Speech Given

Conference Sponsored by Centre d'Etudes Financieres

"Politics and International Commercial Banking"

Brussels

November 28, 1988

Dilemmas Facing U.S.

- Foreign Investment
- Lowering Value of the dollar
- Increasing Savings Rate
- Government Intervention in guaranteeing or protecting banks to facilitate new LDC lending
- Banking losses in thrift and savings institutions

Foreign Investment - Direct

- U.S. has borrowed $700 billion from foreign sources in the last six years to permit it to consume and to make up gap caused by low savings rate.

- So long as investment in three-month T bills, ok. T-bill investment encouraged when OPEC invested in liquid instruments or when Japan purchased thirty-year bonds. Increasing concern over real estate investment and recently, greatest over FDI -- particularly at one-half value compared to three years ago because of exchange rate changes.

- Concern if hostile takeovers or LBOs are constrained by removing tax deduction on interest for U.S. companies. Opens up even more so direct foreign investment.

- Concern over effect on role of labor unions, long-term pensions, health and medical progrmas (in Japan there is no health and retirement safety net), loss of corporate management positions, loss of community involvement.

- More subtle -- admission of loss of control, power, authority, dominion; national security.

- Therefore, rumblings to limit FDI and force investment to "less invasive" investment, namely, financial instruments, preferably debt.

- The Dilemma

  1. FDI is more stable, less volatile, less liquid and can be serviced only if profitable.

  2. Greater stake in U.S. economy...more ammenable to pressure for reciprocity. Not possible if investments are made in bonds, which are needed to finance domestic deficit.

  3. Indeed, if restrictions on FDI implemented, would

discourage investment in dollar <u>financial assets</u>. EC would reciprocate in other areas: trade, protectionism.

4. If one form of dollar investment (FDI) were constrained, it would cast a shadow on others, implying future controls or limitations of repatriation of earnings or trade barriers or exchange controls. This, in turn, would force dollar investments into shorter, liquid holdings. More volatile -- difficult to manage exchange rates and interest rates.

5. Would prompt run on the dollar.

<u>Lower Value of Dollar</u>

Facts:

- Current account deficit of $140 billion.

- To reduce to 0 by 1992, assuming imports stay same, U.S. must increase exports by $200 billion by 1991, or export continually, each month, at 15% more than imports.

- Virtually all gain will have to be in merchandise and manufacturing. Services are minimal.

- $200 needed because of $60 billion shift in investment income which in a few years will be $30 billion negative because of interest on debt.

- U.S. will need 80% of worldwide increase in overall exports to non-U.S. Would require doubling our exports -- from $200 to $400 billion by 1991.

- U.S. would end up with 30% of world's total exports. Highly unlikely. Why: wage rates, relative productivity of others, new products, substitution/synthetics, speed of transfer of technology and difficulty of keeping technological and scientific developments "in" U.S., government subsidy, lead time in marketing, increased competition.

- Very high plant capacity now in U.S.

- We would have to end up 1991 with double share of world exports now maintained by Japan and Germany. We are now one-half of theirs.

- Concern by manufacturers of stability of weak dollar. Otherwise, reluctant to take chance to increase productivity.

- Answer is not agriculture. The agricultural surplus

declined from +$25 billion in 1981 to +$7 billion in 1987. Subsidies make us non-competitive. Airplanes have major non-U.S. components. Therefore no major export gain.

o Therefore, gains must occur in import substitution:

1987: Import Imbalance:

- $5[illegible] billion - cars and trucks;
- $16 billion - hi fi, VCRs, sound, audio;
- $20 billion - clothing, wearing apparel.

U.S. initial reaction: protectionism. Restriction on FDI.

o Clearly cars, where there is U.S. production, is where the import substitution will occur.

o Weaker dollar will put upward pressure on U.S. prices and rai[illegible]es in other markets where U.S. will seek to export, but the threat of weaker dollar will be the vehicle in the negotiating process to cause Japanese to put plants here, as will selective buying from Taiwan, Hong Kong, Korea in return for revaluation of their currency.

o Bergsten. Yen 100
DM 1.20 (guilder, Belgium franc, shilling)
675 Won

The Dilemma

Why not a weaker dollar?

1. Inflationary.

2. If too fast, rates will have to increase to avoid panic -- recession.

3. France, Great Britain, Canada also running deficits and cannot afford appreciation of currency: 20% EMS realignment.

4. Political pressure to appreciate dollar would be disaster for exports and long-term planning. (Also would encourage more U.S. protectionism.)

5. Would weaken confidence in U.S. resolve to attack trade deficit and our consumption habits.

Increase Savings

- Lowest for all major industrial countries.
- Declining since early 1980s.
- Increasing use of leverage, debt; reduction of equity, LBOs

and consumer use of credit latest manifestations. Removal of interest cost as a tax deduction for consumer debt -- has had uncertain effect on borrowing and spending.

- Level of U.S. investment in U.S. lower in 1987 than 1979. Therefore, implement tax incentives to save.

The Dilemma

1. Tax benefits will add to budget deficit.

2. High income earners already save. It further skews distribution of wealth. Politically unacceptable.

3. Prompts a recession because of fall-off of consumer demand.

4. People will feel poorer -- political dimension.

5. Finally, given deregulation of asset allocation, not yet implemented capital requirements, and resolution of thrift, crisis could worsen if more savings came into the system.

Thrift Problem - What can happen if minimal capital

- Case study of what can happen when a nation tries to deny,

then hide a problem:

- o Deposits up to $100,000 insured. As a practical matter, all are.

- o Costs to take care of depositors of currently insolvent thrifts now estimated at $50-100 billion, depending on when it is done and level of interest rates.

How did it happen?

- o Short deposits -- all insured on liability side.
- o Fixed rate mortgages on asset side.
- o Rising short-term rates in early 1980s.
- o Long-term bonds, purchased to increase rate of return.
- o Use of leveraged instruments. <u>Futures and options.</u>
- o Wider permissable asset base. (Land speculation, office buildings, equity, oil and gas leases)
- o Deregulation of interest rates.
- o Minimal net worth
  - 25 years to get there
  - moving 5 year average
  - could grow assets 200-300% a year
- o Self dealing/conflicts

- Collapse of oil prices
- Highly accommodating accounting practice on sale to new buyer of insolvent thrifts.

Result:

- 500 insolvent of 3,000.
- Losses wipe out all gains of solvent thrifts.

<u>The Dilemma</u>

1. Remove protection of deposits. Those weak thrifts will have no cash flow -- immediate bankcruptcy.

2. Weakens confidence in whole financial system -- not just thrifts.

3. Close them down. No money in budget in that magnitude.

4. They are recapitalizing thrifts, providing for guarantees of new buyers, keeping it off budget by not counting present value of future stream of interest payments, therefore, causing thrifts to stay in business, take more deposits, thereby increasing costs to federal government over time.

5. Weaker thrifts. No higher rates (insured) and must seek riskier assets.

<u>LDC Debt</u>

o Political, financial instability if countries cannot grow. Banks can't lend, but in U.S. they have substantial exposure. Jobs. Trade.

<u>The Dilemma</u>

LDCs need debt reduction <u>and</u> new money, but U.S. cannot/will not guarantee:

a) Farmers; thrifts; oil developers; domestic priorities.
b) Signal.
c) Budget implications
d) No political support to help LDCs or banks in N.Y.
e) Must encourage new lending.

<u>Effect of All of Foregoing on Fed</u>

Some new constraints on tightening:

a) Effect on thrifts.
b) Effect on LDCs.
c) Effect on floating rate mortgages -- political.
d) Effect on debt from LBOs.

e) Possible appreciation of dollar.

f) Recession.

Country's Hidden Costs/Needs

Domestic

- Nuclear domestic waste -- $100 to $500 billion.
- Huge retirement care and health costs in old age.

Retirement Care/Old Age Healthcare

1. Not funded, not yet accounted for, but it will be under new rules. Significant impact on earnings of corporations.

2. Benefits therefore will be reduced in future.

3. Population getting older -- 20% will be 65 in 2025, same as in Florida.

4. Costs rising, new techniques, more care as organs protected or treated; heart attack rate declines, but strokes continue. That is expensive.

5. No government program in place. Social Security not designed to cover it.

6. No domestic individual required savings plan for future care in place (or for cost of higher education), but that gets back to where we started -- an inadequate savings rate in a country with great demands, requirements, and responsibilities.

The Dilemma

How to increase savings for reinvestment in production enterprises and for education, health and retirement care without (a) a diminution of revenues, and (b) a recession, in a pluralistic society (where rich getting richer) and in a society with very short-term planning horizons.