of our armed forces in West Germany there's a vast amount of dollars which come into the system which are not considered to be part and parcel of any intervention policies and sales of those are a normal daily activity on the part of the Bundesbank. As far as these types of transactions, and there are other equivalent types of transactions by most of the central banks, the answer to your question is, no, it is perfectly consistent with the policies that have been implemented by this government and in conjunction with the G-7 members. And since we are in continuous consultation with the various other members of the G-7, one can assume and I think quite correctly that this is all a coordinated activity and part and parcel of the policies which the G-7 has stipulated in its various communiques of late.

DENNIS WEATHERSTONE: Mr. Chairman, in recent years the Federal Reserve has relied less than formally on monetary aggregates as guides in determining monetary policy. Looking instead at the broad range of indicators, would you agree that the central banker's job has become and will continue to be more subjective, more of an art than a science?

THE HONORABLE ALAN GREENSPAN: I hope it remains something of a science or we're into some mystical endeavor which never seems to work. The problem that we have, and I think you correctly evaluated it, is that while the underlying purpose of central bank monetary policy, and this relates not only to the added states, but pretty much the major central banks of the world, is essentially to restrain inflation, to maintain a non-inflationary environment on the grounds that that is a necessary condition for the sustainable long-term economic growth of an economy. The basic purpose of central banking is to find those particular levers which contribute to that type of policy. For a long period of time it looked as though one of the vehicles that were usable to act as a target for policy which would in fact implement a non-inflationary environment were the various different money supply aggregates. But starting in the early 1980s following the Monetary Control Act of 1980 which basically decontrolled a number of depository institutions and hence created a remarkable proliferation of new different forms of money, all of the old relationships on which we had tended to glean which tied anti-inflationary policy through money supply to actual price stability, those started to break down. And the problems that, that created obviously is that while our fundamental goals have not changed and will not, we need to find different vehicles to accomplish the same goal until, as I suspect they will at some point, the monetary aggregates sort of restructure themselves in a way which we can then understand them and we will again be able to employ those as effective vehicles to run monetary policy. We continually audit the data. We continually evaluate it. And when it is perceived by the Federal Open Market Committee, our basic committee which runs monetary policy, that the monetary aggregates are locking back into the process, I would suspect that we would again resort to much closer monitoring and targeting of those aggregates.

HENRY KAUFMAN: You spoke quite eloquently tonight about the need to reduce the budget deficit. We're now going into another fiscal year very soon, in October, and the estimates officially are, at least by the Congressional Budget Office, of a deficit of around $150 billion or so. Under the economic circumstances that you envision for the coming year, what do you deem is an appropriate budget deficit for that year?

THE HONORABLE ALAN GREENSPAN: Well, I think that the specific goals of the so-called Gramm-Rudman-Hollings targets that a gradual reduction which would be $130 to $140 billion and then continuing to decline are really, as far as I can judge, worthy goals. And I trust that we stay on that path and continue with them into the 1990s.

DENNIS WEATHERSTONE: Mr. Chairman, another question on the budget. In 1983 you headed a Presidential Commission that addressed the threat of bankruptcy in the Social Security System. Now it looks like the Social Security Trust Fund will be generating a long series of annual surpluses. Can you comment on what this means, in particular for the outlook for the budget deficit?

THE HONORABLE ALAN GREENSPAN: First of all, let me say that something of the nature of the type of surpluses which are currently emerging in the Social Security System were contemplated by the type of legislative changes which we recommended and which the Congress passed. The surpluses, however, are really only moving part-way from an essentially pay-as-you-go Social Security System meaning that benefits are about the same size as Social Security taxes coming in to what one might term only part-way towards a fully actuarial insurance system. If we were to run Social Security the way that the private insurance systems are run, we would have surpluses far greater than the numbers we're looking at and a stock of assets hugely in excess of what is currently contemplated. In a sense, what the system is endeavoring to do is to move part-way towards a private type of system which I think would be very useful and very helpful to maintaining the system in the years and decades ahead. However, it is very important to recognize that what is crucial to an evaluation of savings in the American economy is the combined surpluses and deficits of all governmental entities. Because what is happening at this particular stage is the approximately $30 billion annual gap between Social Security receipts on the one hand and benefits on the other are invested in U.S. Treasury securities which in turn essentially finance the Defense Department, the Department of Transportation, NASA, etc. in part obviously. What this basically means is that one cannot view the Social Security surpluses as a net addition to savings. However, the advantage of having the Social Security funds off budget which will occur within the next few years is that it will focus on the non-Social Security part of the budget and hopefully that will induce a significant endeavor to bring the non-Social Security deficit down and implement the type of overall so-called unified budget surpluses which I was commenting in my prepared remarks which in my judgment are crucially necessary in the longer-run to offset the obviously poor savings propensities of the domestic system.

HENRY KAUFMAN: Mr. Chairman, I want to shift the questioning to the issue of inflation. As you know for some time we've had very moderate increases...(Recording Malfunction)...related to this. And first of all, how serious is this issue in the implementation of monetary policy. And secondly, what do you consider to be the natural unemployment rate or full employment rate? It used to be at one time 4%, other times 5 ½ or 6%. What do you feel is the so-called full employment or natural unemployment rate?

THE HONORABLE ALAN GREENSPAN: Well, it is certainly the case that there's been a modest acceleration in underlying wage rates. They are still remarkably constrained and I would scarcely say that at this stage they are the type of wage increases which at the moment are creating great concern. Employment costs have risen in part because non-wage and salary costs have gone up, specifically health insurance costs and very specifically the other side of the Social Security surplus question, significant increase in Social Security taxes as of January 1st. There does not yet appear, at least to us, to be accelerations building in, but it's the type of thing which we don't get all that much in the way of forewarning about. So anything which at all resembles even a slight up tilt in the rate of increase in wages does get our attention needless to say and will continue to do so. The crucial issue is, as you are suggesting, the so-called natural rate of unemployment. This incidentally is the rate of unemployment which economists believe starts to induce an imbalance in the supply and demand for workers and at a certain level if it gets low enough we begin to get an acceleration in wages. And there's been some discussion of late as to whether the 5.4% unemployment rate which we had the month before last was in fact approaching that level and whether there were symptoms of an acceleration occurring in the wage structure as a consequence of that. The problem that we have with that number is that it is difficult to embody the whole wage structure, the whole employment cost structure in the United States in a single number. We all are aware, for example, that the unemployment rate is very significantly lower in New England and a few other areas than it is, for example, in the Southwest. Yet the rate of wage acceleration in New England relative to the Southwest is nowhere near as disparate as one would assume granted this economic concept of there being an unemployment rate which triggers a big acceleration in wages which in turn leads to inflation. What we are observing, I believe, is a process of, for want of a better term, migration arbitrage. That is, people who were moving back and forth in various different parts of the country trying to equalize the supply and demand for workers and trying to move towards the higher wage levels. The result of this is apparently such that we have not created any great acceleration. I think that the obvious major reason for this is that employees confronted with a fairly extended period of very significant import competition and concerns about job security have largely tended to look for job security as distinct from wage increases. And that process I think has been a major factor keeping what is, despite the recent increases, a remarkably slow rate of wage and employment cost increase. However, there is just no question that to the extent that we are running into the types of problems, types of shortages potentially, capacity restraint issues, that may emerge – and I emphasize may as distinct from will – in the year ahead, we are clearly looking at problems which could engender an acceleration in the wage and employment cost structure of this country and that clearly would be an inflationary problem which the Federal Reserve is required to address. We don't quite see it at this particular stage, but I must tell you we are very wary and will continue to be wary.

DENNIS WEATHERSTONE: Mr. Chairman, perhaps we could move from migration arbitrage to the other kind of arbitrage. We've had some excitement in the financial markets starting with October, and I have a series of questions. I'll just put two of them, though, for starters. What are your thoughts on the merits of a common regulator for the cash and the derivative markets? And then secondly, you were a member of the Presidential Working Group which proposed a trading halt in both the cash and derivative markets if the Dow declined by 250 points. What is the rationale for the circuit breakers?

THE HONORABLE ALAN GREENSPAN: Well, our general view is that the crucial regulatory structure that financial markets need are the self-regulating organizations. Having been in Washington once for three years and now again for almost a year, it is perfectly clear to me that the skills and capabilities to create prudential and sound financial structures in the United States is best essentially left to the self-regulating organizations. There are various different things which I believe government can appropriately do and we do, do them. There is a general presumption that if there is a single regulator out there such as the Federal Reserve it will create some sort of mystique which will solve all of the problems and come up with all of the right answers. Let me disabuse you that that in fact is the case and let me suggest that the notion that a single regulator somehow is the solution to a lot of the problems which occurred on October 19th and thereafter, let me just stipulate that that is not the case. Having said that, there is no question that there were a number of things that occurred on October 19th and the days immediately subsequent which required re-dressing. It was obvious, for those of us who worked through those days, that there were certain imbalances that occurred that tore the markets apart. Very specifically, it was clear that unlike periods, say of maybe, instead of the 1987 Crash, say 1907 which was also a very severe crash which J.P. Morgan of course solved, the difference basically is that what we're dealing with is time compression. What is evident in all markets is that whenever you get a situation where market prices begin to fall sharply people who are holding assets long get very nervous and they sell. In 1907 it took quite a long while before the evidence of the falling prices was transmitted to the potentially frightened investors and as a consequence it took longer for the markets to decline. In 1987 with sophisticated institutional investing and extraordinary telecommunications capabilities, it was a matter of seconds in many instances before individuals learned what was going on in the market and hence they responded much more quickly. In the process what became evident was that the capacity of the financial system was inadequate to take the surge in transactions and essentially broke apart. We in effect didn't have a circuit breaker. We just had the circuits breaking. And that created a major problem which was, needless to say, about as scary as one can construct an event of that sort. Having observed that phenomenon and recognized that shutting down markets is not a good idea – in Hong Kong it was shut down for several days and they had a terribly difficult time opening it up – shutting down markets, allowing them to stop when the demand is there creates usually considerable types of problems. However, it was the judgment of this Working Group that it is better to have a planned circuit break rather than an unplanned one. That is, it is far better for the markets to know that if something happens, that you will shut the markets down for a specific, definable period of time. And what we were talking about is an hour. The difficulty one obviously has is trying to define what is the appropriate event. The appropriate event is basically to try to capture when the markets are overloaded relative to capability and the best measure of that, rather than volume which can have an awful lot of block trading and cross types of transactions, is price. And it was the judgment of this group in conjunction with a number of members up here that when we got down about 250 points or about 12% of the Dow Jones Industrial Average, roughly at current levels, that was a time that a planned break should occur. It was never our recommendation that that should become part and parcel of the operating procedures of exchanges, which in a sense meant that our view was that that would be triggered very rarely. And, in fact, the presumption is that it would be triggered only when the markets would break without it in any event. And so that was largely the rationale for that and we suspect that it will eventually be introduced and I think appropriately so.

HENRY KAUFMAN: Mr. Chairman, you seem to generally favor policies that let the market work. Apropos of that, how do you feel about deposit insurance? Should there be a significant overhaul of deposit insurance as it applies to both the S&Ls and the commercial banking system? Can the current system really stay in place?

THE HONORABLE ALAN GREENSPAN: Well, I think that it's become pretty much conventional wisdom in Washington, especially amongst policymakers, the Congress, and elsewhere that something has to be looked at in some detail to find means to resolve what has been obviously a rather traumatic experience in some areas of the country, very specifically obviously Texas. I do believe that the issues will be reviewed in some detail and we will all focus in the next year or so on this whole deposit insurance system. There's no question in my mind that the Congress will have at some point extensive hearings to try to find means by which we can put it back in place in a manner which became effective in all of the years subsequent to its initiation. The basic problem that we obviously have is that there's a certain problem which is called – amongst economists and others, stolen from the insurance business – moral hazard, which implies that if in effect you get a depository institution which has access through a charter to deposit insurance, meaning it can sell its liabilities guaranteed by the federal government and proceed to invest those deposits, that various form of fund into high-yielding assets, the outcome is either a tremendous profit for the person who is doing it or the thing goes belly up and the deposit insurance system gets charged. And that's been a major problem in the deposit insurance area and I think we've got to find a way to address that question and I think there is a great deal of thinking that's going on. And I think we will eventually come to grips with this problem in a way to get deposit insurance back on track as it originally was. There is no question, of course, that all deposits under $100,000 are insured, not so much by whether or not there are difficulties with the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation, because behind those two institutions obviously is the United States Congress and the Congress has stipulated in effect that it will stand behind those deposits and there's no question in any of this discussion as to whether in fact deposits will in fact be insured. The problems that we have to confront are technical, financial, and financing problems with how the system is set up and how to construct a system in which moral hazard does not become an overwhelming enemy of the depository insurance system.

DENNIS WEATHERSTONE: Sorry to keep switching about. We've had a wave of mergers and acquisitions and to shorten the question somewhat, the debt structure which has resulted from this wave is of worry to some. Are you worried or do you think it's perfectly manageable? Or do you have any comments on the economic significance of the restructuring generally?

THE HONORABLE ALAN GREENSPAN: Well, I think first of all, let's go back and try to find out why it's happening. It's happening in a technical sense basically because the usual premiums for control of a company that would appear in the stock markets of say a generation ago, would probably be 30% or so over the day-by-day market price of a particular company. That is, the value of getting control of a company basically was such that one would not bid much beyond say 30% over the existing market. What has happened in recent years is that the premium that people are willing to pay for control has risen very dramatically. And what that means is that individuals can go in, make tender offers, or do a variety of other means of accumulating common stock at prices just somewhat over the existing market and in effect gain control of a company, let's say 30, 40, or 50% over the original market price of the stock and have something which in the market would sell much higher so that there was a tremendous potential profit in doing an acquisition of that sort. That process has basically continued despite the fact that the stock market took off. Originally it looked as though it were caused by the fact that stock prices were generally low and that when the stock market came back, that sort of 100% premium on the value of control of a company over the usual day-by-day existing market price, that that would come down dramatically and since there was no arbitrage profit of the dimension which currently exists, that mergers and acquisitions would tail off. That obviously didn't happen. And I think that the reason that it did not happen is that there is something involved in this international adjustment process that I have been discussing this evening which means in effect that restructuring really matters. That is, higher productivity, improved balance sheets, basically significantly improved the potential economic value of establishments. And I think that's kept the premium higher. I haven't a clue, I might say, why the leveraged buyouts are so high because one would think that the heavy debt weight of that would eventually begin to undercut that type of financing, but it's a lot higher than I would have expected. I don't fully understand obviously what's involved. It's that the markets are saying that leverage does create higher stock values and that's what's keeping it going. My impression is that we will continue this restructuring which means mergers and acquisitions will continue at a fairly extended pace until the international economic adjustment process is largely complete and the tremendous pressures that are occurring in our markets for improved efficiency begin to ease off. So it's the type of problem which I think is new, something we have not confronted before in this country, and I suspect it is largely part of the internationalization of the American economy. I've said about as much as I know on this issue.

HENRY KAUFMAN: I'm told by our chairman that this is my last question, so let me ask another one related to this internationalization. Would the Federal Reserve oppose or seek to oppose a friendly merger between one of the top five American banks and a foreign bank?

THE HONORABLE ALAN GREENSPAN: If you seriously think I'm going to answer that question. (Laughter) I don't even know how to mumble an answer. Let's try again, Henry.
HENRY KAUFMAN: I'll ask you another question. You spoke before about the high level of real interest rates. Actually we've had high real interest rates now for some time. Can we really say that this is mostly due to the substantial budget deficit that we've had? Are there other factors involved?

THE HONORABLE ALAN GREENSPAN: I would say there obviously are other factors, but I would argue that the substantial part of the real interest premium, if I could put it that way, is attributable to the budget deficit and the general expectation that the United States is in a period where we're going to have to make some significant adjustments. And when you're dealing with views of potential long-term instability, risk premiums – independent of inflation expectations – rise. And I would say that clearly the budget deficit is one of the major elements involved in the concerns that we have about the whole notion of potential longer-term instability. And if one were to say that the real interest rate premium is essentially a real risk premium related to expected instabilities, then I would say that trying to figure out where the individual instabilities are would, of necessity, require that we place the budget deficit and its uncertainties as comprising at least half of what that number would be. But obviously there are other elements of an unstable potential outlook which would be a key factor in that premium.

DENNIS WEATHERSTONE: Can I get one more? Mr. Chairman, I don't think the evening will be complete without some reference to the LDC problem. I was hoping Henry would ask the question. Would you have some comment on the role of the IMF and the World Bank and attempts to introduce some flexibility into resolving the LDC debt problem?

THE HONORABLE ALAN GREENSPAN: Well, I think the most important principle, I think, that one must stipulate with respect to this problem which is clearly a very difficult one for both the creditors and the debtors, the most important thing to recognize, I think, is that the crucial necessary condition for resolution of this problem is that the debtor nations are able to construct economic policies which eventually get them back to private access to the financial markets. If they can do that, and they are clearly working exceptionally assiduously in many respects, then whatever else happens, this debt issue will get resolved because ultimately they will be able to service the debts and eventually we will find that these debtor nations will be major and important customers of the international financial system in the 21st century and beyond. The problem is that if they don't, if for whatever reasons they are incapable, then all of the other gimmicks, all of the other various different schemes which I have seen enumerable versions of in the last year or so, won't really much matter. Fortunately, I think we are seeing a remarkable change in the world political environment which I think is best described as a dramatic shift away from large, major Socialist type solutions to problems to market-oriented ones. And we are finding not only that this is true in Europe, it's true in Mainland China, the People's Republic, it's true even surprisingly at the margins now in the Soviet Union. There is an awareness of this extraordinary shift and that has spilled over into the politics of the developing nations. And I think it is very impressive to meet some of the people who are the most recent finance ministers and those in charge of developing programs. And what is extraordinary to me is their commitment to market processes and even more unusual is the willingness of the governments to support them. Now I'm not going to say, having said all of that, that this is an easy problem. It is not. It is a very difficult, it is a slow process, it's frustrating. There are all sorts of appropriate terms like debtor fatigue and creditor fatigue and just general fatigue. But the potentials of solving this problem are so great that I think it is worth all the efforts that we are involved in and I must say that while I was, as a private citizen, I had a large element of pessimism about where this was all coming. I'm now really quite impressed with how diligent and how tough-minded some of the people who want to solve this problem are. So while I'm not saying in a sense that the international financial institutions have not roles to play in the international financial structure – that's clearly why the IMF and the World Bank have been there, their roles are well defined – I think we would be fooling ourselves if we believed that there was some gimmick, some huge financial facility which could be created which would solve this problem without doing very severe damage to the financial capabilities in the future of the debtor nations as well as creating, I think, significant problems for the international financial system itself. Thank you very much ladies and gentlemen. (Applause)

CHAIRMAN: I'd like to thank, first of all, Mr. Weatherstone and Mr. Kaufman for extremely broad-ranging questions I think of a great deal of pertinence and certainly also for the unusually open and direct answers and predictions that we've been given by the Chairman of the Board of Governors of the Federal Reserve System. It's now my pleasure to do what is always done here and Dr. Greenspan is very familiar with this. He gets a Steuben Big Apple to bring back to Washington with him, and we thank you so much for joining us and being with us.

THE HONORABLE ALAN GREENSPAN: I've got a collection of these and I don't think they like them in Washington so I put them in the corner and just watch them. Every time I think about New York, I open it up and I look.

CHAIRMAN: Ladies and gentlemen, we look forward to getting together in the fall and thank you very much for being here. Good night.

End of Meeting