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THE ECONOMY AT MIDYEAR: A LEGACY OF DEBT

A STAFF STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

AUGUST 10, 1987

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LETTER OF TRANSMITTAL

Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
Washington, DC 20510

August 5, 1987

TO THE MEMBERS OF THE JOINT ECONOMIC COMMITTEE:

I am pleased to transmit to you a study recently completed by the staff of the Joint Economic Committee. It focuses on the problem of America's growing foreign debt, a problem with significant implications both for our future standard of living and our influence in the world economy.

The study was prepared by members of the staff under the supervision of the Committee's Executive Director, Judith Davison. Dan Bond, Bill Buechner, Richard Kaufman, Jim Klumpner, and Steve Quick were among those whose contributions helped to shape the study, with valuable assistance from Cynthia Panas and Liz Singer.

The issues raised by the U.S. foreign debt can no longer be ignored, and I hope the staff insight in this study will prove useful to you.

With best regards,

Sincerely,

Paul Sarbanes

Paul S. Sarbanes
Chairman

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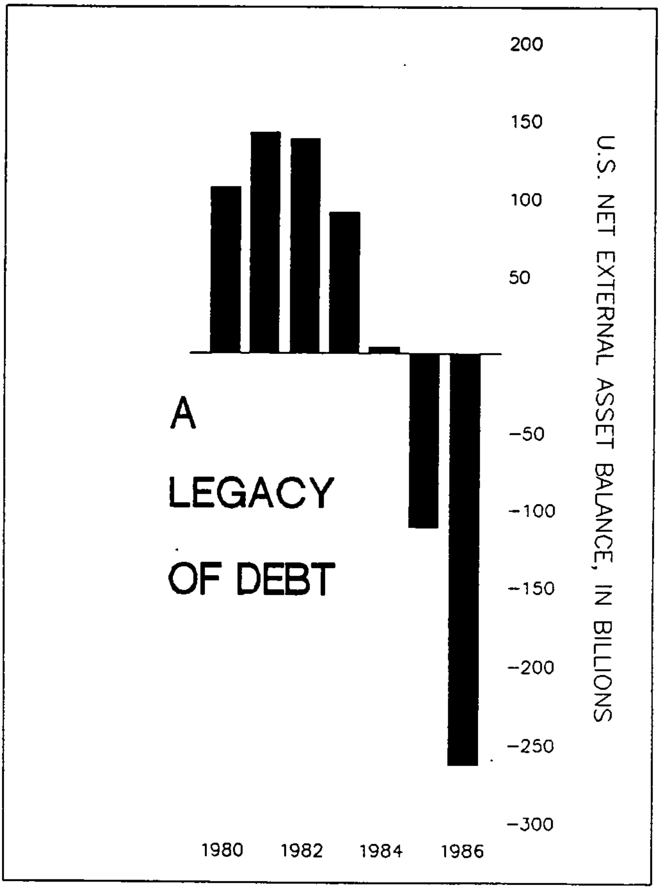
THE ECONOMY AT MIDYEAR:



A STAFF STUDY

PREPARED FOR

THE JOINT ECONOMIC COMMITTEE

THE ECONOMY AT MIDYEAR: A LEGACY OF FOREIGN DEBT

I. THE FOREIGN DEBT PHENOMENON: AN OVERVIEW

In its 1987 Annual Report, the Joint Economic Committee (JEC) drew attention to a range of problems confronting the American economy as it struggled to maintain modest rates of growth in gross national product (GNP). The Report concluded that, despite surface appearances, we were "skating on thin ice," and that a number of potentially serious economic problems were developing which might jeopardize economic progress in the future.

Now, at midyear, the outlook for improved growth remains clouded, and cracks are starting to appear in the ice. One of the most prominent of these cracks is the enormous burden of international debt that the United States has acquired in the past few years [Chart I]. This debt, and the problems it creates for both domestic economic management and international economic influence, are perhaps the major legacy of the economic policies that prevailed during the first half of the 1980's. Reducing the external debt, and restoring our international economic influence, will be among the Nation's major economic challenges in the 1990's.

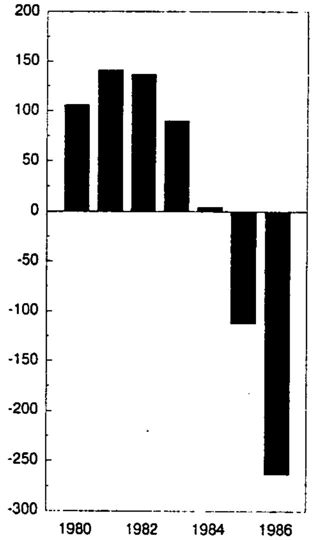
THE WORLD'S LARGEST DEBTOR

Though a nation's external asset position typically changes slowly over time, dramatic shifts in U.S. macroeconomic policy produced an unprecedented swing from creditor to debtor status in only five years.

This change was initially set in motion by an extremely tight monetary policy which drove up interest rates in the United States, widened the spreads between rates of return in the United States and elsewhere, and thereby created very strong foreign demand for dollar-denominated assets. The resulting surge in the value of the dollar, combined with strong growth in domestic demand stimulated by large Federal budget deficits, led to a sharp loss of U.S. competitiveness and drove the U.S. trade and current account deficits to unprecedented levels. The problems created by fiscal and monetary policies were aggravated by our inability to persuade our industrial allies to

CHART I

U.S. NET INTERNATIONAL INVESTMENT POSITION 1980-1985



SOURCE: DEPARTMENT OF COMMERCE

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grow more rapidly, our failure to develop a strategy for economic growth in the debtor nations, and significant neglect of problems of productivity and competitiveness in American industry.

Together these factors transformed the United States from a nation which typically produced more than it consumed, and which therefore generally posted surpluses in its international current account, into a nation consuming substantially more than it produced, running large and growing deficits in the current account. In years where we ran a surplus on current account, we added to our international net asset position. The recent deficits have been financed with external borrowing which has reduced our international net asset position.

The connection between annual current account deficits and growing international indebtedness means that there is little comfort in assurances that "the worst is over" with respect to trade. While the international trade position may not be getting worse each quarter, the United States will continue to experience a worsening of its international net asset position as long as the current account remains in deficit. If the late Secretary Baldrige was correct when he testified before the JEC that there will be a $20 billion improvement this year, and were the deficit to continue to improve by $20 billion annually, the debt would peak in 1993 at roughly $700 billion. It would then equal more than 10 percent of GNP, assuming 7 percent nominal GNP growth.

SHEDDING THE BURDEN

In order for the United States to restore its creditor status, today's trade deficits will have to be transformed into trade surpluses. Simply reducing the trade deficit will not suffice, since the United States will have to run a trade surplus just to keep the external debt from growing. Even assuming a steady reduction in the growth of debt, and assuming as well that interest rates on the debt do not rise substantially, debt service on U.S. foreign obligations will approach 1 percent of GNP. Since these payments correspond to imports of capital services, current account balance will require a significant merchandise trade surplus.

The shift from deficit to surplus on our trade accounts must be faced, since international investors will not finance huge U.S. trade deficits forever. The challenge is to reduce the trade deficit in an orderly manner, through substantial growth in GNP and exports, before foreign investors refuse to provide additional credit, thereby forcing a painful and abrupt improvement in our trade position through a major economic contraction.

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EXTERNAL DEBT AND DOMESTIC GROWTH

In order to run a trade surplus, future U.S. production will have to exceed domestic consumption. This implies that the growth of domestic spending, i.e., U.S. living standards, will have to lag behind GNP growth for some period of time. It is clear that the faster GNP grows, the less onerous will be the burden of reducing the external debt. Unfortunately, current policies do not hold out the prospect that the United States will pay its debts through sustained expansion of production.

THE NEED FOR A NEW STRATEGY

The massive U.S. external debt has been accumulated as the result of policies which sought to buy current prosperity on credit, while ignoring major structural problems in both international trade and the domestic economy. Reversing the decline in our external position thus requires reversing a number of macroeconomic, microeconomic, and trade policies which have prevailed over the past six years.

The country urgently needs a strategy that will ensure more rapid GNP growth combined with a strong improvement in our external account position. Such a strategy will require policies which:

- Improve the productivity and competitiveness of American industry
- Enhance the skills of American workers
- Resolve the Third World debt crisis and resume import demand growth in the debt-burdened countries
- Improve the efficiency of the American economy through improved investments in infrastructure
- Produce an appropriate exchange rate for the dollar against the currencies of all our trading partners
- Create a better balance between savings and investment in the American economy
- Establish fairer rules of international trade and ensure open access for U.S. products in foreign markets

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The choice at this juncture is clear. To continue on the present course will risk either an enormous further run-up in our external debt obligation or a sharp recession. Either foreign investors will continue to lend us money, adding to our future obligations, or the foreign lending will stop, forcing a severe adjustment. Neither outcome is desirable for the long-term health of the U.S. economy. The country needs a change of direction in overall economic policy, a change whose contours will be explored in this Report and in subsequent hearings and reports by the JEC in the coming months.

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II. THE ORIGINS, NATURE, AND FUTURE GROWTH OF THE FOREIGN DEBT

On June 23, 1987, the Department of Commerce released its estimate that the "negative net international investment position of the United States increased to $263.6 billion in 1986 from $111.9 billion in 1985." Since U.S. net foreign assets were a positive $141 billion at the end of 1981, the latest figure represents a $405 billion deterioration in the U.S. position in five years.

ORIGINS OF THE PROBLEM

Major shifts in U.S. macroeconomic policy in the first half of this decade largely caused the unprecedented swing from creditor to debtor status. Broadly expansive fiscal policy, resulting from a sharp reduction of revenue growth and rapid increases in defense procurement, in combination with a restrictive monetary policy that kept real interest rates high, caused a surge in the dollar. The resulting loss of competitiveness drove the U.S. trade and current account deficits to unprecedented levels.

The Federal deficit rose from less than $60 billion in 1981 to more than $200 billion by 1985 [Chart II].

Although the Federal Reserve permitted fairly rapid money growth after mid-1982, nominal interest rates in the United States fell more slowly than inflation, and real interest rates remained quite high during the first half of the decade [Chart III].

Between 1981 and early 1985, the value of the dollar rose approximately 60 percent against the currencies of major trading partners as foreign investors sought dollar-denominated assets bearing high real returns [Chart IV].

The dollar's surge in this period overwhelmed strong growth of manufacturing productivity and moderating wages, making U.S. goods more expensive abroad and less competitive with imports at home. U.S. unit labor costs rose more slowly than other economies' costs when measured in each country's home currency [Table I]. When those costs are translated into dollars using the then-prevailing exchange rate, however, foreign competitors enjoyed tremendous cost declines relative to U.S. firms.

As a result of the overvalued dollar, American manufacturing industries have experienced a prolonged period of deep stagnation. In nine of 20 major manufacturing sectors, among them primary metals, nonelectrical machinery, instruments, chemicals, and apparel, job losses have continued despite the recovery. Low import prices helped keep a lid on inflation, but at the cost of about two million manufacturing jobs. Foreign

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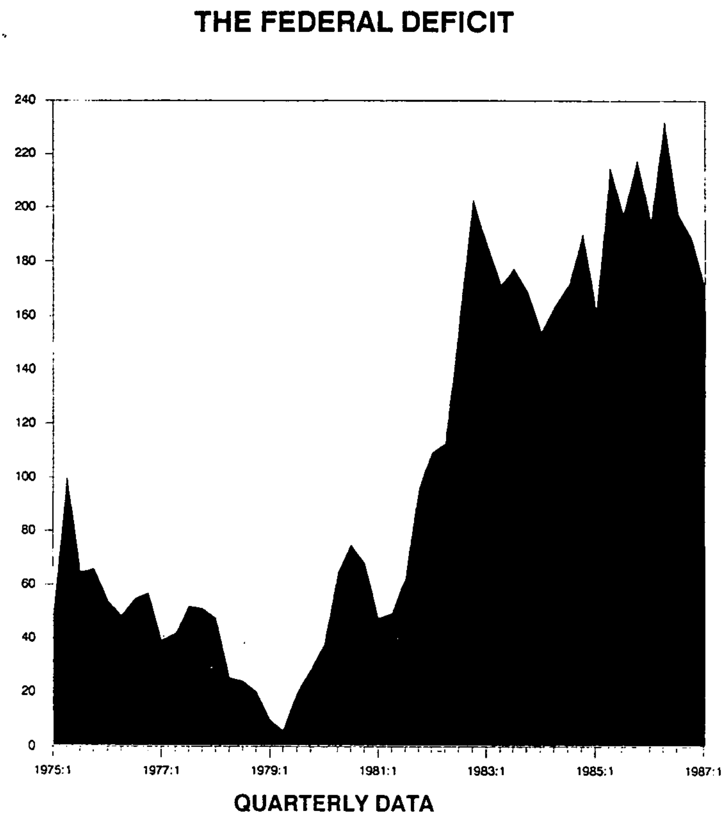
CHART II


THE FEDERAL DEFICIT
240
220
200
180
160
140
120
100
80
60
40
20
0
1975:1
1977:1
1979:1
1981:1
1983:1
1985:1
1987:1
QUARTERLY DATA

8

CHART III

NOMINAL VERSUS REAL INTEREST RATES

3-MONTH T BILLS, 1978 - 1986

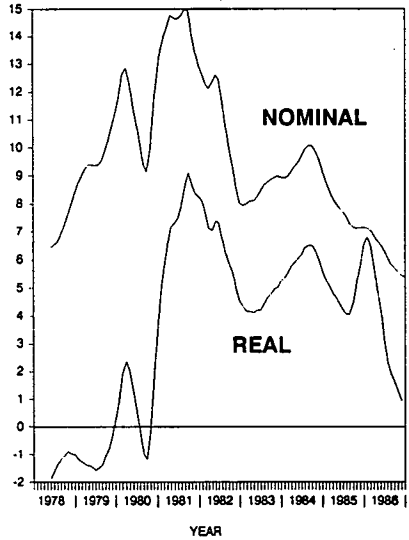


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CHART IV

THE VALUE OF THE DOLLAR

TRADE-WEIGHTED INDEX, FEDERAL RESERVE BOARD

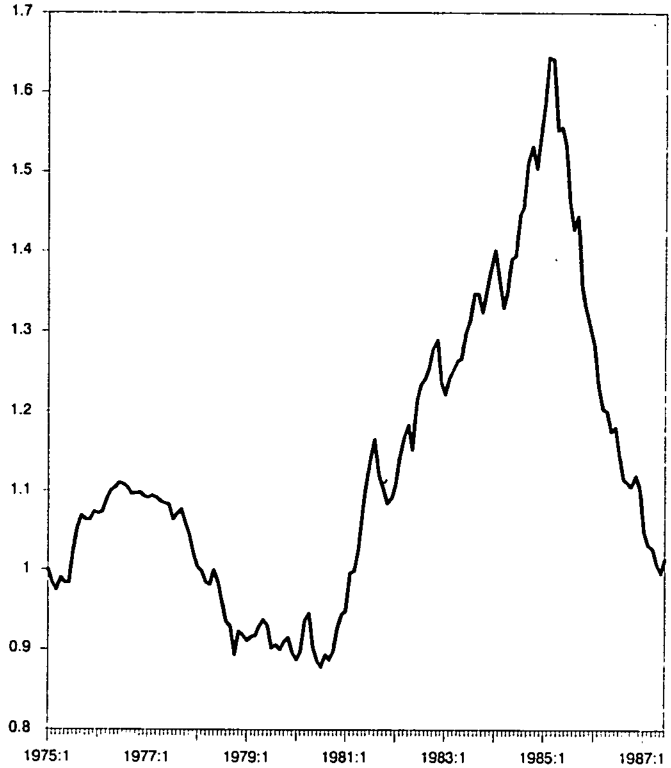

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TABLE I

UNIT LABOR COSTS, 10 COUNTRIES, 1982-1986
AVERAGE ANNUAL RATES OF CHANGE PER YEAR

	NATIONAL CURRENCY BASIS	U.S. DOLLAR BASIS
UNITED STATES	0.7%	0.7%
CANADA	3.5%	0.3%
JAPAN	-2.3%	-4.0%
DENMARK	6.2%	-3.8%
FRANCE	6.5%	-6.0%
GERMANY	0.8%	-5.7%
ITALY	10.8%	-2.6%
NORWAY	6.2%	-3.9%
SWEDEN	4.2%	-8.3%
UNITED KINGDOM	2.7%	-8.1%

producers' cost advantage did not begin to reverse until 1986. Though manufacturing employment staged a brief rebound at the beginning of the recovery, competition from abroad caused declines in 1985-1986 from which we have yet to recover.

The problems created by macroeconomic policies have been aggravated by the inability to persuade our major trading partners to re-orient their macroeconomic policies toward greater fiscal stimulus with less monetary ease, and the failure to develop an effective growth-oriented strategy for debtor nations.

Germany and Japan -- and much of the rest of the Organization for Economic Cooperation and Development (OECD) -- pursued fiscal restraint from 1981 through 1985. For example, in 1984 and 1985, Japan reduced its structural budget deficit by a total of 1.5 percent of GNP. Germany in the same time period reduced its structural deficit by a total of 0.8 percent of GNP. France, Great Britain, Austria, Denmark, and the Scandinavian countries also reduced their structural deficits.

In contrast to the anti-inflationary U.S. monetary policy, other nations generally provided easy credit, opening significant interest rate differentials with the United States [Chart V].

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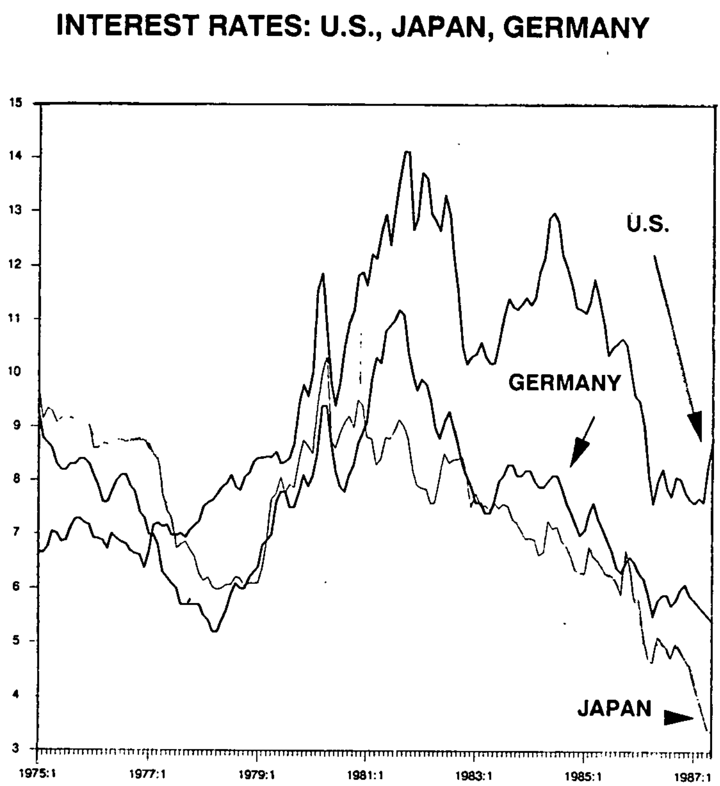
CHART V



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The Latin American debt crisis also contributed to the transformation of the United States from a creditor to debtor nation. Between 1981 and 1984, the trade balance in Latin America moved from a $4 billion deficit to a $38 billion surplus. This $42 billion swing resulted largely from import reductions that significantly affected U.S. producers. U.S. exports to Latin America of iron and steel, construction equipment, and agricultural machinery all fell by over 70 percent in this period.

The combination of fiscal stimulus and monetary restraint in the United States, in conjunction with tight budgets and easier money abroad, created major imbalances in capital markets. With real asset returns much higher in the United States than elsewhere, the world's savings came here, pushing up the value of the dollar and thereby adversely affecting our trade balance. Further, the United States changed from a nation that traditionally produced more than it consumed, to a nation that consumed substantially more than it produced. Large and growing current account deficits were financed with external borrowing that has now undermined the U.S. international net asset position.

The United States had occasionally posted current account deficits earlier in the postwar period, but such deficits were modest and the general trend was toward surplus [Chart VI]. The U.S. net creditor position thus tended to grow slightly throughout most of the postwar period.

Indeed, as recently as 1981, the United States had a current account surplus, equivalent at the time to 0.2 percent of GNP. In 1986, the current account deficit stood at 3.2 percent of GNP.

IS THE DEBT REALLY A DEBT?

Administration spokesmen have downplayed the importance of our new status as a debtor nation, maintaining that part of the U.S. net foreign asset position is equity, and that measurement problems distort the true picture of our international assets and liabilities. These assertions require close examination.

<u>Equity, Direct Investment, and Debt</u>

Equity and direct investment by foreigners -- for example, the purchase of corporate stock or ownership of a factory -- are not "debt" in the sense that interest must be paid regularly on the asset. With equity, the return to the investor depends upon the success of the enterprise, not on a contracted debt-service obligation. Foreign investors earn a return only if their investments are successful; they bear the costs if the investments fail to provide an adequate return.

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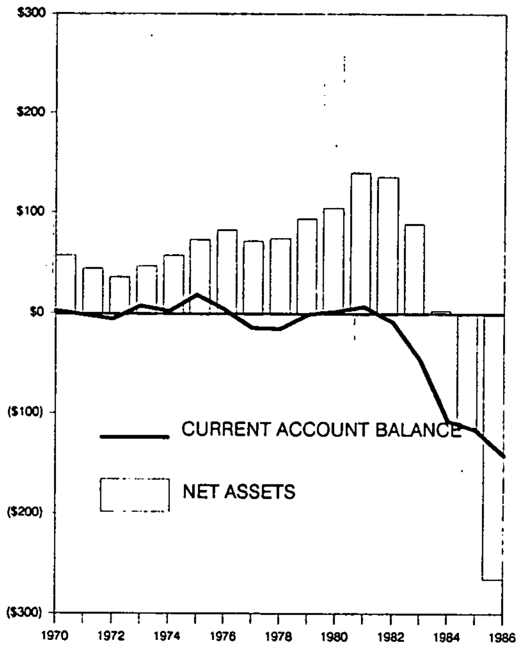
CHART VI

U.S. CURRENT ACCOUNT AND NET ASSETS



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Unfortunately, only a small share of foreign investment is of this type [Table II]. The Commerce Department estimates that, at the end of 1986, out of total U.S. foreign liabilities of $1,331 billion, foreign direct investment accounted for $209 billion and corporate equity for $167 billion. Thus that portion of our liabilities that Administration officials object to labeling "debt" constitutes only 28 percent of the total [Chart VII]. The other 72 percent, correctly labeled "debt," has been the major contributor to our declining net asset position.

Although these types of liabilities -- foreign direct investment and corporate equity investment -- will not necessarily place a burden on future U.S. living standards, they raise other questions.

Allen Sinai, Chief Economist, Shearson Lehman Brothers, noted in testimony before the Joint Economic Committee on June 30, 1987:

> ...there is more direct investment in real estate and in businesses by foreign investors in the United States. One can look at that as a plus because we are such an attractive place to invest. But you can also look at it as a negative because we do lose some control over our own means of production as more and more of our businesses are sold to foreign investors who increase their equity in the United States.

Apart from foreign direct investment and corporate equity investment, the remaining $955 billion of U.S. liabilities are in the form of debt instruments owned by foreigners. Offsetting part of this are $746 billion in foreign debt instruments of U.S. ownership. It is the difference between these two figures -- $209 billion -- that is correctly labeled net debt of the United States.

Part of this debt may also have been used to finance productive investments in the U.S. economy. In such cases, the difference between foreign investment in the United States and foreign loans to the United States for investment purposes is primarily in who bears the investment risks. When borrowing from abroad for investment purposes, we expect that the returns from the investment will cover the costs of the loan. If they do not, we still have to pay those costs.

However, the U.S. net debt of $209 billion largely reflects a higher rate of consumption in the United States over the past few years rather than increased investment. In the future, the income diverted to service this debt will pose a threat to U.S. living standards.

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TABLE II

INTERNATIONAL INVESTMENT POSITION OF THE UNITED STATES: 1970-86
(billions of dollars, yearend)

	ALL INVESTMENT			DIRECT INVESTMENT			CORPORATE EQUITY			DEBT INSTRUMENTS		
YEARS	ASSETS	LIABILITIES	NET	ASSETS	LIABILITIES	NET	ASSETS	LIABILITIES	NET	ASSETS	LIABILITIES	NET
1970	165	107	59	76	13	62	7	27	-21	72	66	6
1971	179	134	46	83	14	69	8	31	-23	78	89	-10
1972	199	162	37	90	15	75	11	39	-29	88	108	-20
1973	222	175	48	101	21	81	10	34	-24	99	121	-21
1974	256	197	59	110	25	85	9	24	-15	125	148	-23
1975	295	221	74	124	28	96	10	36	-26	150	158	-8
1976	347	264	84	137	31	106	10	43	-34	189	190	-1
1977	379	306	73	146	35	111	10	40	-30	211	232	-21
1978	448	372	76	163	43	120	11	42	-31	262	287	-25
1979	511	416	95	188	55	133	15	48	-34	297	313	-17
1980	607	501	106	215	83	132	19	65	-45	362	353	9
1981	720	579	141	228	109	120	18	64	-47	463	406	57
1982	825	688	137	208	125	83	19	76	-58	587	487	100
1983	874	784	90	207	137	70	26	96	-71	630	551	79
1984	896	892	4	211	165	47	27	94	-68	647	632	15
1985	949	1061	-112	230	185	45	40	124	-85	668	752	-84
1986	1068	1331	-264	260	209	51	51	167	-116	746	955	-209

Source: Survey of Current Business, U.S. Department of Commerce, various issues.

Note: 1/ Official gold holdings (about $11 billion throughout this period) are included in total assets.
2/ Not always exactly equal to the difference between assets and liabilities due to rounding.

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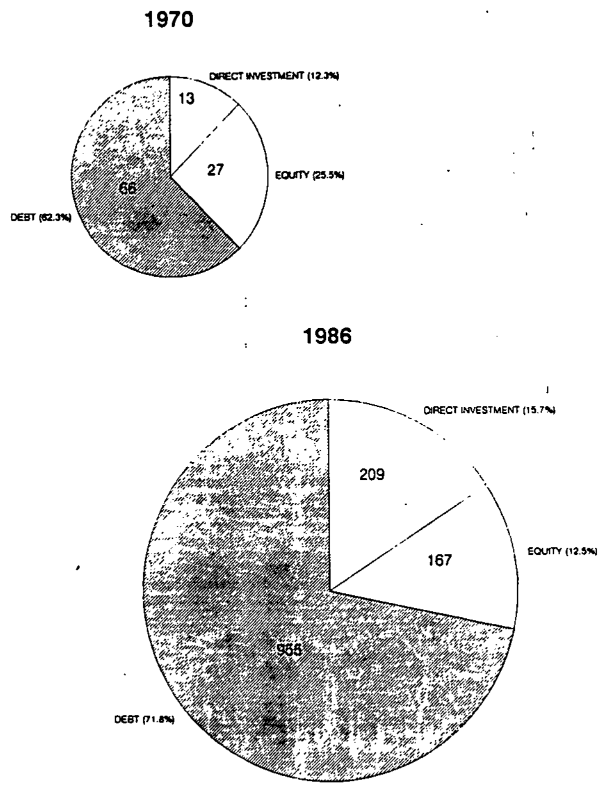
CHART VII

FOREIGN ASSETS IN THE U.S.



Net Investment Income

While the United States still earns more on investments abroad than foreigners earn on their investments in the United States, the gap is rapidly narrowing. The Department of Commerce estimates that in 1986 our earnings were $88 billion while our payments were $67 billion. The net surplus of $21 billion helped to offset a small part of our trade deficit. This earnings surplus will, however, soon disappear.

Since 1985, we have benefited from inflation in our receipts as the value of the dollar declined. Income from investments in Europe and Japan swelled as the local currencies in which revenues were received appreciated in value relative to the dollar. Without further declines in the value of the dollar, we will lose this source of revenue growth.

It is also likely that foreign investments in the United States will eventually earn roughly the same rate of return as U.S. investments abroad. One explanation of the current differential in our investment receipts and payments is that a large part of foreign direct investments in the U.S. economy (for example, in manufacturing plants) are relatively recent and have not reached maturity. Out of a total estimated foreign direct investment of $209 billion in the United Sates at the end of 1986, $154 billion or 74 percent has been accumulated in the 1980's. In contrast, only 28 percent of U.S. direct investment abroad is of such recent origin. Once these foreign direct investments in the United States have reached full production capacity, their earnings will help reduce the gap in rates of return.

Quality of the Data

Much of the debate about the size and nature of the U.S. debt is based on data which are themselves quite open to question. We simply do not know at this time the degree to which official net asset statistics exaggerate or undervalue our foreign assets and liabilities.

A recent study by Shafiqul Islam of the Institute of International Economics, after careful examination of the debt data, has concluded that U.S. direct investments (which represent 24 percent of U.S. assets abroad) are probably undervalued when measured at book value. The distortion is smaller for foreign direct investment in the United States, since a larger share of it is of recent origin. Foreign direct investment accounts for only 16 percent of total U.S. liabilities.

On the other hand, official statistics probably also underestimate U.S. liabilities. The sharp increase in "statistical discrepancy" in the U.S. balance-of-payments data since 1978 is probably due in large part to unrecorded capital inflows into the United States. As a result of these offsetting corrections, Mr. Islam writes:

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> Taking all other possible sources of data deficiencies into consideration, it is not clear whether the recorded data are overstating or understating America's net international investment position. [Shafiqul Islam, "America's Foreign Debt: Is the Debt Crisis Moving North?," Stanford Journal of International Law, Spring 1987]

PROJECTING DEBT GROWTH

While there is uncertainty about the actual level of the U.S. net debt, there is no question that it is rising rapidly and will continue to increase for several more years.

In recent testimony before the Committee, the late Secretary of Commerce Malcolm Baldrige predicted a $20 billion improvement in the 1987 current account deficit, which would bring that deficit to approximately $120 billion. Assuming the current account continued to improve by $20 billion annually, the debt would reach nearly $700 billion by 1993 before beginning to decline. If the current account continued to improve steadily by $20 billion per year, it would still take more than eight years to pay off the accumulated debt burden [Chart VIII].

Other Committee witnesses forecast even higher levels of indebtedness. Mr. Sinai testified:

> Our estimates show a $775 billion net debtor position for the U.S. by 1990 with $725 billion the net deficit position for securities upon which interest payments must be made.

Another witness, Donald Ratajczak of the Economic Forecasting Project, Georgia State University, concurred:

> We will probably be borrowing something on the order of another $120 billion from abroad next year. It [editor's note: the trade deficit] will be shrinking, but it's shrinking at a relatively slow rate and indeed it's going to be very hard to get capital borrowing from abroad down below $100 a year. We could very well see our debt going up to a trillion dollars by 1993.

In the same hearing, one Member of the Committee submitted a chart [Chart IX] prepared by the Committee on Economic Development (CED) entitled "Deepening Net U.S. International Debt." It showed the debt peaking at $800 billion in the early

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CHART VIII

PROJECTIONS FOR DEFICITS AND DEBT

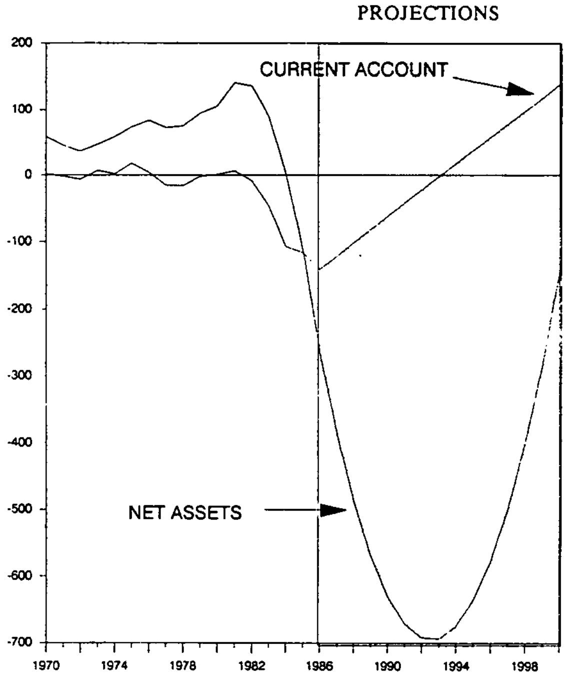

CHART ASSUMES STEADY IMPROVEMENT IN THE U.S. CURRENT ACCOUNT OF $20 BILLION PER YEAR

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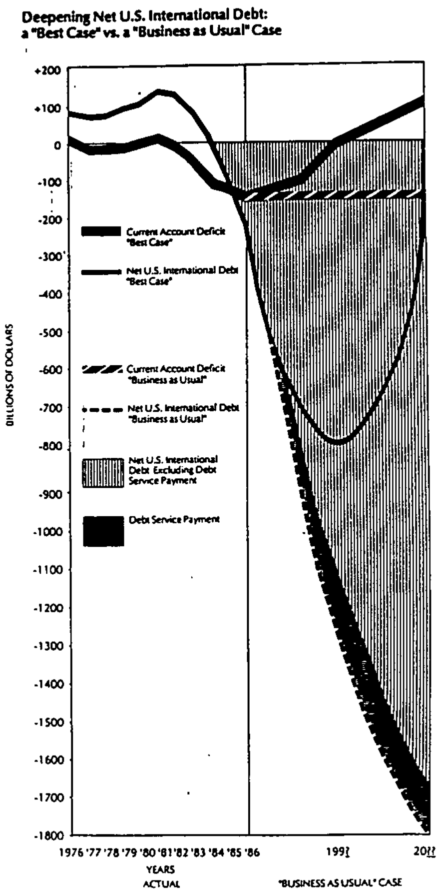
CHART IX


Deepening Net U.S. International Debt:
a "Best Case" vs. a "Business as Usual" Case
+200
+100
0
-100
-200
-300
-400
-500
-600
-700
-800
-900
-1000
-1100
-1200
-1300
-1400
-1500
-1600
-1700
-1800
BILLIONS OF DOLLARS
Current Account Deficit "Best Case"
Net U.S. International Debt "Best Case"
Current Account Deficit "Business as Usual"
Net U.S. International Debt "Business as Usual"
Net U.S. International Debt Excluding Debt Service Payment
Debt Service Payment
1976 '77 '78 '79 '80 '81 '82 '83 '84 '85 '86
199?
20??
YEARS
ACTUAL
"BUSINESS AS USUAL" CASE

1990's in a "best case" scenario. But the CED projected that a continuation of "business as usual" would mean a debt exceeding $1 trillion in a few years and continuing to rise into the next century.

Slowing the rise and eventually reversing the indebtedness trend is becoming more difficult. Our balance of payments on investment income will turn negative in the near future, and these payments will then be added to our merchandise trade deficits in determining the increase in our debt each year. As interest charges compound, steady improvement in the current account will require accelerating improvement in the merchandise trade balance.

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III. THE BURDEN OF THE FOREIGN DEBT

LIVING STANDARDS

The obligation to pay foreigners interest on their loans and earnings on their direct investments will require U.S. producers to relinquish part of their annual earnings to foreigners. The longer we run large trade deficits, the higher the debt will mount, and the greater will be the claim on future earnings.

Committee witnesses C. Fred Bergsten, Director of the Institute for International Economics, Alan Blinder, Professor of Economics at Princeton University, Robert Hormats, Vice President of Goldman Sachs and Company, and Lawrence Chimerine, Chief Economist for Wharton Econometrics, all predicted that interest charges on U.S. external debt will approach 1 percent of GNP. This implies that Americans will have to consume 1 percent less than they produce just to service the debt.

Paying down the debt by bringing the merchandise trade balance into surplus will require the growth of output to exceed the growth of domestic spending for some time, a reversal of the past five years when the growth of living standards outstripped GNP. If real GNP continues to increase at 2.5 percent per year, the average thus far in the 1980's, and the production going to Americans grows at only a 2 percent rate, the United States could again be a net creditor before the end of the century. With even modest population growth, however, this implies more than a decade of near-stagnation in American living standards.

Professor Blinder testified to the likelihood of exactly this outcome:

> We managed to go from a balanced trade to a mammoth deficit over a course of about five years. If we go back to roughly balanced trade over a five-year period from '86 to '91, it's going to mean that the rate of growth of domestic consumption is about one percentage point less than GNP [growth]. So if GNP growth averages 2.5 percent over that five-year period, domestic consumption, in other words living standards, will only average 1.5 percent. ...We've done the opposite in the last five years. Our consumption has grown about one percentage point faster than our production and now we're just going to have to give that back.

Professor Blinder also pointed out that, even after making this adjustment, the United States would still be heavily in debt to the rest of the world.

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How sharply U.S. citizens feel the burden of the debt service will depend on the pace of trend growth in GNP. If average real growth for the next decade surpasses the slow pace of the 1980's, then growth in domestic consumption could be adequate, even if slower than output growth. Mr. Chimerine told the Committee:

> ...consumption growth will be considerably less, 1 percent or something in that range, than production growth in the years ahead by definition virtually. But the key question is at what rates? Is it going to be 1.5 [percent growth in consumption] and 2.5 [percent growth in GNP]...or is it going to be 0.5 and 1.5, or minus 0.5 and 0.5...? The debt's impact on U.S. living standards also depends on how long the rest of the world lets us use their funds. If foreigners suddenly decide that they wish to reduce their dollar assets, the adjustment of U.S. living standards could occur abruptly and be very severe. Only if they are willing to hold such assets for many years will the adjustment be moderate.

In answer to the Chairman's question as to what it would take for the United States to begin reducing its debt, Mr. Bergsten replied:

> ...our objective to achieve your target of current account surplus and start reducing the foreign debt has got to be a turnaround of something like $200 in our annual international position. ...that is the way I like to size the problem.

POLICY CONSTRAINTS

In addition to the threat to future living standards, indebtedness increasingly restricts domestic economic policy choices. Foreign investors keep a wary eye on economic developments here; if they fear capital losses from further dollar depreciation, or if real interest rates decline relative to rates in other countries, foreign investors might abruptly turn away from dollar-denominated assets. Such a withdrawal of foreign financing could force a sharp adjustment of our external accounts, pushing the United States into recession.

This reality puts the Federal Reserve into an extremely difficult position, and may result in the Fed paying excessive attention to the reactions of foreign investors, even at the expense of the optimal growth of domestic jobs and income. It is possible that, for the foreseeable future, the Federal Reserve will be forced to maintain relatively high interest rates, to the detriment of interest-sensitive sectors such as housing, to ensure a continued inflow of foreign funds to this economy.

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In his comments to the Committee on July 1, 1987, Jerry Jasinowski, Chief Economist, National Association of Manufacturers, elaborated on this point:

> ...a substantial part of the growing dependency on foreign capital to finance our budget deficits and to finance our debt service is making the U.S. a permanent hostage to foreign capital inflow, which, in turn, is going to and is in the process of rendering monetary policy obsolete, as a means for controlling the American economy. ...the Federal Reserve will consistently have to take protecting the dollar as a major priority, something that is relatively new, in terms of economic policy, putting a much lower emphasis on encouraging domestic economic growth and permanently becoming a contributor to what has become a fairly stagnant growth pattern for the American economy.

At the same hearing, Mr. Bergsten underscored the implications of this constraint in the event of an economic downturn:

> ...I think a key issue for this Committee is to note that when we get into that next recession in the United States, as we inevitably will, it is going to be very hard to get out of it. Neither the fiscal or monetary policy tools will be available, and that means our next recession in this country might be unusually prolonged because we don't have the normal tools to extricate ourselves from it.

INTERNATIONAL INFLUENCE

The external debt also weakens U.S. influence throughout the world, since a debtor must strive to accommodate its creditors for fear that the needed financing might stop. No country has ever managed to be a great power and a great debtor at the same time, and two great powers (Britain in this century and Spain in the 16th century) lost their stature as world leaders when they moved from creditor to debtor status. Mr. Bergsten asked in a recent article:

> Can the world's largest debtor nation remain the world's leading power? ...Can the United States continue to lead its alliance systems as it goes increasingly into debt to the countries that are supposed to be its followers? Can it push those countries hard in pursuit of its economic imperatives while insisting on their allegiance on issues of global strategy? ["Economic Imbalances and Politics," Foreign Affairs, Spring, 1987, p. 771]

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The U.S. external debt has also jeopardized the dollar's status as a reserve currency. The dollar, by virtue of its dominant role in international trade and finance, has assumed the role of the world's primary reserve currency since the end of World War II. This has given the United States the privilege of financing its trade deficits in its own currency, relieving the domestic economy of liquidity problems.

While the dollar's reserve currency status has been an advantage for the United States, it can cause problems for other countries. Foreigners lending to the United States or making dollar-denominated loans to other countries assume the exchange rate risk of holding such assets. When the dollar's exchange value moves relative to the currency in which they normally purchase goods and services, the real value of their loans change. Thus the dollar's recent decline has been costly for foreign holders of dollar assets.

Should dollar-denominated assets become less acceptable to foreigners because they fear further dollar depreciation, the United States might have to finance part of its deficits with securities denominated in other currencies. This would shift the exchange rate risk back onto the United States.

Finally, it should be noted that constraints on U.S. economic policy due to indebtedness limit our efforts to address Third World debt problems. The need to reduce the U.S. trade deficit leaves little room for directly stimulating debtors' exports. Any effort to bring down interest rates to lessen the Third World's debt service conflicts with the need to attract funds to finance U.S. debt.

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IV. IMPROVEMENT IS NOT ENOUGH

THE INADEQUACY OF NARROWING THE GAP

The task facing us, if the Nation's standard of living and status as a great power are to be maintained, is to return the United States to a net creditor position. Because this shift will depend not merely on a reduction in the U.S. merchandise trade deficit but on a transformation of that deficit into a surplus, it will require a fundamental re-orientation in economic policy. Steady progress in first reducing the growth of debt and then paying it off means steady improvement in the current account. Growing interest payments, in turn, mean that steady improvement in the current account will depend on even greater improvement in the merchandise trade balance.

Most witnesses who testified before the Committee were cautiously optimistic that the trade balance will show improvement in the months ahead, and current policies continue to focus on these short-term developments, rather than on the longer term objective of posting trade surpluses. With the decline in the value of the dollar against some currencies from its 1985 high to about its 1980 level, the Administration appears satisfied that the problem will be solved by gradual erosion of the trade deficit. The late Commerce Secretary Baldrige told the Committee:

> The U.S. has seen the worst of our trade and current account deficits. While trade data will likely fluctuate somewhat month to month,.....We've finally turned the corner on U.S. trade.....

While there has been modest improvement in the external deficit measured in quantity terms [Chart X], there has been no comparable improvement in the nominal deficit. Quantitative improvement is relevant to the performance in the U.S. economy but it has less bearing on the foreign debt, which is determined by the nominal deficit.

In fact, the nominal current account deficit may not improve at all this year, since import prices have been rising even as the volume of imports has been falling. Since it is the current account deficit that adds to our national indebtedness to foreigners, Mr. Jasinowski told the Committee that growth in our debt in 1987 may be nearly as great as the $166 billion added in 1986:

> There is no reason to believe that we are going to be able to see a substantial reduction in the current account. I don't have precise estimates. My colleagues, some of them, have estimated

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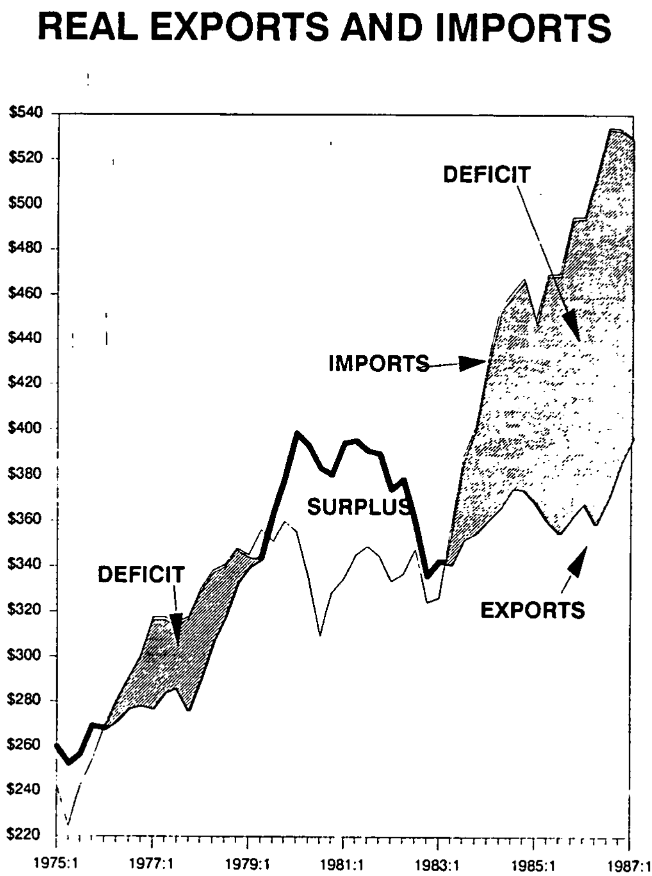
CHART X



REAL EXPORTS AND IMPORTS
$540
$520
$500
$480
$460
$440
$420
$400
$380
$360
$340
$320
$300
$280
$260
$240
$220
1975:1
1977:1
1979:1
1981:1
1983:1
1985:1
1987:1
DEFICIT
IMPORTS
SURPLUS
DEFICIT
EXPORTS

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a $10 billion to $15 billion improvement. I see the current account as flat for 1987. I see no particular signs that you will see improvement, perhaps a modest improvement of $10 billion.

POOR PROSPECTS FOR SELF-CORRECTION

Simply to bring the merchandise trade balance back to zero will require extraordinary trade performance. Since the United States has run merchandise surpluses in only three years since 1970, such a movement would be a sharp departure from the established pattern.

Though the lower dollar may narrow the deficit somewhat more in the near term, the degree of sustained improvement remains problematical. First, while the dollar has fallen substantially against a number of currencies (particularly the German mark and the Japanese yen), it has declined much less against the currencies of many other countries with which we have extensive trading relations [Chart XI]. A number of countries manipulate the value of their currencies to "peg" them effectively to the dollar, and several other countries have seen little appreciation of their currencies against the dollar even though they do not actively manipulate the value of their currency.

A substantial body of opinion holds that the dollar has not fallen enough, particularly against countries with administered exchange rates, to produce a swift and steady improvement in our trade position. Foreign producers have chosen to absorb currency appreciation in the form of reduced profit margins, rather than giving up market share in the United States. As a general rule, the costs of foreign goods in the United States have risen significantly less than would have been expected if all the changes in the value of the dollar had been passed through to consumers.

But beyond the question of the dollar's value, there are a number of obstacles to expanding U.S. exports and moving vigorously toward a trade surplus that should not be addressed simply by relying on a weak dollar:

- Unwillingness of the Germans and the Japanese to stimulate their own economies, and slow growth elsewhere in the developed world
- Substantial trade barriers abroad, particularly in Japan, Korea, and other Pacific Rim countries
- Foreign competitors' ability to achieve more rapid increases in productivity in the traded-goods sector

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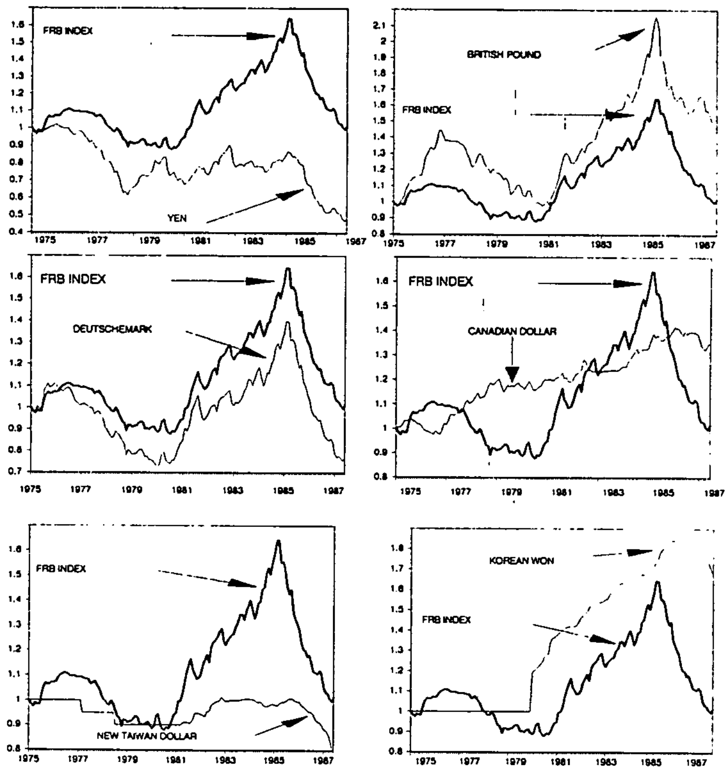
CHART XI

EXCHANGE RATE COMPARISONS: SELECTED BILATERAL RATES VS. FEDERAL RESERVE BOARD COMPOSITE INDEX



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- Debt burdens in the heavily indebted lesser developed countries(LDC's), which require austerity at home and export surpluses to meet debt service obligations.

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V. TOWARD A STRATEGY FOR THE FUTURE

Restoring balance in our external accounts is not an end in itself. It is the means for assuring economic growth on which a rising standard of living depends, while simultaneously addressing the debt burden which threatens to undermine the Nation's future well-being. How we pursue that objective is critical. Historically, the remedy for trade deficits and excessive debt has been austerity, whether accomplished through formal programs, as in many developing nations, or by means of a recession. As recently as 1974-1975, recession transformed a U.S. merchandise trade deficit of $11 billion, modest by today's standards, into a $2 billion surplus.

Although a major recession -- far more massive than even the 1975 downturn -- would be effective in restoring external balance by reducing imports, the clearly preferable alternative is to expand exports. We need a strategy to restore the U.S. position in world trade, and that strategy must be grounded in a commitment to promote vigorous, sustained economic growth. Reversal of the trade balance, which is inevitable over time, should be a stimulus to GNP and not a reflection of inadequate real growth.

In the absence of marked improvement in net exports, prospects are dim for a significant acceleration of GNP growth. Though the upturn after the severe 1981-1982 recession is now the third longest of the eight expansions since 1950, it is among the weakest. The tepid performance of the last two and one-half years has left the average growth rate for this upturn below that of all previous ones except the truncated rebound of 1980-1981. Similarly, the growth of real disposable income has been weaker than for all expansions except 1980-1981, despite repeated cuts in personal taxes. The rate of job creation and the growth of industrial production have lagged all previous expansions [Table III].

Earlier this year, the Economic Report of the President estimated that poor net export performance reduced 1986 economic growth by 0.7 percentage points and that improved performance "would contribute a similar amount to growth in 1987," raising the 1986 rate of 2.5 percent to 3.2 percent.

Most private forecasters are less confident about growth prospects. Growth rate predictions of the most recent Blue Chip survey average 2.5 percent for 1987 and 2.8 percent for 1988. Many forecasters expect a recession, although probably not before 1989. Lawrence Chimerine observed to the Committee at its midyear hearings that growth in the 2-2.5 percent range is likely to continue not only this year but indefinitely into the future, emphasizing that the risks "are largely on the down side over the next 18 months." In the same hearings, Donald Ratajczak forecast growth of slightly more than 2.5 percent for the next 18 months, and Allen Sinai anticipated a 2.6 growth rate this year and again in 1988.

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TABLE III

GROWTH RATES FOR POSTWAR EXPANSIONS

EXPANSION	GNP	INDUSTRIAL PRODUCTION	EMPLOYMENT	REAL DISPOSABLE INCOME
1949-1953	7.5%	10.0%	4.3%	5.1%
1954-1957	4.9%	9.1%	3.6%	6.5%
1958-1960	4.9%	10.7%	3.6%	3.7%
1961-1969	4.9%	7.4%	3.7%	5.2%
1970-1973	4.6%	8.0%	3.4%	4.9%
1975-1980	4.3%	6.5%	3.6%	3.6%
1980-1981	3.3%	8.2%	2.0%	2.5%
AVERAGE	4.9%	8.6%	3.5%	4.5%
MOST RECENT EXPANSION (1982-1987)	4.2%	5.1%	3.2%	3.5%

A number of key segments of the economy have been showing significant signs of weakness in recent months. For the first quarter of this year, consumer spending, residential and nonresidential fixed investment, and government spending all were negative, with inventories and net exports providing the only sources of growth in GNP. There are additional indications that weakness in these sectors is likely to persist.

Several economic indicators suggest that a slowdown in domestic economic activity may offset the positive impact of somewhat stronger trade just as the external accounts have begun to show some improvement. Residential construction, which typically presages changes in activity elsewhere, has declined for the last two quarters, and housing starts in June dropped 12 percent below their 1986 pace. Auto sales, which also tend to lead overall economic activity, stand almost 15 percent below last year's pace. Flat real disposable income over the past year despite a significant cut in personal taxes resulting from tax revision will probably constrain most household spending, and businesses project hardly any rise in new plant and equipment purchases. With the phase-out of revenue sharing in 1986, state and local governments will increase their spending only marginally.

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CONSEQUENCES OF CONTINUING SLOW GROWTH

The underlying growth rate of the economy has clearly slowed in recent years. When asked in a recent New York Times interview (May 31, 1987) whether the current pattern of slow growth would not have been classified as a "growth recession" just a few years ago, Chairman Beryl Sprinkel of the President's Council of Economic Advisers replied, "Our standards have changed."

In contrast, the late Walter Heller offered a very different perspective in his last presentation to the Joint Economic Committee. He compared economic performance in the current decade with the 1960's and 1970's, when real growth of GNP averaged 4.2 percent and 3.1 percent, respectively. Assuming average annual growth of 3.0 percent in 1986-1989, Heller projected a 2.4 percent growth rate for the 1980's and rejected this performance as inadequate, given its clear implications of nagging poverty and idle productive capacity.

In the context of servicing and repaying our debt, as outlined in the previous sections of this Report, the implications of continuing slow growth become even more serious. Acquiescence in the pattern of recent years is not enough; policy should instead actively promote faster growth that will be sustainable over the long term.

We need a steady and sustained expansion of exports. The improvement in U.S. competitiveness that will allow such growth must come from improved productivity, and increased product quality, not from a lowering of incomes of U.S. producers. Our challenge is to produce better, not to become poorer. Reversing the decline in our external position will therefore require fundamental redirection of current macroeconomic, microeconomic, and trade policies.

A FOREIGN ECONOMIC POLICY TO STIMULATE GROWTH

An economic growth strategy which places a priority on improving our external trade and net asset position will require:

- Reduction of foreign trade barriers
- Achieving and maintaining appropriate exchange rates with our trading partners
- Economic policy coordination to ensure faster growth in Japan and Europe, and thus increased demand for imports
- A solution to the debt crisis in the developing countries which will allow them to increase their imports

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The General Agreement on Trade and Tariffs (GATT) process provides one avenue for lowering barriers to trade on a multilateral basis. But this is a slow process, and additional, bilateral negotiations are necessary to eliminate more promptly some of the most egregious barriers U.S. exporters face. Countries for whom the United States is a major market should not be allowed continued free access to our markets if they are not prepared to reciprocate in full measure.

The dollar has already depreciated sharply relative to the currencies of our major trading partners in Europe and Japan. The rates of exchange between the dollar and the currencies of these countries are set in international financial markets, and are not subject to direct government control. But the leading industrialized nations need to coordinate their national economic policies in order to ensure exchange rates which will facilitate world economic growth and stability.

The dollar clearly has not depreciated sufficiently relative to some countries which manipulate the value of their currencies at a specific dollar value to gain a competitive advantage. Since the exchange rates of the latter countries' currencies are not market-determined, government action is necessary to bring them into a more realistic alignment with the dollar. The United States should undertake negotiations with such countries, bilaterally or in conjunction with the International Monetary Fund (IMF), to assure regular and prompt adjustment of their exchange rates.

Most of the European economies and Japan are achieving only sluggish growth at this time, and their current economic policies suggest little immediate improvement. These countries should now take steps to stimulate domestic demand -- both to maintain their own growth as demand for their products in the U.S. market declines, and to provide a greater market for the goods of other countries, including the United States. While considerable agreement on the need for such economic policy coordination has been expressed, little action has been taken so far. The United States must to continue to press for action, and not just words.

Sluggish growth in most of the developing countries, especially in Latin America, is also an impediment to the growth of U.S. exports. In these countries, it is debt service obligations that retard economic growth, since resources must be sent abroad that would otherwise be invested at home. It is in our interest, as well as the interests of these countries, to find a solution that will allow them to service their debts through increased growth rather than continued contraction.

There are currently several procedures consistent with this objective, including support for economic reforms in debtor countries through the IMF or other institutions, bank lending to provide additional external finance, and private investment either

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through direct investment or debt-for-equity swaps. These procedures should be encouraged. But it should be recognized that their use is limited and that, by themselves, they do not constitute a comprehensive solution.

Serious consideration should also be given to establishment of a mechanism for restructuring of developing countries' debt in order to assure resumption of economic growth while debt service obligations are met. A new multilateral authority could serve this purpose by purchasing certain Third World countries' debt from the commercial banks at a discount and passing the discount along to the countries involved through restructuring, in conjunction with internal economic reform policies.

Because the debt problem is truly international, with U.S. domestic banks accounting for roughly one-third of the total outstanding debt, it must be addressed on a multilateral basis. Specifically, countries with substantial current account surpluses should play a major role in the establishment and operation of any new debt management authority, and close working relationships with both the World Bank and the IMF would be essential to the authority's success.

A DOMESTIC ECONOMIC POLICY TO PROMOTE GROWTH

Repaying our creditors through growth rather than austerity will require a long-range and constructive approach to domestic economic policy. A more responsible fiscal policy is essential to any foreign debt-reducing strategy for the Nation. However, fiscal policy is only part of the solution, since a reduction in the Federal budget deficit will not in itself restore balance to our external accounts.

Given the importance of other factors in strengthening our ability to export and compete, Federal budget policy, while directed to deficit reduction, must also seek appropriate budgetary priorities. Progress on reducing the Federal deficit should not come at the expense of factors which contribute to our overall economic strength. It would be shortsighted and self-defeating to sacrifice the skills of our future workers, or the technology and knowledge base of our industry, because we were unable to assign a priority to these areas in developing a responsible and forward-looking Federal budget.

To achieve an understanding on a course of deficit reduction that will not undermine the future strength of the economy will require an active commitment by the Administration. Regrettably, that commitment has not been made, and does not appear to be forthcoming. Recent reports on the probable course of future deficits indicate that, if the commitment is not made, the Nation will face a Hobson's choice: either arbitrary deficit reduction jeopardizing areas critical to future economic growth, or continuing high deficits that will preclude substantial improvement in our external position.

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Sustaining vigorous and steady growth of both output and exports of the U.S. economy will require significant investments by both the public and private sectors in improvements to our stock of human, intellectual, and physical capital. With respect to a prudent public investment in future economic strength, priority areas include:

- Human Resources -- We must bring the skills of our work force up to the standards set by our most effective international competitors. Adult illiteracy, deficits in basic reading and computational skills, and a relatively weak base of scientific and engineering personnel will act as an ever-increasing drain on our economy unless a major commitment is made to improving the skills of American workers.

- Physical Infrastructure -- Too much of our Nation's basic physical plant is worn out and deteriorating to the point where it inhibits the efficient production and movement of goods. Rebuilding the ports, railroads, bridges, and roads over which goods move are essential if we are to expand our role as a major exporter. At the same time, cities and towns will be unable to cope with the stresses of growth without substantial new investments in water and sewer systems to serve an expanding work force.

- The Civilian Technology Base -- At the beginning of the 1960's, the United States, Japan, and West Germany all spent about the same proportion of GNP on civilian research and development (R&D). Such an investment has stagnated in the United States, while rising steadily in these two major competitors so that their share of GNP going to civilian R&D exceeds our own by about a third. In a world of rapid technological change, failure to invest in the civilian technology base means effectively ceding control of the future to our competitors.

- Statistical Infrastructure -- Federal statistical programs account for less than two-tenths of 1 percent of the Federal budget. Consequently, very minor savings in budget terms can have crippling effects on critical programs. Today more than ever, sound decisionmaking in both the private and public sectors requires accurate, comprehensive, and timely information.

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CONCLUSION

This Report has shown that the U.S. position as the world's largest debtor nation confronts us with an utterly new set of economic challenges. We cannot continue to go ever deeper into debt and still retain our status as a world leader. Yet present policies hold out little prospect that we will soon be able to eliminate the annual trade deficits and begin the longer term process of restoring our position as an international creditor nation.

A fundamental re-orientation of policy is needed to meet these new challenges. This will require hard choices and new directions. We will need to place a higher priority on production than on consumption, and to promote investment for the future rather than indulgence in the present. This country possesses immense resources at home and great strengths in the international economy. Crafting government policies that build on, rather than undermine, those resources and strengths should make it possible to reverse the deterioration of the past six years. Our challenge is to develop and implement those policies.