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U.S. FOREIGN DEBT

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDREDTH CONGRESS

SECOND SESSION

SEPTEMBER 13, 1988

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U.S. FOREIGN DEBT

TUESDAY, SEPTEMBER 13, 1988

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:20 a.m., in room SD–138, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes and D'Amato.

Also present: Judith Davison, executive director; and Bob McCauley and Dayna Hutchings, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order.

Today the Joint Economic Committee holds a hearing to review the current position of the United States in the international economy and the implications of that position for the economy at home.

Among other important matters, the hearing will focus on the U.S. current account for which quarterly figures have just been released. The U.S. foreign debt, which of course continues to rise as the current account remains in deficit, the effects on U.S. capital markets of our continuing dependence on foreign capital to finance our current account deficits, and the effects of volatile foreign participation in the U.S. bond market on sectors of the economy like housing, which depend on long-term credit.

The figures announced by the Commerce Department this morning with respect to the second quarter current account deficit provide a sober background for this hearing. The current account deficit indicated by the Commerce Department this morning is $33.3 billion, which is roughly in the range that we've experienced for the previous seven quarters—somewhat lower by $2 to $3 billion.

Figures for the first 6 months of this year, therefore, provide a current account deficit of just over $70 billion.

The foreign debt, which of course along with the current account deficit, reached $368 billion in 1987. It stood at about $440 billion at the end of June and appears likely to reach $500 billion by the end of the current year.

The accumulation of foreign debt means that the United States each year must pay more interest and dividend income to foreign investors than foreigners are paying to us. The size of this annual payment will continue to grow as long as our net indebtedness continues to grow. And these payments constitute an ever-increasing drag on our current account deficit even if we manage to balance our merchandise trade accounts.

In fact, we must start posting a surplus in our merchandise trade accounts in order to make the needed payments to foreign investors and begin the task of reducing the size of our net external debt. Without such trade surpluses, this year's payments to foreign investors must be borrowed abroad, adding further to the net debt situation.

Our heavy borrowing abroad has raised important questions about the role of foreign investors in U.S. financial markets. To some extent, the expanding foreign role reflects the clear trend worldwide toward the internationalization of investment activities.

While in most cases United States and foreign investors may respond to the same factors influencing investment decisions, there's a critical difference between them. The foreign investor is sensitive to exchange rates and developments in home markets in a way that American investors are not. As a result, activities in U.S. capital markets are now affected and potentially significantly affected by foreign investment decisions. This means that sectors of the domestic U.S. economy that require long-term credit may depend increasingly in decisions made by foreign investors, whose decisions are influenced by the exchange rate factor.

Our growing foreign debt has thereby put foreign investors in an unprecedented position with respect to important elements in our own domestic economy.

Moreover, foreign investment in U.S. capital markets encompasses foreign central banks as well as private investors. Mr. Alan Greenspan, Chairman of the Federal Reserve, testified to this committee in March of this year that foreign central banks financed virturally all of last year's $154 billion current account deficit, stepping in to fill the gap left when private investors withdrew.

Such a shift from thousands of private investors to a small number of official agencies raises other significant questions. It is clear the Federal Reserve is now operating in an environment sharply different from that faced by previous Federal Reserves.

Our witnesses will address, amongst other things, the constraints on Federal Reserve policy imposed by the need to borrow well over $100 billion per year for the foreseeable future.

We are fortunate this morning to have a panel of witnesses with a broad range of expertise. Mr. Nigel Gault is well know for his careful workmanship with Data Resources, Inc., in forecasting the U.S. external account. Mr. Robert Brusca is a close follower of U.S. financial markets with a vantage point that may prove of particular usefulness today as chief economist of Nikko Securities Co. And Mr. Lyle Gramley interprets U.S. financial market developments for an important body of housing market practitioners as chief economist at the Mortgage Bankers Association.

Gentlemen, we are very pleased to have you here and for you to participate in this panel. Before I ask you to begin, I'll turn to my colleague, Senator D'Amato, for any opening comments he may have.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'Amato. Thank you, Mr. Chairman.

Mr. Chairman, a number of forces came together during the 1980's to reshape our international investment position. Capital market liberalization in Western Europe and Japan during the 1980's opened the floodgates to previously restrained international capital flows. Attracted by relatively high real interest rates, declining tax rates, low inflation, and strong economic growth, much of the world's surplus funds came here to the United States. The money came in the form of stocks, bonds, direct investments, and bank deposits. At the same time, U.S. foreign investments abroad slowed substantially as American banks shied away from lending to Third World borrowers following the debt crisis.

As a result, the United States went from the world's largest investor to the world's best investment opportunity. The inflow of foreign capital helped keep interest rates down, allowing a higher overall level of investment than would have been otherwise possible. I think that's indisputable. Our economic growth was sustained and employment rolls surged. We benefited from imported technology and management techniques that are the byproducts of the internationalization of the world's capital and goods markets.

Many people are concerned, however, that foreigners are taking over control of American businesses. I believe that some of these fears are somewhat exaggerated. About three-fourths of foreign investment in this country consists of fixed income assets such as bonds and bank deposits that do not confer any control over corporate management. Direct investment only constitutes 17 percent of foreign assets in the United States.

Now in spite of the benefits of foreign investment, it's hard to ignore a debt position of $368 billion. This sum appears enormous and economists tell us it will continue to grow until our current account deficit starts falling.

But what does that mean? We certainly have no problem servicing the debt. Last year we earned more on our investments abroad than foreigners earned here. The Council of Economic Advisers estimates that even if the current account continues to amount to about 3.5 percent of U.S. GNP every year until the end of the century, the net foreign debt would amount to about 40 percent of the U.S. GNP. But this share of GNP is similar to Canada's relative burden over the past several years and servicing the foreign claims would only consume about 2 percent of our gross national product.

We obviously hope that the current account deficit narrows before the end of the century so we don't have to worry about such a large amount of debt. I would also hope that we don't enact policies such as tax hikes and capital controls that will make the future economic climate hostile to both foreign and domestic investors.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much, Senator D'Amato.

I will include in the record an article which appeared in the New York Times of Sunday, September 11, entitled "America's Financial Markets: Frankfurt and Tokyo Take Control." The opening sentence reads "The United States has lost control of its financial markets to foreigners and has run out of easy policy options to regain it. The American financial tune is no longer being called in New York, but rather in Tokyo, London and Frankfurt."

The article goes on to discuss the huge U.S. foreign trade deficits and the resulting fact that the United States has now been transformed into a net debtor nation, my recollection is for the first time since World War I. We were a creditor nation over roughly a 70-year period.

[The article referred to follows:]

THE NEW YORK TIMES, SUNDAY, SEPTEMBER 11, 1988

Forum

AMERICA'S FINANCIAL MARKETS

Frankfurt and Tokyo Take Control

By A. GARY SHILLING

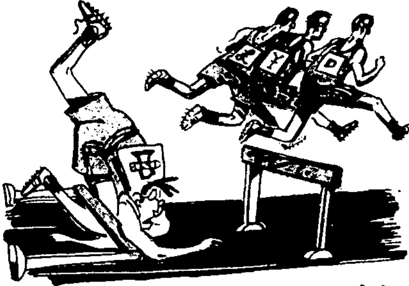
THE United States has lost control of its financial markets to foreigners and has run out of easy policy options to regain it. The American financial tune is no longer being called in New York, but rather in Tokyo, London and Frankfurt. In fact, this loss of control had a lot to do with the timing of the stock market crash last fall. Foreigners lost confidence in American economic policy and started the selloff. American investors, well aware that foreigners held all the important cards, panicked and joined the rush to sell stocks.

Huge foreign trade deficits — $171 billion in 1987 — which have turned the United States into a net debtor nation, are to blame. At recent Treasury auctions the Japanese bought up to half of both 10-year and 30-year Treasury bonds. While foreigners have little choice but to invest those dollars in the United States, they can wreak havoc in the process by disrupting exchange rates, or by switching their investments from Treasury bonds to investing solely in Los Angeles office buildings, for example.

Early in 1987, the Administration sensed this loss of control over our financial markets and decided to attack the problem through a competitive devaluation of the dollar. A weaker dollar, they reasoned, would improve our trade position by making American products cheaper abroad, encouraging exports while increasing import prices and thereby reducing their appeal.

In effect, the Administration hoped for an easy route to improving trade performance. But like the British in a similar ill-fated devaluation attempt after World War II, the Administration failed to comprehend that the rest of the world was by no means willing to hand us their market positions. The trade deficit has shown improvement, but imports are still growing as foreigners cut costs and shift production out of the strong currency countries to the United States and to the low-cost newly industrialized countries.

A. Gary Shilling is an economic consultant and portfolio strategist. His most recent book is "After the Crash Recession or Depression."



In addition, the weak dollar strategy created a severe domestic problem. Starting around March 1987 American investors began worrying whether foreigners would continue financing the Federal budget deficit as the value of their Treasury bond holdings declined when figured in terms of their own national currencies. This, along with fears of imported inflation, led to skyrocketing bond yields that threatened to induce a recession. As a result, the Administration threw in the towel on competitive devaluation as a policy tool.

The Federal Reserve, too, has limited options for dealing with the United States' loss of control over its financial markets. In September 1987, when the Federal Reserve decided to give the market a whiff of anti-inflationary grapeshot and to support the dollar by increasing the discount rate, the results were unexpected and devastating. "Good grief, now even the Fed is nervous over the loss of domestic control of financial markets," was a common investor reaction. Short-term interest rates and bond yields jumped further and the stock market, which had reached a peak the previous week, started its slide, ending in the October crash.

Since the crash, the Federal Reserve has had even less room to tighten credit to dampen inflationary fears. It has less room to tighten if it does not want to risk a recession in 1988 before the first Tuesday in November — to pick a random date. But suppose that in coming months the Federal Reserve is faced with a recession and wants to deal with it (and with our international debts) by inflating the economy and thereby deflating the value of those debts. A substantial easing of credit would probably lead to a collapse in the dollar and to a surge in interest rates that would negate the stimulative effects of an easy credit policy. The ultimate effect would be the odd combination of inflationary fears combined with fears of high real interest rates. What would result from this combination would be a stagnant economy but one with virtually no inflation.

> *The Japanese buy half of the 10-year and 30-year U.S. Treasury bonds.*

Fiscal policy has even more clearly run out of options to regain control of America's financial markets. Given the huge size of the Federal deficit, any attempt to cut taxes or increase government spending to deflate the value of foreign debts would lead to skyrocketing real interest rates and to a collapse of bond prices and the dollar. This would come as American and foreign investors lose their remaining confidence in the Administration and Congress.

CONVERSELY, sizable tax increases or precipitous Federal spending cuts intended to reduce the budget deficit rapidly — and end the dependence on foreigners to finance it — would probably also be self-defeating. Substantial fiscal tightening would insure a recession that would spread abroad as America's imports fell. This would reinforce America's business weaknesses as foreigners cut their imports of American goods. The net result might be an even higher deficit.

Despite the lack of easy policy fixes through dollar manipulation, monetary policy changes, or fiscal expansion or contraction, regaining control of America's financial markets is possible in the long run. For instance, the ongoing, zealous cost control and restructuring now being pursued by American businesses will do wonders to improve the trade balance.

In addition, the ongoing polarization of American household incomes will move the nation from being a country of spenders to a land of savers. This will happen as an increasing number of wealthy people save more. Increased saving will reduce the dependence on borrowing abroad and will help finance the tremendous growth in capital spending projected for the next decade, as part of the cost control and corporate restructuring effort. Furthermore, more saving means less domestic consumer spending and more production available for export.

Finally, the Federal Government can reduce the need for foreign financing by reducing the budget deficit in an orderly way. Every voter wants this, but not at his expense, so big spending cuts and tax increases seem unlikely. Perhaps the best that Congress and the Administration can do is to hold spending growth while revenues rise. This, coupled with long-run economic growth, will gradually whittle down the deficit and return to America control over its financial markets. ■

Senator SARBANES. Gentlemen, we are very pleased to have you here and I think we will proceed in the order in which I introduced you. So, Mr. Gault, we will go with you and then we will turn to Mr. Brusca and then to Mr. Gramley. We'll hear from the entire panel and then have our questioning directed to the panel as an entirety.

STATEMENT OF NIGEL GAULT, SENIOR ECONOMIST, DATA RESOURCES, INC.

Mr. GAULT. Mr. Chairman, members of the committee, thank you very much for allowing me the opportunity to testify on this important issue.

Over the past year, from second quarter 1987 to second quarter 1988, we've seen a substantial improvement in the U.S. merchandise trade deficit, nearly $40 billion at an annual rate. Over the same period, the current account deficit has improved by about $30 billion.

As a result of that improvement, the gloom about the prospects for trade improvement which gripped the foreign exchange markets in 1987 has dissipated and, buoyed by rising U.S. interest rates, the dollar climbed 20 percent against the mark and 13 percent against the yen from the end of 1987 to the end of August 1988. Since then, the dollar has slipped back, but it remains well above its yearend trough.

In these remarks I shall try to address the question of whether substantial further current account deficit reduction is in sight or whether further progress will be difficult without new policy action.

I'm afraid my views are quite gloomy. A baseline projection using a model of the current account and assuming similar real growth in the United States and its major competitors, and the dollar's real exchange rate holding at around its current level, shows the merchandise trade deficit bottoming out at around $113 billion in 1989 and the current account at around $134 billion and then deteriorating again.

This indicates strongly that further depreciation combined with restrained U.S. demand growth will be necessary to put the deficit on a sustainable path.

Before examining projections of the future, though, it is helpful to look and examine the reasons for the deterioration in the current account balance during the 1980's.

As recently as 1982, the United States actually had a small surplus, $7 billion, on current account. The huge deterioration in the merchandise deficit from $28 billion in 1981 to $160 billion in 1987 explains most of the expansion of the current account deficit to $154 billion in 1987. As the current account balance widened, so the U.S. net investment position, which in 1981 was positive at 4.6 percent of GNP, at first shrank and then in 1985 went negative. By the end of 1987, the U.S. net investment position stood at a debt of $368 billion, 8.1 percent of GNP.

I would note that there are many question marks regarding the accuracy of the data on the level of the U.S. net investment posi-

tion, but there is no doubt about the direction and magnitude of the charge in that position.

Given the extent of the deterioration in the net investment position, the U.S. investment income balance seems at first glance to have behaved remarkably well. It fell to a surplus of $20 billion by 1987, from $34 billion in 1981. Unfortunately, this overall statistic obscures a deeper underlying deterioration.

The balance was sustained from 1985 to 1987 only by temporary capital gains related to the dollar's depreciation. The balance, excluding capital gains, fell from a $34 billion surplus in 1981 to a $5 billion surplus in 1987 and, at least in the preliminary statistics, had turned into a deficit by the first quarter of 1988.

As long as the United States runs current account deficits, it will continue to deteriorate.

To analyze the reasons for the expansion of the trade deficit, I examined an adjusted measure of the trade balance, excluding food exports and petroleum imports, both of which have been affected by special factors. This adjusted measure deteriorated from a surplus of $21 billion in 1980 to a deficit of $140 billion in 1987.

The model explains the deterioration as a function of three main factors. First, the appreciation of the dollar through 1985 is assigned primary responsibility until 1986. But as the dollar fell back beginning in early 1985, the estimated contribution of that appreciation declined. By now the dollar is back close to its 1980 level, so the model would estimate that the dollar appreciation contribution should be roughly eliminated.

I would accept, though, that damage from the appreciation remains. Foreign companies that have established distribution networks and broken into the U.S. market during the period of the strong dollar will not be easily dislodged.

Even if all the appreciation effects are removed, a large deficit remains. First, spending growth in the United States in the 1980's outpaced that in the rest of the OECD by a wide margin, causing the United States to suck in imports much faster than its customers increased for demand U.S. exports. LDC spending was also weak, hit by the debt crisis.

Second, the United States continued to lose market share to import competition even aside from the deterioration that exchange rates can explain. This continues a long-term pattern of rising import penetration, reflecting the opening up of international markets and the development of new sources of supply; first Europe, then Japan, then in the 1980's the Asian newly industrializing countries, such as Korea, Hong Kong, and Taiwan. In part, this reflects a catching up of the rest of the world to U.S. levels of technology and productivity. In addition, the U.S. market is large and relatively open and therefore an inviting target for industrializing nations.

The important point for the external deficit is that merely reversing the 1980's appreciation won't be enough to cure the merchandise trade deficit because it won't offset these other adverse factors that have contributed to the widening of the deficit in the 1980's.

Still less will it eliminate the current account deficit, because of the deterioration in the net investment income balance. It's there-

fore hardly surprising that my baseline projection for the current account deficit is gloomy.

I assumed 2.5-percent real growth in the United States, Europe, and Canada, and 3.5-percent growth in Japan, translating roughly to estimates of longrun potential growth, and no change in the real exchange rate from July 1988 when the dollar stood at about 1.85 marks and 133 yen, below its late August peaks but about at current levels.

I also assumed no further trend deterioration in import penetration. The later is an optimistic assumption but may be justified. Growth in supply capacity here and abroad seems to be much more similar now than in the past. There may be little catch up in productivity and technology yet to come. Further, in certain sectors where import penetration has increased particularly rapidly in the past, it may now stabilize. For example, the Japanese are looking to increase their share in the auto market not by exporting to the United States but by expanding production facilities here.

Even under this optimistic assumption, though, the outlook is gloomy. The current account balance drops to $134 billion by 1989 but then deteriorates again, even as a proportion of GNP, exceeding $200 billion by 1992. It does so because, first, the growth gap which emerged in the 1980's never narrows. Second, import penetration may not worsen but the secular deterioration of the past is not reversed. Third, the net investment income balance steadily deteriorates as foreign debt rises to pass $1 trillion by 1992, and the investment income deficit exceeds 1 percent of GNP by 1994.

Given that these baseline assumptions do not appear to provide a sustainable path for the current account deficit, it's important to estimate what magnitude of adjustment will be necessary to achieve such a path.

It is not clear that the United States has to eliminate the deficit entirely. The debt-to-GNP ratio could be stabilized in the early 1990's at a current account deficit of around $50 billion, but it seems far to optimistic to hope that foreigners will continue to finance deficits of the current magnitude indefinitely.

The three adjustments I consider are, first, slower U.S. growth; second, faster foreign growth; and third, further dollar depreciation.

For the United States I consider 1 percent per year slower growth than in the baseline. That's 1.5 percent rather than 2.5 percent, effective mid-1988. This assumption should be considered to apply to U.S. spending growth rather than to U.S. output growth. The United States will need to maintain output growth faster than spending growth in order to produce exports and import substitutes. Slower U.S. growth of this magnitude can in the short term make only a small direct contribution to reducing the current account deficit. It contributes only $12 billion by 1990, but as the effects of slower compound growth accumulate, it helps by $31 billion by 1992 and $76 billion by 1995. Only a U.S. recession would produce a large, speedy contribution to current account deficit reduction from U.S. spending.

For foreign growth, I consider the implications of 1 percent per annum faster growth than in the baseline. That would be 4.5 percent in Japan, 3.5 percent elsewhere. Foreign economies are doing

well now, but this is probably the outer limit of what we could reasonably hope for on a sustained basis.

Since the initial value of exports is less than that of imports, and since foreign demand for U.S. exports seems to respond less to changes in income than does U.S. demand for foreign imports, the contribution of faster foreign growth is less than that of slower U.S. growth. It is just $9 billion by 1990, then $24 billion by 1992, and $60 billion by 1995.

Finally, I consider a 15 percent real exchange rate depreciation from the level of July 1988, gradually phased in through mid-1989. The initial impact here is to worsen the deficit by the familiar J curve effect, but as import and export volumes respond, the deterioration is transformed into an improvement. By improving the competitiveness of U.S. goods, the depreciation reduces the deficit by $35 billion in 1990, $92 billion in 1992, and $138 billion in 1995.

A combination of all three alternative assumptions could reduce the deficit to $50 billion by 1992 and virtually eliminate it by 1995. The net foreign debt would peak at 12 to 13 percent of GNP and investment income payments would flatten out at about 0.6 percent of GNP.

Now it may not be necessary for the United States to go all the way to eliminate the current account deficit by 1995 or indeed by any particular date. A less ambitious target for the deficit naturally implies that action on growth and depreciation need be less dramatic, or could be spread over a longer period of time, but I think that these figures indicate the order of magnitude of the action needed.

How to achieve these changes? First, let me point out that slower U.S. demand growth and exchange rate depreciation are not substitutes. They are complements. While it is certainly the case that the direct impact of slower growth on the deficit is relatively small compared with depreciation, depreciation cannot work without it. Depreciation works by expanding production of exports and import substitutes. The economy presently is very close to if not at full employment. If export and import substitute production is to expand, we must increase spending on other items more slowly. Otherwise, there simply will not be room for the extra net exports and the economy will overheat and inflation will rise. We are already seeing warning signs of this now. Further depreciation without domestic demand restraint would just make matters worse.

To achieve both depreciation and domestic demand restraint, the obvious tool—which unfortunately has not been available this year—is fiscal policy. Tighter fiscal policy restrains domestic demand and allows interest rates to come down, weakening the exchange rate. This year we are using monetary policy to restrain demand, but by raising interest rates that has had the unfortunate side effect of pushing up the dollar. We need both instruments of demand management working in combination, tighter fiscal policy and looser monetary policy, to achieve the twin objectives of noninflationary growth and a reduced external deficit.

That concludes my statement.

[The prepared statement of Mr. Gault follows:]

PREPARED STATEMENT OF NIGEL GAULT

THE OUTLOOK FOR THE U.S. CURRENT ACCOUNT DEFICIT

This year, at last, we have clear evidence of improvement in the nominal U.S. trade deficit. The second quarter merchandise trade deficit of $120 billion, at an annual rate, was still enormous but a vast improvement over the $158 billion deficit in the same quarter last year. The gloom about the prospects for trade improvement which gripped the foreign exchange markets in 1987 has dissipated and, buoyed by rising U.S. interest rates, the dollar climbed 20% against the mark and 13% against the yen between December 31, 1987, and August 31, 1988.

It is clearly important to ask whether our trade problems are behind us. Can we now look forward to a further steady decline in the merchandise and current account deficits? Or have we only achieved the easy part of deficit reduction, with substantial progress in the future unlikely without further action on exchange rates and macroeconomic policies in the United States and abroad?

Unfortunately, empirical analysis suggests that the latter is the case and that we are far from a sustainable path for the current account. In these remarks I shall attempt to examine the magnitude of the problem by utilizing DRI's model of the U.S. current account, employing assumptions about future growth in the spending and activity drivers of U.S. exports and imports (similar growth in the United States and abroad) and about the real exchange rate (no change from its July 1988 level) which broadly reflect current policies. I therefore assume that "current policy" means little further action on the U.S. budget deficit to restrain U.S. demand and no further stimulative action, beyond that already announced, in foreign economies.

The baseline projections suggest that while a healthy improvement in the current account is in prospect for 1988, the balance will deteriorate again after 1989, even under an optimistic assumption about import penetration trends. Precisely how much in the way of further adjustments is necessary depends on whether it is possible for the United States to live with deficits (at a reduced level) or whether the deficit must be eliminated. Some combination of further U.S. demand restraint, foreign expan-

sion, and dollar depreciation is, however, essential and I provide some estimates of the contribution that each could make.

SOURCES OF THE TRADE DEFICIT

In order to interpret the model's projections, it is useful to look back and examine how the model assigns the responsibility for the deterioration in the trade balance in the 1980s (Table 1). Because food exports and oil imports have been affected by special factors, I focus on the "nonfood exports less non-oil imports" merchandise trade balance, which went from a $21 billion surplus in 1980 to a $140 billion deficit in 1987 (Table 2). The model assigns part of the blame for the deterioration to the dollar's appreciation in the 1980s, but assigns most of the blame to the growth gap between the U.S. and foreign economies and to secular trends in import penetration.

The "growth gap" reflects a combination of sluggish growth in foreign economies and surging aggregate demand in the U.S. economy. European growth has been particularly weak. Spending on goods and services surged 27% in the U.S. from 1980 to 1987 but, for example, grew only 13% in France and just 7% in Germany.

The other major contributor to the widening trade gap during the 1980s is the continuation of a secular trend towards increased import penetration. That such a trend has existed historically seems indisputable. Most observers tract rising import penetration of the U.S. market to the opening up of international markets and the development of new sources of supply (first Europe, then Japan, and most recently the newly industrializing countries such as Korea, Hong Kong, and Taiwan). In addition, the LDC debt crisis has induced debtors to look to the United States as a source of export earnings.

The important lesson from the model's tracking of the deficit in the 1980s is that merely returning the real value of the dollar to its 1980 level, reversing the appreciation that occurred through February 1985, will not be enough to remove the merchandise trade deficit because it would not offset the other adverse factors that have contributed to the deficit in the 1980s.

The task of closing the current account deficit is, in turn, even more difficult because the deficits of the 1980s have transformed the U.S. into the world's largest debtor and by early 1988 had wiped out the

$20-30 billion surplus formerly earned on investment income. As long as the U.S. runs current account deficits, the investment income balance will continue to deteriorate.

BASELINE ASSUMPTIONS AND PROJECTIONS

As a starting point for analysis of the outlook for the current account balance over the next few years, I set up a baseline projection that incorporates the following assumptions:

- 2.5% real growth in the United States, Europe, and Canada, and 3.5% growth in Japan,
- 5.0% inflation in the United States and 4.0% inflation for its major trading partners.
- no change in the dollar's real exchange rate from its July 1988 level (in July the dollar averaged 1.85 marks and 133 yen),
- all additions to the U.S. net foreign debt to be financed at 7.5%
- permanent weakness in the volume of food exports, which have been damaged in the 1980s by expansion of supply abroad and will be further weakened by the 1988 drought, and
- no further trend deterioration in import penetration.

By far the trickiest assumption is whether the adverse import penetration trends will continue. Since the DRI trade equations model the increase in penetration by simple time trends, without modification they naturally produce continued deterioration. Other models have attempted a more sophisticated treatment, for example modeling the trends as a function of relative capital stock growth in the U.S. and abroad, and conclude that the growth in supply capacity here and abroad is now much more similar than in the past. In addition, one can point to sectors where import penetration has increased very rapidly in the past but is clearly likely now to stabilize or even decline. In particular, foreign automobile manufacturers, particularly Japanese, are looking to increase penetration of the U.S. market not via imports but by expanding production facilities located in the U.S. It is also worth noting that *import* markets in supplier nations are likely to open up more in the future, providing opportunities for U.S. exports. For this study, I adopt the assumption that there will be no further trend deterioration in import penetration.

Table 3 shows the model's projection under the above assumptions. The merchandise and current account deficits improve until 1989—the latter by $20 billion from 1987's peak of $154 billion—and then begin to deteriorate again.

The improvement through 1989 reflects the effects of the dollar's depreciation from early 1985 to late 1987, and also the recent improvement in growth in domestic demand in Japan and Europe. Unfortunately, part of that depreciation has now been reversed. On a broad trade-weighted basis, the dollar's July 1988 real exchange rate stood 4.6% above its July 1980 level, whereas in April 1988, it stood virtually at that level. The recent appreciation, though undesirable, is not the main problem, however. First, the assumption that U.S. and foreign demand grow at about the same rate means that the absolute difference between imports and exports tends to widen because imports are much greater than exports. The growth gap between the U.S. and foreign economies that emerged in the 1980s never narrows. Second, even though it is assumed that trend import penetration does not worsen, the inroads made in the past are not reversed. Third, the net investment income balance steadily deteriorates, as the U.S. net foreign debt accumulates.

Please note that DRI's latest current account forecast is more optimistic than my baseline projections (DRI expects the deficit to decline to $100 billion by 1990 and $77 billion by 1995) because it assumes that some of the action necessary to bring down the deficit—including a renewed dollar decline and further fiscal correction—will be forthcoming. My purpose is to illustrate whether current policies and exchange rates imply a sustainable path for the current account. The projections indicate clearly that they do not.

It is particularly unfortunate that the improvements in the trade and current account balances this year have been taken as a signal that the dollar can now rise again. The outlook for the current account indicates a need for a further dollar decline, probably to a level below its end-1987 trough. This year's dollar appreciation undoes part of the previous impetus to net exports from the 1985-87 decline.

ALTERNATIVE SCENARIOS

Given that the baseline projection does not appear to be sustainable, it is interesting to examine the effects of alternative assumptions about growth and exchange rates (Tables 4-8). First, we consider an assumption of 1% slower U.S. growth than in the baseline (effective mid-1988). This assumption

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should be considered to apply to spending growth rather than to output growth. This could reduce the current account deficit by $12 billion by 1990 and $76 billion by 1995.

Second, we consider 1% faster foreign growth than in the baseline. This reduces the deficit by $9 billion in 1990 and $60 billion by 1995. Note that slower U.S. growth helps more than faster foreign growth, because imports exceed exports and the estimated U.S.expenditure elasticity for imports slightly exceeds the foreign activity elasticity for exports. Note that the effects of the growth assumptions are small at first, but become substantial in the 1990s as the effects of compounding accumulate.

Third, we examine a 15% real dollar depreciation, put into effect gradually through mid-1989. This initially hurts the deficit, through the familiar J-curve effect, by raising import prices before import and export volumes adjust. By 1991, though, it contributes $76 billion. By 1995, it contributes $141 billion, about the same as the combination of the growth assumptions.

A combination of all three assumptions is sufficient to put the current account deficit on a declining path. The deficit drops to $96 billion by 1990 and to $6 billion by 1995. While it may be possible for the U.S. to continue to run current account deficits indefinitely, a long-term target of zero to $50 billion would seem to be reasonable. This "combined" scenario indicates the order of magnitude of the adjustments necessary to achieve that.

Note that the implied improvement in real net exports in this combined scenario is perfectly feasible. It implies that real GDP must grow about 0.8% faster than domestic spending. With real spending growth of 1.5% per annum, the implied real GDP growth rate is 2.3%, clearly within the economy's potential.

CONCLUSION

While it may neither be necessary nor desirable to eliminate the current account deficit completely, current policies and exchange rates will not achieve declining or stable deficits, even relative to GNP. More U.S. demand restraint (which can be achieved most easily by further action to reduce the budget deficit), more foreign demand expansion, and a further real depreciation are all essential elements for

a successful adjustment to declining current account deficits. Budget deficit reductions can slow domestic demand growth and at the same time allow monetary policy to ease, bringing down interest rates and allowing the dollar to decline. Dollar depreciation alone would be counterproductive—since the U.S. economy is now operating close to full capacity, it would exacerbate the trend towards higher inflation. It must be accompanied by slower growth in U.S. domestic demand so that resources can be transferred to the production of exports and import substitutes.

Table 1
Current Account Balance
Historical Data

	1980	1981	1982	1983	1984	1985	1986	1987
	Billions of Dollars							
Non-Investment Income	-29	-27	-37	-71	-126	-141	-162	-174
Merchandise	-25	-28	-36	-67	-113	-122	-145	-160
Services	5	8	8	5	-1	-4	-2	-1
Transfers	-8	-7	-9	-9	-12	-15	-15	-13
Investment Income	30	34	29	25	18	26	23	20
Current Account Total	2	7	-9	-46	-107	-115	-139	-154
Net Foreign Debt	106	141	137	89	4	-111	-269	-368
	Percent of GNP							
Non-Investment Income	-1.0	-0.9	-1.2	-2.1	-3.3	-3.5	-3.8	-3.9
Merchandise	-0.9	-0.9	-1.2	-2.0	-3.0	-3.0	-3.4	-3.5
Services	0.2	0.3	0.3	0.2	0.0	-0.1	0.0	0.0
Transfers	-0.3	-0.2	-0.3	-0.3	-0.3	-0.4	-0.4	-0.3
Investment Income	1.1	1.1	0.9	0.7	0.5	0.6	0.5	0.5
Current Account Total	0.1	0.2	-0.3	-1.4	-2.8	-2.9	-3.3	-3.4
Net Foreign Debt	3.9	4.6	4.3	2.6	0.1	-2.8	-6.3	-8.1

Table 2
The Adjusted Merchandise Trade Balance, 1980–87
(Nonfood exports less non-oil imports, billions of dollars, NIPA basis)

	1980	1985	1986	1987
Actual Balance	21	-93	-131	-140
Estimated Improvement in Deficit Without:				
Growth Differential	—	38	57	69
Exchange Rate Appreciation	—	40	60	34
Import Penetration Trends	—	31	43	54
Total	—	108	161	156

Table 3
Current Account Balance
Baseline Projection - Without Adverse Time Trends

	1988	1989	1990	1991	1992	1993	1994	1995
	Billions of Dollars							
Non-Investment Income	-134	-121	-131	-142	-153	-164	-176	-189
Merchandise	-122	-113	-123	-134	-145	-157	-170	-184
Services	2	7	8	10	12	14	17	20
Transfers	-14	-16	-17	-18	-19	-21	-22	-24
Investment Income	-3	-13	-23	-35	-48	-63	-80	-99
Current Account Total	-137	-134	-154	-177	-201	-227	-256	-288
Net Foreign Debt	-506	-639	-794	-971	-1,171	-1,398	-1,654	-1,942
	Percent of GNP							
Non-Investment Income	-2.8	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Merchandise	-2.5	-2.1	-2.2	-2.2	-2.2	-2.2	-2.2	-2.3
Services	0.0	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Transfers	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Investment Income	-0.1	-0.3	-0.4	-0.6	-0.7	-0.9	-1.1	-1.2
Current Account Total	-2.8	-2.6	-2.7	-2.9	-3.1	-3.2	-3.4	-3.5
Net Foreign Debt	-10.4	-12.2	-14.1	-16.0	-17.9	-19.9	-21.9	-23.9

Table 4
Current Account Balance
1% Per Year Slower U.S. Growth

	1988	1989	1990	1991	1992	1993	1994	1995
	Billions of Dollars							
Non-Investment Income	-134	-115	-119	-123	-124	-125	-126	-126
Merchandise	-122	-108	-112	-116	-119	-121	-123	-125
Services	2	8	9	11	14	17	20	23
Transfers	-14	-16	-17	-18	-19	-21	-22	-24
Investment Income	-3	-13	-23	-33	-45	-58	-72	-86
Current Account Total	-137	-129	-142	-156	-169	-183	-197	-212
Change From Baseline	1	5	12	21	31	44	59	76
Net Foreign Debt	-505	-634	-776	-932	-1,101	-1,284	-1,481	-1,693
	Percent of GNP							
Non-Investment Income	-2.8	-2.2	-2.2	-2.1	-2.0	-1.9	-1.8	-1.7
Merchandise	-2.5	-2.1	-2.0	-2.0	-1.9	-1.8	-1.7	-1.6
Services	0.0	0.2	0.2	0.2	0.2	0.2	0.3	0.3
Transfers	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Investment Income	-0.1	-0.3	-0.4	-0.6	-0.7	-0.9	-1.0	-1.1
Current Account Total	-2.8	-2.5	-2.6	-2.7	-2.7	-2.7	-2.8	-2.8
Change From Baseline	0.0	0.1	0.2	0.3	0.4	0.5	0.6	0.7
Net Foreign Debt	-10.4	-12.2	-14.0	-15.8	-17.6	-19.2	-20.8	-22.3

Table 5
Current Account Balance
1% Per Year Faster Foreign Growth

	1988	1989	1990	1991	1992	1993	1994	1995
	Billions of Dollars							
Non-Investment Income	-134	-117	-122	-127	-131	-134	-136	-139
Merchandise	-122	-109	-115	-121	-126	-131	-136	-141
Services	2	8	10	12	15	18	22	26
Transfers	-14	-16	-17	-18	-19	-21	-22	-24
Investment Income	-3	-13	-23	-34	-46	-59	-74	-89
Current Account Total	-137	-130	-145	-161	-177	-193	-210	-228
Change From Baseline	0	4	9	16	24	34	46	60
Net Foreign Debt	-505	-635	-780	-941	-1,117	-1,310	-1,520	-1,748
	Percent of GNP							
Non-Investment Income	-2.8	-2.2	-2.2	-2.1	-2.0	-1.9	-1.8	-1.7
Merchandise	-2.5	-2.1	-2.0	-2.0	-1.9	-1.9	-1.8	-1.7
Services	0.0	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Transfers	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Investment Income	-0.1	-0.3	-0.4	-0.6	-0.7	-0.8	-1.0	-1.1
Current Account Total	-2.8	-2.5	-2.6	-2.7	-2.7	-2.7	-2.8	-2.8
Change From Baseline	0.0	0.1	0.2	0.3	0.4	0.5	0.6	0.7
Net Foreign Debt	-10.4	-12.1	-13.8	-15.5	-17.1	-18.6	-20.1	-21.5

Table 6
Current Account Balance
15% Dollar Depreciation

	1988	1989	1990	1991	1992	1993	1994	1995
				Billions of Dollars				
Non-Investment Income..	-136	-129	-95	-68	-68	-72	-77	-82
Merchandise	-123	-119	-92	-72	-75	-81	-87	-95
Services	2	6	13	22	26	29	33	37
Transfers	-14	-16	-17	-18	-19	-21	-22	-24
Investment Income	-3	-13	-24	-33	-40	-49	-58	-68
Current Account Total ...	-138	-142	-119	-101	-109	-121	-135	-150
Change From Baseline ..	-1	-9	35	76	92	106	121	138
Net Foreign Debt........	-507	-649	-768	-869	-978	-1,099	-1,234	-1,383
				Percent of GNP				
Non-Investment Income..	-2.8	-2.5	-1.7	-1.1	-1.0	-1.0	-1.0	-1.0
Merchandise	-2.5	-2.3	-1.6	-1.2	-1.1	-1.1	-1.2	-1.2
Services	0.0	0.1	0.2	0.4	0.4	0.4	0.4	0.5
Transfers	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Investment Income	-0.1	-0.3	-0.4	-0.5	-0.6	-0.7	-0.8	-0.8
Current Account Total ...	-2.8	-2.7	-2.1	-1.7	-1.7	-1.7	-1.8	-1.8
Change From Baseline ..	0.0	-0.2	0.6	1.2	1.4	1.5	1.6	1.7
Net Foreign Debt........	-10.4	-12.4	-13.6	-14.3	-15.0	-15.6	-16.3	-17.0

Table 7
Current Account Balance
1% Slower U.S. Growth, 1% Faster Foreign Growth, and 15% Dollar Depreciation

	1988	1989	1990	1991	1992	1993	1994	1995
	Billions of Dollars							
Non-Investment Income..	-135	-120	-73	-32	-15	0	17	38
Merchandise	-123	-111	-71	-39	-26	-15	-2	14
Services	2	7	15	25	31	36	41	48
Transfers	-14	-16	-17	-18	-19	-21	-22	-24
Investment Income	-3	-13	-23	-30	-35	-39	-42	-43
Current Account Total ...	-137	-133	-96	-62	-50	-39	-24	-6
Change From Baseline ..	0	1	58	115	151	188	232	282
Net Foreign Debt	-506	-638	-734	-796	-846	-885	-909	-915
	Percent of GNP							
Non-Investment Income..	-2.8	-2.3	-1.3	-0.5	-0.2	0.0	0.2	0.5
Merchandise	-2.5	-2.1	-1.3	-0.7	-0.4	-0.2	0.0	0.2
Services	0.0	0.1	0.3	0.4	0.5	0.5	0.6	0.6
Transfers	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Investment Income	-0.1	-0.3	-0.4	-0.5	-0.6	-0.6	-0.6	-0.6
Current Account Total ...	-2.8	-2.6	-1.7	-1.1	-0.8	-0.6	-0.3	-0.1
Change From Baseline ..	0.0	0.0	1.0	1.9	2.3	2.6	3.0	3.5
Net Foreign Debt	-10.4	-12.3	-13.3	-13.5	-13.5	-13.2	-12.8	-12.1

Table 8
Effects of Alternative Growth and Exchange Rate Assumptions on the Current Account Deficit
(Billions of dollars)

	1989	1990	1991	1992	1993	1994	1995
Current Account Baseline	-134	-154	-177	-201	-227	-256	-288
Improvement in Current Account from:							
1% Per Year Slower U.S. Growth	5	12	21	31	44	59	76
1% Per Year Faster Foreign Growth	4	9	16	24	34	46	60
15% Real Exchange Rate Depreciation	-9	35	76	92	106	121	138
All Three Factors	1	58	115	151	188	232	282

Senator SARBANES. Thank you very much, Mr. Gault.
Mr. Brusca, please proceed.

STATEMENT OF ROBERT A. BRUSCA, CHIEF ECONOMIST, NIKKO SECURITIES CO. INTERNATIONAL, INC.

Mr. BRUSCA. Thank you very much for inviting me to come and speak today. What I would like to do is to just read two sections from the prepared statement that I have and I will start with this part on the current account deficit.

The U.S. current account deficit will shrink to $142 billion this year and to about $135 billion next year. Based upon the revisions reported this morning, I would tend to cut some $45 billion off of the estimates that I made at the time of this writing.

Even so, the deficit will persist as it shrinks and the U.S. net debtor status will remain, while the extent of indebtedness will worsen. Already a chain of perverse events is underway, a chain that should make us less complacent about the progress that we've made so far in the merchandise trade deficit and more eager to continue to extend the gains in trade progress that already have been made.

The U.S. current account can usefully be viewed in two ways. One is the statistical explanation of the balance under current accounting conventions. Despite being boring, this approach muddles us in an intractable web of data and accounting problems. The only useful thing to note on the accounting side is that the current account attempts to measure income flows in and out of the country. Not all of these are real. Many are estimated. Many do not reflect the movements of any funds whatsoever. Moreover, because U.S. residents hold large amounts of financial assets overseas, assets denominated in foreign currencies, wide swings in exchange rates lead to a remarking to market in the value of these assets expressed in dollar terms. This, in turn, produces wild fluctuations in the U.S. current account balance as paper capital gains and losses are washed through it—when nothing much may have happened at all. Indeed, swings of this nature have dominated our last several current account reports. While such purely statistical fluctuations are not totally meaningless, they seem to miss the spirit of what the current account is trying to measure. For that, we turn to another way of looking at the deficit.

The second view is one from the ground up. It looks at the deficit from the standpoint of what caused it and what can cure it. To strip a complicated issue down to its bare elements, we can say that the current account depends on several prime factors: relative growth rates, relative interest rates, exchange rates, the economic outlook, and certain initial conditions. Looking at the deficit in this way, in terms of the elements that affect the deficit and that are affected by policy, is probably the most useful from the standpoint of public policy. It focuses attention on things that policymakers think about and away from statistical quirks that impede an understanding of the true issues.

In broad terms, we can divide the current account deficit into two parts: Trade and services, and ignore the totally policy-determined unilateral transfers component. Newspaper headlines focus

on the trade element because it is measured 12 times a year or more, while the services balance is measured only 4 times a year and it is much more difficult to comprehend. But we must separate these two components because they are tugging the current account in different directions.

The trade deficit is narrowing because U.S. growth in consumer spending is slowing, the dollar has fallen, making U.S. producers more competitive, and the Fed is trying to keep them that way by holding inflation low; foreign direct investment is building and more products that used to be imported are being produced here with American labor; growth abroad has picked up; and oil prices have stabilized or fallen.

The services balance is turning from surplus to deficit, however, because foreign direct investment in the United States is growing and profits from those enterprises are being repatriated overseas; foreign purchases of U.S. financial assets are growing and outpayments due to dividend and coupon payments are growing; as the foreign presence in the United States grows other foreign-owned service-producing firms will locate in the United States and other services outpayments will increase too.

In conclusion, the trade balance in some sense stands alone as a policy success story—principally because of the weak dollar policy. The services balance is deteriorating because of the continuation of a current account deficit, even one that is shrinking, leads to an increase in foreign claims on the United States and lays the foundation for services outpayments that will persist for years to come. This refocuses our attention on trade and the need to contract that deficit more rapidly. Forces beyond our control are acting to balloon the services deficit. Continued progress on the trade front is therefore essential.

Now next I'd like to turn to the section on the foreign investor.

Foreigners' purchases of U.S. securities loom as an important factor in the U.S. balance of payments. Since the current account slipped into deficit in 1982, securities purchases by foreigners have comprised between 38 percent and 80 percent of the current account deficit financing. In the first quarter of this year, net securities purchases by foreigners financed 93 percent of the current account deficit by themselves. The bulk of these flows reflect bond purchases. In 1986, $19 billion out of $114 billion in net securities purchases were stocks. That's 17 percent. In 1987, $16 billion out of $79 billion were stocks. That's about 20 percent. In the first quarter of this year, less than 2 percent of the net foreign securities purchases reflected stock purchases. Bonds are the dominant security that foreign investors seek.

Purchases are hard to track by the nationality of the investor because foreign investors maintain offices in many different locations while U.S. statistics track transactions, as best they can, by the domicile of the investor, not by his nationality. As a result, any purchases of U.S. securities made through foreign subsidiaries located in the United States where those subsidiaries retain the securities are not treated as purchases by foreigners at all. Similarly, purchases by any investors located in offshore or Euromarket centers, such as Luxembourg, Switzerland, the United Kingdom, and so forth, would "appear to be" made by residents of those coun-

tries. Therefore, the answer to the question "Who is buying" is always a difficult one to answer.

Clearly, however, the capital surplus countries are doing the bulk of the purchasing. Japanese investors have been very active and through the first 4 months of this year have purchased $13 billion in Treasury notes and bonds. That's 43 percent of the total purchased by foreigners. This calculation attributes to Japanese investors only those net purchases made out of Japan itself. Another $4.1 billion of bond and note purchases came out of the United Kingdom and $1.2 billion out of Luxembourg, two prime habitats for Japanese investors with an international investment scope.

These flows are prompted by investors who seek to profit from their investments. They are therefore best understood as being subject to exactly the same factors that influence U.S. investors, except for one big difference. Foreign investors must be wary of exchange market conditions to a much greater extent than domestic investors. Realizing this, the great U.S. policy problem becomes clearer, and it is this: How can the United States improve its trade competitiveness and its trade deficit while at the same time attract the foreign capital needed to finance the deficit that will persist?

The point is that improving the trade balance is a simple thing for policy to do. Attracting foreign capital is also easy. But doing both while avoiding recession is extremely difficult. Pushing the dollar down to improve competitiveness is good for the trade balance. But while that is being done, the dropping dollar scares foreign capital out of the country, stops new inflows from arriving, and inflicts losses on holdings already amassed. Thus, the foreign investor has come to feel a little like Charlie Brown, and to see us as Lucy, ready to pull the football away just as he approaches for his big kickoff.

Foreign inflows have been erratic owing to the dollar's steady tailspin up until this year. The foreign investor principally looks at bond yield differentials when making the decision to invest. The long-term investor compounds the differential forward comparing the bond yield gain against the likely dollar decline expressed in his own currency. When foreigners are skeptical about the dollar, U.S. bond yields are pushed up and foreign yields are pushed down. Thus, the U.S. bond market has become more sensitized to exchange market events and monetary policy in general is held hostage more by what foreigners think and what foreigners want.

Thank you. That concludes the part of the prepared statement that I wanted to read.

[The prepared statement of Mr. Brusca follows:]

PREPARED STATEMENT OF ROBERT A. BRUSCA

CAUSES, CONSEQUENCES, AND RISKS OF GROWING EXTERNAL DEBT

I expect that the US current account deficit will improve gradually overtime. That is because I also expect the dollar to continue to fall and US growth to settle into a lower track. I expect that growth overseas will persist and provide a market for US produced goods. I expect that foreign direct investment will increase and help us to improve the mix of goods that we produce and export in this country. I do not expect that protectionist legislation will be passed and used to balance the current account deficit. I also expect that all these expectations will not come to pass and that we will be forced to deal with the unexpected in the not too distant future. But just because even the best laid plans go awry, that's no reason for not making them. US policy must be geared to anticipate the fallout that is likely from these circumstances.

I am not a great believer in interventionist government policies. Yet, I do believe that policy levers exist and that they can be pulled at the right time to smooth adjustments in the economy. It is also fair to criticize much of what has been done in the name of fine tuning because many policy moves made with the best intentions have worsened the problem that they set out to solve. Both economists and politicians have made mistakes. It is my hope to discuss some of today's pressing issues in a way that will make economic trade offs clearer and help to foster better policy choices. It is my deepest hope that I am not part of the destabilizing process that so often intrudes.

In our current circumstance little direct policy action seems appropriate. The economic mechanisms show signs of working and policy should be geared toward fiscal conservatism and monetary restraint. Continuing a weak dollar policy will provide enough stimulus and inflation risk to warrant a restrictive fiscal policy and a less than accommodative monetary policy. Actually it is fiscal policy that should be restrictive and monetary policy that can retain some element of flexibility while erring on the side of caution. This is the best policy mix I can think of and it requires little more than continuing as things have been and, of course, taking great care not to backslide.

Above all, policy must be careful not to be dogmatic. Flexibility in the pursuit of policy is clearly the only course of action. We have learned from our own mistakes, turning away from a no intervention policy in foreign exchange and an isolationist economic approach to an interventionist approach in early 1985 and then to a cooperative approach in early 1987. This policy, that has used both the stick and carrot in pursuit of freer trade and better opportunities for US firms abroad, has paid great dividends. It offers the opportunity for our economic expansion to continue to break records, rather than hearts. In contrast, a protectionist approach promises to help a few and to break the hearts of many.

Persisting current account deficits will have to be financed and they imply a greater indebted position for the US, and with it greater foreign ownership of US land, businesses, and financial assets. But economic analysis offers few tools to use to assess the impact of such an event. Politicians worry about it but neoclassical economics gives us no model that looks at the impact of specific types of ownership of the means of production. Apart from national security matters in selected industries, there is little to focus on as a potential for problems. Most of these concerns about foreign ownership are without foundation anyway. There was a time when we worried that the oil producing and exporting nations would "own us and the world". What came of that fear? It came to nothing!

Liberal economists used to speak of the countervailing power of unions against big business. These notions are passe. To the extent that countervailing power is applicable, it is on the national scale. It is reflected in exchange rate policy and national bargaining in trade conferences and in certain bilateral agreements. Individual firms aren't big enough to control their own domestic markets, let alone international markets. Instead, the predictions of international economic theories are coming true: given mobile capital, wages are tending to be equalized on an international scale. This is to the horror of the unskilled US worker and the delight of the poor Korean and Mexican worker. To fight it is to fight progress and development. Instead, we must accept and embrace these changes. We must focus on education and training to produce new jobs of higher quality that pay a higher wage. Our salvation will be won through our own development and hard work. We must trust in the economy's ability to provide jobs beyond our most optimistic forecasts--just as it has been doing. This approach implies a confidence in America rather than a fear of the foreigner.

With these statements as background, let me turn to your specific questions, as listed in Senator Sarbanes' letter to me dated 25 August 1988.

US CURRENT ACCOUNT OUTLOOK AND IMPACT ON DEBTOR STATUS

The US current account deficit will shrink to about $142 billion this year, and again to about $135 billion next year. Even so, the deficit will persist as it shrinks and the US net debtor status will remain while the extent of indebtedness will worsen. Already a chain of perverse events is underway, a chain that should make us less complacent about the progress that we have made so far on the merchandise trade deficit and more eager to continue to extend the gains in trade progress that already have been made.

The US current account can usefully be viewed in two ways. One is the statistical explanation of the balance under current accounting conventions. Besides being boring, this approach muddles us in an intractable web of data and accounting problems. The only useful thing to note on the accounting side is that the current account attempts to measure income flows in and out of the country. Not all of these are real. Many are estimated. Many do not reflect the movements of any funds whatsoever. Moreover, because US residents hold large amounts of financial assets overseas, assets denominated in foreign currencies, wide swings in exchange rates lead to a remarking to market in the value of these assets expressed in dollar terms. This, in turn, produces wild fluctuations in the US current account balance as "paper" capital gains and losses are washed through it--when nothing much may have happened at all! Indeed, swings of this nature have dominated our last several current account reports. While such purely statistical fluctuations are not totally meaningless, they seem to miss the spirit of what the current account is trying to measure. For that we turn another way of looking at the deficit.

The second view is one from the ground up. It looks at the deficit from the standpoint of what caused it and what can cure it. To strip a complicated issue down to its bare elements, we can say that the current account depends on several prime factors: relative growth rates, relative interest rates, exchange rates, the economic outlook and certain initial conditions. Looking at the deficit in this way, in terms of the elements that effect the deficit and that are affected by policy, is probably the most useful from the standpoint of public policy. It focuses attention on things that policy makers think about and away from statistical quirks that impede an understanding of the true issues.

In broad terms, we can divide the current account deficit into two parts: trade and services, and ignore the totally policy-determined unilateral transfers component. Newspaper headlines focus on the trade element because it is measured 12 times a year (or more) while the services balance is measured only 4 times a year and it is much more difficult to comprehend. But we must separate these two components because they are tugging the current account in different directions.

TRADE DEFICIT: Is narrowing because, (1) US growth in consumer spending is slowing, (2) the dollar has fallen, making US producers more competitive, and the Fed is keeping them that way by holding inflation low, (3) foreign direct investment is building and more products that used to be imported are being produced here with American labor, (4) growth abroad has picked up, (5) oil prices have stabilized or fallen.

SERVICES BALANCE: Is turning from surplus to deficit because, (1) foreign direct investment in the US is growing and profits from these enterprises are being repatriated overseas, (2) foreign purchases of US financial assets are growing and out-payments due to dividend and coupon payments are growing, (3) as the foreign presence in the US grows other foreign-owned and service-producing firms will locate in the US and other services out-payments will increase too.

IN CONCLUSION: The trade balance, in some sense stands alone as a policy success story--principally because of the weak dollar policy. The services balance is deteriorating because the continuation of a current account deficit, even one that is shrinking, leads to an increase in foreign claims on the US and lays the foundation for services out-payments that will persist for years to come. This refocuses our attention on trade and the need to contract that deficit more rapidly. Forces beyond our control are acting to balloon the services deficit. Continued progress on the trade front is essential.

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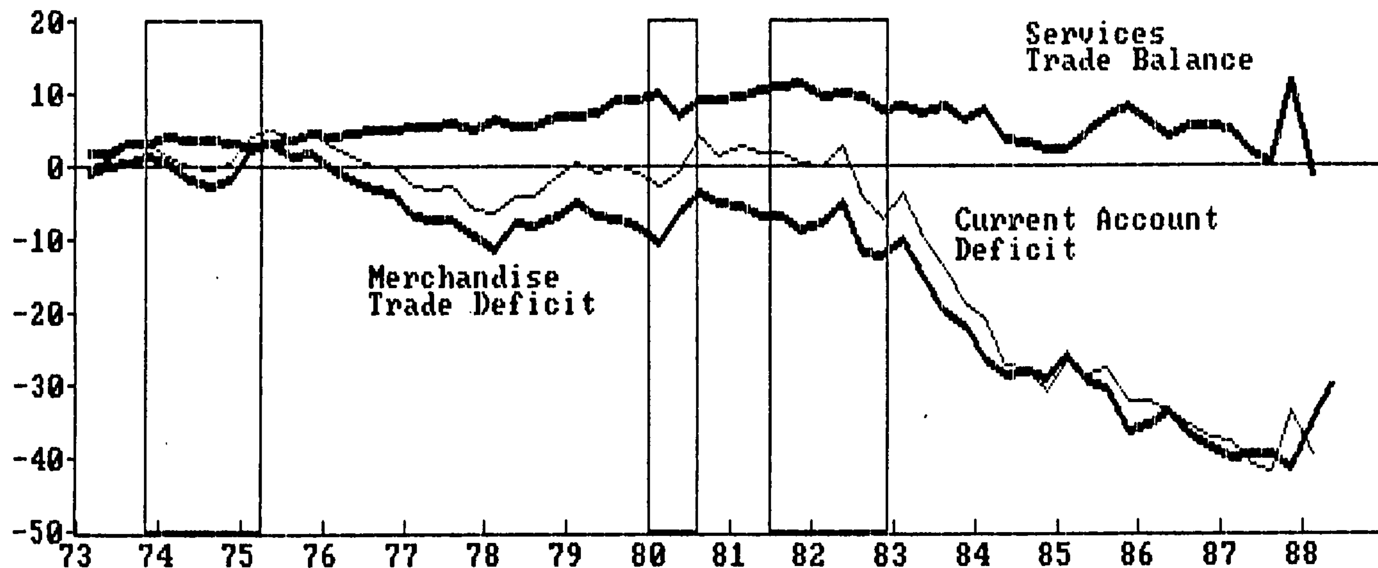

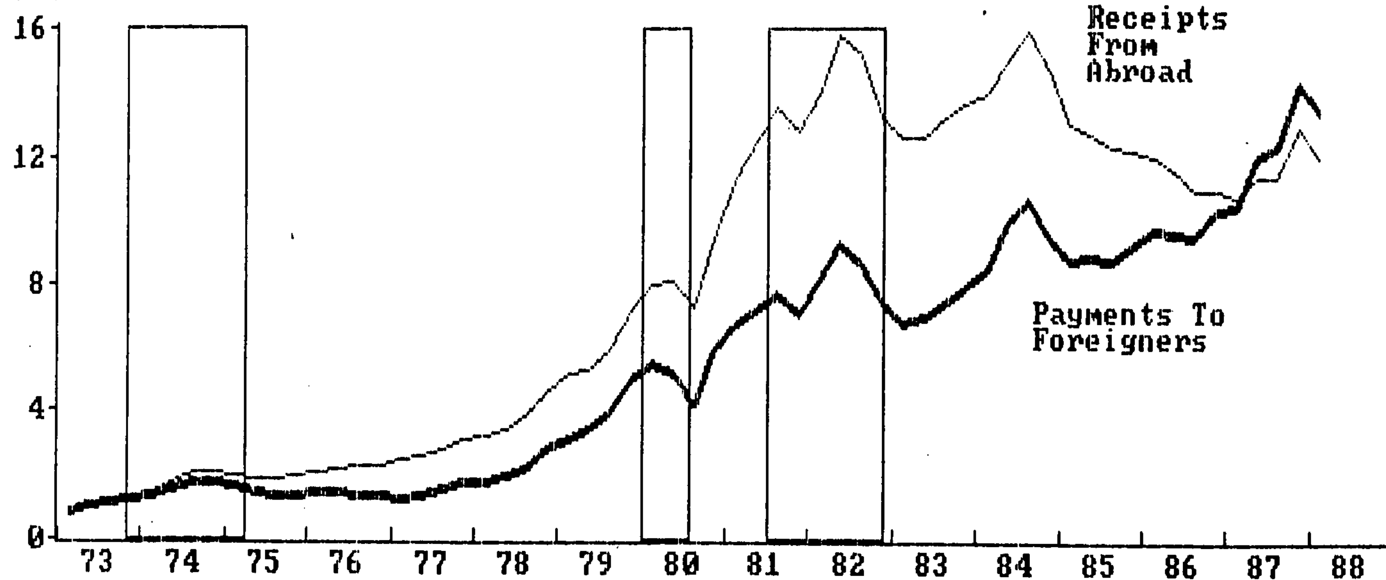
SECURITIES INVESTMENT INCOME
$ Billion
16
12
8
4
0
Receipts From Abroad
Payments To Foreigners
73
74
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77
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83
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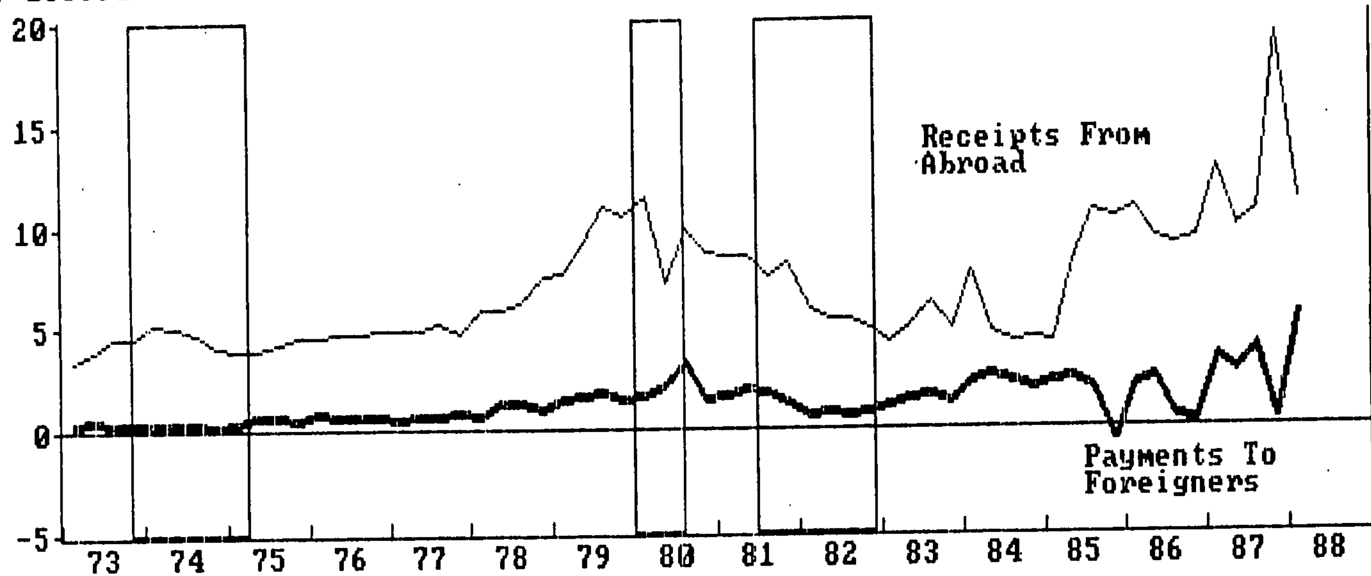
85
86
87
88


DIRECT INVESTMENT INCOME
$ Billion
20
15
10
5
0
-5
73
74
75
76
77
78
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81
82
83
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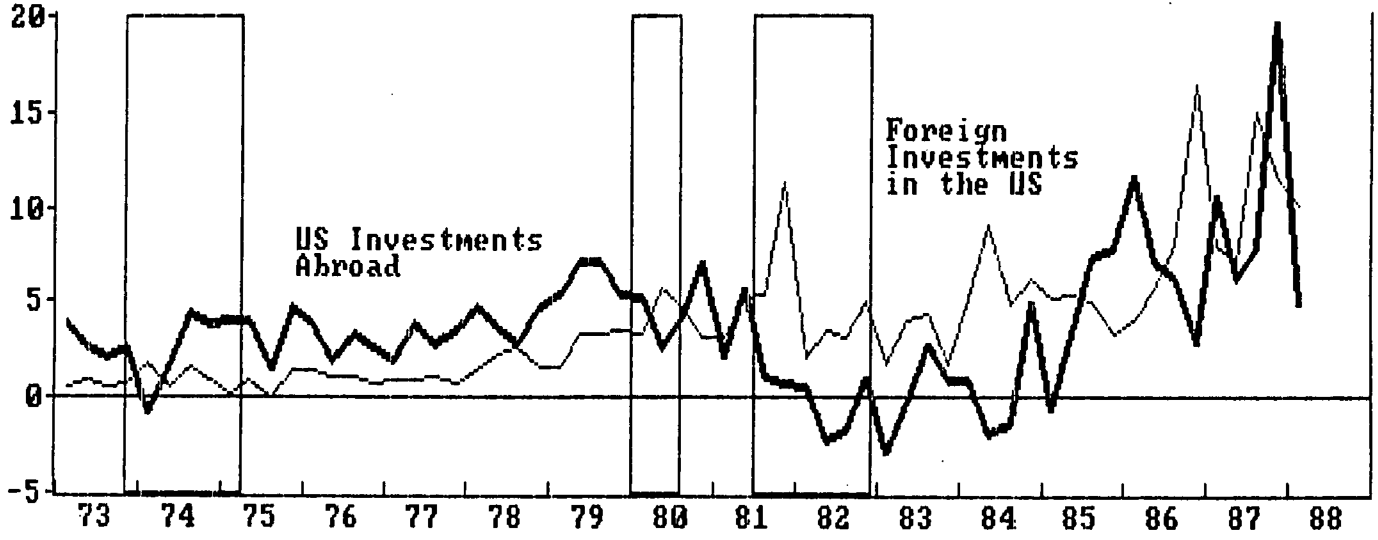
Receipts From Abroad
Payments To Foreigners



DIRECT INVESTMENTS
(Capital Account Item)
$ Billion
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10
5
0
-5
73
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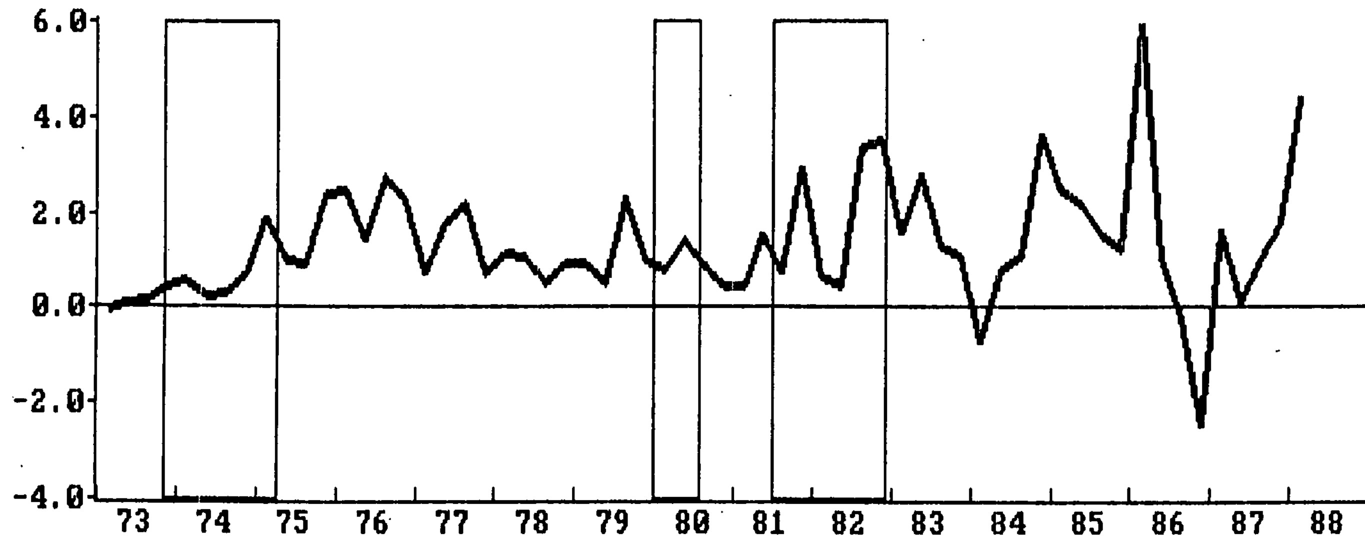
85
86
87
88
US Investments
Abroad
Foreign
Investments
in the US


US INVESTMENT IN FOREIGN SECURITIES
(Capital Account Item)
$ Billion
6.0
4.0
2.0
0.0
-2.0
-4.0
73
74
75
76
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86
87
88

Role Of The Foreign Investor

Foreigners' purchases of US securities loom as an important factor in the US balance of payments. Since the current account slipped into deficit in 1982 securities purchases by foreigners have comprised between 38% to 80% of the current account deficit financing. In the first quarter of this year net securities purchases by foreigners financed 93% of the current account deficit by themselves. The bulk of these flows reflect bond purchases, in 1986 $19 billion out $114 billion in net securities purchases were stocks (17%); in 1987 $16 billion out of $79 billion were stocks (20%); in the first quarter of this year less than 2% of the net foreign securities purchases reflected stock purchases. Bonds are the dominant security that foreign investors seek.

Foreign Investor Purchases of US Securities

	1980	1981	1982	1983	1984	1985	1986	1987	1988QI
Total	17.8	15.2	19.2	24.3	40.6	70.6	113.6	79.3	36.9
(% of Current Acc't. Deficit)	-*	-*	(71)	(58)	(38)	(61)	(80)	(49)	(93)
Central Banks									
Treasuries	9.7	5.0	5.7	7.0	4.7	-0.8	34.5	43.3	27.6
(% of Fgn Securities Purch.)	(55)	(33)	(30)	(20)	(12)	-	(30)	(55)	(75)
By Others									
Treasuries	2.6	3.0	7.1	8.7	23.1	20.4	8.3	-6.1	7.0
Other Securities	5.5	7.2	6.4	8.6	12.8	51.0	70.8	42.1	2.3

* Surpluses

Purchases are hard to track by the nationality of the investor because foreign investors maintain offices in many different locations while US statistics track transactions (as best they can) by the domicile of the investor, not by his nationality. As a result any purchases of US securities made through foreign subsidiaries located in the US, where those subsidiaries retain the securities, are not treated as purchases by foreigners. Similarly, purchases by any investors located in offshore or Euromarket centers such as Luxembourg, Switzerland, the UK, etc. would "appear to be" made by residents of those countries. Therefore, the answer to the question "Who is buying" is always a difficult one to answer.

Clearly, however, the capital surplus countries are doing the bulk of the purchasing. Japanese investors have been very active and, through the first four months of this year, have purchased $13 billion in Treasury notes and bonds, 43% of the total purchased by foreigners. This calculation attributes to Japanese investors only those net purchases recorded as made out of Japan itself. Another $4.1 billion of bond and note purchases came out of the UK and $1.2 billion out of Luxembourg, two prime habitats for Japanese investors with an international investment scope.

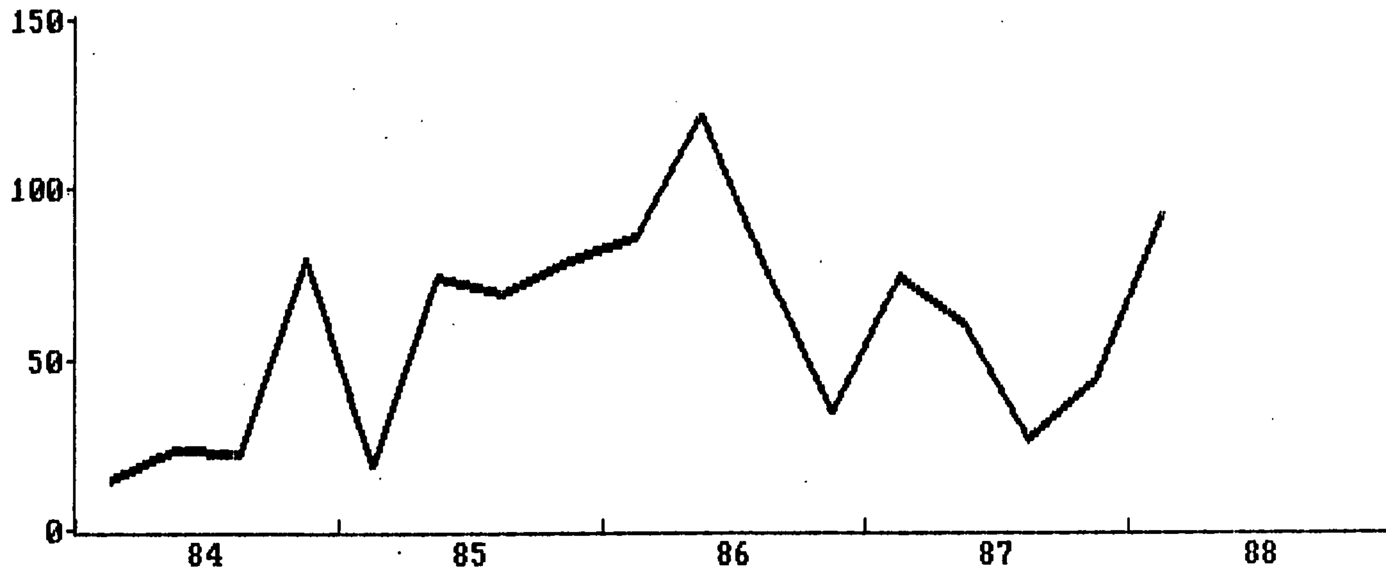
These flows are prompted by investors who seek to profit from their investments. They are therefore best understood as being subject to the same factors that influence US investors--except for one big difference. Foreign investors must be wary of exchange market conditions to a much greater extent than domestic investors. Realizing this, the great US policy problem becomes clearer, it is this:

> How can the US improve its trade competitiveness, and its trade deficit, while at the same time attract the foreign capital needed to finance the deficit that will persist?

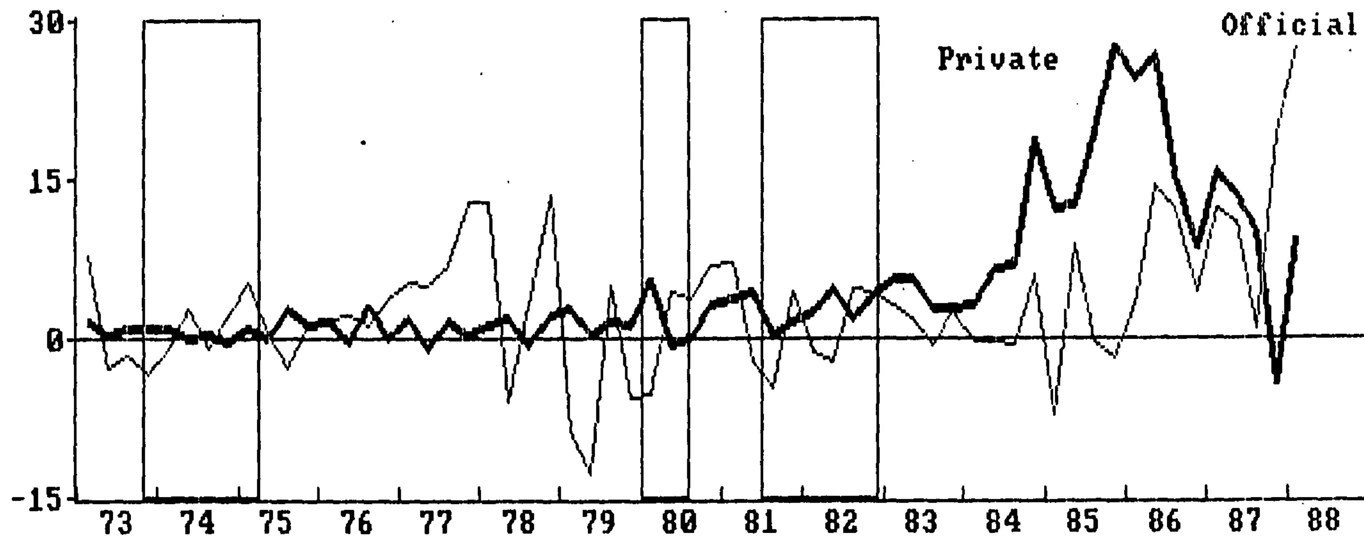
The point is that improving the trade balance is simple. Attracting foreign capital is easy. Doing both while avoiding recession is very difficult. Pushing the dollar down to improve competitiveness is good for the trade balance. But while that is being done, the dropping dollar scares foreign capital out of the country, stops new inflows from arriving, and inflicts losses on holdings already amassed. Thus the foreign investor has come to feel a little like Charlie Brown, and to see us as Lucy, ready to pull the football away just as he approaches for his big kick-off.

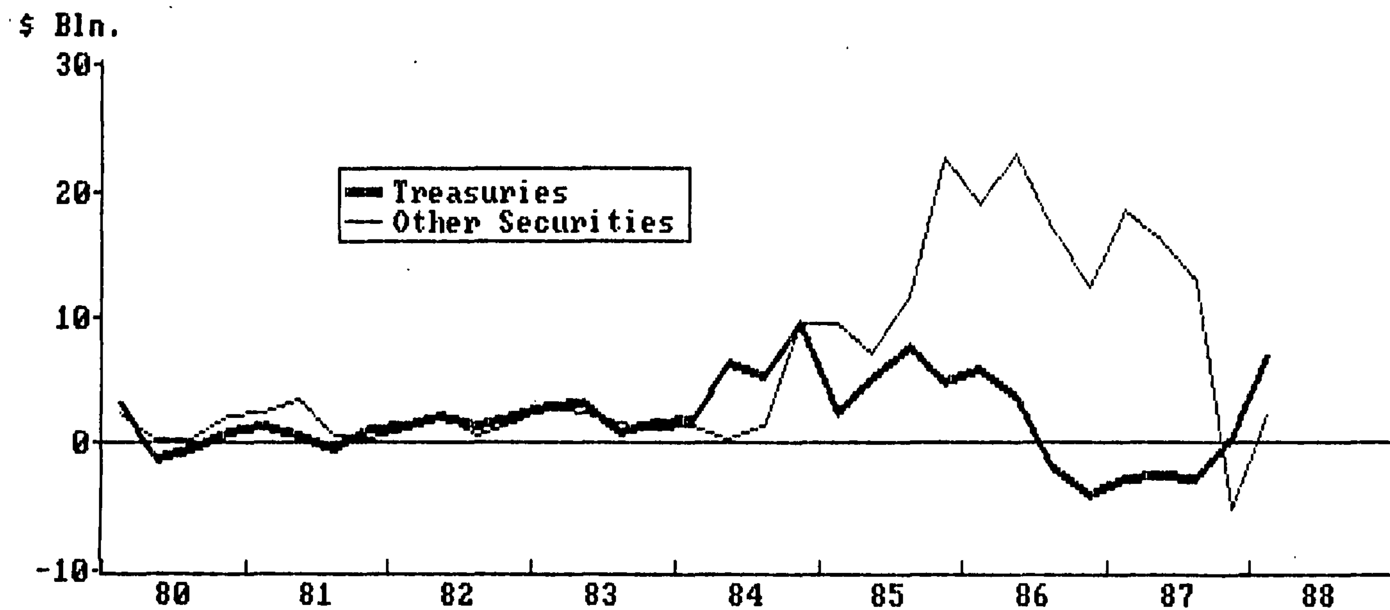
Foreign inflows have been erratic owing to the dollar's steady tail-spin up until this year. The foreign investor principally looks at bond yield differentials when making the decision to invest. The long term investor compounds the differential forward comparing the bond yield gain against the likely dollar decline expressed in his own currency. When foreigners are skeptical about the dollar, US bond yields are pushed up (foreign yields pushed down). Thus the US bond market has become more sensitized to exchange market events and monetary policy in general is held hostage more by what foreigners think and want.

FOREIGN PURCHASES OF US SECURITIES AS % OF CURRENT ACCOUNT BALANCE



FOREIGN INVESTMENT IN US SECURITIES
(Capital Account Item)





FOREIGN SECURITIES INVESTMENT IN THE US
$ Bln.
30
20
10
0
-10
Treasuries
Other Securities
80
81
82
83
84
85
86
87
88

Shifting Foreign Demand For Bonds: Its Impact On Housing

Certainly the rapid turnabout in the dollar's fortunes, capital flows, and in foreign investor perceptions of US policy have an impact on the US markets. Greater volatility in bond prices is likely one result. But the counterpoint comes when we ask the question, "what would take the place of this foreign capital?" Without foreign capital, in a "closed economy" to use an expression, interest rates would have been much higher long ago and would have stopped the recovery dead in its tracks long ago. Some increase in volatility is a small price to pay for the extra funding that has bought us time in our adjustment.

From this perspective, foreign inflows have helped to reduce interest rates and to keep housing affordable. But at this point in our economic expansion, jittery foreigners may begin to force somewhat higher interest rates to prevail; on balance this will help keep a credible inflation fight intact. Moreover, should the US economy weaken, foreigners would accept lower rates in the absence of an inflation threat. The foreigner is not a nefarious usurer, just careful under current circumstances with virtually all the inflation indicators flashing warning signals (until very recently).

Housing will be less affected than in the past by all these events because of the introduction of variable rate mortgages. Unless the Federal Reserve takes short rates higher as part of a concerted policy move, variable rate mortgages will allow a steady flow of credit to potential home buyers. This implies little effect on financing rates from any interest rate premium foreign investors might demand in the bond market itself.

Consequences for Federal Reserve of Shifting Foreign Demand For Bonds

The variability that increased reliance on foreign capital brings to the bond market is harmful in the sense of its muddling the signals given off by the bond market—signals that the central bank likes to read. But, in truth, I see little difficulty that this volatility poses. For the most part we should be happy that foreign capital is there to help satisfy our voracious appetite for credit.

The reliance by foreigners on bonds as investments does help to tie US monetary policy a bit more tightly to monetary policy abroad through the exchange market and bond market arbitrage. Of course, the academic framework is that monetary policy is more independent when exchange rates float. This is true, but we do not now have a pure float. In particular there is a perception of some desired band for exchange rates. Fixed rate-like effects can be produced when the dollar reaches the extremes of this band, as happened at the end of 1987. The bond markets, more so than eurocurrency markets, have simply become the conduits for these economic effects to flow through.

If there is an important impact on the Fed it is not because of shifting foreign demand but because foreigners will be looking at US policy in general, trying to assess monetary policy, the inflation outlook, and the outlook for the dollar all at once. The foreigner is a more fundamentally oriented investor, interested in not just what the Fed will do today but what its actions will do to the inflation rate and the dollar tomorrow. To the extent that one set of investors dominates the scene, monetary policy in that country will be similarly affected as the international investor focuses on <u>relative</u> interest rates, <u>relative</u> inflation rates, etc.

In short, I see no particular significance from foreign involvement in US bonds other than the fact that without it US policy would already have been greatly tempered. In the future, however, policy is likely to be more tempered by the foreigner who, by this time, has built up a far larger stake in our market and will be even more affected by financial events here in the US.

Foreign Central Banks and The Financing of the US Deficit

I don't understand this last question. Foreign central banks did not finance "virtually all" of the US current account deficit in 1987. The $154 billion deficit compares to a net change in foreign official assets in the US of $45 billion, about one third of the deficit--a big chunk--but hardly "virtually all" of it. That is unless we are to abandon virtue entirely!

If the point is to discuss the significance of that intervention, that I can do. Financing of the US deficit by foreign central banks simply means that the current constellation of market interest rates and exchange rates does not suffice to bring private capital flows to finance the existing current account deficit. Official inflows, which are the proceeds from foreign exchange intervention, suggest that US interest rates needed to be higher or that the dollar needed to be lower at that time. Of course, compared to its average value, the dollar did fall in 1988 from its level of 1987.

But sometimes the markets and policy suffer from a credibility problem and foreign exchange intervention does not reflect hard-headed and wrong-headed central banks but rather a productive exercise. Indeed, from the end of last year the dollar has risen. Long term interest rates have fallen and have risen back to where they were at year end 1987. The US current account since has become self financing--probably over financed--judging from the dollar's strength and the opposite flow of intervention that we have seen this year.

I do not view this financing, or the intervention that brought it, to be a bad thing. It is simply the manifestation of international cooperation. Of all the policy tools at the disposal of central banks, this one can be employed the quickest, even if it is the least effective of all policy tools available. Intervention is a lot like bailing water out of a boat. It can be useful but it is better to fix the leak. Central banks have combined their "bailing" activities with real leak-fixing as domestic policies have swerved in concert with the intervention. That is why the intervention has worked. Europeans place more emphasis on the role of intervention compared to American economists. One way to view it is that intervention is like a handshake with them and so we should cooperate and try to be friendly. Shaking hands won't make them our friends but failing to shake hands could make them our enemies. Viewed in this way, intervention activity has a policy role in the US. It buys time. It fosters friendship instead of making enemies. And, any adverse economic effects that stem from intervention, can be offset by monetary policy. It's a "no lose" proposition.

Senator SARBANES. Thank you very much Mr. Brusca. Your full prepared statement will be included in the record and I note that there are subsequent sections on the shifting foreign demand for bonds, its impact on housing, the consequences for the Federal Reserve of this shifting foreign demand for bonds, and the foreign central banks in the financing of the U.S. deficit.

Mr. Gramley, please proceed.

STATEMENT OF LYLE E. GRAMLEY, SENIOR STAFF VICE PRESIDENT AND CHIEF ECONOMIST, MORTGAGE BANKERS ASSOCIATION OF AMERICA

Mr. GRAMLEY. Thank you, Mr. Chairman.

During 1988, the U.S. current account deficit will decline by $30 billion or so from its record level of $154 billion in 1987. This reduction is a result of the turnaround in our merchandise trade deficit underway since late 1986. In constant dollar terms, the improvement in the trade balance began in the fourth quarter of 1986, continued in 1987 and accelerated in the first half of 1988. In current dollar terms, the improvement was delayed until early this year, but recently the current dollar merchandise trade deficit has also declined markedly.

This turnaround in trade flows has reinvigorated the U.S. economy. From mid-1984 to the end of 1986, real GNP rose at an annual rate of a little over 2.5 percent. During the past six quarters, the annual growth rate was 4.5 percent. Growth recorded a 5-percent rate over the four quarters of 1987 and then slowed to a 3.3-percent annual rate in the first half of this year. This slowdown, however, partly reflected the impact of the drought on farm output and partly a switch from rising nonfarm inventory investment in 1987 to declining inventory investment this year. Final sales in the nonfarm sector of the economy grew at an annual rate of 6.2 percent in the first half of this year, compared to 3.4 percent over the four quarters of 1987.

The U.S. economy is thus growing very strongly as a result of the stimulus of an improving merchandise trade deficit.

As Mr. Gault indicated in his testimony, continued reduction in the U.S. trade deficit will require a substantial slowdown in the rise of domestic aggregate demand. That process has begun, but it has not gone far enough to keep GNP growth down to a sustainable longrun pace. The consequence is that wage and price pressures have begun to increase and they are likely to intensify more over the remainder of this year and on into 1989 unless the rise of GNP slows to its long-term potential growth rate, which is around 2.25 to 2.5 percent. I doubt that this will happen without further economic policy measures designed to restrain the rate of economic expansion.

It would be far better for the health of the U.S. economy, and the world economy as well to apply the fiscal, rather than the monetary brakes. A reduction in the Federal deficit would encourage a slowdown in domestic aggregate demand, and thus release resources to permit an expansion of exports without resort to higher interest rates. That would be good for housing. It would also en-

courage more business fixed investment, enlargement of the capital stock, and higher productivity gains.

In the absence of such fiscal actions, the Federal Reserve has had no choice but to apply the monetary brakes. Gradual measures of monetary restraint were taken this past spring and the Fed took the more decisive step of raising the discount rate in early August. In my judgment, further tightening actions by the Federal Reserve will be needed to slow economic growth to a noninflationary pace and that will mean higher interest rates.

If interest rates rise further in 1988, is the reduction in net inflows of capital associated with the decline in the current account deficit the cause of that increase? A better way to interpret the interest rise, I think, is to attribute it to the economy's rapid growth, which is in turn being caused by the reduction in the merchandise trade deficit. Such an interpretation seems to me preferred because, while actual net capital inflows to the United States are declining this year, the amount of private capital seeking investment in the United States has been rising.

This is evident from the fact that the dollar's exchange value, after declining during most of 1987 and the first few months of this year, has since recovered to a level above that prevailing at the end of 1987. This rise in the dollar has occurred despite sizable amounts of exchange market intervention by central banks here and abroad to dampen the dollar's rise and despite increases in interest rates in Western Europe whose principal purpose was to discourage outflows of funds from Europe to the United States.

Does the renewed inflow of private capital in 1988 and the dollar's recent strength take the heat off the Federal Reserve to raise domestic interest rates? Under present circumstances, it does not. Private capital inflows tend to be heavily concentrated in long-term bonds, common stocks and direct investment in real assets. Increased demand for those assets by foreigners raises their price and decreases the cost of capital. This tends to encourage more real investment in the United States and to some degree more consumption as well. Coming at a time when the Fed is trying to avoid domestic economic overheating, this tends to make the Fed's job harder and not easier.

The trend of desired private capital inflows in 1988 contrasts sharply with developments in 1987 when desired capital inflows were far below the amount needed to finance the current account deficit. The dollar's value in exchange markets was hammered down by market forces, despite large amounts of intervention by central banks here and abroad.

The available data do not support the view that central banks' purchases of dollars financed virtually all of last year's current account deficit. They indicate that private sources accounted for about 60 percent, and official sources the remaining 40 percent, of recorded net capital inflows into the United States. It is quite possible that some official sources of net capital inflow were incorrectly recorded as private capital inflows and therefore that official sources may have accounted for perhaps more than half of total recorded net capital inflows last year. It seems very doubtful to me, however, that official sources financed the entire 1987 current account deficit.

Last year's weakness in private capital inflows to the United States posed a different set of issues for monetary policy than those the Fed encountered in 1988. During the summer and early fall months of 1987, the Fed was tightening monetary policy to ward off the threat of domestic economic overheating and also to counter weakness in the dollar. At that time, foreign and domestic objectives of monetary policy were consistent with one another.

Earlier last year, the Fed had tightened monetary policy for reasons that seem to have been largely related to the decline in the value of the dollar. In adopting restraining measures under those circumstances, the Fed was adopting a course of monetary policy that it might not have chosen based solely on shortrun domestic economic objectives. And to that extent, the domestic and international objectives of monetary policy were inconsistent with one another in the short run.

For this reason, the Fed has come in for some criticism because of the more restrictive policies it adopted last year. More generally, it is sometimes argued that the Federal Reserve should focus exclusively on domestic economic objectives, particularly on controlling inflation, and ignore the dollar's exchange value.

I do not share this view. Maintenance of confidence in the value of a nation's currency is a legitimate, indeed vital, concern of central bank policy. Major downward pressures on the dollar are justifiably a matter of concern to the Federal Reserve, and they may at times require the Fed to adopt a more restrictive course of policy than would be indicated by shortrun domestic economic policy objectives.

This kind of potential conflict between monetary policy objectives is perhaps most likely to occur in situations like 1987, when the U.S. current account deficit was large and signs of a forthcoming reduction were hard to discern. But changes in the willingness of investors to hold dollar-denominated assets could give rise to serious problems for the United States and for monetary policy under other circumstances as well.

Funds can move from one country's financial markets to those of another country with lightning speed and in enormous amounts. The United States is particularly susceptible to such capital movements because U.S. financial markets have for many years been larger and more well developed than those of other leading countries. The United States has been acting as a financial intermediary to the rest of the world. In the process, some foreigners have borrowed heavily in the United States, while others have accumulated substantial claims against the United States. At the end of 1987, total foreign assets in the United States totaled $1.5 trillion, of which $1.25 trillion were assets in private hands. Roughly $1 trillion of those private claims were financial assets which could be sold quickly and the proceeds moved to other financial markets if foreigners perceived the United States to be a less attractive place to invest.

Sharp changes in the net amount of capital seeking investment in the United States can have upsetting effects on the U.S. economy. They can raise or lower long-term interest rates and stock prices, increase or decrease activity in housing, accelerate or retard the pace of economic expansion, and raise or lower the inflation

rate. These effects can occur, of course, in other countries as well as our own. Clearly, international capital flows complicate the task of running monetary policy here and abroad, but there is no simple formula by which the Federal Reserve or other central banks can take the effects of such shifts in capital flows into account.

The experience of recent years, however, does indicate that the United States and other large countries need to avoid policy actions that generate large changes in desired amounts of investment in their respective economies and wide swings in exchange rates. In particular, the United States must avoid repeating the mistakes of economic policy that permitted inflationary pressures to build in the late 1970's, but it must also adopt the necessary fiscal measures to reduce, and ultimately eliminate, the Federal budget deficit.

That completes my statement, Mr. Chairman. Thank you very much.

[The prepared statement of Mr. Gramley follows:]

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PREPARED STATEMENT OF LYLE E. GRAMLEY

Mr. Chairman and Members of the Committee, my name is Lyle E. Gramley. I am Chief Economist of the Mortgage Bankers Association of America.

I am not an expert in matters of international trade and finance. My field of specialization in economics is on the domestic side, and particularly in economic forecasting and monetary policy. I will confine my comments, therefore, to the effects of foreign capital inflows on interest rates in the United States and the dollar's value in exchange markets -- and through that route to their effects on the economy and monetary policy.

Last year, the current account deficit in the United States (U.S.) reached $160 billion and amounted to 3 1/2 percent of the Gross National Product. This figure of $160 billion also measures the net inflow of capital to the U.S. from nonresidents, since it represents the excess of what we spend abroad to purchase goods and services from what we receive from sales of goods and services to foreigners, an excess financed by borrowing from abroad. As recently as five years earlier, the current account deficit and the net inflow of capital to the U.S. were negligible. During this very short period of time, the U.S. went from a net creditor country to a net debtor country in terms of the balance between total U.S. claims on foreigners and total claims by foreigners on the U.S.

During 1988, the U.S. current account deficit will decline by perhaps $30 billion or possibly more. This reduction is a result of

the turnaround in our merchandise trade deficit that has been underway since late 1986. The dollar's decline in exchange markets since early 1985, together with impressive improvements in productivity and cost control in the manufacturing sector, have restored the competitive position of U.S. industry in world markets. Exports are booming, and imports -- although still generally rising-- are no longer flooding into the country as they were a few years ago. In constant dollar terms, the improvement in our merchandise trade balance began in the fourth quarter of 1986, continued in 1987, and accelerated in the first half of 1988. In current dollar terms, the improvement was delayed until early 1988, because import prices were rising faster than export prices. Since the fourth quarter of last year, however, the current dollar merchandise trade deficit has also declined markedly.

The turnaround in trade flows underway during the past year and a half has reinvigorated the U.S. economy. From mid-1984 through the end of 1986, real GNP rose at an annual rate of a little over 2 1/2 percent. During the past six quarters, the annual growth rate was 4 1/2 percent. Growth recorded a 5 percent rate over the four quarters of 1987, and then slowed to a 3.3 percent in the first half of this year. This slowdown, however, partly reflected the impact of a drought on farm output and partly a switch from rising nonfarm inventory investment in 1987 to declining inventory investment this year. Final sales in the nonfarm sector of the economy grew at an annual rate of 6.2 percent in the first half of

this year, compared to 3.4 percent over the four quarters of 1987.

The U.S. economy is thus growing very strongly as a result of the stimulus from an improving merchandise trade deficit. Manufacturing output is rising faster than capacity to produce, and with profits also increasing, the manufacturing industry has stepped up its investment in plant and equipment. The increase in investment in equipment has been particularly impressive. During the first half of this year, purchases of durable equipment by all U.S. businesses rose at an annual rate of 20 percent.

Continued reduction in the U.S. trade deficit will require a substantial slowdown in the rise of domestic aggregate demand. That process has begun. Residential investment has been generally declining since late 1986; growth of personal consumption expenditures has been substantially slower over the past six quarters than it was earlier in the expansion, and defense purchases have been flat since the middle of last year. The resulting moderation in the rise of overall domestic aggregate demand, however, has been insufficient to keep GNP growth down to a sustainable long-run pace. The consequence is that wage and price pressures have begun to increase, and they are likely to intensify more over the remainder of this year and on into 1989.

As yet, the upturn in inflation is of moderate proportions. For

example, consumer prices excluding food and energy increased at an annual rate of 4.7 percent in the first seven months of 1988, compared with 4.3 percent in the same period a year earlier. But comparisons of wage and price behavior with a year earlier are going to worsen further unless the rise of real GNP slows to about its long-term potential growth rate, which is around 2 1/4 to 2 1/2 percent. I doubt that this will happen without further economic policy measures designed deliberately to slow the expansion of domestic aggregate demand. My judgment is that the U.S. economy still has a good head of steam, and will continue to grow too fast until the economic brakes are applied more severely.

It would be far better for the health of the U.S. economy, and the world economy as well, to apply the fiscal, rather than the monetary, brakes. A reduction in the Federal deficit, while trade and current account deficits are declining, would encourage a slowdown in domestic aggregate demand, and thus release resources to permit an expansion of exports, without resort to higher interest rates. That would be good for housing. It would also encourage more business fixed investment, enlargement of the capital stock, and higher productivity gains.

In the absence of such fiscal actions, the Federal Reserve has had no choice but to apply the monetary brakes. Gradual measures of monetary restraint were taken this past spring, and the Fed took the more decisive step of raising the discount rate in early August.

In my judgment, further tightening actions by the Federal Reserve will be needed to slow economic growth to a noninflationary pace. That will mean still higher interest rates.

Long-term Treasury bonds now yield a little over 9 percent, compared with less than 8 1/2 percent in late February and early March of this year. I believe the long bond rate will have to go up to about 10 1/2 percent to bring down economic growth to the 2 1/4 to 2 1/2 percent range. I expect, therefore, that housing activity in our country will be generally declining over the next year. That is not a happy prospect, but it is, I believe, a realistic expectation.

If interest rates continue to rise over the remainder of the year, is the reduction in net inflows of capital associated with the decline in the current account deficit the cause of the increase? A better way to interpret the interest rate increase, I believe, is to attribute it to the economy's rapid growth, which is in turn being caused by the reduction in the merchandise trade deficit. Such a interpretation is preferred, I believe, because while actual net capital inflows to the U.S. are declining this year, the amount of private capital seeking investment in the United States has been rising.

This is evident from the fact that the dollar's exchange value, after declining during most of 1987 and the first few months of this year, has since recovered to a level above that prevailing at the end of 1987. This rise in the dollar has occurred despite sizable amounts

of exchange market intervention by central banks here and abroad to dampen the dollar's rise, and despite increases in interest rates in Western Europe whose principal purpose was to discourage outflows of funds from Europe to the United States.

I am sometimes asked whether the renewed inflow of private capital in 1988, and the dollar's recent strength, take the heat off the Federal Reserve to raise domestic interest rates. The logic behind this question is clear enough. A rising dollar will eventually slow the improvement in the trade deficit, and this will help to cool off the economy. Moreover, a rising dollar helps to hold down inflation. Given lags in the adjustment of trade patterns to exchange rate changes, however, the effect on trade flows of the recent strength in the dollar is not likely to happen before late 1989 or early 1990. And the direct anti-inflationary benefits stemming from the dollar's current increase in value are likely to be small, just as were the direct inflation-raising effects of the dollar's decline from early 1985 until this spring.

The principal significance for monetary policy of this year's renewed private capital inflow to the U.S. is found in another line of reasoning. Private capital inflows tend to be heavily concentrated in long-term bonds, common stocks and direct investment in real assets. Increased demand for those assets by foreigners raises their price and decreases the cost of capital. This tends to encourage more real investment in the U.S. and to some degree more consumption as well.

Coming at a time when the Federal Reserve is concerned about domestic economic overheating, this tends to make the Fed's job of cooling off the economy harder, not easier.

The trend of desired private capital inflows in 1988 contrasts sharply with developments in 1987. In that year, desired capital inflows were far below the amount needed to finance the current account deficit of $160 billion. The weakness in foreign demands for dollar-denominated assets partly reflected the fact that the improvement in the trade balance then in process was not perceived; in part, also, foreigners were discouraged by the failure of the U.S. to adopt Federal budget deficit reducing measures. The dollar's value in exchange markets was hammered down by market forces, despite large amounts of intervention by central banks here and abroad.

One heard rumors in 1987 that central bank purchases of dollars were financing virtually all of that year's current account deficit. The available data do not support that view. They indicate that private sources accounted for about 60 percent, and official sources the remaining 40 percent, of recorded net capital inflows into the U.S. in 1987. It is quite possible that some official sources of net capital inflow were recorded in the statistics as private capital flows, and that official sources may have accounted for more than half of total recorded net capital inflows in 1987. It is very doubtful, however, that official sources financed the entire 1987 current account deficit.

Last year's weakness in private capital inflows to the U.S. posed a different set of issues for monetary policy than those the Fed encountered in 1988. During the summer and early fall months of 1987, the Federal Reserve was tightening monetary policy to ward off the threat of domestic economic overheating and also to counter weakness in the dollar. Foreign and domestic objectives of monetary policy were consistent with one another at that time. Weakness in the dollar, moreover, was a consequence of a limited willingness of foreign investors to acquire dollar assets, and this was putting upward pressure on long-term interest rates. Reductions in private capital inflows from abroad were thus aiding the Fed in achieving the desired degree of restraint on domestic aggregate demand.

Earlier in 1987, however, the Fed had tightened monetary policy for reasons that seem to have been largely related to the decline in the value of the dollar created by weak foreign demands for dollar-denominated assets. At that time, the developing strength of the U.S. economy was not yet clearly apparent. Moreover, although inflationary expectations in the U.S. were worsening because of the dollar's sharp decline, the dangers of an upturn in the actual inflation rate were still relatively remote. In adopting restraining measures under those circumstances, the Fed was adopting a course of monetary policy in response to international economic developments that it might not have chosen based solely on short-run domestic economic objectives. To that extent, the domestic and

international objectives of monetary policy were inconsistent with one another in the short-run.

For this reason, the Federal Reserve has come in for some criticism because of the more restrictive policies it adopted in 1987. More generally, it is sometimes argued that Federal Reserve policy should focus exclusively on domestic economic objectives, particularly on controlling inflation, and ignore the dollar's exchange value.

I do not share this view. Maintenance of confidence in the value of a nation's currency is a legitimate, indeed vital, concern of central bank policy. Destruction of that confidence would have serious adverse consequences for the long-run health of the economy. As a result, major downward pressures on the dollar are justifiably a matter of concern to the Federal Reserve, and they may at times require the Fed to adopt a more restrictive course of policy than would be indicated by short-run domestic economic policy objectives.

The potential conflict between the short-run international and domestic economic objectives of monetary policy is perhaps most likely to occur in situations like 1987, when the U.S. current account deficit was large and signs of a forthcoming reduction were hard to discern. But changes in the willingness of investors to hold dollar-denominated assets could give rise to serious problems for the United States under other circumstances as well.

Funds can move from one country's financial markets to those of another country with lightning speed and in enormous amounts. The U.S. is particularly susceptible to such international capital movements because U.S. financial markets have, for many years, been larger and more well developed than those of other leading countries. Some foreigners have borrowed heavily in U.S. markets, while other have accumulated substantial claims against the U.S. denominated in dollars. At the end of 1987, total foreign assets in the U.S. totalled $1 1/2 trillion, of which $1 1/4 trillion were assets in private hands. Roughly $1 trillion of these private claims were financial assets which could be sold quickly and the proceeds moved to other financial markets. The potential amount of capital seeking exodus from the U.S. is not, of course, limited to foreign holdings of dollar-denominated assets. Americans could also seek to switch their financial wealth into assets denominated in foreign currencies if they choose to do so.

Sharp changes in the net amount of capital seeking investment in the U.S. can have upsetting effects on the U.S. economy. They can raise or lower long-term interest rates and stock prices, increase or decrease activity in housing, accelerate or retard the pace of economic expansion, and raise or lower the inflation rate. These effects can occur, of course, in other countries as well as our own. Clearly, international capital flows complicate the task of running monetary policy here and abroad, and there is no simple formula by which the Federal Reserve or other central banks can take the

effects of such shifts in international capital flows into account.

The experience of recent years, however, does indicate that the U.S. and other large countries need to avoid policy actions that generate large changes in desired amounts of investment in their respective economies and wide swings in exchange rates. In particular, the U.S. must avoid repeating the mistakes of economic policy that permitted inflationary pressures to build in the late 1970s; it must also adopt the necessary fiscal measures to reduce, and ultimately eliminate, the Federal budget deficit.

Senator SARBANES. Thank you very much, gentlemen. We appreciate all of your statements. I know you've abridged them, and the full statements will be included in the record.

Let me put this question to all the members of the panel. There have been some efforts to sort of explain away or dismiss the deterioration in the U.S. trade position, and subsequent to that the U.S. international debt position. This deterioration is a marked departure from what has prevailed for quite an extended period of time.

Do any of you regard this as not something to be concerned about—this deterioration, I mean, in the trade position and following on that the deterioration in our international net asset position?

Mr. GAULT. Well, I certainly would not regard it as something that we shouldn't be concerned about. We ought to be concerned about it because it does imply that we're going to need continued enormous inflows of capital from abroad if we're going to sustain deficits at around the current level and I don't believe that foreigners are going to be willing to sustain the capital flows at the current levels indefinitely.

So it's a problem in the sense that I don't think we can continue as we are. We need to do something about it in order to reduce the necessary inflows of capital.

Senator SARBANES. Could I hear from the others on that point?

Mr. GRAMLEY. I would just add one point, Mr. Chairman.

As Mr. Gault mentioned in his testimony, one of the reasons for the buildup of the trade and current account deficits was the fact that the U.S. economy was growing considerably more rapidly than those of other industrialized economies around the world in the early 1980's. I think this made a positive contribution to the health of the world economy.

Still, having said that, it would have been far better had we adopted a mix of monetary and fiscal policies that would not have driven the exchange rate up to such high levels and would not have led to this large an increase in the trade deficit.

Mr. BRUSCA. I don't think there's much good that you can say about the tremendous ballooning in the deficit. In some ways it's like going out and having a spree with your credit card. It's a lot of fun while you're doing it, but at some point you reach credit limits and you have to start making the payments.

Senator SARBANES. I think this is an important point. Even if we continue to receive the capital flows from abroad, which Mr. Gault raised some question about—and I think it is a reasonable question—we would just be compounding the problem you're talking about, in a sense going even deeper into the box and therefore heightening the possibilities even further of what Mr. Gault fears. It interacts back and forth, does it not?

Mr. BRUSCA. Yes, it does, and in the past it was a little bit easier with interest rate ceilings and the like for credit crunches to occur and for flows of funds to be shut off. Now in this environment with flexible exchange rates and more open trading in the international system, it's hard to know where you reach a point where foreign money won't flow any more. It's just hard to know. There's no magic line and I think the only thing you can say in defense of the large deficits that have occurred and our dependence on foreign

capital is that while it's a different kind of problem, foreigners have a symmetric problem. Their problem is that they have all of this capital and they have to find a place to put it.

So while we can be concerned about out situation wondering about foreigners and their ability and willingness to place capital here, in terms of the ability, the ability seems to be there because there are large surpluses around the world; but I think to assure that capital will in fact flow in the future we have to make sure that we conduct ourselves in a responsible way. Having run up our national charge card in some sense, we have to make sure that people see us in the light that we appear like we're going to pay our bills and be responsible rather than just throw it away because we're a very unique consumer. We print our own money.

Senator SARBANES. We have two charts here. The one on the far side shows the American trade balance—the blue line is the balance on merchandise trade and the red line is the balance on goods and services and we see an extraordinary deterioration first beginning in the 1970's and then accelerating very rapidly in the 1980's.

The consequence has been reflected in the net asset position of the United States, which shows us moving from creditor nation to debtor nation status. That chart only begins in 1971, but if it were extended back to the time of the First World War, we would still be in a positive net asset position. We we were a creditor nation throughout that entire period and it's only in these last few years that we've deteriorated into a debtor position.

Mr. Gault, as I understand your testimony, that red line as you see it would be down at about—it would be almost tripled by 1992. Is that what you expect to happen, in other words?

Mr. GAULT. Without policy changes and at present exchange rates, I have $1.2 trillion at the end of 1992 and $368 billion at the end of 1987.

Senator SARBANES. Suppose we improve our position this year from minus $160 to minus $140. We're still going to add another $140 to that red line. The same thing would be true in each subsequent year, even if we were able to achieve some improvements, until we were actually able to bring it back into balance. Isn't that correct?

Mr. GAULT. Yes. There's some slippage between the current account deficit and the addition to the net asset position because of statistical discrepancies and valuation changes, but approximately you could consider the current account deficit as being the addition to the net asset position.

Senator SARBANES. One of the things I understand is happening is that as the net asset position deteriorates, the return on investment, which previously offset our balance on merchandise trade, will work in the other direction. Is that correct? In other words, we had a period where—and in fact it may still hold just barely—where we showed a positive balance on investment income. We were getting more from abroad than we were paying out. As that net asset position deteriorates, obviously, we are going to be paying out more and more on that debt. We're going to be paying interest and dividends out on that debt, so we're going to shift into a position where the investment component of the balance would be working against us. Is that correct?

Mr. GAULT. Yes, that's right. In fact, during most of the 1980's the United States was running a surplus of between $20 and $30 billion on investment income and it held up very well in fact through 1987, despite the deterioration in that net asset position that you see there. Even when the net asset position turned negative, the United States still was running a surplus because, at least as the assets are measured, the United States earns a higher rate of return on its assets abroad than foreigners do on their assets in the United States.

Now that may partly reflect a problem of measurement in the asset stocks, but the important point is the slope of the line there showing the deterioration in the net asset position, and the fact that by the end of 1987, excluding capital gains on direct investment income which are very sensitive to fluctuations in the value of the dollar, the net investment income surplus was eliminated.

So we sustained a positive investment income balance at around $20 to $25 billion from 1985 through 1987, largely through temporary effects from the dollar's depreciation. We are now at a point where the balance, excluding capital gains, is starting to turn negative and I think I show in my prepared statement that if we continue to run large current account deficits that balance deteriorates at around $10 billion per year.

Senator SARBANES. Mr. Brusca said in his statement: "The point is that improving the trade balance is simple." I'm not sure it's that simple, but in the context in which we're talking, "attracting foreign capital is easy. Doing both while avoiding recession is very difficult."

I wonder if the other two panelists could address that comment. He then goes on to say, "Pushing the dollar down to improve competitiveness is good for the trade balance, but while that is being done the dropping dollar scares foreign capital out of the country, stops new inflows from arriving, and inflicts losses on holdings already amassed."

Mr. GAULT. It's very difficult, if not impossible, to manage a dollar depreciation. Obviously, if everybody knows the dollar is going down, they will immediately try to get out.

I think that we have a very tough problem in trying to switch over the orientation of demand growth in the economy from domestic demand to foreign demand. We need to try to restrain domestic demand growth and have foreign demand come in to make up the difference and maintain real GNP growth if possible at around a potential growth rate of 2.5 percent.

It's a tough balancing act to pull off. So far, we've been doing reasonably well, but there are now indications that we are near full capacity and that inflation is becoming a serious threat. So we've pretty much gone as far as we can in expanding output to push extra output into net exports. Now we need to try to contract domestic demand growth, have foreign demand growth come in to replace it at the same time, and things can easily go wrong. If you do too much on the domestic side, you could push the economy into a recession, if the foreign demand didn't come in sufficiently to make up the gap.

We're looking to transfer up to 1 percent of GNP per annum into net exports if we wish to eliminate the current account deficit over

the next 7 to 8 years, and that's a very difficult transition to manage while maintaining growth at our potential.

Senator SARBANES. Even if you manage it, at the end of that 7 or 8 years you're going to have a net asset position which has deteriorated very markedly, are you not?

Mr. GAULT. It's bound to deteriorate very markedly, but we would be able to stabilize it at 12 or 13 percent of GNP. It would take much, much more to actually turn that around and return to a balance in net asset position. I don't think that's a realistic prospect.

Senator SARBANES. So the consequence would be in contrast to what we've experienced for an extended period of time, that we would have placed a burden on ourselves which we would then have to carry forward. We're carrying it now and it would be increased and we would have to continue to carry it. Is that correct?

Mr. GAULT. That's correct, and that's why it would be desirable within the framework of a slowdown in U.S. domestic demand to have a shift within domestic demand away from consumption and toward investment so that we have the capital in place so we can produce the output to service that debt.

Senator SARBANES. Well, that leads to the next question I want to ask. There are some who have argued—and I think the Council of Economic Advisers in their report tended to move in this direction—that other countries carry a large negative net asset position, and of course they can also point to an earlier time in American history when that was the case.

It seems to me that this argument fails to take into account a number of important distinctions. First of all, if you're a developing country seeking to develop your resources and expand your investments, you find financing from abroad. That's what we did at an earlier point. That's what developing countries are now seeking to do. It seems to me it's something different if it is done by a developed country.

Second, in the case of a developed country, you have to look at what's being done with the net debt that's being built up. My impression is that we haven't invested it in order to strengthen our capacities to service it later, but have in effect consumed it and therefore created more of a problem for ourselves. And I think you have the further problem of whether the world's leading power in a political and military sense can long sustain that position while being a major debtor in an economic sense.

I wonder if the panelists would address that question and those observations.

Mr. GRAMLEY. I think your point is very will taken, Mr. Chairman, that the significance of what has been happening to our international debt position is not just in how much our net debt has grown but in how we've used the proceeds of those capital inflows. Had we used them for more investment in plant and equipment, or had the rate of net investment in the United States been high relative to GNP, one could perhaps argue that a productive use had been made of the world's resources. That certainly has not been the case. The early 1980's have been years of very high consumption, very high Government spending, and low rates of net in-

vestment relative to GNP. That certainly is as big a part of the problem as is the magnitude of debt and how much it's grown.

Mr. BRUSCA. I think it's interesting that you focus on the idea that we're not a developing country any more and you go back in American history and say that there was a time that we imported this capital. I think if you take a look at the country it's certainly true that we're not a developing country, but I think it's true that we're a redeveloping country. And as you look around the country and you see the big changes in technology, there obviously is a lot of decay in our capital stock that has occurred and I think in some sense you can justify the dependence on foreign capital because the countries whose capital stock was completely decimated in the immediate postwar period engaged in investment that certainly gave them a newer capital stock, where as we lived on the capital stock that had been there and that in some sense is still there. Now what is going on in the United States is that there's a tremendous redevelopment. We are a redeveloping country. We are dependent on this money from overseas and, frankly, they have it to lend. And there is a certain interesting element here how these economic needs do fit in with one another.

I think the important point is not to be too concerned about the gigantic debt. I mean, it's there, and the big problem is that we maintain control—the point that you make of our military independence is one that goes right to the heart of it, how can you be militarily independent if you're dependent on a foreigner to finance your growth because you have such a large stock of debt?

However, the important thing is to run our economic house in a fashion that foreigners will continue to want to place funds here and to use the proceeds in a useful fashion. You take a look at these charts here and you think these are pretty amazing charts with these red lines going down and our stock of indebtedness going up. If you turn them upsidedown you would see the kinds of things that I see from Japanese research institutions all the time. They are really concerned with the problems of the growing surpluses. They have big trade surpluses, a big increase in their asset stocks and they're trying to figure out where to put the money, how to put it so it will be productive and so it will be there for use in the future.

Senator SARBANES. I think I'd rather be concerned about where to put my money then be concerned about where to get it from, frankly.

Mr. BRUSCA. Well, I would agree with you, but the point that I'm making is that there are these different concerns that mesh together in a certain way.

Senator SARBANES. Let me show you another chart, because it follows on Mr. Gramley's point. That's an interesting observation of yours, that we may be a redeveloping country. If you're going to run this large debt we need to ask about investment. This chart shows net nonresidential investment as a share of the net national product. This line is 1947, and this 1986 [indicating] and this line is the average of 1947 and 1980. What you have is an incredible deterioration in net nonresidential investment, which supports the observation that the heavy capital inflow from abroad has not essentially been used for investment purposes. This means that we have

not been building up the economic strength of our economy and therefore enhancing our capacity in line with your redevelopment theory—if we accept it—in order to handle the burden that we're assuming.

I think it underscores the point that Mr. Gramley has made. You said yourself earlier something about a credit card binge in terms of what was happening. If this green line were up there [indicating] at least one could make the argument that while we're borrowing we're investing and therefore building the future strength of the economy. But that's not the case.

Mr. Gault, did you want to comment on this issue?

Mr. GAULT. Yes. I completely agree with the reasoning that there would be less reason to be worried had we used the investment inflows to add to the capital stock. What happened is we were able to avoid more of a squeeze on investment because of the fact that the inflows from aboard allowed real interest rates to be lower than they otherwise would have been. Now that we have investment rebounding sharply now, we very quickly have moved toward our capacity limits and the need to restrain consumption growth in order to make room for extra business fixed investment has become clear.

Mr. GRAMLEY. Mr. Chairman, I wonder if I might go back to a question that you asked earlier about whether or not Mr. Brusca is right that we have a serious problem of trying to improve the trade deficit, attract foreign capital and at the same time avoid recession.

I would agree that that's difficult technically. We don't really know how to use economic policies in ways that make sure the economy moves along a nice smooth path that permits us to achieve all of our desired social and economic objectives. I think, however, that it would be a mistake to overestimate the difficulties of what needs to be done. We all know that domestic aggregate demand growth must slow. We agree that the way to do that is to adopt measures of fiscal restraint. The problem is less the ability of our analytic minds to figure out a solution than the political problem of biting the bullet and getting the deficit reduction job done.

It needs to be done soon. The problems that our country is facing will get worse if we continue more or less indefinitely with a structural deficit of $150 billion or so in the Federal budget, while at the same time trying to improve the trade deficit and the current account deficit over the next 3 to 5 years.

Senator SARBANES. I think that's an important observation, but it brings me back to the alternative scenarios discussed by Mr. Gault in his presentation which indicate that an assumption of 1 percent slower U.S. growth than is included in the baseline reduces the current account deficit by $12 billion by 1990. The current account deficit this year we expect to be $140 billion. By the time it works its way out to 1995, it's $76 billion. But nevertheless, we're still in the position of continuing to run a very large current account deficit and therefore continuing to add to our negative net asset position.

Mr. GAULT. That particular set of numbers illustrates the direct effect of slower growth in U.S. demand, reducing the merchandise trade deficit by slowing demand for imports and the direct effect is indeed in the early years quite small.

I think the important point, though, is that as an adjunct to dollar depreciation slower demand growth is essential. Not only would slower domestic demand growth reduce directly the demand for imports, it slows demand for U.S. produced goods and therefore allows resources to move into the production of exports and import substitutes. Dollar depreciation on its own, given that we are now very close to full capacity, would be counterproductive as a method of reducing the deficit since it would in a short time lead to much higher inflation. So I think that the slower demand growth should be viewed as essential not so much for its direct impact on the deficit, because that's quite small, but because it can allow further depreciation to work. It can allow resources to shift into the production of net exports.

Senator SARBANES. So you're coupling it with a further dollar depreciation. Is that correct?

Mr. GAULT. That's right.

Senator SARBANES. Do the others agree with that?

Mr. GRAMLEY. I would argue that slower growth in U.S. GNP alone provides no permanent solution at all to our trade and current account deficits. Certainly we're not going to let our economy continue to flounder indefinitely. A recession will, to be sure, lower the demand for imports, reduce the trade deficit somewhat, but when the economy begins to grow again the deficit will widen.

The only longrun solution is to switch more of our resources into production of exports and into production of goods that substitute for imports and that's necessarily going to mean, given the overall capacity of our economy to produce, a slower growth of domestic aggregate demand. That's unavoidable.

Mr. BRUSCA. If you take a look at the chart, I think it's pretty obvious that the problem that we have had that obviously has to be corrected is with the merchandise balance of trade, the chart on the right. What we have now is a growing problem with the services balance that stems really directly from the problem with the merchandise trade balance. Solving the merchandise trade balance is at the bottom of all of these problems in some sense.

In order to do that, what we're saying is we're going to have to solve the economy's problems with the goods sector of the economy, which is only about half of GNP. So you're going to have to take this one sector of the econmy, which is big, and you're going to have to drive it to produce all of the adjustment that we need. This process already has brought us up against capacity constraints that Nigel Gault was discussing earlier and the real problem is how do we do this, how do we keep income growth fairly low and how do we keep output growth extremely high; and we have to run this terribly delicate balance where we're going to have high employment rates; we're going to have high rates of capacity use and we're going to have try to keep from creating inflation.

Now the one thing that bothers me in terms of policy prescriptions here is that I hear people talking about tight fiscal policy and easy monetary policy and it seems to me—yes, we would like monetary policy as easy as it can possibly be, but in this environment where we're pushing the dollar down to solve this problem and cranking up the goods sector of the economy, we're running with resources highly utilized at an inflation threshold. And this is the

background for this economy. Easy monetary policy really isn't in the cards. Monetary policy is going to be constantly vigilant fighting against the problems of straining capacity and low unemployment and potentials for wage pressures. We have an economy that is going to be very curious—I guess Charles Dickens would describe it as the best of times and the worst of times. Everybody is working but all of the output is being exported abroad and we're trying to work off this debt that we've accumulated over the years and it's kind of a strange background to think about an economy that's doing so well and where we're going to be talking about curtailing living standards and making progress on paying off accumulated debt. But that seems to be the fact, and it's a two-pronged approach of being competitive so that this increase in output that we create can go abroad, can be exported, so that we can reduce imports and reduce our growth so that not too much of that is absorbed at home. So it's domestic absorption versus international competitiveness.

Senator SARBANES. Isn't the fact of the matter that the economy is now on a path that cannot be sustained? Would any of you differ with that?

Mr. BRUSCA. I suppose it depends on what path you think we're on right now. There are some aspects of this path that do seem to be sustainable. If the path has the dollar staying at this level, it's not sustainable. If it has the dollar rising, it's not sustainable. But I would see economic growth already showing signs of slowing. GNP growth has slowed. Consumer spending seems to be slowing to some extent. Output is advancing at a rapid rate. I see the dollar still in a long trend decline, certainly this year we have it in a rebound but I still view the dollar in some sort of a trend decline.

Senator SARBANES. All of that means a rise in interest rates, does it not?

Mr. BRUSCA. I believe so. It will mean a rise to some extent and it will mean remaining with the situation where real interest rates will remain fairly high. Of course, how high will depend in part on how monetary policy and growth overseas do because it's not just an isolated problem here. It's a problem that has counterparts I spoke of earlier overseas.

Senator SARBANES. Does anyone else want to add anything?

Mr. GAULT. Well, I believe that at the moment there is still considerable momentum behind the economy and in that sense we are on an unsustainable path in that we are still growing at a rate which is not sustainable indefinitely and, unfortunately, the only policy instrument available at the moment to correct that is monetary policy and we need to bring in the other policy instrument—fiscal policy—in order to help us slow down to a sustainable rate of domestic demand growth.

Mr. GRAMLEY. In my prepared statement, I went a little further than I did in my oral comments this morning and perhaps I should elaborate a bit.

I think it's important to remember that the process of adjustment to slower growth of domestic aggregate demand is underway. Residential investment has been generally declining since late 1986. Growth of personal consumption expenditures, particularly for goods, has been much slower since the end of 1986 than it was

during the first 4 years of the expansion. Defense purchases in constant-dollar terms have flattened out since the middle of last year. This process hasn't yet gone far enough.

What needs to happen now is a reduction in the Federal budget deficit. We have to take steps to bring that deficit down, over a 3- to 5-year period, to make possible a further expansion of exports and increased use of resources to produce products that compete with imports. We are either going to do this with higher interest rates or we're going to do it with a reduced budget deficit. Those are the only two ways that are available to us.

So it seems to me that the direction we need to take as a country is very, very clear. It may be difficult to take the precise steps that make everything work out exactly the way we'd like, but where we have to go is very, very clear. So I don't think we really have any alternative.

Senator SARBANES. What is your view of the assertion that we have lost considerable control over our own economic destiny and that much of that control resides in the hands of people abroad, foreign decisionmakers?

Mr. GAULT. Well, I think part of that is a natural result of the expansion and integration of world financial markets and doesn't necessarily have anything to do with our current account deficits. Capital is much more mobile now than it used to be.

Our real problem with the deficits is that we are obliged to continue to attract an enormous inflow of foreign capital every year in order to finance the current account deficit and that is the sense in which I think we may be losing control, in that we may not have control over on what terms we are able to finance that deficit. We've been able to do it so far, but will foreigners be willing to continue to increase their dollar investments at the rate they have in the past? If not, the price of obtaining that investment flow may be much higher in the future than it has been so far.

Mr. BRUSCA. I think that economic theory is pretty clear on the way we should look at this and that is with international factors becoming more important, with the large size of our trade deficit, everything focuses on the relative values of variables. It's not just U.S. interest rates. It's U.S. interest rates relative to interest rates overseas that are going to affect investment flows into the country. It's not just the price level in the United States. It's the price level compared to prices overseas adjusted by the exchange rate. So yes, we are tempered by what goes on overseas and of course the greater the foreign stake in our country becomes, the more concerned foreigners are going to be about what goes on over here.

I think that this part of the integration process, but I think that that process is an added element. I think that you could imagine a world in which we had increasing integration without having these kinds of enormous trade deficits.

Senator SARBANES. It seems to me that's the only world you can imagine. One of the things that is really amiss right now is the extraordinary extremes we have reached. It's not as though the United States were only slightly in a deficit position.

I worked for Walter Heller when he was Chairman of the Council of Economic Advisers. He we concerned that the United States, which at that time, given its position in the world's economy, could

have run much larger positive balances, not do so in order to help sustain the growth of the world economy. So the objective was to stay within a certain range and keep others from steep declines. Now we have the reverse—extraordinary current account surpluses in some of the other advanced economies, particularly Japan and West Germany and some of the Pacific Rim countries that are running very large surpluses, and holding very large reserves. I don't see how you can look at this and think it's sustainable internationally over an extended period of time.

Mr. BRUSCA. Well, the fluctuating exchange system which serves us today, I think it's no coincidence that the volatility in these balances and the big changes have occurred during a period when exchange rates were allowed to float because exchange rates did impose a certain discipline when the exchange rates were fixed and when monetary policy was held hostage to the discipline of trying to keep currencies in a narrow band. Once that was done away with, all of a sudden all of the lines became very blurry. Financial markets—the way they operate under these circumstances—they'll tolerate a great deal and then all of a sudden one morning they wake up and they see a big problem that's been growing and growing and all of a sudden there's a big adjustment, and the dollar has undergone a big adjustment. We've seen interest rates undergo big adjustments and now people are trying to come to grips with this big external deficit. It's large. It's going to remain big while the debt gets bigger because you can't wipe out that current account overnight. Even if you start to diminish the deficit, the stock of debt is going to grow at a rapid rate. This, in my mind, stems from the lack of discipline that you have in a floating exchange rate system and the extent to which it's allowed certain problems that have cropped up to be postponed in terms of being addressed.

A lot of it does depend also on the kind of coordination and cooperation we get between countries. I have to emphasize that. I think it's a little wrong for us to think that these are problems we're going to solve totally by ourselves. It's going to create cooperation because it's going to be relative growth rates that will balance the current account deficit along with competitiveness, which is also a statement about relativity. And if foreign growth is going to be the thing that's going to temper U.S. growth, one of the important determinants of how low or high U.S. growth can be is going to be the kind of growth that is posted overseas. So it's to that extent that I think we have to pay some attention to what's going on in other parts of the world in addition to browbeating ourselves about what we can do.

Senator SARBANES. A little over a year ago, the JEC did a study which took a look at the deteriorating indexes. The study quoted Fred Bergsten, who in an article in Foreign Affairs had said, "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?"

In the report we made the assertion—and I think it's historically accurate—that no country has ever managed to be a great power

and a great debtor at the same time. You have instances of great powers—Britain in this century, Spain in the 16th century—which lost their stature as world leaders when they moved from creditor to debtor status.

Now that's not technically an economics question. You're talking about the political ramifications of an economic position, but it seems to me that I think it's a very legitimate question and one that has caused me a great deal of concern.

Given U.S. international responsibilities and our effort to be a world leader, isn't it clear that the position which prevailed prior to the late 1970's and the 1980's is a stronger position? In other words, it would be better to be running something of a merchandise trade balance, a positive balance on goods and services, and to be a creditor nation. Isn't that a far better position in which to find yourself?

Mr. GRAMLEY. Mr. Chairman, I'd go back to a question you asked earlier—are we losing control of our own destiny?

I think, as Mr. Gault indicated, that we live in a world in which the interdependence among nations has become so great, the movements of capital have become so great, that to some degree control of our economic destiny is bound to be lost. We should not concern ourselves with that excessively because there are tremendous improvements in economic welfare that stem from this internationalization of trade and finance.

Senator SARBANES. I don't quarrel with you this far, but it seems to me there's a difference between recognizing a growing interdependence and an internationalization of both trade and finance on the one hand, and having deteriorated sharply with respect to the trade balance and into a debtor position on the other.

Mr. GRAMLEY. I agree. Indeed, what I was going to say next was that under those circumstances it's terribly important for all countries—and particularly leading industrial countries—to avoid the kinds of policies that can be disruptive to the world economic and financial order. I don't think anyone looking back at the early 1980's could conclude anything other than the fact that the mix of monetary and fiscal policies we ran during that period was not conducive to world economic health. We should have run a much tighter fiscal policy. That would have permitted an easier monetary policy and we would have brought inflation down without the kind of dramatically high real interest rates which have been injurious to housing and to net investment more generally. We would also have avoided, therefore, the tremendous increase in the exchange rate which has been part and parcel of this huge current account deficit and the switch to a net debtor nation.

Senator SARBANES. Mr. Gault, do you want to comment on that?

Mr. GAULT. Clearly, the expansion in the U.S. net debt means that it is much more difficult for the United States to get its way economically. It has to pay much more attention to the fears and the wishes of its main competitors. It points to a need for much greater policy coordination among the United States and its main competitors than has been evident in the 1980's. Part of the reduction of U.S. control over its destiny, I agree, is inevitable given the internationalization of the world economy, but the huge net debt status now does imply that the United States cannot proceed on its

own without paying any attention to what the rest of the world is doing.

Senator SARBANES. Mr. Brusca, do you want to add to that?

Mr. BRUSCA. Well, just to the statement that you make about the performance being better: I think if we take a look at economic performance up until the 1980's, that looking at current account deficits and things like that, things look fine and certainly as an economist looking at those deficits compared to these deficits, you would have to agree that those things looked better then.

But it's in terms of the direction the country was taking. Up until that point, we were building the problem with inflation. What we have done since is to go through a wrenching experience that has tried to solve some of the problems that were building even at that time. There was a time in which oil prices rose sharply. There were commodity shocks. And we had to make all kinds of different domestic investment decisions because we were looking at higher relative energy prices. A lot changed in the economy during that period. Monetary policy, I think you just have to judge was just too lax during that period of time. Subsequently we had a period of very lax fiscal policy, and these things have accumulated.

I think the conditions we're looking at now are just the result of things that were done in the past and we can't blame policymakers now for it.

Senator SARBANES. Where would we find ourselves if we had a downturn, an economic downturn, in terms of our ability to address these problems? We would then be in danger of falling through the ice, wouldn't we?

Mr. BRUSCA. Well, I guess it depends on the kind of downturn we get. Right now I'm not very concerned about a recession. I would agree that the economy is doing well. I think the low dollar has given us some pretty good competitiveness conditions from which to work. The kind of recession I would be afraid of is a recession that came from keeping monetary policy too easy too long that gave us an inflation rate problem that interest rates would have to address, a recession where monetary policy would not have the flexibility to try to bring us out of it. That would be a dangerous recession. We don't have that kind of problem now because inflation isn't yet a problem that's gone rampant, but clearly it's something that we have to be careful about and it's why I think the best way to stay out of a recession condition right now is somewhat ironically to keep interest rates high because that will give you the flexibility to reduce them later on. Should we reduce interest rates too much at this point in the business cycle, we certainly tempt an inflation process that is already underway and if it gets out of hand, then we're really in the soup because we can't control fiscal policy. Fiscal policy is going to be held hostage. It can't become expansive again. And the dollar is going to follow, more or less, the dictates of monetary policy subject to policies overseas. Again, it depends on these relative variables and in the short run the dollar can do things that are seemingly at odds with what theory can tell you. So the only thing that we can clearly control as far as affecting our destiny is monetary policy and I think the trick right here is to run monetary policy in a way that it retains flexibility to

make sure we're able to move rates up or down, which means that we have to run a vigilant anti-inflation policy at this time.

Senator SARBANES. Mr. Gramley, what's the impact of that on housing?

Mr. GRAMLEY. The impact on housing has not been great so far, but if we move into a period of rising inflation, larger wage and price increases, interest rates are going to go up further, and housing is going to begin to decline. I do anticipate that we will see some decline in housing between now and the middle of 1989, because I think interest rates are going to go up. I think the economy is still going very robustly, and it is therefore urgent that the new President, whoever he is, take action as soon as possible to begin the process of reducing the budget deficit.

Senator SARBANES. Well, gentlemen, we thank you very much. On the question whether the world's largest debtor nation can remain the world's leading power, Walter Heller put it very graphically once when he said, "It's very difficult to ride into town and stand tall in the saddle when you owe money to everybody you see on each street corner." I think that's a very real concern.

We thank you very much for your tesitmony.

The committee is adjourned.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

[The following written questions and answers and a statement were subsequently supplied for the record:]

RESPONSE OF NIGEL GAULT TO WRITTEN QUESTIONS POSED BY SENATOR D'AMATO

1. The baseline scenario represented by Table 3 is indeed the worst case among the tables I have presented, and I certainly do not regard it as a likely outcome. Taking it at face value, though, the implied net debt service burden of 1.2% of GNP by 1995 could certainly be handled economically. The ratio of interest payments to GNP for Latin American debtors is substantially higher, for example about 4% for Brazil and 6% for Mexico, and the U.S. would still be far from such levels. Note that the Latin American figures represent gross interest payments only (i.e. they do not net out interest receipts) and they also exclude flows of income on equity investments, but these would not affect the comparison substantially.

The problem in this scenario is not that the U.S. could not service its debt--it would be burdensome, but it could be done--but rather that it is unlikely to be able to obtain the capital inflows necessary to finance current account deficits of over 3% of GNP (and deteriorating) indefinitely.

2. If the scenario in Table 4 were to be achieved solely by U.S. fiscal restraint, then the outcome would ultimately be little reduction in the overall federal deficit but a large decrease in its structural component and a large increase in its cyclical component. The scenario implies that U.S. output growth runs at about the same rate as demand growth--1.5%--which given a potential U.S. growth rate of about 2.5% would result in rising unemployment and a large increase in the cyclical component of the federal deficit, as GNP falls farther and farther below its potential path. The overall reduction in the federal deficit would be very small. Attempts to cut the deficit by reducing spending or increasing taxes would be offset by increased spending and lower tax revenues resulting from depressed levels of activity.

Please note that I do not regard this scenario as likely. The purpose of Table 4 is to illustrate the direct effects of slower U.S. demand growth on the current account deficit, not to suggest a feasible alternative path to the baseline.

It may be more helpful to examine the scenario outlined in Table 7. In this case, although demand growth is also only 1.5%, the extra 15% depreciation of the dollar and the faster foreign growth allow real GNP growth to remain close to its 2.5% potential, so the cyclical component of the federal deficit does not increase.

The scenario in Table 7 implies a reduction in the current account deficit of about 2 percentage points of GNP from 1988 to 1993. The Gramm-Rudman targets imply a reduction in the federal budget deficit (NIPA basis) of about 3 percentage points of GNP from 1988 to 1993. Clearly, the federal budget deficit reductions do release more than enough savings to make up for the loss in the capital inflow represented by the current account deficit. Some of those savings would likely be absorbed by a higher ratio of private investment to GNP, encouraged by lower real interest rates, but I think that the Gramm-Rudman targets are certainly broadly consistent with the outlook in Table 7.

The important point remains, though, that simply restricting U.S. demand growth by tight fiscal policy will not lead to a substantial decline in the current account deficit unless the resources released by slower U.S. demand growth are transferred into production of net exports. As a comparison of Tables 4 and 7 indicates, that will require both further dollar depreciation and a stimulus to demand by the other major industrial nations. Other nations must accept smaller surpluses if the U.S. is to reduce its deficit.

Japanese Investment in Dollar Securities after the Plaza Accord

Statement Submitted to the Joint Economic Committee of the United States Congress

October 17, 1988

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Japanese Investment in Dollar Securities after the Plaza Accord

One of the greatest mysteries in international finance during the last three years must be the courage of Japanese investors to stay with the dollar when its value was falling rapidly. In the same period, most other Western investors shunned the dollar as soon as they realized that the G-5 central banks were serious about pushing the dollar down. West German investors, for example, stopped buying dollar securities as early as the first quarter of 1986. In contrast, and contrary to textbook recommendations to get out of falling currencies, Japanese investors persisted with the dollar for at least a year and a half longer (Exhibit 1).

At the time of the Plaza Accord in September 1985, Japanese investors held about $82 billion in dollar-denominated securities, of which $59.7 billion were domestic US securities and approximately $22.2 billion were Eurodollar securities purchased through Luxembourg. By the end of 1986, their total holdings of dollar-denominated securities not only did not decrease but actually increased to $170.0 billion, and then increased further to $234.5 billion by the end of 1987 (Exhibit 2).

Although some of these purchases were hedged, foreign-securities-related losses during this period also reached astronomical levels. The top five life insurance companies alone, which account for about 23 percent of all Japanese foreign

securities purchases, lost $25.3 billion by the end of March 1988. Total losses sustained by the entire Japanese investment community during the last three years are likely to have reached many times this amount.

Many in the US, including some in the government, have attributed this extraordinary investment behavior to the poor judgement of investors, and said that the losses incurred were their own fault. It is true that most investment decisions were made by the fund managers of those companies at their own risk. With the deregulation of Japanese financial market progressing at a rapid pace, the scope of judgement for these investors has also increased signficantly during the last few years. Large losses they have incurred ex-post are, therefore, due to their own judgment.

To argue that bad judgment was everything, however, misses the important policy actions that were taken to make sure that the necessary adjustments to the dollar, the key reserve currency, could be completed without the entire international financial system coming apart. In particular, there were numerous occasions when Japanese and US authorities tried to keep these investors from bailing out of the dollar.

For example, Mr. Sprinkel, the former Under-secretary of the Treasury, came to Japan in 1984 and visited financial institutions to ask them for their cooporation in financing the US deficits. During this period, the US Treasury also issued bonds specifically designed for foreigners. Because of Mr. Sprinkel's sales pitch, these bonds were called Sprinkel bonds in Japan. Moves like this by the US government gave the Japanese

investment community the strong impression that the US needed help, and that their commitment to the dollar would be appreciated.

On the regulatory front, the US government abolished withholding taxes on interest income for non-residents in 1984 in order to attract more foreign savings. In Japan, limits on holdings of foreign securities were raised sharply in 1986 for most investors so that Japanese savings could flow to the US more easily.

During 1986 and 1987, the most difficult years of exchange rate adjustment, when the dollar and financial markets around the world came precariously close to total collapse, Japanese authorities tried to keep investors in dollars by telling them how much good the US had done for Japan after the war, and how important it was for Japan to stay with the dollar to prevent the total collapse of the world financial system.

The effectiveness of this moral suasion is based on the tradition of the long-term give-and-take which characterizes the relationship between Japanese authorities and the private sector. In crisis situations, therefore, some institutions are willing to put aside their private interest in favor of containing problems to keep them from developing into a major disaster.

In spite of mounting losses, therefore, the senior management of major insurance companies and trust banks refrained from selling dollar securities as long as they could. Fortunately, many insurance companies had large unrealized capital gains on their domestic stock holdings which they had

patiently accumulated over the last 40 years. By realizing some of these gains, they were able to offset the losses arising from their foreign securities holdings and still remain solvent. It was sheer luck that this cushion, a product of conservative Japanese accounting practices, was available to help the US.

One may argue that these policy actions and moral suasion were taken by the Japanese in their own self-interest in order to keep the yen from strengthening too much too fast. However, it should be remembered that avoiding a rapid appreciation in the yen is the same as making sure that there is enough financing available for the US deficits. As the events in the March-April period and the September-October period last year demonstrated, disruptions in the flow of financing can produce major strains in the US economy and its financial system.

Before discussing what happened during those critical periods, it would be useful to clarify the changing Japanese sentiment toward the appreciation of yen during 1986 and 1987. It is true that keeping the yen from appreciating too much too fast was a major consideration for Japanese policy makers in 1986 as many Japanese manufacturers screamed loudly for help and relief. By the middle of 1987, however, complaints about the strong yen had disappeared.

By then, most Japanese manufacturers had realized that the strong yen was here to stay, and that there was no point in complaining. Based on that assumption, these firms began massive restructuring efforts by increasing direct investment abroad, redirecting marketing efforts from exports to the domestic market, and increasing outlays on research and development. The

record profits many of these firms are now reporting have prompted them to realize that the strong yen is not all that bad after all.

While Japanese sentiment toward the strong yen was changing in 1987, the US continued to pressure Japan to choose between an even stronger yen or stronger domestic demand. US officials' willingness to talk the dollar down and the subsequent erosion of market confidence in the US currency finally produced the long-feared shortfall in financing the US deficit.

On March 25, 1987, the dollar fell below the psychologically important ¥150 level. It is still a mystery how monetary authorities in the G-5 countries allowed this to happen at such a critical time; critical in the sense that it was just five days before the fiscal year-end for most Japanese investors. The result was the first massive sell-off of US dollar securities by Japanese investors.

In the early part of that month, Japanese investors had increased their gross purchases of US securities by nearly 30 percent to reach an all-time record of $132 billion compared with $107 billion in the previous two months. Until March 25, many of these investors believed in the Louvre Accord concluded just a few weeks earlier which advocated stable exchange rates. The two so-called Baker-Miyazawa Agreements which preceeded the Louvre Accord also gave these investors reason to believe that the exchange rates would remain stable for a while.

When those views turned out to be incorrect, panic selling followed; total net purchases for the month fell to less than $1 billion from nearly $7 billion in February. Large gross purchases

at the early part of the month imply that the selling during the last few days must have reached many billions a day.

This was followed by a classic symptom of capital flight, with interest rates in Japan and the US moving in completely opposite directions. In the US, the long-term bond yield increased from 7.5 percent to nearly 9 percent. In Japan, the yield on the bellwether #89 Japanese government bond fell from 4.5 percent to 2.55 percent as investors scrambled to move funds back to Japan and invest them domestically. The Bank of Japan's official discount rate at that time was 2.5 percent.

In spite of massive intervention by the central banks of both Japan and the US, the dollar fell from ¥150 to as low as ¥137 in early May. The contrasting movements of interest and exchange rates during this period are shown in in Exhibit 3.

Although the Ministry of Finance's moral suasion was effective in keeping long-term investors such as pension trusts and insurance companies from selling dollars, it could not restrain relatively short-term investors such as securities investment trusts. During this period, securities investment trusts sold off nearly a quarter of their total holdings of dollar assets. They bought some of that back in the May-August period only to sell it all off again during the September-December period. These activities are illustrated in Exhibit 4.

For the first few weeks of this panic, however, most market participants in the US, including the monetary authorities, were apparently unaware of the massive capital flight that was taking place, and attributed the increase in US interest rates to the rekindling of inflationary expectations in the US. Those in

Japan, however, knew that there was more to the story than just inflationary expectations.

The resultant increase in US interest rates hit Japanese investors especially hard, even though their selling had contributed to the increases. This is because many of these investors had assumed many years earlier that when the dollar fell, it would be associated with a fall in US interest rates. Based on this assumption, many investors purchased long-term bonds which should have produced capital gains to offset foreign exchange losses.

In 1986, continued purchases by Japanese investors and a fortunate decline in oil prices did bring US interest rates down, which produced handsome capital gains for bond holders. With these offsetting movements, most Japanese investors incurred only limited losses by the end of fiscal 1985 (March 1986) even though the dollar fell from ¥250 to ¥177 during fiscal 1985. This offsetting process is shown in Exhibit 5.

Towards the end of fiscal 1986, losses increased to nearly 10 percent, but many considered that tolerable. The fall of the dollar below ¥150 just five days before the end of the fiscal year, however, provoked a panic. The final losses for the fiscal year far exceeded the initially hoped for 10 percent because of both the fall of the dollar and the reversal of US interest rates.

With losses mounting from both the exchange rate and interest rate fronts, Japanese investors became extremely cautious. Many investors began to actively reduce their dollar holdings after this episode, forcing massive intervention by the monetary authorities to keep the dollar from collapsing and

interest rates from skyrocketing.

The situation was so bad that in May, the Ministry of Finance required banks handling foreign exchange to submit detailed reports including the daily maximum and minimum positions taken, a process which made the usual conduct of foreign exchange business difficult. This way, the authorities were able to find out quickly who was engaged in selling dollars.

Many banks and other financial institutions bitterly complained about the imposition of such reporting requirements and the implicit threat behind them. Even though the imposition of such quasi-capital controls was against the spirit of the Yen/Dollar Committee sponsored jointly by the Japanese Ministry of Finance and the US Treasury to deregulate Japanese financial market, no complaints were heard from the US.

By May the US authorities were fully aware of the critical situation faced by the dollar, and the Federal Reserve was ready to consider raising its discount rate if necessary to defend the dollar. In spite of such efforts, however, poor US trade performance continued to discourage investors, especially after the release of the record June trade deficit figures in August.

In spite of the Federal Reserve's attempt to provide support for the dollar by increasing its discount rate from 5.5 to 6.0 percent on September 4, the situation was aleady out of hand. Japanese net purchases of US securities fell to only $839 million in September, the lowest figure since March 1985. This lack of interest added to the upward pressure on interest rates seen prior to the stock market crash in October.

Although there have been some allegations that the crash was caused by Japanese investors' selling, the actual figure shows that Japanese investors' net sales of US securities in October was only $39 million. Thus, in all likelihood, it was not Japanese selling, but the lack of Japanese buying which added to the upward pressure on US interest rates during the two months prior to the crash.

These two episodes in 1987 show how close the difficulties of financing the US external deficit came to undoing the US financial system. Any future attempt to address the problem of external imbalances with exchange rate adjustments, therefore, must include in its plans a means to counter possible disruptions in the flow of financing to the deficit country.

It is interesting to note that, in contrast to the modest amount of US securities sold by Japanese investors in October, American (and some European) investors in the Japanese market sold $12 billion net, or nearly 300 times as much as the amount the Japanese sold in the US during the same month. There were brakes on Japanese investors in the form of Ministry of Finance moral suasion, but there were no such brakes for non-Japanese investors.

Although much fear has been expressed over the possibility of foreigners pulling funds out of the US, there is now a real danger that US investors may do the same, if not sooner. Realizing the importance of foreign investors in the US market, many US fund managers are now actively trying to anticipate and move ahead of foreign investors. This was most obvious in March 1988.

Around the fourth week of March, reports began circulating in European and US markets that Japanese life insurance companies might sell dollars once the fiscal year ended. This view was based on the Japanese accounting provision which required these investors to write off foreign exchange losses if the average exchange rate for the month of March was 15 percent below the level of the previous fiscal year end.

For the fiscal year ending in March 1988, the critical 15 percent for the yen/dollar rate was just above ¥127, and the exhange rate hovered slightly above that level for most of the month. It was argued that insurance companies would hold on to their dollar securities until the end of the fiscal year to prop up the currency. After that, the argument went, these investors would unload their troublesome dollar assets. Based on this report, American and European traders and investors dumped dollars, causing the US currency to fall sharply.

Those in Japan, however, could not believe what was happening because most fund managers were planning to do exactly the opposite. They were saying instead that the dollar market was looking interesting in the new fiscal year. Indeed, Japanese investors increased their purchases of foreign securities sharply in the fourth week of March, buying over $2 billion.

By then, however, the rumor in the US and European markets had taken on a life of its own. In spite of repeated public denials by even the chairman of the Life Insurance Association of Japan that its members had no plans to dump the dollar in April, the dollar continued to experience strong selling pressure outside Japan. When the dollar continued to lose ground during

the last week of March, even Japanese investors could not stay calm. On the very last day of March, they suddenly turned around and sold nearly $2 billion in what was described as panic selling.

Where there is smoke there is fire. Thus, it is likely that a small minority of Japanese investors were either selling dollars or had planed to do so in the new fiscal year. It should be noted here that because of deregulation, it has become very difficult to generalize about investors, even those in the same industry such as life insurance. It is frequently the case that one insurance company is buying dollars while another is selling.

It is important, therefore, to check whether the Japanese investor activity depicted on the Reuters or Telerate screens can be generalized. Too frequently, rather unimportant events are blown far out of proportion by the media, as was the case above. This late March episode demonstrated how misinformation can carry a market thin on confidence, and become self-fulfilling in a most destructive way.

True to their announcements, Japanese purchases of foreign securities picked up in the new fiscal year starting in April. Large purchases made in late May, for example, pushed dollar interest rates sharply lower. In this instance too, it was reported that those American fund managers who noticed that the Japanese were back were only too happy to piggyback on the Japanese inflow, thus amplifying interest rate movements.

This danger of domestic investors jumping the gun and acting before the foreigners is increasing because during the last three years of the dollar's depreciation, those US funds which produced outstanding results were frequently those which had forsaken the dollar in favor of the yen or the DM. This means that when the

dollar appears weak again, American fund managers would feel the pressure to get out of the dollar.

As Mr. Michael Sesit of <u>The Wall Street Journal</u> pointed out, the losses incurred by Japanese investors can and perhaps should be viewed as a Japanese Marshall plan to rebuild the US industrial base. According to the Economic Planning Agency, the US spent $2 billion rebuilding Japan after the war, and another $2.4 billion during the Korean War for a total of $4.4 billion from 1945 to 1953. With the US consumer price index increasing nearly 490 percent during the last four decades, the above outlay in real terms today would be worth about $22 billion. This amount is smaller than the total foreign exchange losses endured by Japanese life insurance companies in their dollar portfolios during the last three years.

Just like Japan or Germany after the war, the US must rebuild its industrial base if it is going to reduce its dependence on foreign supply. After the inflationary neglect of the late 1970s and strong dollar days of the early 1980s, the erosion of US maunfacturing had progressed to the point where dependence on imports was growing at an alarming rate. By the second half of 1987, the US trade deficit was reaching $15 billion a month. Such a figure would have been considered unacceptable for an entire year not too long ago.

Between 1981 and 1985, however, the US was stuck with the strong dollar which was considered necessary to attract foreign savings to finance the huge twin deficits. At that time, many in policy circles, not just in the US but also in other major

countries, believed that exchange rates were endogenous to the system. In other words, they were skeptical that they could just move the exchange rate without changing other fundamentals in the economy, such as the budget deficit which was believed to have caused the strong dollar.

It was feared that pushing the dollar down without reducing the budget deficit could trigger a huge capital flight from the US, which in turn would force US interest rates to skyrocket. For no textbook of finance has ever recommended investors to stay with a falling currency.

With its financial system strained by the highly leveraged domestic economy and the troubled Latin American borrowers, US policy makers could ill afford any risk of higher interest rates. Mr. Paul Volcker, the former chairman of the Federal Reserve, repeatedly warned that any action to push the dollar down without reductions in the budget deficit would put "unwelcome pressure on US financial markets."

Thus, the manufacturing sector was sacrificed in order to keep the rest of the economy going. By the summer of 1985, however, this strategy was reaching its limits. With even traditionally strong US industries unable to compete with imports, protectionist sentiment was encompassing the whole country.

This development forced the G-5 countries to push the dollar down without any progress having been made on the budget deficit front. The Plaza Accord was a desperate attempt. But more importantly, the success of this effort was critically dependent on foreigners holding dollar assets staying with the US unit.

It was a tall order. What was not supposed to be possible, however, was made possible by Japanese investors staying with the dollar. Their willingness to hold dollar assets and add to their dollar portfolios allowed the currency to fall without pushing US interest rates higher.

During 1986 and 1987, the Bank of Japan intervened by a total of $55 billion to support the dollar. If the Japanese private sector had gone the way of other Western investors, however, required intervention would have been many times this amount. In the final analysis, therefore, Japanese savers were mobilized, and in some real sense, sacrificed, in order to bring the dollar down while keeping US interest rates from skyrocketing.

The argument heard often in the US that Japanese investors bought and kept those bonds purely for profit sounds offensive to many senior managers of Japanese institutions who thought they went out of their way to keep crisis from developing into major disaster. With anti-foreign-investment sentiment growing in the US, the situation for many Japanese investors has indeed been "Damned if we do and damned if we don't."

The United States believed in the future of Japan and Western Europe when it spent billions through the Marshall Plan to reconstruct economies of these countries after the war. Today, Japanese believe in the future of the US as they stay with the US currency and endure billions of dollars in losses.

All investors, domestic and foreign, are constantly reviewing their investment decisions. If the US stumbles again, or does things that give the impression that its economy really

is hopeless, investor patience could evaporate quickly. The result would be something which so much effort has been spent until now to avert: skyrocketing US interest rates and a collapsing dollar.

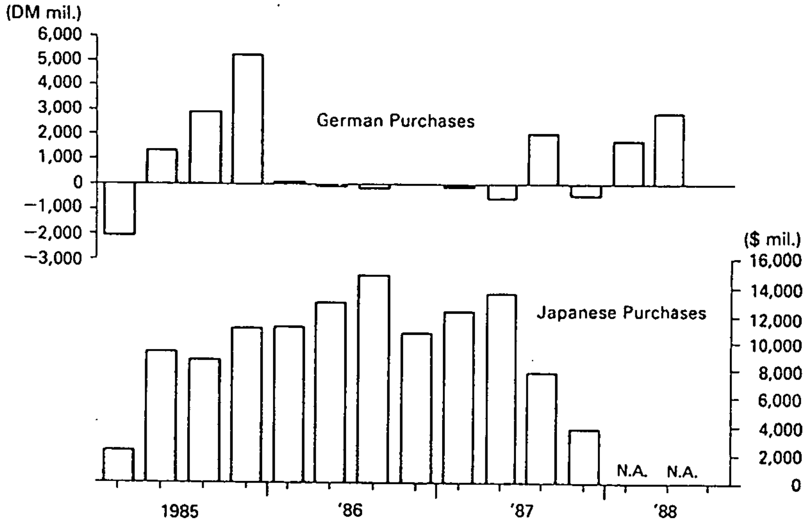
Given the fragility of the world's financial system, investors in Japan are hoping that US leaders will spend at least 90 percent of their time finding ways to correct the federal budget deficit and 10 percent for everything else. The reports reaching this shore, unfortunately, give the impression that the exact opposite is true in Washington.

So far, everything has worked amazingly well. US industries are now showing strong signs of comeback, with both exports and fixed capital investment growing at a brisk pace. The protectionist threat, once so prevalent in the country, is now under control.

There is still a long way to go, however, and the system has come precariously close to total collapse a number of times already. Whatever the motives behind Japanese investors' behavior until now, none of these investors are willing or able to repeat huge losses again, no matter how lofty the cause. The give-and-take long-term relationship which exists between Japanese authorities and the private sector institutions cannot be stretched any further. The next loss of confidence, therefore, would not be met by a very forgiving group.

Japan used US help effectively after the war to produce one of the mightiest economies in the world. It is now time for the US to demonstrate that it too can grab the opportunities provided and meet the challenge of re-industrialization.

Exhibit 1. Japanese and German Purchases[1] of US Securities[2]



Notes: 1. Figures are net purchases.
2. Bonds and equities.

Sources: MOF, Bundesbank

Exhibit 2. Net Purchases of Foreign Securities by Country

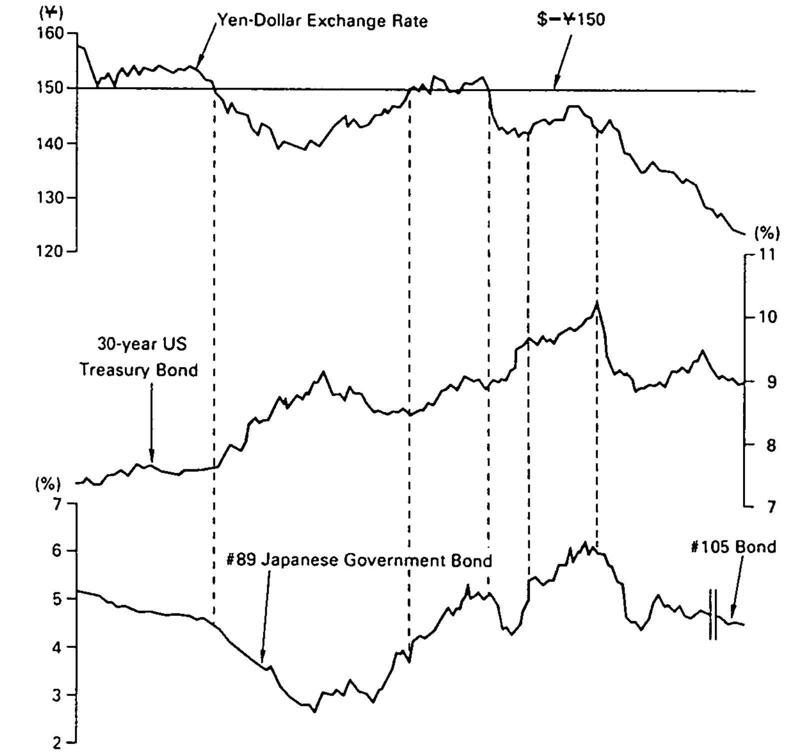
(US$ mil.)

	Total	US	UK	West Germany	Nether-lands	France	Luxem-bourg	Switzer-land	Australia	Canada	Others
4/77-3/78	942	581	195	26	6	Δ 2	116	Δ 1	Δ 0	6	15
4/78-3/79	9,728	8,416	809	92	52	15	210	Δ 1	12	48	76
4/79-3/80	11,684	8,676	1,386	218	Δ 34	Δ 6	191	3	58	1,215	Δ 23
4/80-3/81	19,672	13,371	1,375	229	91	46	844	36	65	3,465	132
4/81-3/82	7,856	2,056	1,816	451	107	Δ 41	2,263	16	201	886	102
4/82-3/83	5,772	359	1,837	Δ 100	Δ 98	144	1,298	44	1,826	43	419
4/83-3/84	14,492	5,608	2,424	169	34	22	3,378	358	931	1,173	395
4/84-3/85	30,611	12,618	4,127	7	39	33	7,842	903	1,891	2,279	873
4/85-3/86	66,237	40,142	5,494	801	Δ 16	39	13,492	353	296	1,818	2,818
4/86-3/87	111,188	50,718	14,521	4,321	93	726	27,158	263	86	5,518	4,786
1985 Jan.	2,090	981	235	10	Δ 1	5	319	46	381	50	64
Feb.	2,949	613	326	44	17	9	1,251	40	294	271	85
Mar.	2,286	678	412	Δ 7	Δ 16	5	862	53	6	304	Δ 11
Apr.	4,062	2,726	295	Δ 4	Δ 4	Δ 1	855	43	Δ 26	80	97
May	3,358	1,699	443	Δ 1	Δ 3	24	1,005	18	Δ 57	200	28
June	7,091	4,825	1,100	25	Δ 13	2	730	54	128	178	63
July	8,440	5,227	916	82	Δ 21	4	1,543	9	122	302	255
Aug.	4,897	2,545	404	Δ 9	Δ 22	Δ 1	1,278	12	143	217	329
Sept.	2,699	954	649	42	71	Δ 0	629	30	79	231	80
Oct.	6,105	3,945	206	163	5	3	1,155	46	16	175	391
Nov.	4,277	2,522	444	23	Δ 1	Δ 11	760	3	Δ 88	218	407
Dec.	7,152	4,556	762	65	2	Δ 1	1,279	175	Δ 36	21	328
CY 1985	55,406	31,271	6,192	433	Δ 50	38	11,666	529	962	2,247	1,645
'86 Jan.	6,018	4,260	514	68	Δ 3	Δ 2	979	Δ 22	Δ 13	77	158
Feb.	6,225	3,648	781	246	9	7	1,393	Δ 9	43	72	34
Mar.	5,916	3,236	Δ 20	102	24	14	1,885	Δ 5	Δ 15	47	648
Apr.	11,673	6,736	1,619	204	20	58	2,085	11	194	262	485
May	9,051	3,916	1,355	178	27	41	2,576	5	14	321	619
June	5,840	2,281	1,506	87	2	42	1,408	3	128	317	66
July	9,345	4,619	1,192	320	Δ 2	15	2,801	11	Δ 172	356	205
Aug.	8,207	3,118	1,520	255	Δ 34	50	2,466	8	Δ 54	584	294
Sept.	11,038	7,107	707	327	13	54	1,790	8	Δ 70	1,007	93
Oct.	8,434	3,271	895	276	Δ 1	38	2,644	39	Δ 28	1,012	289
Nov.	8,603	3,986	964	365	10	71	1,544	17	Δ 138	1,308	477
Dec.	10,677	3,409	1,756	775	13	35	2,738	29	Δ 185	1,279	828
CY 1986	101,027	49,587	12,789	3,203	78	423	24,309	95	Δ 296	6,642	4,196
'87 Jan.	10,800	4,581	1,251	407	Δ 6	14	3,136	18	Δ 4	1,010	393
Feb.	11,184	6,727	694	484	37	52	1,821	60	146	729	435
Mar.	6,334	967	1,062	643	14	256	2,148	54	254	333	601
Apr.	9,473	2,085	933	2,237	73	401	2,819	29	462	72	362
May	7,440	3,308	787	105	241	71	2,018	56	185	44	625
June	13,934	8,169	1,033	1,180	118	31	3,095	17	160	Δ 242	375
July	10,401	4,092	1,328	581	40	72	3,195	22	288	Δ 35	819
Aug.	6,667	2,828	235	Δ 115	24	35	2,637	16	266	Δ 46	788
Sept.	3,543	838	466	225	Δ 1	38	1,980	16	14	348	Δ 382
Oct.	5,157	Δ 39	464	Δ 183	136	55	3,299	3	157	253	1,011
Nov.	3,716	3,471	Δ 120	Δ 110	Δ 35	23	Δ 66	15	369	254	Δ 83
Dec.	1,963	365	546	183	Δ103	0	1,106	78	115	Δ 216	Δ 111
CY 1987	90,610	37,392	8,678	5,635	537	1,048	27,187	383	2,413	2,503	4,834
4/77-12/87	340,472	157,662	40,655	10,315	766	1,702	76,873	2,225	7,382	19,882	12,997

Notes: 1. Excludes Samurai bonds and short-term government papers.
2. Includes foreign currency-denominated bonds issued in Japan.

Source: MOF

Exhibit 3. Capital Flows, Exchange Rate and Long-term Interest Rates in 1987



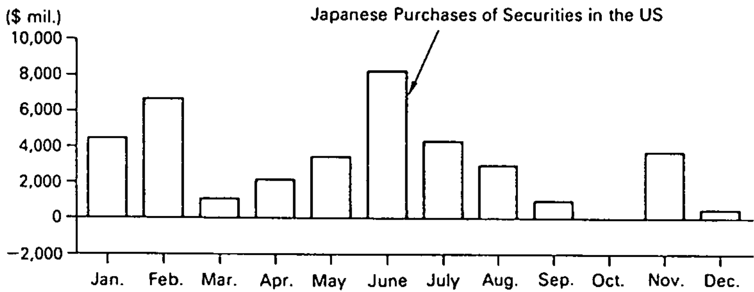
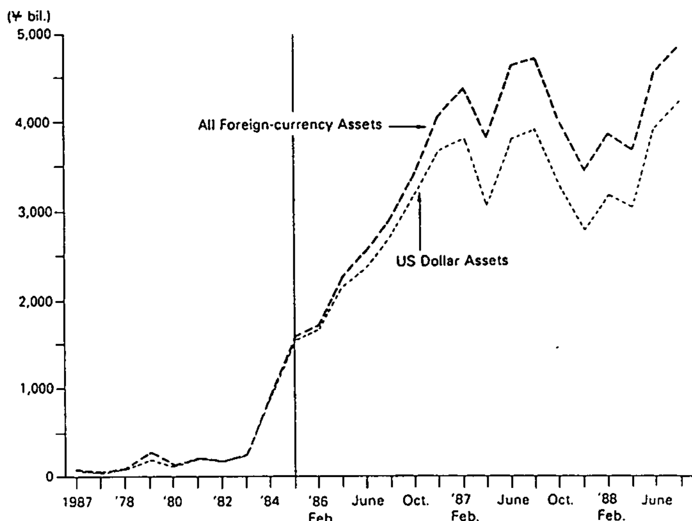
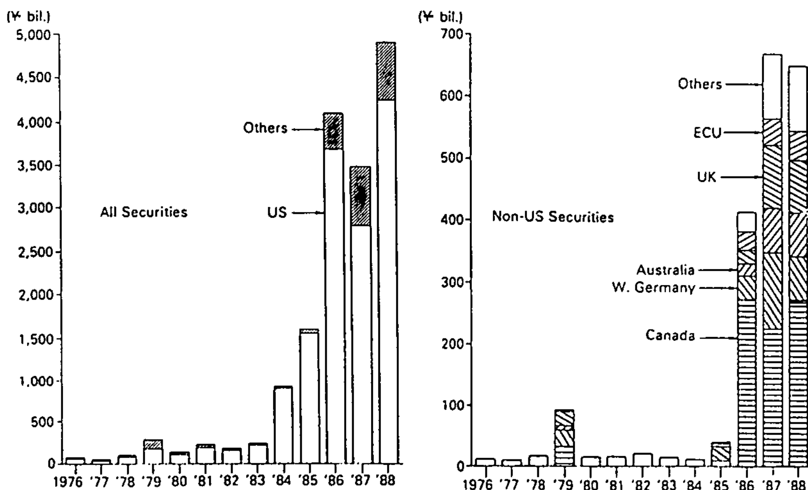


Exhibit 4. Foreign Asset Holdings of Securities Investment Trusts



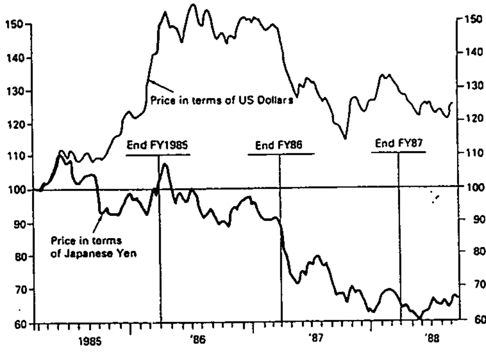
Source: Monthly Report of Investment Trust

Foreign Securities Held by Securities Investment Trusts



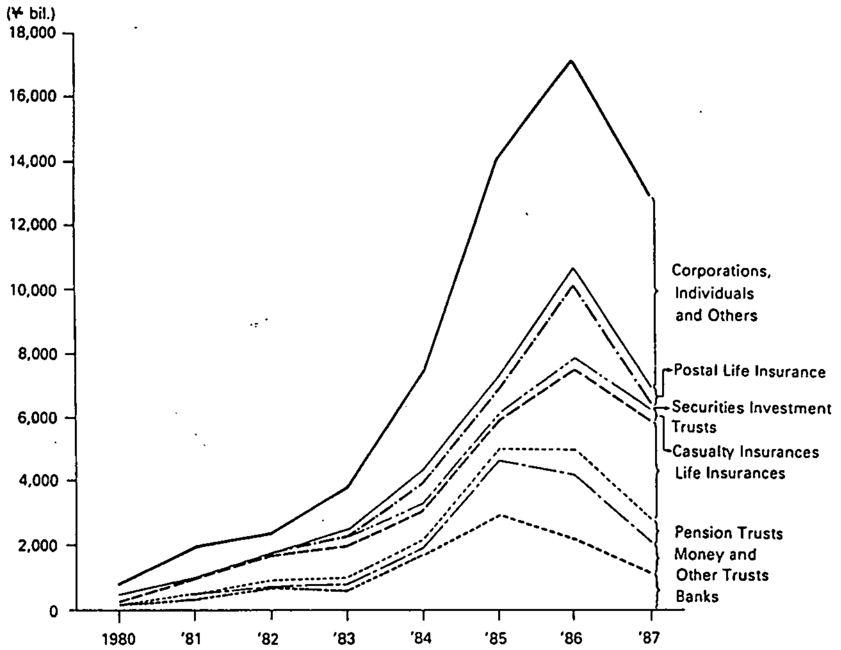
Note: End-July figures are shown for 1988.
Source: Monthly Report of Investment Trust

Exhibit 5. Changes in the Yen and the Dollar Values of 30-year US Treasury Bond (March 31, 1985=100)



Note: 11.25% Treasury Bond due 2015 used.

Exhibit 6. Acquisition of Foreign Securities by Type of Investors



Sources: MOF, BOJ, Nikkei Newsletter on Bond and Money