1517

S. HRG. 101-751

THE INTERNATIONAL ADJUSTMENT PROCESS

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

SEPTEMBER 27, 1989

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

27-042 WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.]

HOUSE OF REPRESENTATIVES	SENATE
LEE H. HAMILTON, Indiana, *Chairman*	PAUL S. SARBANES, Maryland, *Vice Chairman*
AUGUSTUS F. HAWKINS, California	LLOYD BENTSEN, Texas
DAVID R. OBEY, Wisconsin	EDWARD M. KENNEDY, Massachusetts
JAMES H. SCHEUER, New York	JEFF BINGAMAN, New Mexico
FORTNEY PETE STARK, California	ALBERT GORE, JR., Tennessee
STEPHEN J. SOLARZ, New York	RICHARD H. BRYAN, Nevada
CHALMERS P. WYLIE, Ohio	WILLIAM V. ROTH, JR., Delaware
OLYMPIA J. SNOWE, Maine	STEVE SYMMS, Idaho
HAMILTON FISH, JR., New York	PETE WILSON, California
FREDERICK S. UPTON, Michigan	CONNIE MACK, Florida

JOSEPH J. MINARIK, *Executive Director*
RICHARD F KAUFMAN, *General Counsel*
STEPHEN QUICK, *Chief Economist*
DAVID R. MALPASS, *Minority Staff Director*

CONTENTS

WITNESSES AND STATEMENTS

WEDNESDAY, SEPTEMBER 27, 1989

SUBMISSIONS FOR THE RECORD

WEDNESDAY, SEPTEMBER 27, 1989

THE INTERNATIONAL ADJUSTMENT PROCESS

WEDNESDAY, SEPTEMBER 27, 1989

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10:30 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (vice chairman of the committee) presiding.

Present: Senator Sarbanes.

Also present; Lee Price, Judith Davison, and Carl Delfeld, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, VICE CHAIRMAN

Senator Sarbanes. The committee will come to order.

I apologize to the witnesses for the late start of this hearing. The Joint Economic Committee has done some hearings on the Nation's infrastructure, particularly its transportation network, and the need to increase our investment. We see the costs of failing to do so in lost productivity and output, wasted time, and so forth, and this morning is a classic example. [Laughter.]

We are here today to review the question of the current account and trade imbalances in the world economy. This hearing comes at a particularly opportune time, with the IMF and World Bank meetings taking place.

These imbalances have reached very disturbing levels. Two years ago this committee published a staff study, "A Legacy of Debt," which sought to analyze the decline and project future trends in the U.S. net asset position. The problem is not only still with us, but has taken on a new urgency. In the last year, for the first time in 30 years, the United States had begun to report deficits in trade and services, particularly for investment earnings. This reflects rising payments to foreigners on their assets in this country, payments which will continue to rise in the years ahead.

Commerce Department figures released 2 weeks ago show that the rise in the services deficit outweighed improvements in the merchandise trade account, driving up the second quarter current account deficit. While the quarterly numbers are distorted by changes in the exchange rate, the trend seems clear. Our current account deficit is becoming larger than our merchandise trade balance.

We noted 2 years ago the potential adverse effect of rising debt service payments on our national standard of living. The drumbeat of concern is becoming more insistent. Roger Altman in the New York Times said about 10 days ago, "More and more of our nation's gross national product will be diverted to service our debts. Long term, and if we don't reduce our deficit, American incomes will fall."

The Commerce Department report was followed this week by the semiannual report of the IMF on the global economy. In the IMF's World Economic Outlook forecasts a small decline in the U.S. current account deficit this year, but a substantial widening of the deficit in 1990, accompanied by growing Japanese and German surpluses.

We have some charts here that I just very quickly want to outline before I turn to our witnesses.

The first shows projections for the U.S. current account deficit contained in the just-released IMF World Economic Outlook and those prepared earlier in the year by DRI. While DRI is somewhat more optimistic than the IMF for this year and next, it does not show much improvement in the U.S. current account over the decade ahead.

The second chart shows projections for the net asset position of the United States through the end of the century. It shows the U.S. negative net asset position rising from its 1988 level of $532 billion to $1 trillion by 1992 and reaching $1.8 trillion by the year 2000.

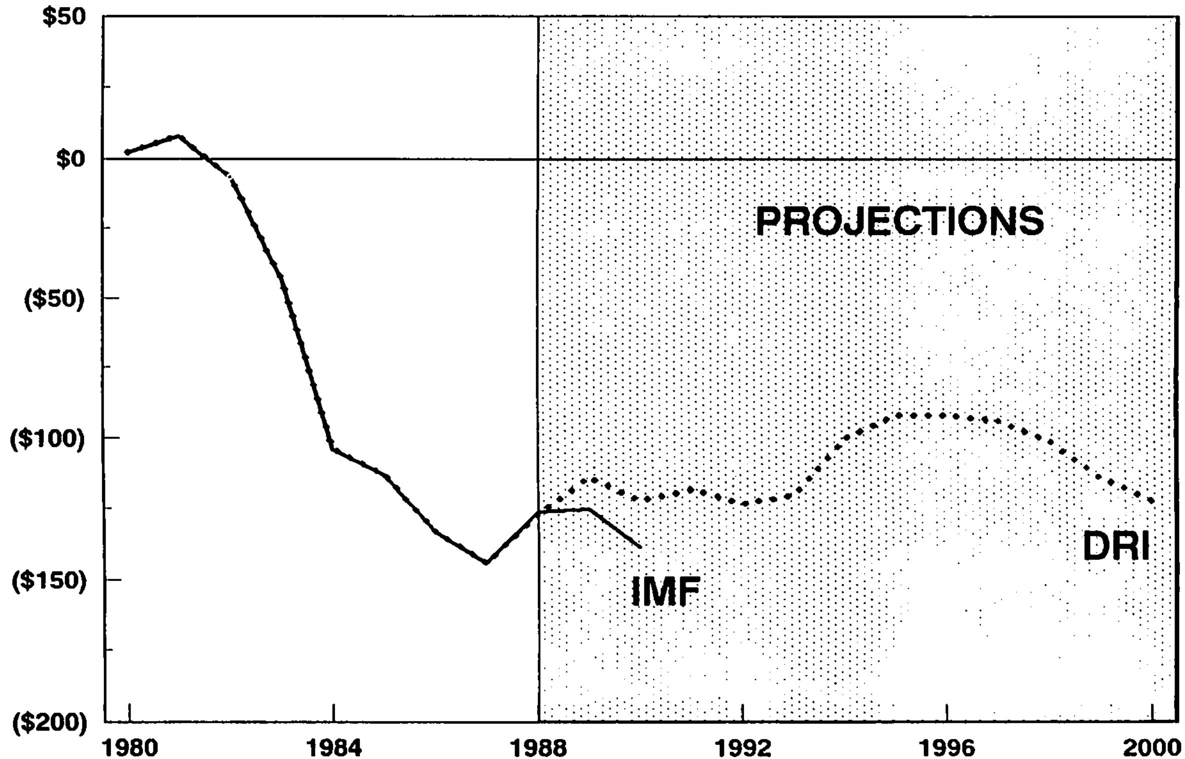
When we first started looking at this problem more than 2 years ago there were some hopes that we would bottom out at about $700 to $800 billion. That has not happened.

The third chart compares the net asset trend of the United States to those for Germany and Japan, and it shows their financial streangth continuing to grow stronger. They are actually projected to increase their net creditor status to $1.5 trillion by the end of the century, which raises a question of how power and influence in the world will be distributed with the United States in such deficit and Germany and Japan in such strong creditor positions.

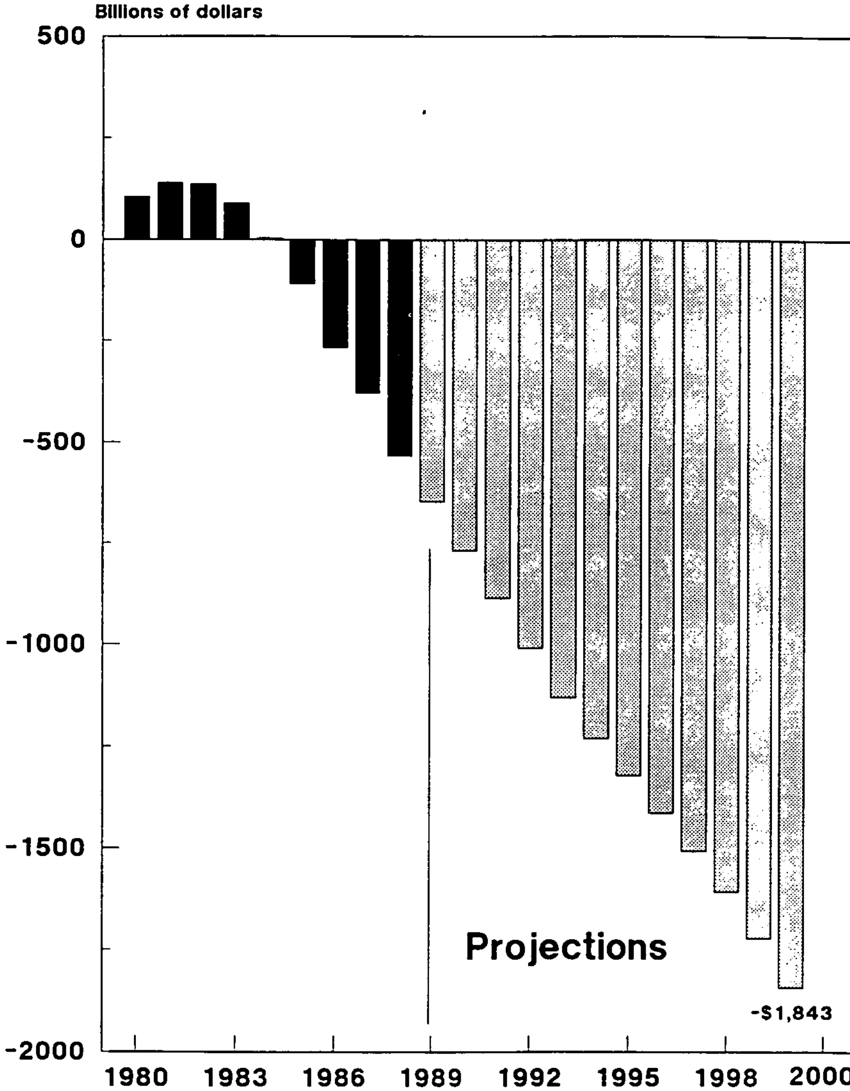
The fourth chart shows the roller coaster path of the dollar since 1980. Between 1980 and early 1985, the years of Donald Regan at the Treasury climbed by more than 60 percent before declining by almost that amount through 1987. Since then it has risen roughly 15 percent.

[The charts referred to by Senator Sarbanes follow:]

U.S CURRENT ACCOUNT BALANCE
(In billions of Dollars)

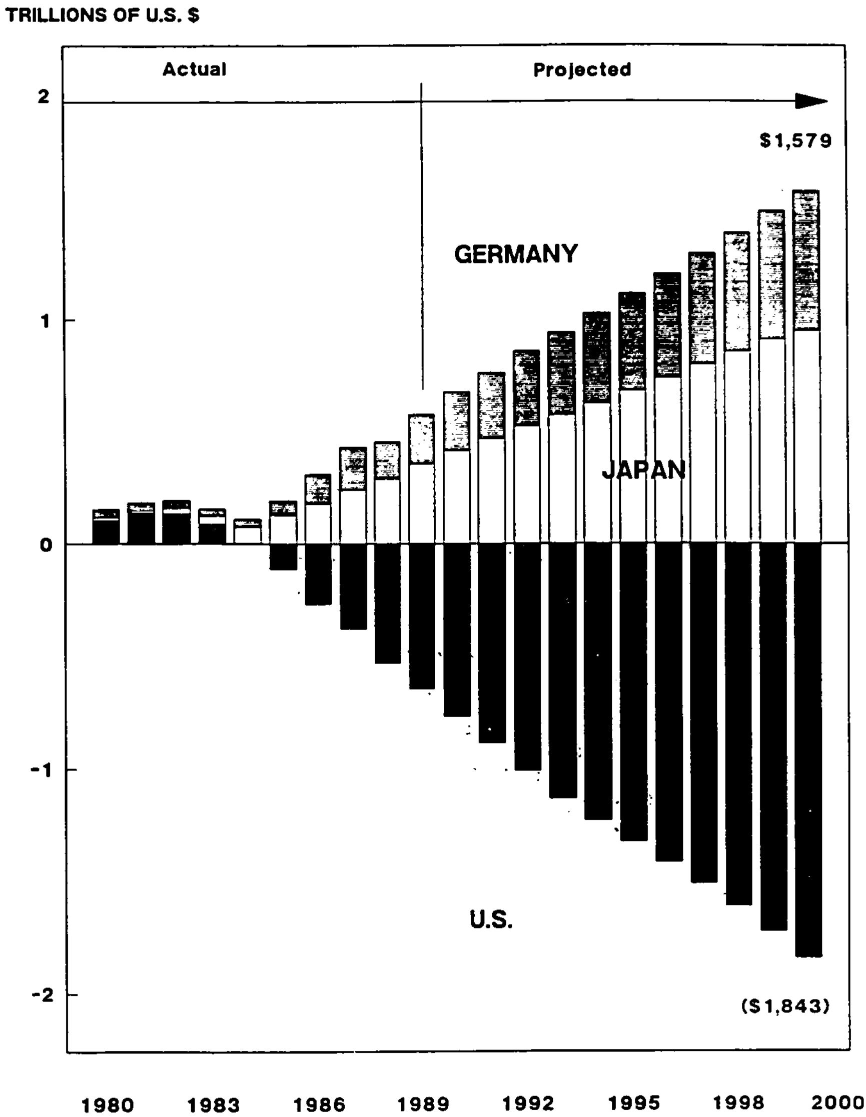


U.S. NET EXTERNAL ASSET POSITION



SOURCE: DATA RESOURCES, INC.

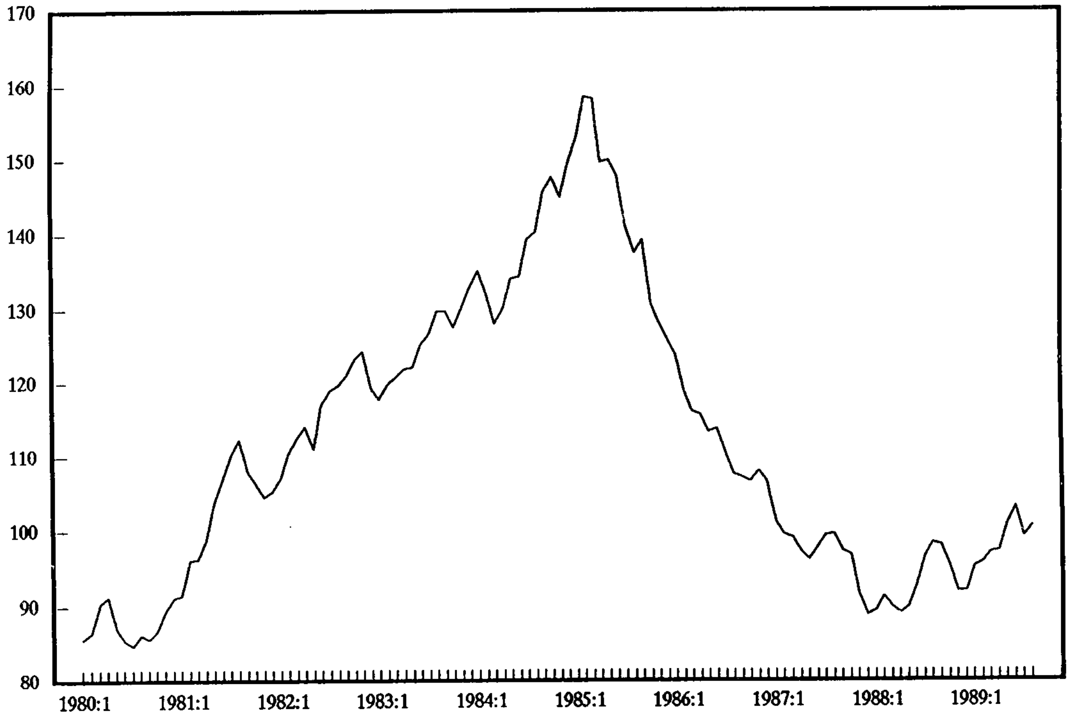
NET ASSET POSITIONS



SOURCE: DATA RESOURCES, INC.

EXCHANGE VALUE OF THE DOLLAR

TRADE-WEIGHTED INDEX



SOURCE: FEDERAL RESERVE BOARD

Senator SARBANES. To look at these issues and others, we are fortunate to have three very distinguished witnesses this morning: John Williamson, senior fellow at the Institute for International Economics; Ed Lincoln, senior fellow at the Brookings Institution; and Gary Hufbauer, Wallenberg Professor of International Financial Diplomacy, which is a nice name and a nice title for a chair, I must say, at Georgetown University.

Gentlemen, have you worked out an order amongst yourselves? [Witnesses nodding negatively.] If not, why don't we start with Mr. Williamson and move right across.

We will include your prepared statements in the record, and you can summarize it now.

Please go ahead, sir.

STATEMENT OF JOHN WILLIAMSON, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. WILLIAMSON. Thank you very much, Mr. Vice Chairman.

I am delighted to be here this morning and to be able to contribute to this hearing.

My prepared statement starts by looking at the record, what was done once the administration became concerned about the mounting U.S. deficits which, as you pointed out a moment ago, they were not during the first Reagan administration while the Treasury was under the care of Donald Regan.

But as from 1985 there clearly became a concern that these deficits were dangerous and that it was necessary to pursue policies to reduce them, and I tried to trace very briefly what first the Group of Five and then the Group of Seven did in order to reduce the dollar to a more competitive level and then in early 1987 when they came to the conclusion that it had depreciated enough to stop the decline, but nevertheless maintain the other element of the adjustment process, the faster expansion of demand in the surplus countries and the corresponding restraint in demand that was needed in the United States.

I think one very important change of sentiments that came out of this process involved a reevaluation of the effectiveness of intervention in the foreign exchange markets.

In the early 1980's most observers had more or less written off intervention in the foreign exchange markets as a useless policy tool, and I think that that opinion has been substantially modified in the past 2 to 3 years and primarily as a consequence of the success that the Group of Seven had primarily through concerted intervention early in 1988 in reversing the weakness of the dollar, in first stopping it and then indeed contributing or laying the basis for the subsequent recovery in the value of the dollar, which in the view of some of us has now gone too far.

In any event, that intervention in early 1988 did appear to change the tone of the markets, and that has led many economists to the conclusion that intervention can accomplish more than had been believed in the past.

However, even those who have come to this conclusion tend to believe that the way in which it works is through what are called announcement effects. In effect, this is saying that intervention can work because the market is interpreted as a guarantee of the seriousness of the authorities in trying to change exchange rates and implicitly therefore their willingness to follow through with other actions. The danger therefore arises that if they lose that reputation, then intervention will once again seek to be effective.

In my prepared testimony I suggest that if the authorities are shown to be paper tigers who are not willing to change their monetary and fiscal policies when necessary, one must anticipate that the credibility needed to make intervention a useful additional policy weapon will erode, and I say indeed this seems to be already happening.

Well, that was, of course, written before last weekend. We have had now another injunction from the Group of Seven, another invocation to the markets to please reduce the value of the dollar and with the intervention on Monday that had some initial success. But already it seems to me that the effect is wearing off and there is really going to be a need for some additional policy action if the authorities are to manage exchange rates effectively.

I think one should also say that the Group of Seven did have some success in correcting rates of demand growth, particularly in the case of Japan. In the case of Germany not so much was done deliberately, but, nevertheless, demand is once again growing at an appropriate rate.

The area where I think everyone has been disappointed with progress is, of course, the minimal action in the last year or two to correct the U.S. budget deficit, which is the other side of the same coin.

I also discussed the other surplus countries. I mentioned that there are other European surplus countries besides Germany, three of them that are quite significant, Beglium, the Netherlands, and Switzerland.

In Asia there are two other important surplus countries besides Japan, namely, Korea and Taiwan, both of which were heavily pressured by the United States to take adjustment action and both of which I think it's true and important to recognize responded to those calls and have allowed their currencies to appreciate.

They have liberalized their trade policies in quite a significant way, and also they have had strongly expanding domestic demand, although it's not quite as clear the extent to which that outcome was a result of deliberate policy rather than perhaps as in Germany against something that fortuitously occurred.

How much progress has been made on the basis of these policies, I show there some figures at the end of my prepared statement. I have a table. Unfortunately, I give the United States as they are still appearing in the international publications and not after the latest data revisions. But the basic message is the one that you have just said, that there has been a reduction in the U.S. deficits, and there looks like being some further reduction this year. I would actually guess that it will come in at under $120 billion rather than something over, but that next year it looks as though the deficit is going to start rising again.

The German surplus is still increasing, the Japanese surplus has decreased, but it's not clear that that is going to be maintained in the future. In the cases of Taiwan and Korea we don't have forecasts from the international agencies, but the impression is that the Korean surplus will be down very significantly this year, perhaps to $6 billion this year from $14 billion last year.

The Taiwanese surplus will actually be slightly bigger this year in crude terms, but probably be rather smaller after one allowed for the fact that last year they magnified the improvement by buying 2.5 billion dollars' worth of gold from the United States and treating it in the statistics as though it was steel or copper which, in my view, isn't an unreasonable thing to do, but it's not traditional. So after allowing for that, the Taiwanese surplus is also somewhat lower this year, but still very large at over $10 billion.

The other thing one should recognize is that the U.S. deficit at the moment is probably lower than its underlying trend value by perhaps as much as a billion dollars a month reflecting the recent appreciation of the dollar and the fact that a lot of imports are entering denominated in foreign currencies at dollar prices therefore which are lower than they would be had they been contracted at the present set of exchange rates.

So that tends to reduce the deficit currently being recorded, and so perhaps all the euphoria about the lowest monthly deficit in 4 years is a little bit overdone.

The second part of my prepared statement is concerned with the objectives of balance of payments policy. The first point I make is that it's possible to have two different philosophies on this subject. There are those, and the Regan Treasury was a good example of this line of thought, who believed that economic policy should be made by simply setting out some longrun policies and sticking to those and not worrying about what the markets do to exchange rates or interest rates or anything else in the process of carrying through those policies. Let the markets decide and accept that outcome.

I think that is not, however, the philosophy underlying the Group of Seven. If it was, they wouldn't have issued their statement over the weekend calling for a lower dollar. They clearly are worried about exchange rates, and I think that that is right. I think it's a better way to make policy and to try and have some idea about where exchange rates should be and design policy around that.

However, there is a major disappointment in that the Treasury has so far been unwilling to state what the objectives of U.S. balance of payments policy are and how far it is trying to get down the deficit and how fast. This was some information that was specifically being looked for by the Congress when it passed the exchange rates reporting provisions in the Omnibus Trade Act, and I think one has to be disappointed that nothing has been done by the Treasury to respond to that request to date.

Rational debate simply is not possible without some view which can indeed and I think should be rather imprecise, broad brush, but some articulation of where we are trying to go, and only on that basis can one then try and discuss whether the exchange rate intermediate target is appropriate for getting there.

Now my own view is that it is rather urgent for the United States to get its current account deficit down to a level at which the ratio of debt to GNP would not be increasing in the way that it is in those figures shown on the diagrams there. I think that that is a high priority objective because as long as there are deficits of this magnitude, there has to be a risk that the hard landing of the dollar and the collapse of financial confidence in the dollar will come one day.

Simply because it hasn't happened yet doesn't mean that it can't happen in the future. Indeed as that debt builds up, the United States becomes progressively more vulnerable to a confidence crisis. So I think that that is important.

On the other hand, I don't think that it's essential to get the deficit down to zero and to prevent any further increase in debt. There are good reasons for saying that the United States is currently a country that should be importing capital on a safe scale because it has relatively good investment opportunities and it has a population in the low savings phase of the life cycle.

So for those reasons I would not want to see the deficit go to zero, but I do think that it is urgent to get it down from where it is now.

Perhaps I should add that I hadn't anticipated that this committee would be looking out as far as the year 2000. That's way beyond the time horizon of most policymakers, but my own philosophy is not to say that I would expect this deficit of 1 percent of GNP, the figure that I suggest could be accepted safely in the next few years, to continue right up to the end of the century.

Those demographic factors that I mentioned a minute ago will be going into reverse in the second half of the 1990's, and by the year 2000 I would expect them to be leading the United States back to balance or even surplus on current account. But until the demographic factors come into play, I think it's logical to accept a deficit, but a deficit of a size that does not pose these risks of financial crisis somewhere along the road.

Now one of the major objectives of policy coordination should, in my view, have been to try and make sure that these sorts of balance of payments objectives by the United States were acceptable to other countries and consistent with their objectives. And I think that the evidence is that once again the Group of Seven really haven't had this sort of discussion, despite the fact that in the original Tokyo list of indicators current account balances were very clearly included as one of the items which should be coordinated, and they seem not to in fact even had those discussions, which I think is very regrettable.

I think also that that's the type of subject in articulating medium run objectives for policy in which it is absolutely appropriate for there to be consultations between the Congress and the Executive. You may know that our institute recently published a study on that subject which tried to make some suggestions about the way the process could be improved.

I do mention that there might be a potential problem in negotiating such objectives with Europe, but I will leave that subject to Gary Hufbauer.

Perhaps where the Asian countries are concerned there fairly clearly would be an initial reluctance to accept an explicit set of current account objectives which were low enough to be consistent with a move of the United States back to something like balance, and I think that negotiations would be necessary, not just with Japan, but also with Taiwan and Korea on that subject.

But I want to make two points about that. The first is that I think that we should try and look for some multilateral forum in which to conduct those negotiations. Clearly in the case of Korea we already have the IMF because Korea is a member of the IMF, and really this is a subject that I think the IMF should be involved in. Taiwan is a problem because it is not a member of the IMF and so perhaps as an alternative is bilateral negotiations. But in principal I would want to see those negotiations done on a multilateral basis largely to avoid the unfortunate resentment that has arisen in those countries through the feeling that they are being pressured by Big Brother.

The other point that I think is very important is that if we are going to ask them to contribute to an adjustment process, which we surely should do, then we should at least give them adequate time and not risk wrecking their domestic economic progress in order to adjust very quickly.

If the United States needs 3 or 4 years to adjust, and that now seems a rather conservative estimate of the time that this country needs, then surely Taiwan and Korea need that sort of time as well, and the fact that their surpluses have not been eliminated after they have been trying for 2 years, but have only been roughly halved, that really they should get rather good marks for having adjusted that quickly rather than continuing to be the recipients of so much pressure.

Indeed, I think that the essence of the policy coordination exercise is to try and combine payments adjustment with continuing good domestic economic performance in all of the participating countries.

So I want finally to suggest three principles which could help in achieving that objective.

The first is that the system of policy coordination should be based on certain agreed principles, rules of the game. I don't think it's realistic to suggest that you can create some rigid rules which countries have to obey and, if they don't, then there are sanctions that automatically kick in. We are dealing with sovereign countries and I don't think that the Congress would be very happy if the United States was asked to subscribe to rules of that sort and, quite properly, because we can't foresee all the contingencies and therefore all the circumstances that might create legitimate exceptions to such rules.

But I do believe that we know enough in order to create some general principles which ought to underlie balance of payments adjustment under normal circumstances. If you don't do that, then the danger is of a breakdown of the coordination exercise of the sort that we have had in recent months.

It seems to me that at the time of the Plaza all the participants received a strong common interest in correcting the overvaluation of the dollar, and that then built up a cooperative momentum which served to sustain cooperation as long as the Finance Ministers initially involved, namely, Messrs. Baker, Miyazawa, and Stoltenberg, remained in charge.

But there came a point, however, where all those three left office and their successors didn't have the same commitment or the same reputation and there was no agreed set of principles to sustain the process and, hence, one saw the dollar rising above the target zone which we were given to understand it had previously been contained in, which was certainly a setback for the process of policy coordination.

So that's the first principle. One does need a set of guidelines.

The second point, I think that these should be medium-term guidelines from which you then work back to the short-term implications. There has always been much too much of a tendency to have policy coordination as a firefighting approach to simply resolving crises or at best to avoiding them.

I think instead what one should try and do is ask where one wants to be in the medium term, say 5 years out, and that is something which I suspect it would be much easier to get people to agree on than asking them what their policies should be next year.

Then one can work back from that to the implications for intermediate targets in the way that I have tried to articulate this system. Those intermediate targets would concern both exchange rates and the growth of domestic demand based on a set of principles mutually agreed and perhaps also a medium-run path fiscal policy, and then that would give some shortrun guidelines.

Then the third principle of this policy coordination exercise would be an agreement to use monetary and fiscal policy to try and keep the economy reasonably close to this agreed path to a satisfactory medium-run outcome.

Under normal circumstances I would envisage economic policy being conducted much as now, medium-run fiscal policy and then monetary policy being used in order to keep the economy on track.

However, if the exchange rate threatened to move too far from its target path, and that is outside a target zone, first, one could use intervention to try and bring it back and, if the markets were convinced that one was willing to follow through if necessary, I think that would normally be sufficient.

However, as I argued earlier, that would depend upon the markets being convinced that if intervention failed, it would in fact be backed up by a change in monetary policy.

And, of course, if one is going to change monetary policy under some circumstances to manage the exchange rate, then one also needs to have the facility to change fiscal policy in order to compensate for any undesirable impact on domestic demand. So that is the sense in which I would still see fiscal policy being used in a flexible manner in the short run.

Although I don't think that such a policy regime would require frequent departures of fiscal policy from its predetermined path, it would require that possibility to be there, and that is absolutely central to a satisfactory macroeconomic management, and I think it's most unfortunate that at the moment one doesn't see the necessary flexibility in fiscal policy, and my interpretation of why is it's largely because of tax phobia.

I then conclude my prepared statement by asking what such principles would imply for current policy. I see a little sign of weakness in overall demand in the United States at this time. On the other hand, I do see a dollar that is too strong in the medium term. I'm sure the Group of Seven is right in saying that.

So that calls for a shift in the policy mix involving lower interest rates compensated by a tighter fiscal policy. We come back to this question of fiscal policy and too large a budget deficit as the central weakness of the G-7 policy coordination process which is not making it impossible for the Fed to play its part in getting the dollar down by relaxing monetary policy.

Right now I think that is the major problem. We all complained about German and Japanese policy 2 or 3 years ago, and certainly Korean and Taiwanese policy as well. It seems to me all those countries have taken major steps to adjust, but one has to be sure that they will keep on the good work, as it were, but right now I don't see a strong reason for additional action to be called for in the short run.

Thank you.

Senator SARBANES. Thank you very much, sir.

[The prepared statement of Mr. Williamson follows:]

27-042 - 90 - 2

PREPARED STATEMENT OF JOHN WILLIAMSON

Since the Plaza Agreement of September 1985, the major industrial countries have sought to reduce their mutual payments imbalances though cooperative action. I am pleased to have this opportunity of testifying on how far the adjustment process has already gone, on how much farther it needs to go, and on what should be done to complete the desirable adjustment in an orderly way.

The Record

The Group of Five agreed at the Plaza that adjustment of the perilously large US trade and current account deficits would require a depreciation of the dollar. By February 1987 they estimated that the dollar had fallen far enough to restore US competitiveness to a level that could sustain correction of the trade deficit, and the Louvre Accord therefore sought to stabilize the dollar. The Group of Seven (as it had then become) recognized that adjustment would require not just a competitive value of the dollar but also complementary changes in the growth of domestic demand, with demand growth rising in surplus countries like Germany and Japan and falling in the United States (implying a need to cut the budget deficit).

The G-7 had substantial success in arresting the decline of the dollar. Admittedly it did fall again substantially at the end of 1987 after the stock market crash, but the bear raid mounted through concerted intervention in the first days of 1988 was conspicuously successful in arresting the dollar's decline. This is the incident that has done the most to reopen the question as to whether, after all, sterilized intervention may be capable of having substantial and lasting effects on exchange rates. My current appraisal is that such effects are possible but that they depend on the market treating intervention as an indicator of the willingness of the authorities to change other policies to achieve their exchange rate objectives (i.e. that intervention works because of the announcement effect). If the authorities are shown to be paper tigers who are not willing to change their monetary and fiscal policies when necessary, one must anticipate that the credibility needed to make intervention a useful additional policy weapon will erode. Indeed, this already seems to be happening.

The G-7 also had some success in correcting rates of demand growth. The major accomplishment concerned Japan: in return for foreign cooperation in stemming the yen's appreciation in April 1987, Japan introduced a significant stimulatory fiscal package, which helped launch the healthy domestic demand-led growth that Japan has since enjoyed. Germany was more resistant to using fiscal policy to accelerate growth, but in the event has nonetheless experienced the desired increase in growth. The United States also showed a welcome reduction in its budget deficit in 1987, but everyone has been disappointed by the lack of subsequent progress. This is the major shortfall from the G-7's proclaimed program.

Japan and Germany are not responsible for the entire counterpart to the US deficit (see table). Three other European countries--Belgium, the Netherlands, and Switzerland--have large, persistent surpluses. All three have currencies closely linked to the deutsche mark, and therefore appreciated against the dollar along with the DM. None of them has come under pressure to take special action to expand their domestic demand.

In contrast, the other two surplus countries, Korea and Taiwan, have come under heavy pressure from the United States (endorsed by the G-7) to take adjustment action. This pressure surely contributed to the substantial trade liberalization that both have undertaken and to the decision to appreciate their currencies. From September 1985 (just after the Plaza) to the end of 1986, before pressures started, the Korean won appreciated 3 percent against the dollar and the New Taiwan dollar appreciated 12 percent; since then, the won has appreciated 23 percent and the NT dollar 27 percent. Both countries have also experienced the sort of rapid expansion in domestic demand that was needed to support the adjustment process, though it is much less clear that this was a response to US pressure or indeed that it was the result of policy action pursued in the interest of payments adjustment.

While most of these policies were exactly what was needed to correct the payments imbalances, the failure to bring the US budget deficit under control has proved to be critical. The trade figures may continue to look reasonable for the next few months, as the strengthening of the dollar reduces the value of imports measured in dollars (the J-curve effect, which may currently be worth as much as $1 billion per month). My own expectation is that the current account deficit for 1989 will come in between $110 billion and $120 billion (after data revision, which has uncovered additional net exports of services), rather lower than the IMF and OECD projections shown in the table. But, by some time next year I, like just about all the serious model-based forecasters (including the IMF), expect to see the deficit trending up again as a result of the strong dollar.[1]

Recent data suggest that the Japanese surplus will again fall substantially in 1989, partly as a result of the tourist boom. The surpluses in Germany, Belgium, the Netherlands, and Switzerland appear solid. In Korea, the surplus has more than

---

[1]. For example, our inhouse forecast had the 1989 deficit at $119 billion, rising to $130 billion in 1990 and $153 billion in 1992 on the basis of 1987(Q4) real exchange rates; see W.R. Cline, United States External Adjustment and the World Economy, Institute for International Economics, Washington, p.101. A subsequent calculation investigating the implications of exchange rates staying at their 1989(Q2) levels showed a lower 1989 deficit, little change in 1990, and a deficit of over $190 billion by 1992.

halved so far this year, from $7.1 billion last year to $2.8 billion in January-July this year, but it is unclear how much of this is due to real appreciation of the won (caused by the doubling of labor costs in 3 years as well as by nominal appreciation) and how much by labor unrest. Taiwan's surplus may increase modestly again this year, though it will probably be somewhat lower than last year's surplus purged of the $2.5 billion of reported gold purchases.

Objectives

It is not possible to discuss the adjustment process rationally without knowing what outcome adjustment is intended to achieve. It is therefore disappointing that both of the Treasury's two reports to Congress under the reporting requirements of Section 3005 of the Omnibus Trade Act have sidestepped the issue of specifying a balance of payments objective. Such an objective need not be defined precisely, and if it were no one should complain if it were missed by $20 billion or $30 billion. But rational debate has to start by the Treasury explaining what it is trying to achieve and why it considers those goals to be important, as a prelude to consideration of whether the methods being adopted are well-suited to the chosen ends. The only alternative that makes any sense is to say that one does not need to choose a goal as long as one follows a predictable set of policies because then the market could make well-informed decisions that could be relied on to lead to a good outcome, an economic doctrine which the

Congress could then proceed to evaluate.

My own view is that the United States should aim to reduce its current account deficit to no more than about 1 percent of GNP (some $60 billion) by about 1992. I reach this figure on the basis of two considerations. The first is that it makes sense for the United States, as one of the few industrial countries with the high investment needs that accompany a still-expanding labor force and the modest savings that go with a baby-boom generation in the prime child-rearing years, to import capital. The other is that the benefits from borrowing to increase investment pale into insignificance compared with the costs of a collapse of market confidence in the dollar (a "hard landing"), a danger that cannot be dismissed because it has not happened yet, and indeed that becomes more likely as debt increases (relative to GNP) and the dollar rises. Hence I conclude that policy should aim to cut the deficit to a point where debt increases no faster than GNP as quickly as reasonably possible, a criterion that leads me to my objective of a $60 billion deficit by 1992; but that a further reduction beyond that point should not be a high-priority objective.

One purpose of policy coordination should be to ensure that nations pursue a mutually-consistent set of objectives. Since payments balances add up to zero (neglecting statistical discrepancies) and pursuit of inconsistent payments targets could be highly destructive, one would have thought that the G-7 would long ago have pursued this issue. So far as one can make out, however, despite the inclusion of current account balances among the Tokyo indicators, they have been as obfuscatory among themselves as the Treasury has been with the Congress. This is much to be regretted, in both cases.

If and when such discussions take place, I would expect that an important issue of principle will arise in discussing whether Germany and the other European surplus countries should be expected to aim to reduce their surpluses. The Europeans would argue that Europe is in the process of forming a monetary bloc within which surpluses and deficits will be as inconsequential as those between Maryland and Texas, and accordingly that the international coordination process should look only at the net imbalance of the EMS area, which happens to be small. I have considerable sympathy with this argument, though it would perhaps be proper to accept it only if there is reasonable assurance that the EMS is indeed moving to monetary union in the foreseeable future; after all, if it is not, large intra-European imbalances are unlikely to prove sustainable.

Agreement on current account objectives would in any event doubtless require that some countries be persuaded to pursue smaller surpluses than they would choose to do without a mechanism for policy coordination. Taiwan and Korea (as well as Japan) would seem likely to fall in this category at the present time. It is surely important that the legitimate interests of these countries--which provide impressive advertisements for the economic policies that most of us in Washington urge on other developing countries--be safeguarded. I suggest that this requires two thing. One is that some appropriate multilateral forum be utilized for achieving agreement on current account objectives, to minimize the resentment that is inevitable when small countries are subjected to bilateral pressure from big countries. The other is that they be given adequate time to adjust without threatening destabilization of their economic performance. If the United States needs 3 or 4 years to adjust, then that is the time horizon that is appropriate to set before Korea and Taiwan as well.

The latter point can be broadened. While it is important that countries avoid payments outcomes that are unsustainable or that involve a perverse transfer of real resources from areas where their marginal productivity is relatively high to areas where it is lower, it is at least as important that countries achieve the highest level of output consistent with the continued control of inflation. The purpose of policy coordination is to help all the participating countries to combine satisfactory balance of payments performance with their domestic objective of noninflationary growth.

Policy Design

I wish to suggest three bases for the design of a system of policy coordination intended to reconcile the payments and domestic objectives of the participants.

(1) The system should be based on an agreed set of rules of the game: general principles that could be appealed to in order

to delineate appropriate policy under most circumstances, while not pretending to define a rigid set of policy obligations. The idea that target zones for exchange rates, or any other set of "objective indicators", might be accepted by sovereign countries as binding constraints on their economic policy is distinctly implausible. Yet the attempt to base policy coordination on a set of one-off deals with no agreement on the underlying principles is doomed to failure. The recent breakdown of the G-7's attempt to maintain the dollar in a target zone provides a good illustration. At the time of the Plaza all participants perceived a strong common interest in correcting the overvaluation of the dollar. The cooperative momentum built up by the success of that endeavor served to sustain cooperation as long as Messrs Baker, Miyazawa and Stoltenberg remained in charge. Exit the principals, however, and, in the absence of a framework of agreed principles, meaningful cooperation collapsed. Repeated invocations to the markets to be gracious enough to lower the value of the dollar are not a substitute for a resolve to take concerted action.

(2) Instead of the customary firefighting approach of resolving crises, or at best avoiding them, the process should start by thinking about what would be a desirable outcome in the medium term (say 5 years ahead). This would involve agreeing on a set of current account objectives, estimating the growth rate consistent with achieving a zero-inflation full-employment position by the terminal date, and estimating both the exchange

rate and the budget position implied by these medium-run objectives. The Congress (and the legislatures in other G-7 countries) should be intimately involved in designing these objectives. The authorities should then work back from these medium-run targets to calculate trajectories for "intermediate targets" that would be expected to lead the economy to its desired goals at the end of 5 years. The most suitable intermediate targets seem to me to be the exchange rate and the growth of nominal domestic demand; my published work contains discussions of how sensible targets for both variables might be calculated in a rough and ready way.[2] It would also seem sensible to publish a projected medium-run path for the budget deficit somewhat analogous to Gramm-Rudman, provided it proves possible to build in safeguards against the sort of cooking the books that is rendering the Gramm-Rudman limits progressively more worthless. These intermediate targets would be published, both in order to promote public debate and to improve the information available to the private sector.

(3) Monetary and fiscal policy would be used to try and keep the economy reasonably close to the two intermediate targets. Under normal circumstances it should be possible to allow fiscal policy to follow its preordained medium-run path while monetary policy keeps the growth of domestic demand on

---

[2]. John Williamson, The Exchange Rate System, Institute for International Economics, Washington, revised edition 1985, and John Williamson and Marcus Miller, Targets and Indicators: A Blueprint for the International Coordination of Economic Policy, Institute for International Economics, Washington, 1987.

track. If, however, the exchange rate threatened to move too far from its target path (outside a target zone), intervention could be used to try and bring it back. If intervention failed, it would have to be backed up by a change in monetary policy. If that threatened to blow demand growth off course and cause either inflation or recession, a compensatory deviation of fiscal policy from its trend path would be called for.

I do not believe that such a policy regime would involve frequent departures from the predetermined path of fiscal policy. Where such departures were warranted, I would assume that they could normally be accommodated in the regular annual budget cycle rather than calling for "fine tuning." But it is central to the proposal that governments be prepared when necessary to adjust fiscal policy honestly and in a way that will have an impact on aggregate demand, rather than playing accounting games and avoiding effective policy measures because of tax phobia.

What would such principles imply for current policy? So far as the United States is concerned, I see little sign of an overall weakness in demand that would call for net expansionary action, but an urgent need to reduce the value of the dollar. This calls for a shift in the policy mix, involving lower interest rates compensated by a tighter fiscal policy. It is the United States' refusal to tighten fiscal policy in the only way that could make a meaningful impact, by raising taxes, that has gutted the G-7 process. One wonders whether President Bush's misguided pledge not to raise taxes could not at least be reinterpreted as having been directed only to Americans, a reformulation that would allow the imposition of taxation on interest income earned in the United States by foreigners. This would have a direct effect in pushing the dollar down by making the United States a less attractive location for investment, as well as reducing the budget deficit.[3]

I see little reason to complain about Japanese and German policy at the present time. It would be wrong to press them to expand more rapidly and risk renewed inflation; indeed, if that were the outcome, it would destroy their willingness to continue participating in policy coordination at all. So far as Korea and Taiwan are concerned, we should recognize that they have made a good start on the adjustment process, while insisting that the process may need to go further yet. The outlook in Korea is obscured by the effect of labor unrest, but at least in Taiwan the surplus is likely to persist at very high levels without further actions to liberalize trade, appreciate the exchange rate, and expand internal demand. It would in my view be appropriate to make sure that the authorities in Taiwan and Korea share the objective of continuing to reduce their surpluses and plan to maintain an appropriate set of policy actions.

While Korea and Taiwan are nowadays significant actors in determining global payment outcomes, the central responsibility for reducing the US payments deficit at the present time very

---

[3] It would also reduce the incentive to capital flight from Latin America.

clearly rests at home. It is the United States that has failed to play its part in implementing the strategy agreed by the G-7. I hope that the Congress may help to impress on the administration the urgency of making a real cut in the budget deficit as the vital next step.

Current Account Imbalances, 1985-90

(billion dollars)

	1985	1986	1987	1988	1989 forecasts IMF	1989 forecasts OECD	1990 forecasts IMF	1990 forecasts OECD
United States	-113	-133	-144	-127	-125	-123	-139	-116
Japan	49	86	87	80	72	80	90	80
Germany	17	40	46	49	53	48	57	53
Taiwan	9	16	18	10	-	-	-	-
Korea	-1	5	10	14	-	-	-	-
Belgium	1	3	3	3	-	3	-	3
Netherlands	4	4	3	5	-	3	-	5
Switzerland	6	7	7	6	-	5	-	5

Sources: OECD Economic Outlook, June 1989, and IMF, World Economic Outlook, September 1989.

Senator SARBANES. Mr. Lincoln, please proceed.

STATEMENT OF EDWARD J. LINCOLN, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. LINCOLN. Mr. Vice Chairman, thank you for this opportunity to address what I think is a very important topic. Mr. Williamson has taken a multilateral approach and I couldn't agree with him more, that policy coordination is something which must be dealt with in a multilateral setting and not a bilateral one.

However, my own remarks will address Japan as an example of one of the key foreign countries which has moved to substantial surplus. In my oral remarks I would like to simply highlight a few of the points which I have made in my prepared statement.

Let me start by summarizing what has happened to Japan during the 1980's. If we think the United States is seriously out of balance by running large deficits, clearly Japan was out of balance by running large deficits.

Now its current account surplus built very rapidly during the 1980's, peaking in 1987 at $87 billion. The previous year it peaked as a percentage of GNP at 4.3 percent of GNP, which is a very high level for this kind of imbalance.

I would argue that these surpluses were not sustainable in the long run, just as we believe that U.S. deficits were not sustainable in the long run, that Japan was basing its economic growth primarily on exports and that could not be sustained for a long period of time.

From 1985 we begin a process of adjustment driven by the change in the value of the yen. From a low of 260 yen per dollar in March 1985, the yen has appreciated to a peak of 120 and has since subsided somewhat to 142.

In rough terms we are talking about a doubling of the value of the yen against the dollar. Now, unfortunately, I don't have with me trade weighted exchange rate figures for Japan, but as a rough order of magnitude, Japan is facing the kind of currency appreciation that we faced in the first half of the 1980's. This ought to have been a major shock to the Japanese economy, cutting exports and increasing imports.

It is important that domestic macroeconomic policy be consistent with these exchange rate movements, but that change, as John Williamson has noted, didn't really occur until 2 years later in 1987 at a point when yen appreciation appeared to be pushing Japan toward recession because of the damage to the profits of exporting industries.

Since that time there has been a fairly modest expansion of fiscal policy in Japan and an upturn in the private sector in Japan so that from 1987 to the present economic growth in Japan has benefited from a more vigorous domestic demand expansion.

As a result of the combination of the rise in the yen and the expansion of domestic demand, current account has declined very modestly. In 1988 Japan's current account was $80 billion, or just under $80 billion, or 2.8 percent of GNP. So we have had some adjustment.

I might add that the report done for this committee on Japan 2 years ago was done about at the point when this shift was beginning to take place toward strong domestic demand expansion.

But I think if we look at the current situation in the future there are some problems. First of all, if we look at Japanese exports, exports are once again rising not only in dollar terms because of the appreciation effect, but also in yen terms. Japan is expanding its exports in 1988 and 1989 despite the very strong appreciation of the yen. There has been a remarkable resilience of the Japanese export manufacturing industry to cope with the effect of currency appreciation.

Furthermore, the depreciation of the yen that has taken place in 1989 may exacerbate this trend with any even more rapid increase in exports, although I would say the one thing which helps us out on that is that many Japanese corporations are now in the midst of carrying out foreign direct investment in response to currency appreciation, and those are long-term plans which may not be overly affected at least this year by yen depreciation.

Second, if we look at the import side, adjustment has included an encouraging increase in imports and expecially manufactured imports, but they have not risen as a share of GNP. Japan continues to have a share of imports and manufactured imports in GNP which is much lower than other industrial nations.

So there has been a response to the currency movement, roughly a unitary elasticity of demand to the price changes, but not a structural change bringing about a higher level of imports within the economy.

Also, if we think of imports being stimulated by domestic demand, we may have seen the best that Japan has to offer. It has grown at roughly 5 percent in real terms the last couple of years, and there is now concern among Japanese Government officials that the economy is overheating.

The Bank of Japan has raised the discount rate, they have noticed that inflation is rising to the heady level of 3 percent, labor markets are tightening somewhat and there is some possibility that the Government may act to slow down economic growth somewhat, and that will slow down the growth of imports.

Third, I might note that the rise in the yen and the rise in manufactured imports has still left a very wide disparity in prices between Japan and the rest of the world, and oddly enough you pointed out at the beginning that the United States has moved toward a deficit on its services account because of rising net payments on investment.

Japan was expected to move in the opposite direction, in the direction of large surpluses on its services account because of its net income on overseas investment and this has not happened. In fact, they have moved to a larger services deficit fueled by a rapid increase in deficits for travel and transportation related to a rapid increase in the number of Japanese going abroad and all of them making large purchases overseas.

To me this is an indication of the lack of domestic adjustment in terms of prices, and if we can't get it in Japan, perhaps it's nice that at least we have the Japanese going abroad to buy, but it seems to me that this is a rather poor way to carry out adjustment to a higher yen.

The final point I might add about the current situation is that Japan is characterized by some political uncertainty at the moment. They are absorbed in the scandals of the Liberal Democratic Party and at the moment absorbed in what to do about their 3 percent consumption tax. This suggests that they will be less interested in pursuing policy initiatives to make the economy grow because their attention is elsewhere.

The consumption tax in fact may further depress consumer spending in Japan if consumers believe that the Government might get rid of the consumer tax at some point in the near future. They will postpone their consumption.

Therefore, I would argue that Japan still has quite far to go in adjustment and that the current trends suggest that the adjustment may be petering out. The IMF projections, which has been mentioned, forecast that this year Japan's current account may decline a bit more to about $72 billion, but that next year will rise to $90 billion. That I think is a worrisome trend.

In conclusion let me briefly state what I think the United States ought to be doing about this. First of all, our main focus should continue to be our own adjustment. All the the econometric models demonstrate that we have a much bigger impact on Japan than they have on us. Our adjustment would put very strong pressure on Japan to continue stimulating domestic demand as we would put downward pressure on their trade and current accounts.

Second, I agree with John Williamson that we need to continue policy coordination on issues like the exchange rate and, to the best of my knowledge, the Bank of Japan has certainly been very cooperative in this exercise. They, too, are worried about a renewed rise in the dollar this year.

Third, and here perhaps I differ a little bit with John Williamson. I think we certainly need to continue to press Japan on domestic demand expansion. As he put it, we might not be able to push them much further, but we don't want them to be backtracking, and I'm mildly concerned at the anti-inflationary stance now being adopted by the Bank of Japan in Japan.

And, finally, I think we ought to continue pressing Japan on the more fundamental structural adjustment so that an economy which accepts more imports evolves over time, and at the moment the mechanism we have for doing that is the structural impediments initiative, which I think ought to be pressured rather strongly.

Thank you.

Senator SARBANES. Thank you very much.

[The prepared statement of Mr. Lincoln follows:]

PREPARED STATEMENT OF EDWARD J. LINCOLN

JAPAN'S EXTERNAL IMBALANCES

Introduction

Japan has been as far out of balance as has the United States during much of the 1980s. While the United States was heading for enormous current-account and merchandise trade deficits earlier in the decade, Japan was headed for unprecedented surpluses. Some of Japan's surplus could explained by the impact of the U.S. developments, pulling in goods and capital from Japan. However, the Japanese economy was predisposed to move toward large external surpluses because of the domestic surplus of savings over investment in the private sector and the determination of the government to run smaller deficits (and thereby absorb less of those surplus savings). By 1986, the current-account surplus reached $86 billion and represented 4.3 percent of GNP, a large percentage for such a comparison.

As these surpluses were building, Japanese government officials adamantly refused to admit that the situation was unbalanced. They were committed to the goal of government deficit reduction, and displayed little concern or interest in the external impact of their fiscal austerity. If there was a problem, in their view, it was entirely the fault of the United States and not Japan. These attitudes were somewhat unusual since the existence of a demand for Japanese goods and capital in the United States provided the outlet which prevented the contractionary ficsal policies from producing a recession in Japan during the first half of the 1980s.

The large currency movements which began in 1985, plus prodding from the United States to expand domestic demand have now led to some changes in Japanese macroeconomic policy and performance. The government became more willing to stimulate domestic demand and claimed that it was more committed to reducing Japan's large current-account and merchandise trade surpluses.

This testimony addresses what has happened since 1985 in Japan and where it might be headed. My conclusion is that modest progress has been made, but that it is far from sufficient. Furthermore, there is some danger that this modest improvement may come to an end. Continued international coordination to keep the yen strong and to insure that the Japanese government carries out domestic structural change.

The Motivation for External Change

Since 1985 two developments have worked in the direction of reducing Japan's external imbalances: exchange rate movement and growth of domestic demand. Both represented major departures from the earlier years of the decade.

The appreciation of the yen has been quite dramatic. From a range of ¥220-250 per dollar from 1980 through 1984, and a low of ¥260 in March 1985, the exchange rate against the dollar rose quickly to a high of ¥120 in 1988. Since that time the yen has depreciated somewhat to its current level of ¥145, a worrisome trend considered below. Average annual exchange rates (plus other data series mentioned below) are presented in table 1. Nevertheless, the movement over the past four years represents roughly a doubling of the value of the yen against the dollar. This is the equivalent of imposing a 100 percent tax on exports and granting a 50 percent rebate on imports. Exchange rate movements always affect trade flows after a considerable time lag, but enough time has now passed since

Table 1
Economic Data on Japan

Period	Yen-Dollar Exchange Rate yen per $	Export Price Index '85=100	Job Openings/ Job Seekers Ratio	Unemployment Rate	Consumer Prices change from year earlier
1980	227	102	0.75	2.0	7.7%
1981	221	103	0.68	2.2	4.9
1982	249	107	0.61	2.4	2.8
1983	238	101	0.60	2.6	1.9
1984	238	102	0.65	2.7	2.3
1985	239	100	0.68	2.6	2.0
1986	169	85	0.62	2.8	0.6
1987	144	81	0.70	2.8	0.1
1988	128	79	1.01	2.5	0.7
June 1989	144	81	1.34	2.3	3.0

Source: IMF, International Financial Statistics, September 1989, pp. 380-381; Ministry of Finance, Monthly Finance Review June 1989, statistical supplement; and JEI Report, No. 32B, August 18, 1989, statistical supplement.

this major appreciation of the yen should have had a visible and substantial impact on both exports and imports.

Economic growth should also have helped reduce the external imbalances. During the first half of the 1980s, an unusually high portion of economic growth was due to expansion of net exports of goods and services. The external contribution to overall GNP expansion from 1980 through 1984 was 40 percent.[1] From 1985 through 1988 the contribution of the external sector diminished and then turned negative in 1987 and 1988 as net exports of goods and services shrank. Despite the drag from the declining external sector, the economy managed to grow at over 5 percent in real terms in 1988. Private consumption expenditures grew at a somewhat more rapid pace than earlier in the decade, expanding between 4 and 5 percent in both years, while housing investment and fixed nonresidential investment expanded at high rates.

Economic growth in the 5 percent range is at or beyond the long-term potential growth for the Japanese economy; it would be unreasonable to anticipate that a performance in excess of 1987 or 1988 can be sustained. Little of the improved domestic performance came from direct fiscal stimulus. Government current and investment expenditures lagged behind overall GNP expansion and little change has taken place in the size of the government deficit--rises in spending were matched by increases in revenue. In fiscal 1987, government current expenditures actually dropped by 2 percent (in real terms) while investment expanded by 10 percent; In fiscal

---

1. Edward J. Lincoln, Japan: Facing Economic Maturity (Washington: The Brookings Institution, 1988), pp. 39-40, considers the high share of export expansion in economic growth in Japan during these years.

1988 both current and investment expenditures grew at a low rate of just over 2 percent.

The combination of exchange rate movements and expanding domestic demand should have acted as a strong stimulant for imports (and especially manufactured imports) from the rest of the world, as well as a brake on exports.

External Changes 1985-1988

The actual decline in Japan's current-account and merchandise trade surpluses resulting from these factors has been very modest.[2] Japan's current-account surplus continued to expand until 1987 when it peaked at $87 billion. However, because of the rapid currency movement, the yen-denominated current-account surplus peaked in 1986 and by 1988 had dropped 28 percent. As a share of GNP, the current-account declined from a peak of 4.3 percent in 1986 to 2.8 percent by 1988. These data are displayed as part of the accompanying summary table on the balance of payments (tables 2 and 3).

How should these data be interpreted? Currency movements take some time to yield a real impact on trade flows, so that the continued rise in the current-account surplus in both dollar and yen terms in 1986 is not surprising. The progress since that time is real and the Japanese should be given credit for moving in the direction of reducing external imbalances. However, the 1988 data in both yen and dollars imply that

---

2. All data used here on merchandise trade are balance of payments figures in which both exports and imports are measured f.o.b. because it is useful to separate service trade from merchandise trade. The only exception are the manufactured good figures in table 4.

Table 2
Japan's Balance of Payments Data
Denominated in millions of dollars

Period	----Merchandise Trade----			-----------Services-----------				Current
	Balance	Exports	Imports	Total	Invest. Income	Trans-port	Travel	Account
1984	$44.3	$168.3	$124.0	$-7.7	$4.2	$-3.0	$-3.6	$35.0
1985	56.0	174.0	118.0	-5.2	6.8	-2.6	-3.7	49.2
1986	92.8	205.6	112.8	-4.9	9.5	-2.5	-5.8	85.8
1987	96.4	224.6	128.2	-5.7	16.7	-6.1	-8.7	87.0
1988	95.0	259.8	164.8	-11.3	21.0	-7.4	-15.8	79.6
First six months:								
1988	43.5	122.9	79.4	-4.2	10.6	-4.0	-6.8	37.0
1989	40.9	133.3	92.4	-8.6	.0	.0	.0	30.1

Source: Bank of Japan, Balance of Payments Monthly.

Table 3
Japan's Balance of Payments Data
Denominated in trillions of yen

Period	----Merchandise Trade----			Services	Current
	Balance	Exports	Imports		Account
1984	Y10.5	Y40.0	Y29.5	Y-1.8	Y8.3
1985	13.1	41.2	28.1	-1.3	11.5
1986	15.3	34.4	19.1	-.8	14.1
1987	13.9	32.4	18.5	-.8	12.5
1988	12.2	33.3	21.1	-1.5	10.2

Source: Bank of Japan, Balance of Payments Monthly further adjustment is needed. A current-account surplus running at almost 3 percent of GNP is still very large, and is far above what Japanese forecasters expected to be an equilibrium level earlier in the decade.

The adjustment since 1985 has included a substantial increase in merchandise imports--from $113 billion in 1986 to $165 billion in 1988, representing an average annual growth in dollar terms of 21 percent.[3] Growth of manufactured imports coupled with the enormous drop in the price of oil and other internationally traded raw materials has also meant that the ratio of manufactured imports to total imports has risen over the past several years, and is now at a 50 percent level compared to only 20 percent in 1980.

The substantial rise in imports, and especially manufactured imports is an encouraging development on the surface. We wanted Japan to import more and it has done so. However, these developments are modest in the context of the overall economy. Yen-denominated figures are a better indicator of what the Japanese are actually spending on imports. Because of currency appreciation, each dollar of imports costs less in terms of yen. Table ~~three~~ four focuses on manufactured goods to eliminate the impact of falling raw material products. Imports of manufactures fell from 1984 through 1986. Even by 1988 expenditures on manufactured goods were only 14 percent higher than in 1984. Because the domestic economy was growing during this time, the ratio of manufactured imports to GNP actually dropped in 1986 and even by 1988 was below the level of earlier in the decade. Many Japanese believe that the nation has undergone a revolution in terms

---

3. The drop in dollar-denominated imports from $124 billion in 1984 to $113 billion in 1986 is the result of rapidly falling dollar prices for crude oil and other raw materials.

Table 4

**Japan's Trade in Manufactured Goods
1980 to 1988**

YEAR	Denominated in dollars (millions of dollars)			Denominated in yen (billions of yen)			Imports as a share of:	
	Exports	Imports	Balance	Exports	Imports	Balance	GDP %	GDP in manufact. %
1980	124,651	30,566	94,085	28,213	6,961	21,252	2.9%	11.4%
1981	146,875	31,271	115,604	32,337	6,880	25,457	2.7%	10.6%
1982	134,256	30,251	104,005	33,291	7,506	25,785	2.8%	11.1%
1983	142,247	31,943	110,304	33,798	7,591	26,207	2.7%	10.8%
1984	165,097	37,175	127,922	39,135	8,807	30,328	3.0%	11.5%
1985	170,673	36,414	134,259	40,769	8,744	32,025	2.8%	10.8%
1986	203,535	44,038	159,497	34,341	7,427	26,914	2.2%	9.0%
1987	222,950	60,560	162,390	32,403	8,794	23,609	2.5%	10.4%
1988	257,116	85,598	171,518	32,940	10,072	22,868	2.7%	

Notes: Manufactured goods are SITC categories 5-8. For 19887, GNP rather than GDP is the denominator for calculating the share of exports in the economy.

Source: The Summary Report: Trade of Japan (Tokyo: Japan Tariff Association), December 1980, pp. 90-131, and similar pages in the December issue of each year through 1988; GDP data are from Economic Planning Agency, Annual Report on National Accounts (Tokyo: Ministry of Finance Printing Office, 1989), pp. ; GNP for 1988 is from Bank of Japan, Economic Statistics Monthly, May 1988, p. 178. GDP in manufacturing is from Economic Planning Agency, Annual Report on National Accounts, 1988 edition, pp. 178-189.

of acceptance of manufactured imports; these figures indicate that any such conclusion is premature. The long term income elasticity of demand for imported manufactured goods has been close to one and appears to still be at roughly that level.[4]

While at least some progress has come on the import side due to the exchange rate and domestic demand factors, one of the great disappointments has been the very limited impact on Japan's merchandise exports. Even allowing for a time lag, a currency movement of the magnitude that has occurred since 1985 should have had a substantial negative impact on Japan's exports. Nevertheless, exports have continued to climb in dollar terms. One possibility is that this simply represents the disparity in movements in dollar and yen denominated figures due to the exchange rate shift. When measured in yen terms, exports dropped by 19 percent between 1985 and 1988, giving the impression that the exchange rate has had the expected impact. However, most of this decline is the result of a price movement rather than decline in the volume of exports. Over the same time period the export price index fell by 20 percent (shown in table 1), accounting for almost all of the decline in the yen value of exports. Japanese manufacturers, therefore, slashed export prices in order to maintain market share rather than accepting lower sales. Overall, they

---

4. Estimates of price and income elasticity of demand vary widely by economic model specification. Some recent Japanese work indicates a rise in income and price elasticities over the past several years. See for example, the Ministry of International Trade and Industry, Tsusho Hakusho [International Trade White Paper], 1988 edition, pp. 85, 289; or the Economic Planning Agency, Keizai Hakusho [Economic White Paper], 1988 edition, pp. 92-94, 383. Other work by Robert Lawrence puts both price and income elasticity in the mid-1980s at just about one; Robert Lawrence, "Closed Markets or Closed Minds," Brookings Papers on Economic Activity, 1987, No. 2, p. 542.

absorbed about one-half of the exchange rate movement in the form of lower prices.

Even a strategy of cutting prices ought to eventually yield a negative impact on exports. Lower prices should have reduced profitability of export manufacturers and thereby led to less investment. In 1987 many of these concerns were being voiced by the manufacturing sector. However, since that time corporate profits have expanded and investment--including in the manufacturing sector has surged. Exchange rate appreciation has simply not had as much impact on export industries as one would anticipate.

Throughout 1988 a trend toward renewed growth of exports resumed. By late 1988 and into 1989, the value of yen-denominated exports was running 6 percent ahead of year-earlier levels and dollar-denominated export figures had returned to double digit growth (see figure 1).

Modest import growth and a renewed expansion of exports meant that contraction of Japan's trade surplus in 1988 was marginal. From the peak of $96 billion in 1987, it fell only $1 billion to $95 billion in 1988. As the above discussion of exports and imports indicates, the reason is not a continued lagged effect in which adjustment is just beginning, but rather a diminishing of the desired adjustment effects.

The other major component of the current-account is services trade, and it has actually shown more downward adjustment than the merchandise account. The consequence of running large current-account surpluses is an offsetting net outflow of capital. The earnings on those overseas investments appear in the balance of payments as a service transaction. Accompanying the rise of large current-account surpluses, therefore, Japan's external assets exploded from $11 billion in 1980 to $292 billion

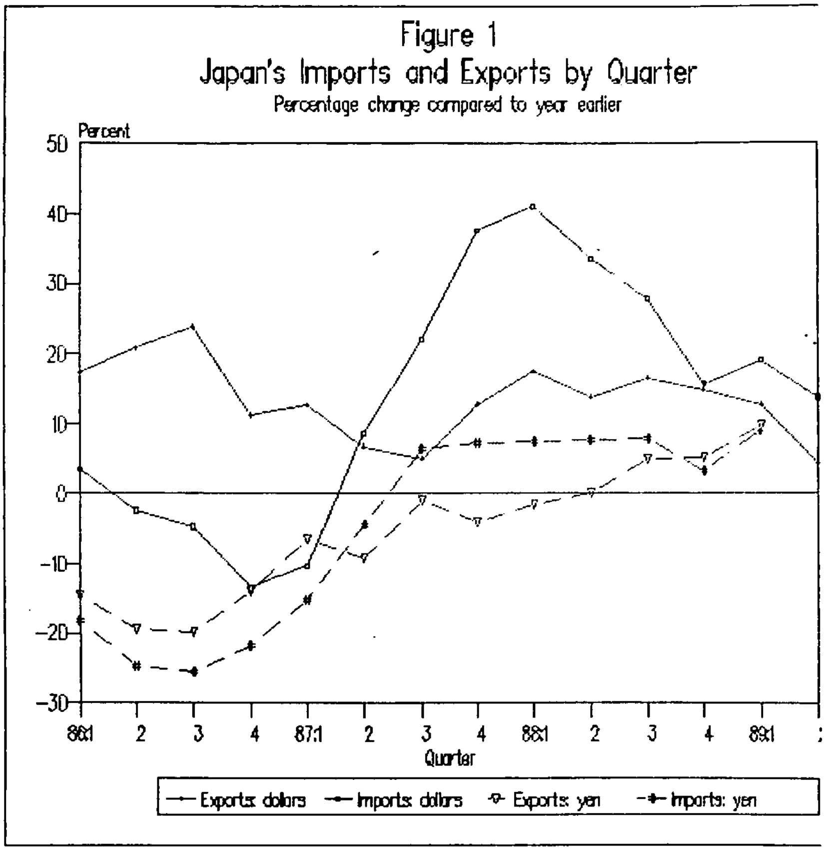


Figure 1
Japan's Imports and Exports by Quarter
Percentage change compared to year earlier
Percent
50
40
30
20
10
0
-10
-20
-30
86:1
2
3
4
87:1
2
3
4
88:1
2
3
4
89:1
Quarter
Exports: dollars
Imports: dollars
Exports: yen
Imports: yen

by 1988, the largest in the world. This rapid shift produced an equally startling growth in net investment income in services transactions in the balance of payments. From less than one billion dollars in 1980, net investment income grew to $21 billion by 1988. Japan has traditionally had a deficit in its services account because of net payments for business-related services such as transportation and technology licensing fees. The jump in investment income should have offset these traditional deficits. From 1981 to 1986, the movement was in this direction, with the services deficit shrinking rapidly from $14 billion to $5 billion.

Rather than moving to surplus after 1986, however, the services account has actually headed further into deficit. This has resulted from a swift deterioration of the transportation and travel accounts. From a deficit of $4 billion in 1985, the travel account dropped to a deficit of almost $16 billion by 1988. Net transportation payments registered a smaller but similar deterioration from a deficit of $3 billion to $7 billion, primarily because of an increasing deficit on passenger travel. The figures for travel, therefore, are net travel expenses paid overseas exclusive of international transportation. Both trends continued in 1989, so that the services deficit for the first half of the year already $8.6 billion, 32 percent larger than a year earlier.

These data are an extraordinary commentary on the lack of structural adjustment in Japan. Not only are Japanese individuals pouring abroad for travel because of the strong yen, they are spending large sums of money, much of it on manufactured products to take back to Japan. A recent survey by the government placed the average purchases brought through customs to Japan at $2,218 per traveller in 1988, constituting a total amount equal to

2 percent of domestic consumption expenditures.[5] This is an extraordinary level of foreign purchasing (especially if one considers that the amount may be understated by concealment of dutiable goods at customs upon reentry to Japan). Heavy purchases by consumers travelling overseas is a result of the continuing wide disparity in retail prices between Japan and the rest of the world. Prices of imported products have responded to the exchange rate movement, but even complete pass-through of exchange rate gains implies that domestic prices are well above international prices for a wide variety of goods. Denying that Japan behaves in implicitly protectionist ways becomes increasingly difficult for Japanese government officials in the face of this behavior of Japanese consumers.

Current Developments

Data through the first half of 1989 suggest that moderate adjustment is continuing on the merchandise and current accounts. The merchandise trade surplus has contracted another 6 percent in dollar terms (compared to the year-earlier period), and the current-account surplus dropped almost 19 percent, reflecting the continuing deterioration of the services account discussed above. Private forecasters in Japan recently put the current-account surplus for the current fiscal year at around $71 billion, lower than the $75 billion they had forecast at the beginning of the year, and lower than the $77 billion for fiscal 1988.[6]

---

5. Economic Planning Agency, The Economic White Paper for FY 1989 (Summary), August 8, 1989, tables, p. 4. Expenditures per traveller are estimated in this source to be roughly twice the level of those of Americans abroad.

6. JEI Report, 31B, August 7, 1989, p. 7.

Continued decline in the current-account surplus is encouraging, although the pace of change is still moderate. However, several recent developments may work against this trend.

1. Yen depreciation. The yen has weakened against the dollar this year. From a high point of ¥120 =$1, it has now depreciated to approximately ¥145. This is a worrisome trend. Much of the reduction in the current-account that has taken place has been motivated by the strong yen. The recent weakening will place in motion decisions by the corporate sector which may strengthen Japanese exports and weaken imports over the next 18 months to two years.

If the weakening of the yen proves to be temporary, the damage to structural adjustment should be relatively small. An important component to Japan's adjustment has been a more rapid expansion of overseas direct investment in the manufacturing sector, for the production of products either to replace exports from Japan or even to produce exports back to Japan. Japanese manufacturers will not change their plans for overseas production unless the weaker yen remains in evidence for some time. In addition, once they have overcome the hurdle of uncertainty and trepidation concerning moving into a foreign setting, they may discover that even with a somewhat weaker yen overseas production remains an economically rational choice.

2. Macroeconomic slowdown? The modest improvement to date in external imbalances has come on the strength of high rates of domestic growth that cannot be sustained. A normal reaction to high domestic growth or overheating of the economy is an acceleration of import growth. This has not happened in Japan, and government concern with possible

overheating may now cause the economy to slow down. Unemployment is falling, from a level of 2.6 percent in the middle of 1988 to 2.3 percent by the first quarter of 1989, and the ratio of job offers to job seekers (registered at government employment offices) has moved steadily beyond one to reach 1.34 by June, the highest level since the early 1970s (table 1). Although inflation remains quite low, it has been on a rising trend for the past several quarters, reaching 3.0 percent by June. The Bank of Japan raised the discount rate from 2.5 percent to 3.25 percent in May, the first tightening of monetary policy since 1980. Business failures are also decreasing in number and amount of liabilities at a rapid pace.

These signs do not mean that the economy is entering a major slowdown, but they are a cause for some caution. Japanese forecasters remain very optimistic, and the mid-year revision of forecasts for the year were mainly in an upward direction. An average of eight recent forecasts for the fiscal year (April through March) came to 4.7 percent, up from 4.2 percent predicted at the beginning of the year.[7] If inflation and other indicators continue to show overheating, the Bank of Japan may carry out further monetary tightening and thereby slowing the pace of domestic demand expansion.

GNP data just released for the second quarter of this year show a real decline in the economy, but this does not indicate the beginning of a major slowdown or recession. The major cause of the small drop is the timing of the newly instituted consumption tax, which went into effect on April 1. This tax artificially pushed up GNP in the first quarter and decreased it

---

7. JEI Report, No. 31B, August 11, 1989, p. 7.

in the second quarter as consumption expenditures were advanced to before April first to avoid the tax.

Other features of current economic growth give somewhat greater cause for concern. Most of domestic growth is now coming from private nonresidential fixed investment. Personal consumption spending has been virtually flat since the summer of 1988 and housing investment has been declining over the past two quarters. Government current expenditures are rising only slowly and government fixed investment has turned negative. Why should corporate investment be so high in the face of these developments? The trends in personal consumption and housing investment suggest that it cannot be justified by anticipated increases in domestic demand. The alternative is that investment will be directed at the export market, accelerating the increase in exports that began last year.

3. Political uncertainty The political uncertainty in Japan does not provide an atmosphere conducive to continued rapid growth or structural change. The victory of the opposition parties in the upper house, preoccupation with the funding sources and morals of members of the Liberal Democratic Party, reconsideration of the unpopular consumption tax, and speculation over the upcoming lower house election add up to the most unusual political conditions in Japan in many years. So far the visible impact of politics on the economy appears to be minimal, although some have suggested that the weakening of the yen against the dollar over the past several months could be related to these developments.

The modest improvement in Japan's merchandise trade balance which occurred in 1988 and appears to be continuing in 1989 are mostly the product of traditional economic factors of currency movement and an increase in domestic demand expansion. However, a much more important structural change still has far to go in Japan. Even prior to yen appreciation began in 1985 prices for many manufactured goods were higher in Japan than abroad, the dominance of domestic manufacturers over the domestic distribution system impeded the inflow of foreign goods, and industry collusion among manufacturers within industries could effectively limit imports. The Japanese government shows some signs of concern and the private sector expresses a more favorable attitude toward imports. Exchange rate movements have made the implicitly protectionist nature of the Japanese market painfully obvious, and the outpouring of Japanese consumers to make their purchases abroad is embarrassing evidence to the government of the lack of structural adjustment at home.

Structural adjustment should be an important component of Japan's current round of macroeconomic adjustment. Protectionism in Japan is not absolute; prices and import volumes have responded to the strengthening of the yen and to the acceleration in growth of domestic demand. But that progress is vulnerable to the problems identified above: the recent weakening of the yen, an overheating and possible slowdown in domestic growth, and political uncertainty.

A U.S. Policy Agenda

Four policy initiatives will be important to ensure that adjustment continues in Japan to bring down the size of the current-account and merchandise trade surpluses.

First, macroeconomic adjustment must continue in the United States. Nothing could put greater pressure on Japan than this. The United States is the largest single market for Japanese exports (absorbing 34 percent of all Japanese exports in 1988) as well as the destination for much of its capital outflow. Adjustment in the United States reduces demand for Japan's exports, reduces the interest rate differential and its impact on encouraging capital flow from Japan, and, by reducing the demand for dollars, keep the yen strong against the dollar. Under such conditions, Japan would have little choice but to continue to stimulate domestic demand to sustain its economic growth.

Second, international coordination must continue on exchange rates. From April to June of this year, Bank of Japan foreign exchange reserves dropped by $11 billion due to exchange market intervention to counter the appreciation of the yen. Coordination of intervention, plus discussions of monetary policy must continue.

Third, the United States government should continue to encourage the Japanese government to stimulate domestic demand in a manner which is less skewed than at present. Housing investment is heavily affected by government policy (since the government provides a substantial portion of mortgage funds available through the Housing Finance Corporation) and it is now declining. Government spending and investment is also growing at a slow pace, as noted above. If domestic demand growth slows in Japan, the government should be called upon to use these tools to maintain growth rather than letting renewed export growth fuel the economy.

Fourth, pressure on Japan to carry out a thorough structural reform of the economy must continue. The structural impediments initiative begun earlier this month is an important means to pursue this goal and appears to have achieved a productive first round of talks. Political uncertainty will be used as excuse to delay or avoid action on needed reforms, but these should not be accepted as legitimate. Japan and the United States would both benefit from these structural reforms by expanding U.S. exports and by making the Japanese economy more efficient. Some Japanese government officials and academics believe that the United States should stop pressuring Japan because the necessary macroeconomic adjustments and structural changes have been made. This is not the case.

Senator SARBANES. Professor Hufbauer, please proceed.

STATEMENT OF GARY HUFBAUER, WALLENBERG PROFESSOR OF INTERNATIONAL FINANCIAL DIPLOMACY, GEORGETOWN UNIVERSITY

Mr. HUFBAUER. Thank you, Senator, for inviting me to this hearing.

At the outset you raised two big and important questions. Why do we have these imbalances and what should we do about them? You would find it remarkable if I said I don't know, but after 30 years of work in these vineyards I have lost all semblance of humility. To show my lack of humility I'm going to add a third question, and start my remarks with it: Why should we even care about these imbalances?

That's more than a rhetorical question. These charts that you displayed are well appreciated in Wall Street, in Hong Kong, Tokyo, in Frankfurt, in all the other financial markets. Yet, Senator, you know very well that the dollar has been strong. So clearly people who make very good remuneration in forecasting future events are not concerned about these current account deficit numbers, nor the buildup of U.S. external liabilities.

On Monday of this week Georgetown ran its Wallenberg Bankers Forum, which we run every year in the context of Bank-Fund meetings. The degree of euphoria expressed at our forum was truly surprising. Many of the speakers were economists and economists are often professional pessimists. Yet even the economic forecasters who could normally be counted on to give a downbeat assessment were optimistic.

Even Fred Bergsten participated in the optimism in the short run. I emphasize that because, from a longrun perspective, Fred agrees with John Williamson that there are many reasons for sobriety.

With this atmosphere of optimism, it is worth asking why we should care about the economic imbalances. I have formulated my remarks in terms of 11 propositions. I won't tire you with all of them. But I come up with two reasons why we should care about these imbalances. First, not because the imbalances are a bad thing in themselves, but because of what they symbolize about our public and private savings habits; and second, because these imbalances are corroding our attitude toward the international economic system and particularly the trading system.

To go on, if the imbalances in the 1980's—the Reagan era—had corresponded to additional investment in the United States—by that, I mean additional fixed nonresidential investment—I would say they would have been wonderful, and I think most economists would agree. The real problem, of course, is that external deficits did not correspond to additional investment in fixed assets.

Following on from that point, the central issue is not whether the current account deficit stays at $125 billion or rises to $200 billion or drops to $50 billion. The central problem is in adequate savings in this country. I emphasize that because I have never been a fan of the twin deficit story. I think that story has been much oversold. It's conceivable that we could greatly improve our public budget posture, yet still have a large current account deficit. If that happened, I would say we would be much better off than we are today if, in the process, we got our national savings rate up.

Following on from that, private savings are a terribly important part of the story. I realize that tax policy doesn't exert a strong effect on private savings. Private savings are motivated by a lot of things which are outside the realm of public policy. There was a tremendous collapse in private savings in the 1980's and we can only hope that private savings turn up in the 1990's. Any small contribution that public policy can make to assist that turnaround would be most welcome.

Next, the quality of investment in this country leaves a great deal to be desired. Particularly we overspend in real estate. I offer some suggestions about that. America must be the most overmalled country in the industrial world. Certainly it has the most abundant supply of vacant office space.

Turning now to the second reason to be concerned about the imbalances; namely, their impact on American attitudes to the international economic system. This subject rather falls within the province of my chair's title, which you kindly remarked upon. Macroeconomic imbalances are dramatically changing our view of the international economic system, and they are giving rise to a powerful school of neomercantilist thinking within this country.

I have recently participated in a 20th Century Fund task force on U.S. trade policy. The task force was divided right down the middle between what I will call the neomercantilists and the old-fashioned liberals. I put myself in the old-fashioned liberal school. The neomercantilists are clearly gaining strength, and they will further gain strength if the forecasts contained in your charts are borne out. We could then have very different policies 10 years from now than we have now, and I think many of the changes would be regrettable.

The changes would be regrettable in the first instance because the types of remedies which are now popular in the neomercantilist camp really don't help us. Neomercantilists advocate a whole range of managed trade remedies. If anything, these remedies help Japanese firms more than they help American firms. Japanese firms love most of what we have done in terms of auto restraints, in terms of semiconductor restraints, and in terms of steel restraints. These restraints enable them to raise prices and add to their profits. In the long run, trade restraints are very destructive to our competitive ability.

Second, current account imbalances are eroding our enthusiasm for a liberal economic system and they are impairing our political leadership, just when our military prowess in the world is counting for less and our commercial prowess should be counting for more—if we are to remain the preeminent strategic power in the 21st century.

I would add to that a further interaction. Ideally, in the 21st century, the United States and Europe should become like New York and California: economic rivals, but not economic adversaries. That is to say, we don't particularly care about current account imbalances between California and New York. The two States are rivals and they compete for industries. Fair enough. But imbalances of the sort shown on this chart are unimportant between the two States. Likewise, they should lose importance between the United States and Europe in the 21st century.

But if imbalances are not properly managed in the next decade, and we could end up erecting a world economic system which divides into a European bloc, a North American bloc, and so forth. So the management of the imbalances during this next decade is terribly important if John Williamson's prescriptions, broadly speaking, are carried out, imbalances will matter much less 10 years from now; if they are not carried out, we could find ourselves in a very different commercial world.

Now I would like to think that Japan and the United States, too, will be able to engage—say like Georgia and North Carolina—in friendly competition by the year 2000. That may be achievable, but it will be much harder to achieve, for reasons that are very familiar to you. In particular, disputes over Japanese investment in the United States are likely to loom larger in the decade ahead.

As for currencies, they will rise and they will fall, as J.P. Morgan might have said. What I would like to add is that recent events have persuaded me that U.S. current account deficits matter surprisingly little in terms of influencing the value of the dollar.

There is no self-correcting mechanism within the private sector which would ensure that, with a larger current account deficit, or the prospect of a larger current account deficit, we will have a weaker dollar that will tend, in time, to strengthen the current account outlook.

Instead, the dollar fluctuations seem to be driven by confidence in the political and economic underpinnings of the American system. For example, is inflation under control? If so, then the dollar will be stronger, pretty much regardless of the current account.

So what we have, then, is a somewhat embarrassing situation where political strength actually translated into a less competitive dollar. The converse is also true. But what administration wants to undermine confidence in this country as a way of making the dollar more competitive in the foreign exchange markets?

To me, this conundrum calls for strong coordination efforts to offset the rather perverse political economy cycle which is now in evidence in the foreign exchange markets.

Now I want to turn to Europe, which is my assignment. I realize I haven't spent as much time on Europe as the organizers of this hearing might have liked, and I will try now to make up for that lapse.

The commercial shape of Europe in the 1990's is America's biggest external trade policy problem. This question overshadows the Uruguay Round and it overshadows our negotiations with Japan. Europe is our big market, especially for high-tech goods; and Europe is a very responsive market for U.S. exports in terms of price elasticity and income elasticity.

We have a good thing going in Europe and we must work to preserve it. I think this point is beginning to be appreciated in administration circles. I hope the USTR keeps up the pressure to ensure that the European market remains exceptionally open. In the natural tendency of things, as the Europe-1992 process goes forward, there will be bargains struck which first accommodate interests within Europe, not U.S. interests. That would be natural in the U.S. political process as well, if we were striking similar bargains.

Let me give just one illustration from the study that I am coordinating for the Brookings Institution on Europe 1992, the auto industry.

The United States is facing a dramatic change in how the auto industry fits into our commercial policy. From the standpoint of United States exports to Europe, what counts are Japanese transplants. If we want to push exports to Europe of United States made autos, we as a nation must get behind Nissan and Honda.

Typically the United States has thought of its policy in automotive matters as an extension of the interests of Chrysler, General Motors, and Ford. Chrysler is not a big player in the European picture, either as a producer or as a potential exporter. General Motors and Ford are big players, but they are big players as producers in Europe, not as exporters to Europe. Their interests will be well served by almost any likely outcome of the Europe-1992 process, but they are not going to become exporters.

If we want exports to move from U.S. soil to Europe, they will be Japanese-brand autos, made here in the United States. What we must avoid is any sort of Brussels/Tokyo agreement which essentially says that, if Japanese-brand autos are going to be sold in Europe, they had better be made in Europe.

Now let me turn briefly to the exchange rate system which Europe has settled upon, known as the exchange rate mechanism (ERM). From the U.S. standpoint, the regrettable thing about the present ERM is that the rate structure locks in an almost permanent German current account surplus vis-a-vis its European neighbors.

This situation gives Germany a very strong monetary grip on the rest of Europe; and, given German priorities, this will ensure against any economic overheating within Europe. Indeed, the Europeans may prematurely dampen down their economy.

Right now, American interests would be best served, I may candidly say, by a moderately overheated Europe and an overheated Japan. If those economies would overheat, they would pull in imports not only from this country, but from the rest of the world and that would be very favorable from the standpoint of reducing the U.S. deficit and stimulating world growth.

But the policy disposition, both in Japan, as Ed Lincoln has said, and in Europe, is dead set against any overheating. Those nations are sovereign nations and, in the end, they will decide their own economic priorities. Still, it would be unfortunate if their policy priorities not only prevented overheating, but also dampened the present satisfactory rates of growth.

I will conclude with some remarks on economic coordination between the United States, Europe, and Japan. The extent of coordination that we have seen in recent months is rather disappointing. It really amounts to fine meals and bland statements. The exercise over the weekend was a 1-day wonder. The deutsche mark and the yen rose on Monday, but the dollar is again strong today. Everybody can see the clear lack of seriousness in present coordination efforts. There is nothing in them. They are all rhetoric.

If and when the United States wants meaningful economic coordination, my one-bullet prescription is this. The Congress should give the President authority to raise taxes across the board, and to cut spending across the board, by 1 percent of GNP, in conjunction with complementary policies by our principal trading partners. I realize the political climate is not appropriate for this prescription in 1989. Who knows, in 1 or 2 years, the political climate could change.

Thank you very much.

[The prepared statement of Mr. Hufbauer follows:]

PREPARED STATEMENT OF GARY HUFBAUER

Mr. Chairman, I regret that I did not have time to prepare a detailed statement. On the other hand, the brevity of these written remarks may be appreciated. I offer my views in the form of eleven propositions. A fuller exposition is contained in my forthcoming volume, U.S. Trade Policy: Guideposts for the Bush Administration, to be published by the 20th Century Fund.

Proposition One. The U.S. trade deficit is not a bad thing in and of itself. It is bad for what it symbolizes about American public and private savings habits, and for what it does to American political attitudes towards the international trading system.

Proposition Two. The cumulative trade deficit of the 1980s -- some $1,000 billion -- would have been wonderful if it had corresponded to an increase of $1,000 billion in U.S. productive investment. My estimates reveal no such increase: in the 1970s, fixed nonresidential investment averaged 10.8 percent of GNP; in the 1980s, 10.9 percent.

Proposition Three. Whether the current account deficit stays at $100 billion, rises to $150 billion, or drops to $50 billion is not the central problem. The central problem is to boost American public and private savings. You know far more about the federal budget deficit than I do, and I will not waste your time with gratuitous advice on that subject.

Proposition Four. A turnaround in private savings is equally important as an improvement in public savings. After a long dry spell in the 1980s, personal savings are beginning to rise. That tendency is most welcome. The process could be assisted by a revival of the IRA concept.

Proposition Five. The quality of American investment would be significantly improved by taking away tax breaks currently enjoyed by the real estate sector. For example, a $15,000 per person (or $30,000 per couple) limit on mortgage interest deductions would discourage "investment" in luxury housing. At current interest rates, a $30,000 deduction cap would enable a couple to deduct all the interest on a

$250,000 home -- not a Potomac mansion to be sure, but quite adequate housing by the standards of most Americans. Similarly, the nation would benefit from a 5 year moratorium on tax depreciation allowances for newly constructed office and retail buildings. Our country is already adequately served with vacant office space and shopping malls.

Proposition Six. The worst effect of the trade deficit is the impetus it gives to neo-mercantilist thinking within the United States. We face severe competition, especially in our high-tech industries, from Japan and Europe. That competition cannot effectively be answered by managed trade regimes that insulate the American market from foreign competition; but the continuing trade deficit creates a political climate that is susceptible to managed trade. Moreover, America shows signs of weariness in carrying the burdens of leadership in the international economic system. The continuing trade deficits furnish political momentum within the United States for an abdication of our leadership role -- despite the Golden Age of world economic growth that American policies have fostered since the Second World War; and despite the fact that American foreign policy will increasingly rest on our commercial power, not our military prowess.

Proposition Seven. Foreign investment in the United States is not alarming. It is welcome. Even in the mid-1990s, when gross foreign investment in the United States will perhaps reach $3.3 trillion, it will represent about 15 percent of total U.S. assets -- not an outlandish figure compared to the experience of other OECD nations. The critical issue is whether the next increment in inward foreign investment corresponds to new investment and whether foreign investment brings new technology and good jobs to the United States.

Proposition Eight. As J.P. Morgan might have said, "currencies will fluctuate". The dollar will rise and the dollar will fall. These fluctuations will bear little relation to the magnitude of trade deficits or the size of foreign investment in the American economy. Currency fluctuations will, however, bear a strong connection to confidence in our political leadership and in our economic policies. Is U.S. productivity rising? Are U.S. savings rates up or down? Is inflation under control? Lack of confidence will send tremors through the whole structure of capital values -- stock prices, currencies, real estate, bonds.

Proposition Nine. In the early 1990s, the biggest commercial prize is the economic shape of Europe. Fortress or free trader? The European Community, our largest export market, bought $75 billion of U.S. exports in 1988. The European market is very receptive to U.S. high-tech exports. The European market has an exceptionally high income elasticity of demand for U.S. goods and services. U.S. trade policy in the Uruguay Round and elsewhere should work to ensure that these features of the European market still exist in the year 2000.

Proposition Ten. It is regretable that European countries have settled on ERM rates which "lock in" a German current account surplus of about $50 billion annually, while Europe as a whole runs a zero current account position. This conjunction means that European fiscal and monetary policy will be biassed toward slower economic growth: Germany is content to run external surpluses indefinitely, and other EC countries dare not expand rapidly lest they put undue pressure on the agreed ERM rates.

<u>Proposition Eleven</u>. It will be easier to get the U.S. trade deficit down, assuming we follow the right policies at home, if Japan and Europe prosper. But there is little the U.S. can do, by jawboning, or by IMF indicators, to get Japan and Europe (especially Germany) to grow faster than they think prudent in light of their own constraints, especially inflation and the environment. In the foreseeable future -- that is, until the next crisis -- macroeconomic coordination will remain a rhetorical exercise, productive of fine meals and bland statements. If and when the U.S. wants meaningful macroeconomic coordination, the first step will be Congressional authorization giving the President discretionary power to raise (lower) taxes and spending, by say, 1% of GNP (about $50 billion annually), in connection with complementary foreign fiscal measures.

Senator SARBANES. Mr. Hufbauer, let me ask you one very quick question. If these trends in fact develop, would that bother you?

Mr. HUFBAUER. For the reasons I said, I think if those trends develop, they will reflect continuing meager private savings and continuing budget deficits, and that bothers me for the reasons I've said. Also, I think these trends will end up dramatically changing the international economic system, the trading system that we have.

Senator SARBANES. Assuming that it didn't do the latter, would it bother you?

Mr. HUFBAUER. Yes, because just confining ourselves now to the savings part of the story—large deficits and low private savings—these trends imply that we will be locked into the slowest growth rate of the major economic powers.

We are locked in by these numbers to real growth of certainly not more than 3 percent and probably closer to 2½ percent. By comparison, our principal economic competitors, Japan and Europe, will be in the 3 to 4 percent range. That 1 to 1½ percent difference tells over a period of time. It means that the United States will eventually be surpassed, in economic terms, by these other countries.

Senator SARBANES. Now you posited, as I understood it, a combination of political strength and economic weakness. I don't understand how over any extended period of time a nation can manage that.

Mr. HUFBAUER. If I understood your question, Senator, how we could be politically strong and economically weak?

Senator SARBANES. Over any extended period of time so your political strength isn't still reflecting your past economic strength, which has not yet fully petered out on you.

Mr. HUFBAUER. Let me paint an alternative scenario to crystallize my initial remarks. If the United States were growing at 4 percent, that would have to be underpinned by a much higher savings rate than we are currently running. If, simultaneously with that, we had big current account deficits and a trajectory of net foreign asset growth in United States which was something like your charts, we would, nevertheless, be economically strong.

The United States would be in the situation that California has been for most of the postwar period. I think if you do a balance of payments of California, you would find that it has been a net importer from the rest of the country. Yet I think of California as very strong in economic terms.

Senator SARBANES. Of course, that leads to my other question, and I'm going to ask the other two panelists as well to comment on this line of thinking. But it's difficult for me to understand how you can posit a United States-European relationship that is the equal or comparable to a New York-California relationship. One takes place within an established national system and the other does not. One takes place within a common currency and the other does not. One takes place within the context of a single national policy and the other does not. I don't see how you can even begin to lay down that parallelism.

Mr. HUFBAUER. Briefly, Senator, my hope is that within the next decade, with correct statesmanship, differences will be much less sharp than they are today. We will be closer to a common currency—by which I mean something like John Williamson's target exchange rate system. The fiscal policies of our two great continental economies will come to have tighter coordination than we see today. Large companies and small companies will be operating in similar economic environments on both sides of the Atlantic. For example, pharmaceutical testing procedures, intellectual property protection, telecommunications procurement—all these will be similar between the United States and Europe.

Senator SARBANES. Well, I would like to hear from the other panelists on this.

Mr. LINCOLN. If I might just say a word about Japan in this respect. I think there is some concern. The United States continues to play a major military role in the Pacific, which I believe contributes substantially to peace and stability in that region. The Japanese certainly like it, but it is not just that we're helping the Japanese, but I think it keeps the Japanese off of other Asian countries, and it keeps other Asian countries off of Japan. We are a mediator in that region.

But if we are in a situation where we think that the Japanese are succeeding economically and we are not, that too large a share of our domestic assets are owned by the Japanese, it seems to me that the political will to maintain that strategic role in the Pacific will be eroded quite rapidly, and we have already seen a rise in concern over it.

Senator SARBANES. Why should the United States invest or spend 6 percent of GNP on defense and Japan spend 1 percent of GNP on defense? We provide the security umbrella for the Japanese in the Pacific, and Japan runs a $50 billion trade surplus with the United States.

Mr. LINCOLN. That's the point. There may be explanations on the strategic side that we are not providing an umbrella specifically for Japan. We are providing an umbrella related to our own global defense and Japan simply happens to be located in a very convenient place geographically blocking the exit from Vladisvostok which makes it a key component of that.

The question I think would be if Japan spent say 3 percent of GNP on defense, would we substantially reduce the amount that we spend, and that's not entirely clear.

Senator SARBANES. They need not spend it on defense. They could make a contributon in other ways, for example, by picking up some of the economic responsibilities which contribute to world economic growth. It seems to me they are getting very much of a free ride under the current arrangements.

Mr. LINCOLN. That's right.

Senator SARBANES. Do the other panelists agree with that? Is Japan getting a free ride?

Mr. WILLIAMSON. They are getting a cheap ride I think you could say.

Senator SARBANES. A cheap ride, that's probably a better phrase.

Mr. WILLIAMSON. Their contribution to the common provision of international public goods by the West is below that of the United States, that's quite clear, and I think it's quite legitimate to raise that type of question. I don't have any ready answers as to what is the right way to go about it, and, of course, there is the problem, which I guess is why this exists in the first place. The United States' best national interests wouldn't necessarily be advanced by simply saying if you don't do more, then we aren't going to do anything. There is no real fallback position, threat position there, and that's the real problem.

In the framework of a cooperative arrangement, I'm always surprised that the United States doesn't make more of an issue of this now that Japan and indeed Europe have reached a comparable level of living standards.

Senator SARBANES. Professor Hufbauer, do you agree with that?

Mr. HUFBAUER. Absolutely.

Senator SARBANES. Let me ask this question to each of the panelists. A point has been made about neomercantilist thinking within the United States, managed trade and so forth. What is your view of neomercantilist thinking in Japan, managed trade in Japan?

Mr. HUFBAUER. They are arch exponents of managed trade. The Japanese system invented it and carried it out for many reasons, only some of which are governmental. I don't think it's the right system for us, and I know it's not the right system for the world as a whole.

Mr. LINCOLN. I couldn't agree more. I think that that does characterize Japan and continues to characterize Japan, and that's one of the reasons that it's not a good system for international trade because we're not good at it and they are and they would benefit disproportionately.

Mr. WILLIAMSON. I want to make one qualification. I think it's eroding at least certain areas, and specifically in the financial field. I'm not qualified to speak in regard to traded goods, but in the financial area the Ministry of Finance doesn't have nearly the ability that it did a few years ago to cause everything to happen by simply making a few telephone calls. There are many more people in Tokyo who are quite happy to make money by stepping out of line if that's possible, and I would expect that to generalize as time goes on.

Senator SARBANES. I would like to suggest, Professor Hufbauer, that perhaps the impetus for neomercantilist thinking in this country is coming from the fact that the Japanese are engaging in it.

Why should we sustain a liberal international trading regime which the Japanese and some others, I would submit, Taiwan and Korea, then exploit very much to their economic advantage and our disadvantage? There is a perception on the part of many in the Congress that there are two sets of rules operating here. If we're going to have a liberal international trading regime, the rules have to apply to everybody.

Mr. HUFBAUER. I certainly agree with that, but I would echo what John Williamson said, that we have made some progress with Japan.

Senator SARBANES. Not much.

Mr. HUFBAUER. Some.

Senator SARBANES. We did this report 2 or 3 years ago. Well, let me ask you this question. The average traveler returning to Japan brings in almost 2,500 dollars' worth of dutiable goods, and, of course, this is offset by their boom in foreign investment earnings.

So their service account remains negative. But what does that tell you about prices in Japan and the availability of imports in Japan if every time the Japanese travel abroad they load up largely on manufactured goods, as I understand it, and bring them home?

We'll give everybody a crack, but go ahead.

Mr. HUFBAUER. It tells me exactly what it tells you, that the Japanese system has many layers of protection and most of them are semiofficial or nonofficial. All of them contribute to a much higher price structure within Japan for a whole range of goods.

To continue a little bit on the optimistic side. I think the mavericks are beginning to emerge, such as shipping vessels which park in Tokyo harbor. There has been limited successes with NTT procurement; but I agree with you in the qualification of "limited."

Beyond that, I really think it's possible for the United States and Europe together to persuade Japan to open its markets over the next decade, and I think if we start closing our markets, we will not in fact do very much to improve our competitive strength vis-a-vis Japan. So it comes down to a question of tactics and strategy to answer, what I agree, is a very serious Japanese problem.

Senator SARBANES. Of course, if you give away that point right away at the beginning, you've lost the force to your persuasive case. This goes to what Mr. Williamson was saying earlier.

Our objective is to get a liberal trading regime, but we may have to not only hold out the threat, but actually apply it in some instances in order to make clear the point that if others are not prepared to play by those rules, we're prepared to impose a very different rule.

Mr. HUFBAUER. If I can impose on your time a little bit, Senator, I agree with that. I'm not talking as a USTR here, but I have been in the Government.

Senator SARBANES. This is coming from the setting of international financial diplomacy. [Laughter.]

Mr. HUFBAUER. Right, and I appreciate tactics, but here I was trying to get down to basic objectives.

A word on tactics. I think it's terribly important that we not create vested interests in this country for the continuation of managed trade regimes, which is exactly what we have done in semiconductors. I deplore Japanese restrictions on semiconductor imports. If I were running U.S. policy, however, I wouldn't attack Japan by restricting U.S. imports of semiconductors. I would choose a totally different Japanese export, so as not to create a vested interest in this country for the continuation of managed trade in semiconductors.

Senator SARBANES. I'm not sure we should do it industry by industry. Perhaps we should say to the Japanese that we don't accept the current situation and we're going to limit the exports we take from you, others do the same, and it is up to you to figure out how to achieve a better balance.

Mr. WILLIAMSON. But I think that's just not the way to go about it given that Japan is much better organized to manage trade than this country is. If one gave the Japanese an opportunity like that, they would end up getting lots of events, and the United States——

Senator SARBANES. Getting what?

Mr. WILLIAMSON. Lots of events. Whenever you have restrictions of this type, somebody gets the payoff from the differential in prices between the free market price and the price that prevails given the restrictions.

Senator SARBANES. From the point of view of dealing with the Japanese managed trade, do you think the Europeans have handled the problem better than the United States?

Mr. WILLIAMSON. I'm not at all sure of that, not in a Europe with 12 countries effectively. I would have thought that Europe and the United States were more similar in this respect.

Senator SARBANES. More similar in which respect?

Mr. WILLIAMSON. More similar in respect to the ability to manage trade in some conscious way and that neither would be very good at it relative to Japan.

Senator SARBANES. What is the deficit of the European countries vis-a-vis Japan?

Mr. LINCOLN. I don't remember just where they have come out. They do have a deficit and it's smaller than ours.

Senator SARBANES. Much smaller, isn't it?

Mr. LINCOLN. It's much smaller.

Mr. HUFBAUER. It's about $8 billion approximately.

Senator SARBANES. About $8 billion.

Mr. LINCOLN. But it comes on a much smaller two-way flow of goods as well. Japan is not a very big trading partner for the Europeans, nor is Europe a particularly large trading partner for the Japanese. So it's a small imbalance, and it's also a smaller total flow of goods, and in that sense I think it may be possibly that managed trade in both directions in that relationship is one reason why the total flow is much smaller and may not have much to do with the imbalance.

I think probably all of us would argue that the imbalances are a macroeconomic phenomena and not industry specific. They are not a result of trade barriers. You can have a deficit country that has high trade barriers, and surplus countries that have none, but we are still unhappy with the impact of those trade barriers.

One other comment on Japan and being neomercantilist. I am certainly in favor of retaliating against Japan not on a broad level, but on a very specifically targeted way as a tactic to get them to open up. Unlike the Europeans, I think the Japanese have been quite responsive when specifically threatened and seriously threatened. You have to do it sometimes to make them believe it, and I think that that works. But the thrust of this should be to get Japan to open and not to permanently close off our market.

Mr. WILLIAMSON. Can I make one other point about how closed Japan is. I mean I believe it's a fact that when these Japanese tourists take back their 2,500 dollars' worth of goods, they take back lots of Japanese cameras along with foreign goods. And the reason it pays them to buy their cameras abroad is because the distribution margins are so high in Japan.

Now that's not specifically protection against outsiders. It's a problem which affects Japanese firms trying to sell in Japan as well, and if the structural impediments initiative can tell the Japanese how to reorganize their nontradable sector better, well, fine, but I really wouldn't look to this to make a major contribution to resolving the trade imbalance. It's going to improve things for Japanese sellers as well as foreign sellers.

Senator SARBANES. What counties do any of you see on the horizon that may develop into large surplus countries?

Mr. WILLIAMSON. What additional large surplus countries?

Senator SARBANES. What countries now not seen or perceived as large surplus countries may in fact be in that category a decade from now?

Mr. WILLIAMSON. That's the sort of prediction I'm sure I really want to make. I mean it's quite conceivable that some countries like Brazil will through and in a decade's time be regarded as chronic surplus countries. Who knows.

At the moment there is no evidence that the Asian countries are following in that path. In fact, their deficit is going up at the moment reflecting the inflow of capital from Japan in particular and faster development. On the other hand, they are some in the phase now that Korea was in the early 1970's, and 15 years on, who knows, maybe some of those will be large surplus countries. I don't know that there is any very systematic basis on which to make such predictions.

Senator SARBANES. Mr. Lincoln.

Mr. LINCOLN. If I had to pick a country, I think I would pick South Korea partly because South Korea of all the Asian countries is the one that is most carefully trying to follow in the footsteps of Japan, and as they continue to industrialize and substitute domestic production for imports, it seems to me that it is quite likely they could move to fairly large, long-term current account surpluses.

Senator SARBANES. The Wall Street Journal on September 7 reported that subsequent to not being designated as a super 301 problem, Korea shifted trade policy and is once again promoting exports, discouraging imports and considering a depreciation of its currency.

What does that tell us about assuring the liberal international trading regime that we've been talking about? As soon as the pressure eased even a little bit, they move off in the other direction.

Mr. WILLIAMSON. I'm not sure that the report was correct to say that this is what is happening. There is a faction in Korea which is arguing for such a policy reversal, but it's not clear to me that it has won yet. Certainly there has been no reflection of that in the exchange rate, for example. There has been no renewed depreciation of the chon, and on the other things also, I think it's still up in the air. I mean there is a big internal debate in Korea, but I think we should not prejudge the outcome of that. It's very appropriate to make it clear what we hope the outcome is, but let's not prejudge.

Mr. LINCOLN. Just because they were not named as a super 301 country also does not necessarily mean that we're taking the pressure off of them. I don't know what went into the decision not to name them. Presumably it was partially a feeling that the political situation in Korea is delicate enough that that kind of major slap in the face would have long-term negative consequences.

But I think even in the absence of super 301 that USTR and other government agencies will continue to monitor South Korea quite closely, and if the policy changes which you mentioned come to pass, I would imagine that our pressure would increase.

Mr. HUFBAUER. Briefly to add to those remarks, Senator, this business of getting a country to liberalize is obviously tricky, and the ability of the United States to pull the levers to liberalize is obviously limited.

I would highlight the role which is played by internal interests within the country as a force for liberalization. I would point specifically to a country you have not mentioned, Australia. I happen to be fairly familiar with Australia, which has a very protectionist history. For internal reasons, there is now a marked push to liberalize within Australia, quite apart from the Uruguay Round.

In banking, which John Williamson mentioned, and which is another area I follow, the reason the Japanese have come around to a liberal view of allowing foreign banks to operate in Japan is that the big Japanese banks see their own interests in terms of becoming global banks. They realized the price that had to be paid was internal liberalization.

It wasn't that the Ministry of Finance suddenly woke up and said, "We want a new policy." Rather, the big Japanese banks, Daiichi Kango, Sumitomo, and others saw their interests in a completely different light about 5 to 8 years ago. Policy change ensued.

I am not making this point to conclude that the United States should just sit back and let events take their course. No. The United States must apply pressure, but I very much believe in skillfully applied pressure.

I do think that quiet pressure often works. This sounds like the State Department and I apologize for that. But I think that when pressure gets reported in the papers, it often creates a backlash. In Korea, specifically, there is a reservoir of anti-American feeling which can be tapped on almost any issue once it gets in the newspapers. On the other hand, quiet pressure can be tremendously effective, as some of our insurance companies would testify who have now gotten into the Korean market.

Senator SARBANES. Why shouldn't it be an international pressure?

Mr. HUFBAUER. It should be.

Senator SARBANES. Why should the United States be carrying the full burden of trying to maintain and sustain an international liberal trading regime? If the argument is premised on the proposition that it's to everyone's benefit, why aren't others having to carry the burden of the argument? Why should we confront countries which have moved significantly—and we can differ about how far they have gone—in the other direction?

If Korea were to take all the steps that the Wall Street Journal indicated they might, would any of you regard that as a desirable thing?

Mr. HUFBAUER. Absolutely not.

Senator SARBANES. In fact, Korea would be exploiting the system to its own advantage, but to the disadvantage of the system, would that not be the case?

Mr. HUFBAUER. It's most irritating and I think all of us have written on the free rider problem. We deplore it. I am personally identified as being a conditional most-favorite-nation exponent, because of the free rider problem. I don't know if my colleagues go along with that position.

Obviously U.S. policy is driven by U.S. export interests when it comes to getting into a country like Korea. That would be true with any other nation. We are only pressuring Korea partly to improve the architecture of the international system. Largely our efforts respond, if I may name a name, to AIG'S interest in getting into the Korean market, and the interests of other U.S. exporters.

But on a broader plane, I think we have a great deal of common and mutual interests with Europe in places like Korea and Japan. Obviously in these markets we have common interests with Canada.

Mr. WILLIAMSON. Mr. Vice Chairman, I very much agree that these things should be done through some international and multilateral forum, but there is one remark you made in the premise that I want to differ with.

I don't think it's true that if Korea decided to do these things they would be acting in their own national interest. I think they would be acting in the interests of some special exporting interests who may have a lot of political power, but I don't see such steps as being in any way in accordance with Korea's national interest, and that's where we should start the argument with them, with that proposition.

Senator SARBANES. Where is the multilateral forum where this could be done?

Mr. WILLIAMSON. In the case of the trade things——

Senator SARBANES. OECD used to do it, didn't they?

Mr. WILLIAMSON. I was going to say OECD might be a good place to do it. Of course, for that you would have admit Korea, and maybe we could also admit Taiwan to the OECD since it's very clearly a club of a limited group of countries and doesn't have any pretensions to universality and therefore to allowing the People's Republic of China to be a member.

Senator SARBANES. Taiwan as a percent of GNP runs the largest trade and current account surpluses in the world by a substantial margin.

Mr. WILLIAMSON. Correct. So it really is desirable to have some multilateral forum, and I would think OECD is the most promising one.

Senator SARBANES. Why do you think OECD is less of an actor in these international trade and financial problems than it used to be?

Mr. HUFBAUER. I will quickly venture an opinion on that. Partly it has been preempted by the summit process in terms of macroeconomic policy. The summit process, and interim G–7 meetings, have taken away the top end of OECD authority. Back in the late 1950's and early 1960's, the OECD was in fact a big actor in trade policy. It hastened the elimination of quotas in Europe, which was tremendously important at the time. But since then the OECD has ceded its role in trade policy—properly I would add—to the GATT.

One of my favorite objectives is to energize the OECD for what I call the deep structural harmonization of policies, but for now that's an academic hope, and nowhere near close to being embraced.

Senator SARBANES. The United States has really walked away from it, hasn't it?

Mr. HUFBAUER. Pardon.

Senator SARBANES. Hasn't the United States walked away from OECD?

Mr. HUFBAUER. Well, the United States has in recent years because of this top-end issue on macro policy. I mean the United States has been running a macro policy, which is totally inconsistent with an objective of external balance, as your charts show. The OECD was bold enough to criticize U.S. policy, and that caused the United States to temper its enthusiasm for the OECD. That's all very shorthand, but that's sort of what happened.

Senator SARBANES. I worked for Walter Heller when he was the Chairman of the Council of Economic Advisers, and I was therefore especially interested in the time period you picked out for OECD influence. The OECD meetings were very important to Heller and the Kennedy administration developing the U.S. position.

That was at a time when we were much stronger economically and politically and much more dominant in the world than we are now, and yet they made an extra effort to try to work the U.S. position through the OECD process so in the end it represented, not the U.S. position, but an international position jointly arrived at—at least in appearance, and I think to some degree in substance.

Do you want to comment on that, Mr. Lincoln?

Mr. LINCOLN. I was just going to add that many of the trade problems we have these days are with Asian countries which are not members of the OECD. There has been some move in the direction of considering them for membership. The U.S. Government and the Japanese Government are interested. The Europeans do not seem to be.

I think they ought to be in there, and if Taiwan and South Korea, possibly Hong Kong and certainly Singapore were members of the OECD, then perhaps we would be more interested because more of the countries which we consider to be important are together in that group.

Mr. HUFBAUER. Could I just add a quick follow-on to this point. This is getting down to detailed structure, but the European Community does have a problem with the OECD because each of the member countries is also a member of the OECD. Of course, the European Community aspires to speak for Europe on economic policy, and an independent voice from, say, France within the OECD conflicts with Community aspirations. Often member state views are worked out by prior group meetings, but this is not a satisfactory long-term solution. I think that, in addition to admitting Korea and Taiwan, one would have to do something about the European problem to revitalize the OECD as a forum.

Senator SARBANES. That brings me to the last subject I want to cover before we adjourn the hearing, and that is Europe 1992. What is developing in the European Community and what you see the implications of that being.

Perhaps each of you could very quickly address that.

Mr. WILLIAMSON. I'm reasonably optimistic that Europe is going to turn out in an outward looking manner and that it will be more free trading than mercantilist.

I think perhaps the major area left where the natural tendency will be in the opposite direction is on public procurement. Procurement is being liberalized internally and any one country will accept tenders from any member of the Community on an equal basis, but it's no obligation to consider tenders from outside the Community as I understand it, and that is quite likely to lead to trade division at the expense of third parties, which I would imagine means overwhelming the United States and maybe Switzerland and Sweden as well, but principally the United States.

So perhaps that's an area on which to focus. But up to now it seems to me to be developing in the way that I would have hoped. In particular, the initial concern was that the banking directives were going to be de facto protectionist because of a reciprocity requirement, and that was very substantially modified this spring after the protests from the United States last year where the United States asked for national treatment or Community treatment in place of the principle of reciprocity.

Well, the clarification by the Community was that what they were looking for was reciprocity in the sense that they would give national treatment to the banks from any country that granted Community headquartered banks national treatment, and that's a very liberal formula and I think it disposes of the concerns that were being expressed in the United States on that subject.

So one has to watch what's going on. The price of liberty is eternal vigilance, and I think the price of free trade is probably something similar. So one should watch what's happening, but so far the omens are that they can be encouraged to go the right way.

Mr. LINCOLN. Economists generally don't like preferential trading areas. It creates distortions in the system. But I, like John Williamson, am relatively optimistic about Europe. I think overall it's probably to our benefit as well as their benefit. In some sense I think of European countries as being inefficiently small in economic terms and they are probably better off to behave as a single nation.

But I would like to add one word on Japan. The Japanese are frightened to death of what's happening in 1992, and the real danger I think is that's driving a process in which the Japanese are beginning to think, or some Japanese are beginning to think in terms of an Asia group led by Japan as a reaction against Europe. This is their alternative. If they are kicked out of Europe, well, they can go and play with the other Asian countries. If you read between the lines, they are not talking about a Pacific Basin that includes the United States, but they are talking about Japan and Asia, and that would be a very discouraging development if it was to develop.

Mr. HUFBAUER. I pick up on what John Williamson said about the price of freedom being vigilance. I'm an optimist, but I think it will take a great deal of vigilance, specifically in the high-technology sector.

Now I'm going to raise an overdrawn specter. The early Common Market of the six had, as its economic glue, the common agricultural policy.

The Europe of the 12 could have as its economic glue high technology. I have referenced the statistics earlier. If you look at the list of high-tech research consortia in Europe which are well funded, it is truly formidable. It is easy to imagine a situation in which those consortia are backed up by public procurement which is discriminatory or by other measures which do not prefer exports from the United States. That's troubling; we must take all the necessary steps to ensure that that does not happen. We have many allies in the Community with whom we can work to ensure that that does not happen.

Senator SARBANES. Well, very good.

Is there any statement that anyone wants to leave on the record before we close the hearing?

Mr. WILLIAMSON. I have much less than a statement.

Senator SARBANES. I don't want you to walk away saying that you just wanted to make one other point and didn't get the chance to do it. [Laughter.]

Mr. WILLIAMSON. I hope it's less than a statement, but I did want to just pick up on one point that came up early in the hearing and I never got a chance to comment on it, and that was the question of Europe versus the United States compared to California versus New York.

I think that when Gary Hufbauer replied to your comments he mentioned all sorts of ways in which one might hope to see closer relations between Europe and the United States, but I, nevertheless, think that you were quite right, Mr. Vice Chairman, to suggest that those things in themselves are not going to make it possible to forget about balance-of-payments positions between Europe and the United States.

What enables you to forget about balance-of-payments positions is when there is only one currency, and maybe Europe will move to that situtation. Within Europe they are certainly planning to try, but I don't see that as likely between the two sides of the Atlantic over the next 10 to 15 years, and, accordingly, I think it will remain important to try and keep balance-of-payments positions and net debt positions within some sorts of limits, which is, of course, what is provided for in the sort of proposals for policy coordination that I've talked about.

Thank you.

Senator SARBANES. Well, gentlemen, thank you very much. You have been a very helpful panel and we appreciate it.

The committee stands adjourned.

[Whereupon, at 12:15 p.m., the committee adjourned, subject to the call of the Chair.]

O

27-042 (76)