

THE PARIS ECONOMIC SUMMIT

HEARING BEFORE THE JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

JULY 6, 1989

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THE PARIS ECONOMIC SUMMIT

THURSDAY, JULY 6, 1989

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

The committee met, pursuant to notice, at 10 a.m., in room 2322, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton and Scheuer.

Also present: Joseph J. Minarik, executive director; Stephen Quick, chief economist; and Hunter Monroe and Carl Delfeld, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The meeting of the Joint Economic Committee will come to order.

Next week, the leaders of the G-7 powers will meet in Paris for the 15th World Economic Summit. These gatherings were started in 1975 in recognition of the increasing interdependence of national economies and the increasing need for cooperation among the world's major powers to safeguard the growth and stability of the world economy.

Three of the major problems facing world leaders are international trade imbalances, Third World debt, and international environmental problems. In addition to these three major areas, there may be other opportunities for making substantive progress at the Paris summit.

The possibilities include new efforts to foster economic reform in the centrally planned economies, progress on removing nontariff barriers to international trade, and greater coordination in the regulation and supervision of financial markets.

To help explore these and other possibilities, today's hearing will allow three experts in international economics to offer their views on what issues should be on the table at the summit. The committee is very pleased to hear the testimony of Mr. Robert Hormats, the vice chairman, Goldman Sachs International and former Assistant Secretary of State for Economic Affairs; Mr. C. Fred Bergsten, director, Institute for the International Economics and former Assistant Secretary of the Treasury for International Affairs; and Professor Jeffrey Sachs of Harvard University.

In addition, Secretary Brady will testify before the committee on July 19 on the results of the summit.

Each of you I think has a prepared statement. Those statements, of course, will be entered into the record in full, and we would appreciate now if you would summarize your statements, and then we will hear from each one of you before we turn to questions.

Mr. Hormats, we will begin with you and your statement.

**STATEMENT OF ROBERT D. HORMATS, VICE CHAIRMAN,
GOLDMAN SACHS INTERNATIONAL**

Mr. HORMATS. Thank you, Mr. Chairman. I will summarize the key points that I have put in my prepared statement.

It is for me a particular pleasure to be here. Having been on the U.S. "Sherpa" team at the first eight of these summits, from Rambouillet through Versailles, I have seen the change rather considerably, both in character and content, over the years. They have come to play a very important part in the international economic cooperation agenda: and this summit, as you said in your opening statement, Mr. Chairman, inaugurates the third round of these conferences. It is the 15th.

I think maybe it would be useful before proceeding to discuss the specific substantive issues likely to be put forward on this particular summit agenda to talk very briefly about what summits can do and cannot do and what they have succeeded in doing in the past.

First, summits have been catalysts enabling government officials and ministers to reach agreement in preparatory or followup discussions. This is particularly interesting because, at least in some summits, agreements have been reached at the meetings themselves. In most cases, however, what is done in terms of details is done with a lot of preparatory work. In some cases the very fact that a summit is going to occur is a catalyst for getting ministers and officials to reach agreement even before the summit actually takes place, or to encourage them to make progress in followup sessions.

A second function of the summit—in fact, probably the chief function—has been to focus international attention on an issue or two and to give national leaders a vehicle to boost domestic support for internationally oriented policies at home. They have succeeded in generating public support for taking a tougher position to reduce energy dependence and dealing with issues such as trade imbalances. A whole range of issues have been discussed at summits. The fact that the summit talks about them gives them a certain political focus and then the followup in international negotiating fora, or in domestic legislatures, is easier because they were discussed at the summit level.

Frequently—and I think this is the case in some areas today—summits confine their roles to crystallizing and giving political blessing to a consensus reached in another forum. The Group of Seven financial ministers and central bank governors does a great deal of work to prepare summits, at least insofar as they relate to macroeconomic issues, exchange rate issues, issues of growth, issues of inflation, et cetera.

The Quad, the meeting of the trade ministers of Canada, the United States, the European Community, and Japan, does as a lot of the preparatory work on the trade agenda items for the summit.

And frequently the OECD ministerial meeting is drawn on insofar as its communique is concerned, and its work is concerned, and endorsed by the summit communiqués. So the OECD plays an important preparatory role in the summit process.

The final point about the summits is that they are increasingly important fora for discussing political subjects. It has to be born in mind that these are heads of state or government who are meeting, and they basically tend, unless they are former finance ministers, to shy away from technical issues.

These are really leadership events—and heads of state like to deal with political issues. East-West issues are going to be clearly an important item on this agenda: events in China, how to improve or support normalization and reform in Eastern Europe, how to respond to Gorbachev's initiatives. All of these are politically important issues that heads of state have to address when they sit down.

Sometimes they are addressed in the formal meetings. Often they are addressed at the private lunches and dinners that the heads of state have together, and they go over and compare notes about important political issues on the agenda.

I will not cover, orally, as I have in my prepared statement, the current economic situation except to make one or two points.

One, I think leaders will, by and large, want to give themselves a little collective pat on the back because economic developments have been a lot better than most people thought they would be after the stock market crash in October 1987. The leaders will want to say, "Look! Things are not as bad as we thought they would be." Growth is relatively robust in most countries in the world. In industrialized countries, in the United States for instance, consumption is beginning to go down, savings are beginning to go up, the trade balance of late has improved, although the improvements are beginning to flatten out now and there is a concern that we may see a deterioration in the U.S. trade balance. But by and large, they will want to give themselves a collective pat on the back.

Notwithstanding that, however, I think they will also want to discuss such things as the recent volatility in currency markets and how to deal with that. They will probably also be concerned about creeping inflation in most industrialized countries, which is certainly a problem; most forecasts indicate that there might be a deterioration in the U.S. trade deficit next year, resulting from the stronger dollar of late. And there is always a possibility of too much of a slowdown in the United States that will concern some people.

On the currency side—Fred Bergsten will talk more about that—I would simply say that it needs to be borne in mind that the European Community is now undertaking an exercise to strengthen European monetary cooperation in the 1990's. It might be very useful for this summit to decide to put together a group to look at how European monetary cooperation will relate to the broader global monetary scene, and whether or not as Europe improves cooperation among the 12 members of the Community, the other industrialized countries, with Europe, take the next step in strengthening or reforming the international monetary system in parallel with

what the Europeans themselves are doing. This is an important issue of how Europe relates to the rest of the world.

Let me just very briefly touch on the substantive issues other than the macroeconomic side.

First, it is important to recognize the Paris summit will coincide with bicentennial celebrations of the French Revolution, and that means that a lot of Third World leaders, some 25, perhaps 30 Third World leaders, are going to be in Paris at roughly the same time as the summit to celebrate the French Revolution with President Mitterrand. There will be a dinner between these people and the industrialized leaders. This is going to create a certain amount of focus on the problems of the Third World, particularly Third World debt.

One particular American objective is going to be to gain greater support for the Brady plan, to give it more momentum. This is an important item. The French are supportive of the Brady plan as well. The French also have traditionally underscored the importance of doing something for the very poor countries.

So I would assume that the French would want to focus attention on the problems of the very poor countries in Africa, and other parts of the world as well, at this summit.

Second, East-West issues. That will be certainly a compelling topic. President Bush will be leaving soon for Poland and Hungary. President Gorbachev is now in Paris. He has just had a major visit to the Federal Republic of Germany. Mitterrand, Thatcher, and Kohl have all made recent visits to Eastern Europe. This has to be an issue. My assumption is the summit will address four East-West issues.

One, how far do they wish to go, what programs they wish to support and how much they wish to spend to aid reforms in Eastern Europe, particularly Hungary and Poland?

Two, how do they react to past Soviet proposals for a "common European house" and any new initiatives launched by Gorbachev in Paris or today, when he is speaking before the Council of Europe in Strasbourg? Gorbachev is more than likely to come up with another set of initiatives at that forum.

Three, how to implement President Bush's express desire to integrate the Soviets into the international system?

And, four, how to respond constructively to events in China.

One point I would make, having read the paper this morning, Mr. Chairman, is that Secretary Baker, in my judgment wisely, warned in the meeting with the ASEAN leaders against isolating China. It seems to me this is an important point, and I think the United States and the Japanese and the Europeans and the Canadians will want to discuss this as well and make some important statements on the subject.

Environmental issues. The environment is clearly an important issue. Past summits have given short shrift to environmental issues. This one, in contrast, promises to go down in history as the "green summit." It will discuss a whole range of environmental issues—climatic change, the greenhouse effect, ocean pollution, stripping of the rain forests—a whole range of these issues. A summit cannot make technical decisions on how to deal with these

issues, but it can establish a political agenda which can be followed up at a later time.

And then, of course, there is the issue, as I mentioned, of the global economy and how to deal with that.

I would, in concluding, make a couple of specific points that can be followed up. One is this is a great opportunity for President Bush, having taken the initiative at the NATO summit on East-West security issues, to take a similar initiative at the Paris summit on East-West economic issues. And having come from Hungary and Poland, I believe he will have some specific ideas as to how to support those countries. Clearly, it has to be done with the Western Europeans, with the Canadians, with the Japanese. This is a particularly important political and economic item; and it gives the President another chance to take the initiative.

Second, Japan. Tragically, the Japanese are having an internal problem at just the time when their importance to the world economy is at a very high level. I think at no point in time in the post-war period has Japan been more important to more issues on the international economic agenda. No answer to the trade problem can be found without the Japanese. The Japanese are critically important in Third World debt issues. They are critically important in supporting environmental programs around the world. They are critically important in international monetary issues.

In other words, the Japanese role in the world economy is enormous, and even though they are having internal problems, it seems to me the United States has to work with the Japanese in a very close way at this summit. And the events in the China indicate all the more so that the United States-Japanese alliance and relationship is of vital importance to both sides.

Third, it is important that the United States work closely with President Mitterrand. He is the host of the summit. He is a summit veteran. He will have just hosted Gorbachev. He is going to be in the Presidency of the European Community for the next 6 months, and he is going to play, I think, a very important role. If President Bush and President Mitterrand can preserve the spirit of Kennebunkport, they can get a lot of things done at this meeting that can be helpful to both sides.

The last point is on trade. Trade items are not going to be major disputes at this summit. There may be a little bit of grumbling about super 301, but I don't think there are going to be any major trade issues. I do think, however, it is important for the United States and for President Bush to underscore that we are supportive of the European Community's efforts to develop a single market by 1992, that we have found the Community to be very cooperative in dealing with issues such as banking reciprocity and setting of product standards. We hope this will continue. We want to work with the Community as it goes along in its process of unification to avoid trade problems. And we want to work closely with the Japanese to resolve the structural and other trade problems we have with them.

Commission President Jacques de Cors will be there. So this is a very good time for the United States to talk about its support for Europe 1992 and the role that it can play in that area.

These are just a quick overview of the summit agenda items. We can certainly discuss them in greater detail as we go along.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Hormats follows:]

PREPARED STATEMENT OF ROBERT D. HORMATS

I am pleased to appear today before the Joint Economic Committee to discuss the outlook for the Paris Economic Summit.

Having been on the U.S. "Sherpa" team at the first eight economic summits -- from Rambouillet through Versailles -- I have seen the content and character of these meetings change considerably over the years. They have come to play an important part in international economic cooperation. The Paris Summit inaugurates the third round of these conferences.

A BRIEF RETROSPECTIVE ON THE PROBLEMS AND POTENTIALS OF SUMMITS

From their genesis, as a the result of a 1975 Franco-German initiative to enable leaders of the major industrialized democracies to discuss informally the problems they then collectively confronted (high unemployment, high inflation and oil shortages), summits have become highly structured and highly publicized events, with a tendency to devote greater attention to reassuring domestic constituencies that their leader's policies are correct rather than to tackling difficult problems on the international agenda.

This is not, however, to say that summits are unimportant, irrelevant, or merely theatrical shows -- as their critics often allege. They have served, and continue to serve, several important functions.

First, they often have been catalysts enabling government officials and ministers to reach agreement in preparatory or follow up discussions. They have led to increased foreign assistance by Summit countries to the world's poorest nations, progress in key areas of the Tokyo Round of multilateral trade negotiations, and a more aggressive industrialized

nation approach to reducing dependence on imported energy. The very first summit was the venue for a French-U.S. agreement to change the rules of the international monetary system, although most of the work was done in advance and the decision was formally incorporated into IMF rules several months later. In some circumstances, deals can actually be reached at the summit itself, e.g. at the 1978 Bonn Summit where Chancellor Helmut Schmidt reluctantly agreed to speed up German growth if President Jimmy Carter would decontrol oil prices.

In most circumstances, the chief function of the summit has been to focus international attention on an issue and to give national leaders a vehicle to boost domestic support for internationally oriented policies at home. Agreeing to take certain actions as part of an international consensus in some cases gives those actions greater credibility with domestic constituencies. Summits can underscore a problem; highlight the need for an international effort to come to grips with it; and focus attention on, and thereby help to generate public acceptance of, domestic measures required to support the international effort. Summits played this type of role during the energy crisis in the last decade, in the effort to avert protectionism in the 1970s, and in the global fight against terrorism.

Often Summits confine their roles to crystallizing and giving political blessing to a consensus reached in another forum. Summit recommendations on trade issues, for instance, are usually worked out in the Quadripartite Meetings among the trade ministers of Canada, the EC, Japan and the U.S. And the existing global trade agenda and timetable normally influences summit discussions. At the Paris Summit, for instance, the leaders are likely to give their support to successful completion of the Uruguay Round by the end of 1990. The Group of Seven now do much of the work on issues relating to domestic economic policy harmonization and currency stability; their efforts and recommendations normally receive the Summit's blessing. And parts of the OECD Communique are often endorsed in Summit communiqués.

Summits are also increasingly important fora for discussing political subjects. At virtually every summit meeting one or two political issues have preoccupied the leaders. At the 1980 Venice Summit, it was the Soviet invasion of Afghanistan and the hostage situation in Iran; at the Versailles Summit of 1982, it was disagreement over the Siberian gas pipeline and Israel's invasion of Lebanon. It is likely that, responding to the current political agenda, the Paris Summit will devote considerable time to events in China, to Gorbachev and to developments in Eastern Europe.

THE CURRENT ECONOMIC SITUATION

The successful domestic economic performance of the major industrial economies must be considered as an especially positive development, particularly given forecasts of gloom and doom following the stock market crash in October 1987. The leaders have a right to do a little back-patting. Domestic demand in the major Western European economies and in Japan, boosted by strong monetary growth, is robust. In the U.S., domestic consumption is weakening as savings grow, and exports account for a growing portion of GNP growth: OECD growth is likely to be in the 3-3.5% range in 1989, but will probably slow to roughly 2.5% in 1990. Although concerns about recession in the U.S. cannot be dismissed, because growth in income and in final sales is slowing markedly, and leading indicators are sharply down, the chance of a recession is reduced by an absence of a generalized inventory overhang or price pressures great enough to prompt monetary tightening, and by continuing strong demand abroad for U.S. goods. U.S. GNP appears headed for a growth rate of 1-2%.

On the negative side, capacity is under strain and price pressures are intensifying in much of the industrialized world. OECD inflation is likely to be around 4.5% in 1989 and about the same in 1990, with the U.K. and Italy at the high end. However in traditionally low inflation countries like Germany and Japan, price pressures are also greater. The stronger

dollar has contributed to higher inflation in European economies and in Japan, but wage pressures and, until recently, relatively relaxed monetary policy have also been factors. The higher rate of inflation in these nations signals the likelihood of higher interest rates; over time these will slow their growth and cause inflation to flatten out.

In addition, although the risk of a U.S. recession appears now to be small, it exists nonetheless. Should a recession occur, it could have a serious impact on highly leveraged sectors of the economy and severely weaken the exports of Latin American debtors. Also, there is an ominous prospect of a reversal next year of the now improving U.S. trade position due to deterioration in the international price competitiveness of U.S. goods resulting from the renewed strength of the dollar and to a possible cooling off of the fast growing economies in Europe and Japan. However, the sluggish growth in demand that is likely in the U.S. should work to slow imports and thus offset, to a degree, the adverse competitive effects of the higher dollar.

This of course leads to the question of whether the dollar/yen or dollar/ECU (or deutschmark) relationships can be changed significantly in the period ahead. While the G-7 has compiled a good record of influencing the direction of currency movements in the past, it recently has found the task difficult. It is hard to effectively reverse a currency's trend through "sterilized" intervention if that trend is consistent with fundamental market judgments. In recent months, the combination of Fed policy, high savings abroad, and the improving U.S. trade account (plus a brief surge of capital inflows from East Asia) have boosted the dollar to levels well above its lows of 1988. Slower money supply growth (M_2) and the Fed's continuing public commitment to fight inflation suggest that the Fed's stance is and will continue to be tighter than that of most other major central banks. And the U.S. current account deficit today accounts for a declining percentage of global savings -- 6% this year compared to about 9% a few years ago, making that deficit easier to finance. In this

environment, the large scale intervention aimed at holding down the dollar (roughly \$25 billion already this year), most of which was "sterilized," had little effect.

This should not imply that the G-7 coordinating process has failed or that it cannot work to hold rates in a preset zone in some circumstance. It does underscore that exchange rate stability recently has been a less important goal for most countries than achievement of domestic growth and/or anti-inflation objectives. The exchange rate zone of the Louvre Accords simply gave way because G-7 domestic policies, particularly monetary policy, and broader market fundamentals were not consistent with the maintenance of currency rates within that zone. The dollar, while down from its recent highs, is unlikely soon to return to its lows of last year, unless there is: 1) a more pronounced easing of Fed policy combined with a tighter monetary policy abroad, or 2) a major deterioration of the U.S. trade balance without a renewed tightening of Fed policy along with a loosening abroad.

THE CONTEXT

Summits do not occur in a vacuum. They are greatly influenced by the circumstances in which they take place.

The Paris Summit will coincide with the Bicentennial Celebrations of the French Revolution. It will thus be surrounded by a series of spectacular events. In connection with these festivities, President Mitterand has invited to Paris roughly 25 leaders from non-summit nations; most will be from the Third World, e.g. the Presidents of Mexico, Brazil, and the Philippines as well as leaders of many of France's former colonies in Africa. This group's presence, including a dinner together with the industrialized nation leaders, will focus Summit attention on the economic problems of the Third World, particularly on the problem of debt.

The Summit will provide the U.S. with a forum for building additional support for, and momentum behind, the Brady Plan. The Plan is currently being implemented in negotiations

with Mexico and other nations, is supported by resources of the IMF and World Bank, and has received the financial backing of Japan; but there is still reluctance by the U.K. and West Germany to give it their blessing, and the amount of resources that will be made available from the commercial banks in the form of rescheduling and new money is still under negotiation. A strong consensus in favor of the Plan is a key U.S. Summit objective. Third World issues will be an especially important subject for President Mitterand, who is likely to support the Brady Plan and to urge new efforts to address the problems of the world's poorest nations.

East-West issues will also be compelling. President Bush will visit Hungary and Poland just before the Summit. President Mitterand, Prime Minister Thatcher and Chancellor Kohl will also have made recent visits to Eastern Europe. President Gorbachev is in France this week, and has just completed a dramatic visit to West Germany. And the Summit will take place less than two months after the very successful NATO Summit in Brussels, which launched a sweeping arms reduction proposal and gave President Bush the initiative on this subject. Summit leaders cannot but consider issues such as: 1) how far they wish to go; what programs they wish to support, and how much they wish to spend, to support reforms in Eastern Europe, particularly in Hungary and Poland; 2) how to react to past Soviet proposals to create a "common European house" and any new initiatives launched by Gorbachev in Paris; 3) how to implement President Bush's expressed desire to integrate the Soviets into the international system; and 4) how to respond constructively to events in China.

Environmental issues are commanding great attention in national political constituencies. The Paris Summit will doubtless reflect that. Past summits have given short shrift to environmental issues. This one, in contrast, promises to go down in history as the "Green Summit." It will attempt to reach agreement on ways to tackle problems such as global climatic change and the greenhouse effect. This is precisely the kind of issue on

which the summits can make a difference not by seeking complicated technical agreements, although better methods of collective action are needed and new ideas for this might well emerge, but by focussing attention on the problem and galvanizing strong political support for follow up actions.

Global economic issues of growth, inflation, trade imbalances, and exchange rates have traditionally been at the heart of summit agendas. At this summit there will doubtless be expressions of satisfaction that underlying economic circumstances are reasonably good. Growth is strong in most of Western Europe and Japan; in the U.S. consumption and the budget deficit are declining, while net exports and savings are growing. But recent volatility in currency markets, creeping inflation in G-7 economies, and the prospect of a slowing down or reversal of recent improvements in the U.S. trade deficit next year will probably be summit topics. Structural adjustment, a major topic of last year's Toronto Summit, promises also to be a subject at Paris.

SUMMARY OF RECOMMENDATIONS

Mr. Chairman, your letter of invitation asked what, in my opinion, the Paris Summit should aim to achieve. Recognizing that the President has a number of highly experienced advisors helping him to prepare for this meeting, I offer, on the basis of my past involvement in the summit process and the opportunities I see for progress at Paris, only a few pieces of advice:

-- Be yourself. The other heads of state want to know what is on your mind, how much weight you give to particular issues, and where you would like the West to move on these issues in the future. While the U.S. president is not in a position to dominate the summit process, he is in a strong position to lead it, particularly if he works closely with the host. In this case President Mitterand. Mitterand will wish to attain his own set of objectives at the Summit; and as host and as an experienced summit veteran he will have considerable

influence over the atmosphere and the outcome of the discussions. He and you, and your two delegations, will need to stay in close touch with one another, as well as with other key players (especially Chancellor Kohl and Prime Minister Thatcher on East-West issues, Prime Minister Mulroney on the environment, and Prime Minister Uno on China) to obtain the results you want and to prevent major differences from arising.

-- It is best to put forward relatively few proposals and initiatives rather than try to "cover the waterfront." There are always pressures from within the administration and from various constituencies to say something about virtually every issue before the group, but doing so could divert attention from the specific items on which progress is especially important to you. You should set a few specific goals which you would like the Summit to achieve during its two days of meetings, e.g. support for Eastern European reforms and for the Brady Plan, and convey them to your colleagues at the first private lunch or dinner, in order to help move the discussions in the direction you desire.

-- Remember summits are not for reaching technical decisions but leadership events to move issues forward and set an agenda which ministers and officials of the Summit countries, and others, afterwards can pursue together collectively. You have, for example, an excellent opportunity to forge a common approach to environmental issues -- one that creates political support for progress in key areas such as acid rain and ocean pollution. You might explain the system of incentives and penalties in your recent Clean Water Bill in order to launch a discussion as to which of these might be applicable in other areas and in other countries; and you will be able to learn how other leaders handle similar environmental issues.

Collective international action is especially important on the environment. If a nation unilaterally imposes costs on its companies or taxpayers in order to reduce harmful emissions, it might place its industries, and economy at a competitive disadvantage vis-a-vis

those of other nations that take no action. If it acts together with them, there need not be a competitive cost.

It is also important to examine environmental issues in light of the sharp increases in U.S. oil imports (which could lead to a dangerous 60-70% dependence in the mid-1990's) and other industrialized nations' growing reliance on imported energy. Summits are useful to anticipate problems, not only to address current ones. An energy crisis in future years could lead to a scrapping of many environmental programs in the urgent drive to boost domestic energy production. Conversely, environmental programs designed without giving sufficient weight to the need for increased energy production could contribute to increased energy dependence. An urgent effort is necessary to develop a comprehensive Western energy/environmental strategy for the 1990's. A summit group (drawing on the expertise of the OECD and International Energy Agency) might be created to examine this.

You also have a great opportunity to complement your NATO Summit Initiative on East-West arms cuts with a Paris Summit Initiative on economic, social and political reforms in Eastern Europe and the Soviet Union. One specific proposal might be to support a dialogue between officials of the Soviet Union and experts from the multilateral economic institutions such as the IMF, World Bank, GATT and the OECD, so Moscow can better understand how the global, market-oriented economic system works and more easily adopt its practices to it as its economic reforms proceed. A similar dialogue might be encouraged between experts of these institutions (if they are not already members) and officials of reform-minded Eastern European nations. In addition, you and your colleagues might explore new ways by which reforms in Eastern European nations such as Hungary and Poland can be supported by the West, and how the West might help them to loosen economic ties with the USSR without triggering a Soviet counter move to pull them back. The European Community appears willing to take the lead on many aspects of improving economic relations with Eastern

Europe; this is an appropriate role for them, especially as their growing unity makes them a strong magnet for Eastern European nations.

You need not feel compelled to duplicate in the discussion, or in the communique, all aspects of the work of the Group of Seven. Secretaries Baker and Brady -- together with Chairman Greenspan and former Chairman Volcker -- have been instrumental in putting the Group of Seven at the center of the international economic and financial system. Despite its recent difficulties in taming large currency fluctuations, the G-7 remains an indispensable vehicle for economic cooperation in the West. While a detailed summit discussion of macro economic issues is unnecessary, it is important that the leaders encourage the G-7's efforts to further narrow trade imbalances between the U.S. and its major trading partners. Policy changes to do this might include: a somewhat tighter monetary policy, accompanied by a more relaxed fiscal policy, in Japan and West Germany, along with a tighter fiscal policy and a more relaxed monetary policy in the U.S. These, combined, would strengthen the deutschmark and the yen, improve prospects for reducing the U.S. trade deficit, and help sustain economic growth in the West.

Specific questions of exchange rate management are best left to the G-7. However, the Summit might encourage the G-7 to consider whether in light of recent currency volatility, and steps at the June EC Summit in Madrid to strengthen intra-European monetary unity, it is probably worthwhile to launch a new study on ways to further improve global monetary cooperation.

You will need to underscore your personal commitment to the success of the Uruguay Round of trade negotiations and elicit a similar commitment from the other leaders. Fifteen negotiating groups are now at work implementing the guidance given them by ministers at the Montreal mid-term review late last year. If the negotiations are to reach a successful conclusion by the end of next year, tough political decisions will have to be made by participating leaders.

The U.S. wants concrete results in these negotiations on agriculture, services, intellectual property, and investment-related trade distortions, among other issues. Our trading partners have their own goals. Without a new set of international rules covering these and other subjects there is a danger of a breakdown of the international trading system, a resurgence of economic nationalism, or a turn toward economic regionalism.

In this connection, it would be useful to encourage the EC, which will be represented by Commission President Jacques Delors, as well as by four member nation heads of state and government, to continue its generally constructive attitude toward resolution of issues connected with creation of the Single Market. You can cite, in this regard, progress made in resolving issues of banking reciprocity and standards setting, and urge the EC to aim for the most open and least regulated market possible. Such an approach will help you to guide the U.S. in a similar direction and to continue your already expressed strong support for the 1992 Single Market. The same point regarding market openness needs to be made to Japan, where progress in reducing barriers has been made and where the primary obstacle to increased trade now appears to be structural. Many of the bilateral U.S.-Japan, U.S.-EC, Japan-EC issues can be resolved in the Uruguay Round, where cooperation among the three is reasonably good, but bilateral talks are also important.

Representative HAMILTON. Thank you, Mr. Hormats.
Mr. Bergsten, please proceed.

**STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR
INTERNATIONAL ECONOMICS**

Mr. BERGSTEN. Mr. Chairman, as you indicated at the outset, there is a long agenda for the Paris summit. Most attention, I think, has been given to the issues of Third World debt, the environment, and perhaps Eastern Europe. But I would argue that the central problem of the world economy, and the one that should be at the center of the agenda for this Paris meeting, is the continued large trade imbalances among the major countries, and what I fear, in the absence of renewed action to deal with them, will be a renewed rise in those imbalances within the next few months, or certainly starting next year, which will have pervasive effects on a whole range of problems.

It is my view that unless these international imbalances are dealt with much more effectively, their spillover effects will hurt badly the efforts to deal with Third World debt, trade policy, and the other issues, and therefore these imbalances should be at the center of the agenda for Paris.

As Bob Hormats mentioned, the U.S. trade deficit has essentially been on a plateau for the last year after coming down in 1987 and early 1988. The Japanese surplus has been rising again for the last year, and the German surplus has never stopped rising. In fact, those surpluses are both likely to hit record levels this year or next, indicating that the surplus side of the equation is already again moving in the wrong direction. There was thus already a need for a renewed attack on these imbalances even before the further increases that will emerge from the latest rise of the dollar.

Some projections done at my institute show that, even with the dollar near the lows it reached toward the end of 1987, the U.S. current account deficit would start rising again later this year or in 1990. It would again exceed \$150 billion by 1992. Now, that may sound pessimistic, but the IMF's projections indicated that the U.S. deficit would be above \$150 billion again already by next year, and that indicates a reversal with serious consequences for a wide variety of issues.

Just recently the dollar rose again. It has come back down in the last few days, but when the dollar was at about 140 yen and 2 deutsche marks we ran our model again, and we found that if anything like those rates were to prevail long enough to get into pricing and trade decisions, the U.S. current account deficit would soar beyond \$200 billion by 1992, carrying our net foreign debt above \$1.2 trillion by the end of that year.

Fortunately, exchange rates have begun to reverse over the last few days, but they could rebound. They are still well above their previous levels, which already suggested a renewed deterioration in the U.S. external position over the next few years.

All that, I think, will have three very negative effects on the U.S. economy. The first is that our whole economy could be thrown into what I will call an import-led recession.

We frequently talk about the need for export-led growth. You reduce your trade deficit by an improvement in your exports. That, of course, gives a positive impetus to the overall economy—increased output, creation of jobs, and the like.

On the other hand, when the trade deficit starts deteriorating again, that not only hurts the Nation's external position, building foreign debt and the like, but it is a drag on the entire economy because, increasingly, demand is going to support production abroad, not at home. You are losing jobs, output, and the like.

Now, if the dollar were to remain at anything like recent levels, our analysis shows the current account deficit rising in nominal terms by \$100 billion between this year and 1992, and because of changes in price relationships that would mean a much bigger decline in volume terms. The result is that we could lose a full 3 percent of our GNP over the next few years. The growth rate could drop by a percentage point or more a year, and given the fact that the domestic economy is already slowing considerably, that could push the economy into a recession.

The point is that if we do not make new efforts toward improving our external position, a renewed deterioration could result instead, which would drag the whole economy into a recession.

I should note for politicians in both the administration and the Congress that the full force of that adverse trade effect would be felt about 1992, which might not elicit great sympathy for those facing reelection that year.

The second effect of renewed deterioration in the U.S. deficit would be renewed pressure for trade protectionism. You know here in the Congress that an overvalued dollar and a large and growing trade deficit produce enormous pressures for trade protection.

You will recall that the proximate impetus for the initial Plaza Agreement that Secretary Baker and the G-5 countries concluded back in 1985—to start reducing the value of the dollar and correcting the U.S. trade deficit—was the threat of major protectionist action here in the Congress. But if the trade balance now stops improving and starts to reverse, I think that pressure will inevitably come back—in this body, in the American business community, and elsewhere—and the world trading system will be at risk, and our economy will face the downturn and its consequences that I suggested.

Third, there remains the risk of a financial hard landing. The dollar has risen in some recent periods rather than fallen, but given the present outlook of trade deficits of \$150 billion or even more as far as the eye can see, the United States will have to continue borrowing over \$10 billion per month from the rest of the world indefinitely.

It is axiomatic that those inflows will decline sharply or even dry up totally at some point. Indeed, a loss of confidence could prompt foreign investors to withdraw some of the \$1 trillion in liquid assets they already hold in the United States.

We know that private foreign investment in the dollar did largely cease in 1987. Foreign central banks stepped into the breach at that point for a variety of reasons that I indicate in my prepared statement. We should not be at all confident that they would do so again in the future.

If we experienced a free fall of the dollar any time soon, with our economy still near full employment and full capacity utilization, then the inflation rate would be pushed up sharply, interest rates would rise even more, and an inflationary recession would be almost inevitable.

Needless to say, issues like the S&L problem, Third World debt, and other interest-sensitive problems would become all the more intractable if we suffered a sharp rise in U.S. interest rates as a result of a free fall—an uncontrolled decline in the dollar.

So, for these various reasons—the risk to the economy, the risk of financial instability, the threat to the trading system—I would argue that the United States has an enormous interest in launching a new international effort to resume the correction of our external deficit and the corresponding foreign surpluses, and that doing so should be at the top of the priority list for the Paris summit.

Now, as Bob Hormats said, the summiteers aren't going to go into great detail on all of these issues, but they could launch or catalyze the kind of program I am talking about, by indicating that they intended to move exchange rates and national policies in a direction that would restore progress toward reducing these international imbalances. They can direct their authorities to carry out sizable and coordinated intervention in the exchange markets to promote such an outcome. They can, of course, welcome changes in interest rates, some of which have already been put in place by foreign central banks, but which are now needed on the part of the Federal Reserve here. A cut in interest rates is desirable both because the domestic economy is softening and, in this context in particular, to add to the currency readjustments that are needed.

We need to get firm pledges from the Japanese and the Europeans—the surplus countries—to maintain their present domestic economic expansion so that there will be markets out there for the increases in exports we need to bring our trade deficit down in a constructive way.

President Bush needs to make a serious pledge to meet the Gramm-Rudman-Hollings timetable for getting the U.S. budget deficit down without smoke and mirrors, thereby fulfilling the critical U.S. part of the international adjustment strategy.

And finally, one thing that the G-7 summiteers could push, I think, in a serious way—and President Mitterrand may initiate it—is an effort to put in place an improved international monetary system to maintain the new equilibrium exchange rates once they are achieved.

American exporters now are very reluctant to invest in new plant and equipment to meet foreign demand for U.S. sales abroad, because they don't know that the dollar won't be up 30 or 40 percent again when their plants come on stream in 2 years. They therefore need assurance that new equilibrium exchange rates will remain in place, so they can have confidence to invest to serve export markets for the future. That is the only longrun solution to the U.S. trade problem. I think the summiteers could direct their central bank governors and their finance ministers to put in place a serious, stabilizing exchange rate system to avoid the huge imbal-

ances that we have seen throughout the 15-year history of floating exchange rates.

One more element is needed to ensure the success of the international adjustment program; namely, renewed progress toward reducing trade barriers. That is crucial both from a global standpoint, to help head off the protectionist risks that I have already mentioned, but also from a purely U.S. perspective to give us the market access abroad we must have to realize the needed trade gains.

The best route to such liberalization would be a successful Uruguay Round of multilateral trade negotiations in the GATT. A meeting in Geneva in April cleared away all the procedural roadblocks, but relatively little substantive progress has been made, and with only 18 months remaining to the end-1990 deadline, an enormous array of issues have yet to be addressed.

In this context summit meetings can play a critical role. Back in both 1978 and 1979, in somewhat similar circumstances, very strong statements at the summit, statements of political support for the Tokyo Round, galvanized the national negotiators to reach a successful outcome. Bob Strauss, who negotiated that round of trade liberalization for the United States, has said on many occasions that without those pushes from the summit the Tokyo Round probably would never have succeeded.

I think a similar push should be a high U.S. priority in Paris, to see to it that the Uruguay Round is given the maximum possible impetus toward success.

In conclusion, I would simply note that there are several other important issues that could be usefully addressed at the summit: Third World debt, which I am sure Jeff Sachs will talk about; environmental issues; and others. But the macroeconomic and trade issues that I have emphasized lie at the heart of the world economy, and we cannot deal effectively with the other problems unless they are put right.

Take Third World debt. Over the 12 months from early 1988 to early this year, short-term interest rates in the United States rose by something like 3 percentage points. Now, for those debtor countries that were actually paying interest on their debt—and Mexico and some of the others have been doing so—that added a burden to their debt service far in excess of whatever relief they could possibly achieve from the full success of the Brady plan in reducing their debt-service obligations.

If we can get interest rates down now by a couple of percentage points, as Alan Greenspan has testified would happen with a serious budget program, we could do nothing more effective to reduce the Third debt burden.

On the other hand, if some of the untoward events I mentioned were to transpire, interest rates would shoot up, and that would torpedo any possible success of the Third World debt effort, such as the Brady initiative or even more ambitious plans.

So I would hope the summitters will address the macro issues because of their pervasive effects as well as the specific consequences I mentioned.

My final point is simply to note that the economic summits have fallen into some disrepair in recent years in terms of dealing seri-

ously with substantive issues. President Reagan and some of his foreign counterparts really rejected using them for substantive purposes, and thus their enormous potential for getting countries to adopt decisive programs to link disparate policy issues has lain fallow.

This will be President Bush's first summit, and I very much hope that he will seize the opportunity to go back to some of the efforts of 1970, during the Ford and Carter administrations, to use the summits to take advantage of their unique opportunity to push for serious, substantive progress on some of the central issues facing both our own economy and that of the world as a whole.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Bergsten follows:]

PREPARED STATEMENT OF C. FRED BERGSTEN

US PRIORITY OBJECTIVES FOR THE PARIS SUMMIT:
A "SECOND PLAZA AGREEMENT" AND THE URUGUAY ROUNDThe Trade Outlook

The dominant US objective for the Paris summit should be a "second Plaza agreement"--a renewed international effort to reduce the imbalances in international trade and current account positions that remain huge despite almost four years of adjustment effort since the original Plaza concord in September 1985. In the absence of such an effort, the imbalances are likely to start rising again by next year and hit new highs in the early 1990s. This could produce a series of severely adverse effects on the American and world economies, including an import-led recession here and protectionist pressures far greater than have existed in recent years.

When the dollar peaked in early 1985, the US current account was on a path toward annual deficits of at least \$400 billion by 1992. Thus the capping of the deficit at about \$150 billion in 1987, and its subsequent declines in 1988 and probably 1989, represent a considerable success. Exchange-rate and macroeconomic policy changes clearly work.

But the American deficit has essentially been on a plateau for the past year. The Japanese surplus has been rising again since mid-1988. The German surplus has continued to climb incessantly. Both surpluses are likely to hit record levels this year or next.

Thus there was a need for a renewed attack on the imbalances even before the further increases in them that will result from the latest rise of the dollar. Projections by my colleague William Cline¹ show that, even with the dollar near its previous low (from the fourth quarter of 1987), the US current account deficit would again exceed \$150 billion by 1992. The Japanese surplus would rise to an unprecedented \$135 billion and the German surplus to about \$85 billion (which, relative to its economy, is considerably higher than Japan's). Projections recently released by the International Monetary Fund suggest an even more rapid deterioration in the US position, with the deficit again exceeding \$150 billion by 1990.²

There are three major reasons for this result. The United States has failed to dampen the growth of domestic demand through a meaningful reduction in the budget deficit (or otherwise). The

¹ William R. Cline, American Trade Adjustment: The Global Impact, POLICY ANALYSES IN INTERNATIONAL ECONOMICS 26, Washington: Institute for International Economics, March 1989.

² International Monetary Fund, World Economic Outlook, Washington, April 1989.

impact of dollar depreciation, which ended in 1987, is likely to peter out this year with the normal two-year lag. And our merchandise imports still exceed our merchandise exports by about 30 percent, so that similar percentage growth in both increases the deficit substantially.

With the renewed rise in the dollar, the outlook has become much worse. Cline has updated his analysis³ to incorporate the exchange rates of May 22, when the dollar was at about 142 yen and 2 DM. If those rates were to prevail, our current account deficit would soar beyond \$200 billion by 1992. Our net foreign debt would exceed \$1.2 trillion by the end of that year.

The Impact on the United States

These developments would have three extremely negative effects on the United States.

First, our entire economy could be thrown into an import-led recession. The current account deficit would rise by about \$100 billion from 1989 to 1992, in nominal terms, if the dollar remained near current levels. It would climb by perhaps twice that amount in real terms, because the higher dollar would cheapen imports and thus their volume increase would be even greater than implied by the deterioration in the deficit.

We could lose about 3 percent of present GNP over the next three years as a result. The growth rate would fall by about 1

³ William R. Cline, "Impact of the Strong Dollar on US Trade," Washington: Institute for International Economics, mimeo, June 1989.

percentage point per year. With growth already softening substantially, additional weakening of this magnitude could tip the United States into recession.⁴ About one million jobs would be lost in export and import-competing industries. Politicians in both the Administration and Congress should note that these effects would reach full force in 1992.

Indeed, the United States should be aiming for export-led growth. For reasons cited below, we needed to bring our external position into far greater balance even before the renewed rise in the dollar threatened to produce further trade deterioration, by expanding exports and dampening the growth of domestic demand to free output to be sold abroad.⁵ It would thus be doubly tragic if we were to fall into an import-led recession instead.

Second, pressures for trade protection will expand exponentially if our trade deficit rises anew along anything like the projected path. Historically, the exchange rate of the dollar and the trade deficit are the most accurate "leading indicators" of American trade policy. When they are in

⁴ The actual rise in imports would of course be reduced by the recession itself, so the observed growth in the external deficit would be less than the numbers cited. This would represent a lasting "gain" for the trade balance, however, only if the United States deviated from its traditional pattern of restoring the output lost in the recession during the subsequent recovery.

⁵ The full story is in C. Fred Bergsten, America in the World Economy: A Strategy for the 1990s, Washington: Institute for International Economics, November 1988.

substantial disequilibrium, the balance of trade politics shifts sharply toward protection.⁶ Recall that the proximate impetus for the initial Plaza agreement by Secretary Baker and the G-5 was the threat of extreme restrictive trade action by the Congress.⁷

In the current environment, a renewed deterioration of the international imbalances would be doubly dangerous for trade policy. Such an occurrence would almost certainly discredit the entire Plaza strategy, which sought to remedy the trade problem through monetary devices and enhanced macroeconomic policy cooperation. As noted, that approach has brought the imbalances far below where they would have been in its absence. It has stalled because the currency changes have not gone far enough and because the United States has not fulfilled its part of the macroeconomic bargain (on the budget deficit).

But the political message could well be that the whole Plaza approach had failed. Hence alternative policies would be sought. Their focus would undoubtedly include additional trade measures: quotas, bilateral pacts, "managed trade" more generally and perhaps a sizable import surcharge (as employed by President

⁶ I. M. Destler, American Trade Politics: System Under Stress, Washington: Institute for International Economics, 1986.

⁷ I. M. Destler and C. Randall Henning, "Wrestling with the Dollar: Exchange Rate Policymaking in the United States," Washington: Institute for International Economics, forthcoming September 1989.

Nixon in 1971 under far less severe circumstances). The Uruguay Round of trade negotiations in the GATT, whose success in opening markets for US exports is crucial for us (see below), would be torpedoed. The world trading system is at risk in the absence of renewed progress in reducing the global imbalances.

Third, there remains the risk of a "hard landing"⁸. To be sure, the dollar has been rising of late rather than falling. (As noted, this is adding considerably to the problem.) But the United States, under the present trade outlook, will have to continue attracting over \$10 billion of net capital inflow per month from the rest of the world for the indefinite future. If the current account deficit were to rise beyond \$200 billion by 1992, this monthly borrowing requirement would soar above \$15 billion--over half a billion dollars daily.

It is axiomatic that these inflows will decline sharply, or even dry up totally, at some point. Indeed, a loss of confidence could prompt foreign investors to withdraw some of the \$1 trillion in liquid assets which they already hold in the United States. Private foreign investment in the dollar did largely cease in 1987. Foreign central banks stepped into the breach on that occasion, but we cannot assume that they will do so in the future--given their renewed focus on fighting inflation, their countries' reduced need for export expansion in light of their

⁸ Stephen N. Marris, Deficits and the Dollar: The World Economy at Risk, Washington: Institute for International Economics, revised August 1987.

achievement of domestic-led growth, and the prospect of virtually perpetual US external deficits in light of our demonstrated failure to control our internal deficits.

A free fall of the dollar, with our economy now near full employment and full capacity utilization, would push inflation up sharply. Interest rates would rise at least as much, and probably much further as the Federal Reserve felt compelled to tighten policy in response. Inflationary recession would be virtually inevitable. So would considerable financial turmoil, given the continuing fragility of large parts of our financial system (notably including the S&Ls) and much of the Third World. And we would have no policy tools to extricate ourselves from the recession, with the budget already in huge deficit (and pushed still higher by the recession itself) and monetary policy constrained to fight the inflationary side of the picture.

Hence the United States has an enormous interest in launching a new international effort to resume the correction of its external deficit and the corresponding foreign surpluses. Doing so should be at the top of its priority list for the Paris summit.

A Proposed Program

President Bush should propose a "second Plaza agreement" at Paris. Such a program would have several parts:

1. Clear statements--by the heads of state at Paris, subsequently by their Ministers of Finance and central bank governors--of official intent to push the major

currencies to levels compatible with equilibrium in national current account positions. Our analyses suggest that dollar rates of about 100:1 for the yen and 1.50:1 for the DM (assuming no intra-European realignments) would be necessary to fully eliminate the US external deficit.⁹ The uncoordinated cacophony of official statements in recent months has given markets the impression that the United States and the G-7 accept the renewed rise of the dollar, or even welcome it, and has been a major factor in triggering and sustaining that rise.

2. Sizable and coordinated intervention in the exchange markets to promote such an outcome, primarily by selling dollars when the currency is already declining in the market to seize the major tactical advantage of "leaning with the wind."
3. Changes in interest rates, notably a cut in US rates by the Federal Reserve and possibly further increases by the Bundesbank and Bank of Japan.¹⁰ It might be enough

⁹ The cut in the US deficit must be mirrored by cuts in the surpluses of the surplus countries--Japan, Germany, a few other European countries, Taiwan and Korea--rather than by additional deterioration of countries already in deficit such as the United Kingdom and Canada.

¹⁰ The Treasury Department has been wrong to oppose such monetary actions abroad, which would help achieve the needed currency correction. Treasury is of course correct to want continued growth of domestic demand in those economies, as noted in the text (next point), but that can be assured by renewed

for the Fed to let the Federal funds rate follow previous market developments by dropping 25-50 basis points, though a similar cut in the discount rate would be more dramatic and thus more effective."¹¹

4. Pledges by Japan and the Europeans to maintain their present rates of domestic demand growth, to keep the world economy expanding during the adjustment period and to provide markets for America's export expansion.
5. A renewed pledge by President Bush to meet the Gramm-Rudman-Hollings timetable for eliminating the US budget deficit, without "smoke and mirrors." Such a pledge is essential for political reasons and would ensure the economic success of the program, by reinforcing the downward pressure on interest rates and the dollar (and thus promoting the private investment needed to enhance American competitiveness and support export-led growth). The magnitude of the needed budget cuts may now be less, however, because the domestic economy is

fiscal expansion if necessary.

¹¹ The actual decisions on interest rates would have to be announced by the central banks themselves, and they do not participate directly in summit meetings. The summit takes place on a weekend, however, so these independent announcements could be coordinated with the political gathering without disrupting the markets.

- already slowing sufficiently to free a substantial share of output to be devoted to export expansion.
6. A redoubled effort by the G-7 to forge an effective mechanism to maintain exchange rates at the new equilibrium levels, to assure the private sector (notably including American exporters) that it will not be hit by renewed currency misalignments in the future and thus can invest in new capacity with greater confidence. The most promising technique would be to convert the "reference ranges" installed in the Louvre Accord of February 1987¹² into a full system of target zones.

Trade Liberalization and the Uruguay Round

One more element is needed to assure the success of this international adjustment program: renewed progress toward reducing trade barriers. This is crucial from both a global standpoint, to help head off the protectionist risks cited above, and from an American perspective to give us market access abroad to realize the needed trade gains. Further protectionism would be the ultimate folly for the United States at this point in time, since we can hardly achieve a swing of \$150 billion in our trade balance by suppressing imports and history teaches that

¹² Yoichi Funabashi, Managing the Dollar: From the Plaza to the Louvre, Washington: Institute for International Economics, May 1988.

forward momentum toward liberalization is essential to counter backsliding into more restrictions (the "bicycle theory).

The best route by far to such liberalization would be a successful Uruguay Round of multilateral trade negotiation in the GATT. An April meeting in Geneva cleared away all procedural roadblocks to the talks. But relatively little substantive progress has been made, and only eighteen months remain to the end-1990 deadline with an enormous array of issues yet to be addressed.

Summit meetings can play a particularly critical role in such an environment. In both 1978 and 1979, in somewhat similar conditions, strong summit statements of political support for the Tokyo Round galvanized the national negotiators to reach a successful outcome. A similar push should be a high US priority for Paris.

Correspondingly, the summitters should take the occasion to indicate that they will not be pursuing further bilateral or regional "free trade areas" during this period. There remain widespread perceptions around the world that the trading system is fragmenting into regional blocs, although the European Community is the only bloc in existence or on the horizon--and it has existed for thirty years. But such perceptions deflect attention away from the Uruguay Round and the GATT and provide

excuses for protectionists everywhere.¹³ Hence the summitters should indicate clearly that the primary focus of their trade policy will be the Uruguay Round until it is brought to a successful conclusion.

Conclusion

There are several other issues that could usefully be addressed at the summit: Third World debt (especially if Mexico and the banks have not yet concluded a new agreement), several international environmental issues, perhaps East-West economic relations in light of developments in the Soviet Union and China. But the macroeconomic and trade issues emphasized here lie at the heart of the world economy, and it cannot deal effectively with other problems unless they are put right. The summitters will be derelict in their duties if they fail to address these topics forcefully and effectively.

The economic summits have fallen into disrepair in recent years. President Reagan and some of his foreign counterparts rejected their use for substantive purposes, and thus their enormous potential for adopting decisive programs linking disparate policy issues has lain fallow. This will be President Bush's first summit, and I hope that he will seize the opportunity to pursue critical national interests of the United States along the lines described above.

¹³ Jeffrey J. Schott, More Free Trade Areas?, POLICY ANALYSES IN INTERNATIONAL ECONOMICS 27, Washington: Institute for International Economics, May 1989.

Representative HAMILTON. Thank you, Mr. Bergsten.
Mr. Sachs, please proceed.

**STATEMENT OF JEFFREY D. SACHS, PROFESSOR OF ECONOMICS,
HARVARD UNIVERSITY**

Mr. SACHS. Thank you very much. I appreciate the opportunity to testify this morning.

Let me start by saying that I agree with many of the dangers that Fred Bergsten has just outlined, but I would disagree on a central proposition, and that is that the summit is a particularly useful place to take care of a lot of those problems.

It seems to me that what Fred Bergsten has said is that if we could get the budget deficit under control we could solve a lot of our problems, and I wholeheartedly agree with that.

I would also add the obverse proposition that if we can't solve the budget problem it doesn't much matter what we do on exchange rates, and so forth, or what other countries do with their policies in regard to the evolution of our external balances.

What I mean to say is that the trade imbalance of the United States is largely a problem that can be solved here. It is not a problem that is going to be solved in the context of international policy coordination, in my view, and I fear that a lot of focus on the macro issues in recent years has really taken away attention to some extent from areas where policy coordination is key.

Those are areas where we really do need the joint efforts of a large number of countries in order to make progress. Those are areas that Fred Bergsten mentioned at the beginning that he hoped would not be at the centerpiece of this summit, but which I in fact hope will be at the centerpiece, issues such as the foreign debt crisis of the developing countries, the environment, and East-West relations.

I think what I would like to do in my few minutes of comments is to explain why I am rather skeptical of the idea of international macro policy coordination as a way out of the trade imbalances and then turn to areas where I do think that the summit could be of enormous significance, and the two that I will choose to talk about out of a long list of very important issues are, first, the developing country debt crisis and, second, East-West financial relations, and I will focus on the issue of financial assistance to Poland, which has been in the news in recent weeks and I think is an area of critical concern for U.S. foreign policy.

With regard to the macroeconomic imbalances, I think it is now extremely clear from extensive analysis of many researchers in many countries that the origins of the U.S. trade imbalances in the 1980's have been extremely low U.S. savings rates that have been caused principally by the sharp rise of the U.S. budget deficit. That, when coupled with some special events, such as the emergence of the foreign debt crisis in 1982 and the one-time and I think permanent decline of budget deficits in Europe and Japan from unsustainable levels to more normal levels on the budget, can account for the great bulk of the deterioration of the U.S. trade balance.

What that suggests is that if we are going to make progress on the trade deficits the way we are going to do it is not to get Europe and Japan to start running unsustainably large fiscal deficits once again; in other words, to reverse the changes that they undertook at the beginning of the 1980's, but rather to get our own house in order to reduce our own budget deficits.

It is true, I think, that the only sure way that economists know of to reduce trade imbalances is through fiscal correction. It is not a panacea, and it is not going to turn around the trade deficit overnight. Most studies suggest that each 1 percentage point of GNP reduction in the budget deficit improves our external trade balance by about 0.4 of 1 percent of GNP.

What that suggests is that even if we totally eliminate our budget deficit at this point we are going to be left with a trade balance deficit in the United States, and the reason is that our private savings is so low that even with a balanced Federal budget the private savings is not enough to fund the level of investment in the United States.

So in the long term we have to work both on the budget deficit and raising private savings in the United States as the way to get out of this external imbalance. The truth is economists don't know very much about moving private savings around. A lot of things were tried in the early 1980's to raise private savings and nothing seemed to work.

We do know a great deal about improving public savings, and that is to lower the budget deficit. I think we are all in favor of that. Probably everybody in this country is in favor of it, just with a particular agenda of how to do it, but I don't think going to Paris really solves that problem in any important way.

I would be delighted if President Bush pledges yet again that we are going to live by certain standards of reducing the budget deficit, but I would say that nothing that the other countries can do within a realistic margin of policy in their own fiscal effort or monetary policies will make any difference, any material difference to the U.S. trade balance.

I should also like to stress that if we don't solve the budget problem or if we continue muddling along—because after all we are making slow improvements at an unsatisfactory rate, but there has been a reduction of the budget deficit relative to GNP—if we continue along this way there is not independent scope for exchange rate policy to further act upon the trade imbalance.

Fred Bergsten may very well be right that the current account deficit is going to start to rise in the future in dollar terms. That may be yet another strong reason for moving faster on the budget problem, but it doesn't mean that we can try to push down the dollar without the fiscal correction and thereby try to stop this turnaround in the improvement of the external balance.

If we were to start to push the dollar down right now by easier monetary policy, we would simply get—we would have two effects. First, we would worsen a situation that is already one of creeping increases in inflation, and we could quite well have a blowout of inflation in the United States, reaching levels of 7, 8, or 9 percent, that we thought we had said goodbye to at the beginning of the 1980's.

The second thing that has been learned is that if we try to push down the dollar through easy monetary policy what will happen is that the dollar, lower dollar, will promote exports of the United States on the one side, but the lower interest rates will promote imports, and the trade balance won't be very much affected by the easy money, lower dollar kind of policy.

And that just brings us back to the basic proposition that I started with. Fiscal policy is the only reliable macroeconomic instrument that we have to improve the trade balance, and only our fiscal policy is a reliable instrument because all macroeconomic models that I know of that try to study international interdependence show that anything that Japan does or that Germany does by themselves will have—or even together, the two of them, would have only very small effects on the U.S. trade balance.

So I don't think that looking toward a solution of a cheaper dollar right now is going to do anything except risk a resurgence of inflation. The dollar stopped falling precisely because U.S. interest rates rose. They were raised deliberately by the Fed to try to put a lid on this process of rising inflation. There was no scope in the U.S. economy for more exports without the fiscal correction because we are at full employment and we are at full capacity.

So we are stymied. Monetary policy can't act in a more expansionary way or to drive down the dollar unless fiscal policy is freed and is contracted to make room for greater net exports at this point. There is no monetary remedy to our problem.

What we have tried in the last few years is basically a monetary remedy. It can't work. This is one case where all the economic models said it couldn't work. They were right. It hasn't worked. We can't make more progress except to the extent that we continue the decline of the budget deficit in the United States or have the good luck or wisdom to raise private savings through some other mechanism.

I would like to mention one other point which Fred Bergsten raised, and that is the scenario of the hard landing. Are we in for a collapse if we don't solve the budget deficit promptly? Will foreigners stop lending to the United States this \$10 billion a month that was mentioned earlier?

Well, even though I am an advocate of major fiscal correction, I would like to state my view that we are not headed for a collapse, that perhaps sad to say we can continue to borrow for quite a long time from the rest of the world. It is unwise for us to do so. It is imprudent for us to do so, but I think the evidence is there is a very big capital market out there and for good or bad there isn't a calamity facing us if we don't quickly get our house in order.

The fear of a hard landing is a real fear, but one that is way down the road, and that perhaps is why it has been so frustratingly hard to make real progress on the budget deficit because the fears of imminent collapse have proven to be wrong over and over again, and I think that the economic record suggests that for good or for bad there are a lot of people that will continue to lend to the United States, perhaps until we do get into extremely deep trouble, but much farther down the road.

Let me turn to two areas where I do think the summit can make a very material difference. Those are on international debt of the developing countries and financial assistance to Eastern Europe.

The debt crisis is the prototypical kind of problem where coordination is necessary. The reason coordination is necessary is that you have creditors of these financially distressed debtor countries all over the world, and unless there is some way to coordinate relief from these creditors each creditor has in his own incentive a reason just to hold back, not give relief, hoping that all the other creditors will give whatever relief is necessary for the particular debtor country.

So this is clearly an area where we need coordination of the industrial countries to put pressure on the commercial banks to give the kind of relief that is clearly needed for the debtor countries that have been in financial distress in the last 8 years.

I would like to state the Brady plan as currently constituted is not going to take us to a solution. The motivation is exactly right. Secretary Brady has stated that the problem of too much debt is not more debt—I am sorry—the solution to too much debt is not more debt; the solution to too much debt is to reduce the debt, but unfortunately the Brady plan has not come up with an adequate negotiating context in which the banks have the right incentives to yield an adequate amount of debt reduction.

The main problem is that Secretary Brady has stated from the beginning that everything has to be voluntary, and I still am looking for a historical example where the bankruptcy judge calls in the creditors and says, OK, who will voluntarily give up his claims on this debtor. It just can't happen, it won't happen. It is illogical. It runs counter to all—to the essence of financial distress.

We don't need voluntarism. We need concerted action, where everybody is called upon to do his share. That is the kind of concerted action that we supposedly had when we were asking for new lending to the countries. We said, we are not asking for voluntary contributions of new lending; every bank must contribute in proportion to its exposure. And what we clearly need here with debt reduction is a policy statement of the G-7 countries that says every bank must contribute to debt reduction on an equal effort basis.

Those are the magic words that I would like to hear coming from the industrial countries right now, and there are several footnotes, of course, to that statement that would be important, the most important footnote of which is simply that new money or new lending is not a substitute for debt reduction.

Mexico I fear is about to fall into a very serious trap in its negotiations despite all of the good will that one finds in the United States for deep debt reduction for Mexico. Under the Brady strategy, Mexico has been led in its negotiations to offer the banks a choice. Either lend us some of the interest that we have to pay you or give us debt reduction, and I fear that the banks are going to end up accepting that, and Citibank has already said, great, we are all in favor, we are going to lend, we are not going to give the debt reduction.

So Mexico is going to end up with a package which is announced to be a debt reduction of 40 percent or so, but when the dust has cleared 4 or 5 months down the road and when the banks have

chosen among these options, we are going to find out Mexico has hardly received any debt reduction at all because our money center banks are going to be choosing the so-called new money option rather than the debt reduction option, even though new money we all know is not new money. It is just refinancing of interest. It is exactly piling on the debt, which Secretary Brady said he didn't want to do.

So I think a clear statement of policy from the G-7 leaders would be enormously important. We must have debt reduction, not new lending. The debt reduction can't be voluntary. It must be concerted, and it must be on an equal effort basis of all of the banks participating in negotiations with a particular debtor country.

Finally, let me turn to the question of financial assistance to Eastern Europe. This is an area that I find to be of absolutely profound significance for U.S. foreign policy and U.S. economic interests in the future. At stake is the stability of Europe and the continuing improvement of East-West relations.

I recently spent several weeks, or back and forth, visiting Poland and looking at the macroeconomic situation, talking with government officials and with Solidarity economists.

The situation in Poland is absolutely desperate right now. The inflation rate in recent months has reached 180 percent annual rate, but it is very likely to explode to rates of 400 or 500 percent per year in the coming months.

The country, in my view, will be ungovernable unless Solidarity takes a leadership role of one form or another, either from its position of dominance in the new Senate that has been elected or, as Solidarity officials have recently proposed, in actually taking ministerial positions within the government.

The situation could collapse in social violence quite soon. What we have to do, in my view, is be very clear at this moment that the West will provide reasonable financial assistance if Solidarity can take up the leadership and start moving the Polish economy toward some long-term solutions, which basically mean privatization and marketization of the Polish economy.

I believe Solidarity is ready to do that. They have circulated a proposal for financial assistance, which is built on the formula of conditional aid, aid which is tied at every single step to market reforms within the Polish economy. They are looking for IMF programs. They are looking for World Bank programs. They are looking for cofinancing and parallel lending from Japan. They are looking for aid from Western Europe, and they are looking for relief on their existing overhang of bad debt.

I believe we should make very clear at this moment that the West understands the plight of this economy, it understands the need for leadership by Solidarity to help pull Poland out of the disastrous mess that 40 years of socialist economics have brought them to, and that we are prepared to provide financial assistance of a generous amount on a conditional basis tied to a step-by-step program of economic reform.

That is the message that Poland wants to hear now. It is an absolutely correct and serious message. It is one that we should be very eager to deliver at the summit next week.

Thank you very much.

[The prepared statement of Mr. Sachs follows:]

PREPARED STATEMENT OF JEFFREY D. SACHS

Mr. Chairman and members of the Committee, it is a pleasure to be here today to discuss the economic issues that will confront the G-7 countries at the Economic Summit in Paris next week. Part of the art of good economic policymaking, and good summitry, is to separate clearly the areas where policy coordination among the G-7 is and is not necessary. Unfortunately, the summit meetings have tended to get stuck excessively on macroeconomic issues (e.g. interest rates, exchange rates, fiscal policy), where the benefits of coordination have been overblown, and have neglected, at least relatively, the consideration of other areas where coordination is desperately needed (e.g. the developing country debt crisis, East-West financial relations, and protectionism).

In my testimony today, I will stress the coordination that is urgently needed in the latter areas, focussing on two pressing cases: the developing country debt problem, and financial assistance for reform efforts in Eastern Europe, especially Poland. I will also discuss the limited value of extensive coordination of macroeconomic policies among the G-7 countries. There are of course several other issues that deserve vital attention at the Summit (environmental issues; trade policy;

international regulation of financial markets, etc.), but I cannot even touch on these other issues in my brief remarks.

1. Macroeconomic Policy Coordination

Since 1985, the U.S. has put great stress on the role of international policy coordination in overcoming the extensive imbalances in world trade. In recent summit meetings and other meetings of the G-7 countries, the U.S. has repeatedly pressed for macroeconomic policy actions abroad (such as fiscal expansions in Germany and Japan; and monetary policies designed to hit given exchange rate targets) in an attempt to reduce the U.S. trade imbalance. Great efforts have been expended in managing the value of the dollar, first during the period of dollar decline in 1985-87, then during the period of dollar stability in 1988, and recently in an attempt to reverse the rise of the dollar that has occurred during the first part of 1989.

These efforts at coordination have probably not been extremely harmful, but neither have they been particularly helpful. The U.S. trade deficit is overwhelmingly the result of the U.S. fiscal deficits in the 1980s, coupled with LDC debt crisis, and the elimination of unsustainable budget deficits in Europe and Japan at the beginning of the 1980s. The solution to the U.S. external deficits lies almost wholly with the U.S., and can best be accomplished by a rise in national savings rates brought about by a further cut in the federal budget deficit. A large number of studies have now demonstrated that macroeconomic

policy actions in Germany and Japan, on a scale that is at all plausible, will do little to improve the U.S. deficit.

Attempts at coordination at the Summit can in fact be harmful if we pressure other countries to pursue policies that are only slightly to our benefit, but that in fact do damage to the rest of the world. For example, pressuring Japan to increase its fiscal deficit could result in a very slight improvement in our trade balance, but also a rise in world interest rates, as the supply of world savings is diminished. In a world of scarce savings, particularly in which the developing countries are starved for capital, it is probable that the negative effects of a fiscal expansion by Japan outweigh any positive results that would be achieved.

The greatest hopes for macroeconomic policy coordination have been placed in exchange rate management, particularly via the implementation of a target-zone exchange rate system. In general, the arguments for exchange rate coordination of this sort are unpersuasive. Target-zone advocates assert that the dollar "misalignments" of the 1980s have been the main source of the U.S. trade deficits. They therefore argue that the misalignments should be avoided through an explicit policy of exchange rate management. But such arguments generally neglect the fact that the dollar movements are themselves largely the product of the underlying fiscal and monetary policies of the U.S. In other words, without policy misalignments (e.g. the Reaganomics tax cuts), there also would not have been dollar

misalignments; and without fundamental policy changes, dollar misalignments cannot just be wished away.

To put the matter another way, the exchange rate of the dollar is not by itself an independent policy instrument. Suppose we want to move the dollar down from its value today. Talking alone will not suffice (except in very rare and unreliable circumstances); sterilized intervention as well will have little effect. Rather, it will be necessary to lower U.S. interest rates or to raise interest rates abroad, through some combination of the following four policies: U.S. fiscal contraction, U.S. monetary expansion, overseas fiscal expansion, overseas monetary contraction.

From the point of view of U.S. policy, a monetary expansion would make no sense: the U.S. is already at the risk of a dangerous increase in inflation; monetary policy has been restrictive for that very appropriate reason. Moreover, a monetary expansion would drive the dollar lower, but it would not improve the trade balance, since the export increase from a weaker dollar would be offset by an import increase resulting from lower interest rates. Of course a fiscal contraction would be desirable, but it is not going to happen simply to meet an exchange rate goal!

As for the foreign actions, they would have to be quite large and across a number of countries to have an important effect on the effective dollar exchange rate (i.e. the value of the dollar against a basket of currencies). Even then, the

effects on the U.S. will tend to be small, and the effects on the rest of the world of a rise in foreign interest rates could easily be deleterious.

Defenders of the target zone system often maintain that dollar fluctuations really are not tied to the fundamentals, so that the dollar can be moved independently of movements in monetary and fiscal policy. The evidence does not support this proposition, however, since the broad movements of the dollar have been closely related to the broad movements of the interest rate differentials between the U.S. and the rest of the world. It is true that in some periods, such as May 1984 - February 1985, and perhaps the Spring of 1989, the dollar has appreciated despite the narrowing of interest rate differentials. But these periods are the exception, and movements of the dollar away from the "fundamentals" tend to be self-reversing. While there may be an opportunity for useful intervention when the dollar appears to drift away from the fundamentals suggested by interest rate differentials, such opportunities are the exception not the rule.

On the specific policy recommendation of a substantial dollar depreciation at this point, let me make clear that I think such a policy -- if it were achievable -- would be quite dangerous except if accompanied by a very substantial reduction of the budget deficit. The U.S. economy is operating at full employment and full capacity, with an inflation rate that has steadily crept up to the range of 6 percent per year. A further sharp fall of the dollar in these circumstances, in the absence

of a contemporaneous sharp cut in the budget deficit, would tend to overheat the economy, and lead to a substantial and unacceptable rise in inflation.

In summary, I believe that it is unnecessary to invest considerable political capital at this point into the formation of a tighter target zone system among the G-7 countries. The floating exchange system has proven adequate; it is the fiscal policy choices of the U.S., and not the exchange rate system itself, that have been the source for most of the imbalances of U.S. trade accounts in the 1980s.

Some advocates of strong macroeconomic policy coordination have also argued that coordinated policies are necessary to avoid a hard-landing for the U.S. economy caused by a drying up of foreign capital inflows into the U.S. They have warned that investors in Japan and Europe will be unwilling to finance the U.S. balance of payments deficit for much longer, and that a sudden cutoff of funds from abroad could well push the U.S. economy into recession. In a recent study, I have suggested why this fear is overstated (See "Global Adjustment to a Shrinking U.S. Trade Deficit", Brookings Papers on Economic Activity, 1988:2). The U.S. balance of payments deficit, while not desirable for our economy, is small enough relative to the size of the U.S. economy and the size of the world capital markets, that it likely can be financed without interruption for many years to come.

II. The Developing Country Debt Crisis

Since the unveiling of the Brady Plan in March, debt reduction has become the focus of the debt management strategy. International policy coordination is vital if the debt reduction strategy is to be successful. When many creditors are asked to reduce the debt burden of a financially distressed debtor, a coordinated approach among the creditors is vital, to assure that the creditors share in the necessary losses. In the domestic context, bankruptcy law guarantees that individual creditors do not attempt to "free ride" on the concessions of other creditors.

Institutions do not yet exist for coordinating commercial bank debt reduction in the case of sovereign debtors, and the new debt reduction proposals of Secretary Brady have done little to create an institutional context for achieving meaningful levels of debt reduction. For this reason, the approach as now formulated under the Brady Plan is unlikely to produce adequate debt reduction. The key features that weaken the Brady Plan are: (1) the emphasis on "voluntary" schemes, which actually encourage many of the largest U.S. banks to avoid participating in debt reduction; (2) the call for "new money" from banks alongside debt reduction, even though "new money" merely results in a piling up of bad debts and does not offer the debtor a "fresh start", which is the goal of debt reduction; and (3) the continuing U.S. Treasury support for debt-equity swaps, which are highly inflationary, and thereby destabilizing in the debtor countries.

These problems are likely to cripple the Mexican negotiations. In the Mexican proposals now before the banks (proposals which have been fashioned under the watchful eye of the U.S. Treasury), a creditor bank can choose not to concede any debt reduction whatsoever merely by refinancing a part of the interest due to Mexico for a few years. Citicorp has already stated that it is "not interested" in debt reduction for Mexico, and that it will choose the interest-refinancing option. The likely outcome is that Mexico will get little debt reduction in the end from the major U.S. banks, and will instead get "new money" (i.e. interest refinancing). In the end, it is likely that Mexico will get some short-term relief, but once again not a long-term solution to Mexico's problems.

The creditor governments of the G-7 have a crucial role to play in adjusting the current negotiating environment to make it possible for the debtor countries to achieve the debt reduction in the magnitude that they need. I have described what I believe to be the necessary steps for the G-7 in a recent article, "Making the Brady Plan Work", Foreign Affairs, Summer 1989, which I should like to submit for the record. To summarize that article, I would urge that following steps should be enacted at the Economic Summit:

1. The major creditor governments should be explicit about the need for concerted participation of the banks (i.e. in which all banks participate with equal sharing) in debt reduction.
2. The so-called "menu of options" should be simplified, to remove "new money" and "debt equity swaps", so that all options involve an equal effort of debt reduction by the creditor banks. Special emphasis should be placed on an across-the-board

reduction of interest rates to sub-market levels as the most efficient and fair means for allocating debt reduction among the banks.

3. For recalcitrant banks that refuse to participate in a debt reduction package accepted by a large majority of banks, the official community should develop mechanisms to ensure that holdout banks cannot benefit at the expense of banks that participate in a debt reduction package.

4. The creditor governments should state publicly and clearly on behalf of a debtor country, that if the banks delay in accepting a program of adequate debt reduction (e.g. consistent with the financing needs as determined by the IMF), the official community will endorse the use of arrears for interim financing.

III. Financial Assistance for Poland

Another area where the G-7 countries must coordinate is in the approach to East-West financial relations, regarding not only the Soviet Union, but also those countries in Eastern Europe now undertaking extensive economic reforms, Hungary and Poland. The subject of G-7 financial relations with the Soviet Union is crucial, but too complex for me to take up at this point. I will instead discuss the issue of financial assistance to Poland, a case where the West can play a vital role in furthering the prospects for political and economic reform. Aid to Hungary is also required, but in lesser amounts given the smaller size of the Hungarian economy, and the more muted nature of the economic crisis in Hungary.

The economists of Solidarity have set forth a program of dramatic reform to convert Poland from a centrally planned economy into a market economy. Solidarity has appealed to the West for financial assistance for this historically unprecedented process -- loans from the IMF, the World Bank, and the industrial

countries, coupled with a generous treatment of Poland's crushing debt. Support from the G-7 at the Economic Summit could have profoundly beneficial effects on Poland's prospects, and on East-West relations more generally.

The stakes are so high because Poland totters precariously on the knife-edge of economic collapse on one side, and dramatic reform and recovery on the other. The economy is in a shambles, in bankruptcy and exhaustion after 40 years of socialist failure. Inflation is running 150 percent per year, and is likely to accelerate soon to rates of 400-500 percent per year, fueled by an enormous budget deficit and speculation against the currency. Much of the deficit covers payments on Poland's staggering \$40 billion foreign debt, money borrowed futilely in the 1970s to pump-prime an economy already moribund two decades ago.

To get out of this mess will take deep economic surgery. Government subsidies will have to be cut in order to balance the budget. Food prices will rise, along with the prices of other basic commodities, such as gasoline, fertilizers, and rents. But a government led by the discredited communists cannot carry out this kind of budgetary squeeze, because the result would surely be an explosion of social unrest and violence, as has occurred in 1953, 1970, 1976, 1980, and 1987. Such a social explosion could gravely destabilize East-West relations, either by derailing the recent process of democratization in Poland, or even more ominously, by prompting some form of Soviet intervention.

Solidarity alone can salvage the economy by investing its

vast political prestige in a process of dramatic economic reform. And it appears ready to lead, either from its dominant position in the newly elected Senate, or by actually taking key ministerial positions in the new government. But Solidarity will not lead a suicide march, in which it does the dirty work for the communists (e.g. by supporting the rise in food prices), but then finds itself without the financial resources to carry out real reforms. The massive restructuring of the Polish economy will take time and resources, a point which Solidarity correctly stresses. Only with the prospects of adequate lending from the West can Solidarity assume the grave risks of economic leadership, without fear of being used and discarded by the communist hardliners.

With Solidarity's leadership, the Polish people will accept the short-run pain of higher prices and social dislocation if it will lead to the creation of a real market economy. Price increases in the past have been all pain, no gain. With Solidarity, the same price increases would be the first step towards stable prices; a convertible currency; a market economy linked to Western Europe; and the large-scale privatisation. The Communist Party cannot credibly offer such policies, even though there are indeed many radical reformers within the Party, for such changes would threaten the privileges of hundreds of thousands of party bureaucrats.

The Solidarity economists have called for a loan package of \$10 billion over three years, with more than half coming from

standard program lending of the IMF and the World Bank, and most of the rest from Western Europe and Japan. Solidarity economists have also appealed for relief on the old debt, in the terms similar to those asked by Mexico and Venezuela.

Most importantly, the Solidarity economists have stressed their desire that real conditionality will accompany the aid. Solidarity does not want a blank check for \$10 billion. They are fully aware that the money could be wasted as in the past. Solidarity therefore wants the money in stages, tied to the stages of economic reform. Conditionality would become Solidarity's internal leverage on the recalcitrant communist hardliners who would oppose the necessary reforms.

Last week, Secretary of State James Baker wrongly undercut Solidarity by casting doubt on the \$10 billion request, saying that the U.S. rejected the approach of "making available a lot of credits and concessionary lending that did not carry with them appropriate economic reforms". Solidarity economists were stung by this statement: economic reform, linked to the aid, is at the very heart of their proposal.

The G-7 leaders should support Solidarity's aid proposals at the Economic Summit next week. The aid can spell the difference between disaster in Poland and real reform under Solidarity's democratic leadership. Poland can thereby become a trailblazer for democratic and market reforms in the Eastern Bloc.

Representative HAMILTON. Gentlemen, thank you very much for your statements, all of which have been very good. We have some differing views, of course, as to what you would like to see accomplished at the summit, and I would like to try to focus those differences among you initially here.

Let's focus on the communique. The question is—and I know that this will call for some repetition of your testimony—but what is it—when you pick up the paper the day after the summit and begin to read the communique, what is it you would really like to see in that communique and what is it you would really not like to see in the communique?

Mr. BERGSTEN. As I said, Mr. Chairman, I would like to see a strong commitment to renew the process of reducing these big international imbalances. Unlike Jeff Sachs, I think it takes more than just the U.S. budget deficit. I yield to no one in my zeal for reducing the U.S. budget deficit. I have testified repeatedly before committees of this body to that end for several years, but it takes two to tango.

A trade imbalance has a deficit side and a surplus side, and I think that the events of recent years show that foreign growth rates are very important to whether the United States can reduce its trade deficit. I think exchange rates are central. I would reject Jeff Sachs' conclusion that the events of the last 3 or 4 years have no effect.

The Plaza strategy, which largely amounted to exchange rate changes, leveled off the U.S. deficit, which was at that time headed toward something like \$300 billion. There is a view that says that the Plaza strategy failed because our trade deficit hasn't come down more, and I am certainly arguing that new action is needed to bring it down further, but all of the analyses show that when the dollar was at its peak 4 years ago we were headed for trade deficits of \$300 or perhaps \$400 billion. Leveling them off at \$150 billion and bringing them down now close to \$100 billion is major progress. And I don't see how Jeff Sachs or anyone else can say that that is a failure, that it shows that monetary means don't work.

So what I would like to see is a strong commitment by the leaders to renew the process, to be sure to flesh out the monetary side with serious economic policy commitments here and abroad. As I indicated, I would also like to see a very strong boost to the Uruguay Round of trade negotiations to make sure that markets are going to continue to open rather than close, which I fear they will if these issues are ignored.

Representative HAMILTON. Just to follow up on that—and then, Mr. Sachs, I will let you respond further and then, Mr. Hormats, I would like you to chip in here, too.

Mr. Sachs put very heavy emphasis on debt relief and on the East-West platform or program to help Poland and perhaps Hungary as well, though you did not mention Hungary.

You are not going to be particularly concerned if the communique does not get into those areas, is that right?

Mr. BERGSTEN. I think it would be desirable to get into them. I am not close enough to the Polish situation to know if Jeff Sachs' apocalyptic forecast is right, but I agree with the policy outcome,

that a program to help Poland would be helpful. I think on a global scale that should be addressed by the heads of state of these seven major countries. But it does not rank in comparison with dealing with these global imbalances, which are so pervasive.

Representative HAMILTON. Mr. Sachs, do you want to respond?

Mr. SACHS. Let me first respond on the economic point.

Of course, there has been improvement in the trade balance, and I would stress that that came about largely because there was improvement in the budget position. We were running a \$220 billion budget deficit 3 years ago. The budget deficit now is somewhere in the range of perhaps \$122 to \$130 billion on a significantly larger economy in dollar terms.

If you look at the size of that change, multiply it by my coefficient of 0.4 that I suggested of how much a budget improvement translates into a percentage point improvement in the external balance, you do rather well in tracking what has happened to our external deficits.

Monetary policy and exchange rate depreciation should play a role in the correction of the trade deficit, but it must be exchange rate depreciation accompanied by the fiscal improvement. If you just tried the monetary alone, which we haven't really tried yet, I think what Fred Bergsten is—it is not what he is proposing. I know that he is a staunch advocate of further improvement in the budget process, but I sometimes hear him as saying that even if we don't get the fiscal, let's move the dollar down more because these gaps are going to widen.

That is why I say we wouldn't have improvement. What we would have is a significant risk of increased inflation in the United States, which is exactly why, after all, the Fed has not let the dollar—why the Fed pursued interest rates that kept the dollar as high as it has been. The Fed, of course, would like to have the dollar come down. The Fed would like nothing more than for its monetary policy to be consistent with even sharper improvements in the net export performance, but it cannot do it alone, and so it has to pursue a level of interest rates compatible with price stability.

It is barely holding the line. We are running an inflation of over 6 percent now. If you push down the dollar more in a full employment economy, with full capacity, without real fiscal improvement, we are just going to get an inflationary increase.

Representative HAMILTON. Do I understand you to say that you really don't think that efforts to bring about macroeconomic policy coordination are worthwhile?

Mr. SACHS. I put it in provocative terms. I almost believe that. Let me state the reasons why they are worthwhile a bit.

Representative HAMILTON. Now, which side are you on?

Mr. SACHS. I do not believe that macro policy coordination is really going to solve our problems anywhere to the extent that people generally do here in this town.

Representative HAMILTON. You would not give very much attention to it at the summit? If you were writing the "Sherpa" paper for the President, you would say, Mr. President, avoid macroeconomic policy?

Mr. SACHS. What I like about "macro policy coordination" is an exchange of views and discussion of where things are—that is very important—and a discussion of where people think things are heading. It was important in 1986 to focus in the Japanese public's attention the idea that they should have domestic led growth. It was important here to focus on the idea that we should have export growth, but the policy coordination of you do this on your macro side and you do this and we will do this on ours I don't think is a particularly fruitful exercise.

But the old idea that talking is better than shooting, I think, is true here. Macro policy coordination may be an escape valve for protectionism. The more we talk, the more we try to discuss these problems, and so forth, the less we are likely to get into an out and out shooting war on trade.

Representative HAMILTON. You are drawing a sharp distinction between discussion of macroeconomic policy, which you favor, and coordination of macroeconomic policy—which was really my question—you seem to reject the idea of trying to coordinate macroeconomic policy; you are just flatly rejecting it?

Mr. SACHS. I am known in the academic literature as someone who, you know, has proven in theoretical terms why it is advantageous to have policy coordination, I have to tell you, and I am also—

Representative HAMILTON. You are confusing me pretty badly.

Mr. SACHS. In academic terms why it is likely to have beneficial but very small effects, and what I am trying to say is the focus on it is just grossly overdone.

Our problems are here. We can solve our own problems. If we respond with sharp budget contractions, Japan is going to do other things. It is just not going to go into a deep depression. It will respond. It is nice to talk about it, but our actions should be here, and there is nothing that they can do to make a big difference for us if we don't take our own actions.

That is the main point.

Representative HAMILTON. I understand. Thank you for that clarification.

Mr. Hormats, you want to get into this?

Mr. HORMATS. Yes. I think it is clearly true that what has to be done to enhance the prospect for a better balance in the global economy is domestic. That goes without saying. Policy, monetary, fiscal, all of these policies require domestic measures by individual governments.

What summits can do, even though frequently they cannot reach detailed agreement on packages, is at least to develop guidelines on a consistent set of domestic measures that governments can take over a period of time, a year or two. The key is to make sure that individual national policies are in a sense moving toward the same types of objectives.

Now, let's look at the United States. The big imbalance here is between investment and savings. We have a shortfall of savings. Part of that shortfall is the result of a very large government budget deficit, which constitutes a "dissaving," and the imbalance between what we save and what we invest is money that has to come from abroad. That is in effect our current account deficit.

The other countries have a problem that is a mirror image of ours—that is, they are exporting a lot of savings. They are utilizing a lot of savings not to enhance their domestic growth, but they have an excess which they are shipping abroad, which constitutes in effect their current account surplus.

What summits are able to do is to give a sense of direction and a sense of political urgency to the adjustment process that Fred Bergsten was talking about. The fact is that all of the statistics, all of the projections I have seen—and I think those in the Federal Government—indicate that we are, if current trends don't improve, headed for a deterioration in our trade balance sometime in the middle part of next year as a result of two things.

One is the stronger dollar that we have experienced since the fall of last year and, two, the prospect that the big surge in growth that we have seen abroad will begin to flatten out over a period of time. We will not get a "kick" from additional demand in Japan and other parts of the world.

Representative HAMILTON. You come down on the side that there is a role that a summit can play in macroeconomic policy coordination?

Mr. HORMATS. Yes. There is a role in developing a harmonious set of domestic policies which move in the same direction.

Representative HAMILTON. I guess if you are a noneconomist and you read articles about international economic policy coordination, what strikes me is that they usually focus on the exchange rates and maintaining the value of the dollar. That seems to be what the articles are all about. Maybe it is more than that. I don't know, but that is what it seems to be all about.

Is that the place that we ought to focus on coordination?

Mr. HORMATS. On exchange rates?

Representative HAMILTON. Yes.

Mr. HORMATS. Having sat in on some of these meetings, there is more talk outside the meetings about exchange rates than inside. Traditionally, the Presidents and Prime Ministers—

Representative HAMILTON. Most politicians don't understand exchange rates.

Mr. HORMATS. And when they talk about them, the signals to the market are such—

Mr. SACHS. Nor do economists.

Mr. HORMATS. It has major implications for the market. They tend more to talk about what their domestic policies are or are likely to be. That is really the main discussion in those meetings, not whether the dollar should be at 140 yen or 150 yen.

Mr. BERGSTEN. Mr. Chairman, I might elaborate. The straightforward answer to your question is that the talk has to be about both exchange rates and the underlying policies that help drive them, but it is very important to understand that if we change budget policy, or the Germans maintain a certain growth rate, or interest rates change, the mechanism through which those changes are translated into changes in trade balances is to an important extent the exchange rate.

Unfortunately, exchange rates also get driven by lots of other things that are basically irrelevant to the underlying trade balances: political speculation, bandwagon effects in the markets, all

sorts of things that, as any economist can demonstrate, carry exchange rates for long periods far away from what underlying economic competitive relationship would suggest.

That is part of my answer to what Jeff Sachs is saying. We agree on the need for U.S. budget correction. We agree on the need for domestically led growth in Japan, Germany, and the other surplus countries. The problem is that the mechanism through which all of that gets translated is to a large extent the exchange rate, and when the dollar soars, as it has in the early part of this year, I think all of us would say that that runs directly counter to what ought to be happening in terms of the underlying adjustments. Therefore, it may be necessary on occasion to address the exchange rates directly.

That is what Secretary Baker and the G-5 did at the Plaza in 1985. Now, there is a lot of debate about how much effect that had. To me it is absolutely clear that it had a big effect in pushing the dollar in the right direction and doing some of the things that Jeff Sachs extolled before, making the Japanese fully aware that they had to move away from relying on exports for their economic growth to relying on domestic demand-generated expansion. Maybe they would have done it anyway, but I don't see the cost of trying to make it explicit through a coordination process.

So, for a variety of reasons, I think that you have to do both, but you certainly have to address exchange rates directly, and there has been demonstrable success in recent years in doing so. When you forget about them, as has been done in the last 6 months, you get very, very adverse and counterproductive movements.

Representative HAMILTON. Mr. Sachs, in your statement you say that it is necessary to invest considerable political capital in the formation of tighter target zone systems among the G-7 countries.

Let me read a statement from Marty Feldstein, and I would like to get your reaction to it.

Mr. SACHS. This is back to the days of oral exams?

Representative HAMILTON. This is an oral exam, yes. He has a sentence in an article he wrote for the Financial Times, and I just want to get your reaction to it. He is talking about the communique at the summit.

"The right message for the communique is that future movements of the dollar and other currencies must help to eliminate major trade imbalance. The key words should be 'trade adjustment' and not 'currency stability.'"

How do you react to that? Do you agree with that?

Mr. SACHS. I would give him a B-minus.

Representative HAMILTON. B-minus, all right. [Laughter.]

By your standards that might not be a very high grade. By mine it is pretty high.

Mr. SACHS. I think we have to start out with two visions. One is whether the exchange rate is moved more or less by the fundamentals and, second—or whether it is just moved by extraneous events.

I happen to believe that the exchange rates are moved largely by interest rate differentials, which are largely determined by monetary and fiscal policy. So I believe if you get the monetary and fiscal policies right, the exchange rates will be where they will be.

I don't really believe that there is too much scope for just announcing tomorrow we want the yen to be at 120 and we want the deutsche mark to be something else.

Yes, once in a while—

Representative HAMILTON. What about all of the intervention in the currency market?

Mr. SACHS. We just had massive failures of intervention in the last 6 weeks.

Representative HAMILTON. You don't think that is a worthwhile effort?

Mr. SACHS. I think when the intervention is clearly perceived to be running counter to the fundamental policy thrust it doesn't work. When the intervention is supporting fundamental policy directions, say of easy money or reduced fiscal deficits, then it does work.

Representative HAMILTON. You make the same point, don't you, Mr. Bergsten.

Mr. BERGSTEN. Yes. You want to have intervention leaning with the wind, in the direction that policy is carrying the underlying fundamentals—that is right.

Mr. SACHS. I didn't mean to interrupt, but I wanted to not lose one thought, which is that speaking against international policy coordination is a little dangerous. It is speaking against motherhood. It is very nice. Everybody should be sitting down and talking, and what more could we ask for?

I think that it has several counterproductive elements that should be kept in mind. It exaggerates what can be accomplished. It causes us to pay attention to others rather than to ourselves, and the things that often we tell our counterparts to do are just not good things.

We spent a lot of time beating up on Japan and Germany to try to get them to run larger budget deficits. If we cannot run smaller budget deficits, then, by gosh, you run larger budget deficits.

I don't think that is helpful for the world or that that is a healthy kind of international policy coordination.

I have a rule of thumb which says that policy coordination is good when the central policy authority involved is acting responsibly because then responsibility permeates the system and that international policy coordination is harmful when the central actor is irresponsible because then irresponsibility permeates the system.

We are off telling the Koreans why don't you run larger budget deficits so you have domestic led growth. We are off telling the Taiwanese don't save so much. We are off telling the Japanese don't get the budget balanced, run deficits, it is great and it will boost demands for our goods. That is harmful. That is not helpful.

Mr. HORMATS. Can I make a point?

It is not a one-way world, Mr. Sachs. We are subject to the same pressures that others are, but of a different sort. The Germans don't just sit there on their hands. The Japanese don't just sit there on their hands, and we make these points. They come back to us, and they say part of the problem, part of the adjustment problem is the domestic imbalance in the United States.

So these summits are truly give and take forums, and other countries are not shy about expressing their views. The question I

think is what you can do by coordination and what you can do by domestic policy.

I said at the outset things happen and must happen as a result of a country's decision to make domestic policy changes or pursue some domestic policy. Summits are not able to help change fundamentals. They are helpful at the margin. They are helpful at the margin in underscoring other countries' perceptions of your domestic policy, and you have a chance to do the same thing with respect to other countries.

Clearly, the exchange rate issue is an issue. It is, however, an issue which leaders, as I mentioned, are very reluctant to get into. Most of it is left to the Group of Seven. They are more willing to take a look at the fundamental domestic policy issues, and they also recognize, as they have over the last couple of years, that sometimes it is very hard to influence exchange rate policy, even if your domestic policies are moving into closer alignment.

One of the issues that I would mention is that exchange rate issues are not just related to trade imbalances. They are really a financial phenomenon. Just to give you an example, the U.S. trade balance has improved somewhat, in some cases rather dramatically, over the last couple of years. The dollar has gone up. The dollar has gone up not only because the trade imbalance has gone down, but because Fed policy has been tighter, and very importantly, because the U.S. trade imbalance and the current account balance represent a smaller portion of overall global savings in the world. In the past it has been about 9 percent. Now it is 6 percent. So you need less global savings as a percentage coming into the United States to support these imbalances.

It is a whole host of things that affect these currency movements, and these leaders are not in a position to get into the currency debate in the way that we are getting into it today. They just don't understand it enough, and if they did understand it, they would leave it to their ministers to do anyhow.

Mr. BERGSTEN. I don't know who the "we" was in Jeff Sachs's litany, that we are telling these countries to run deficits.

Mr. SACHS. The U.S. Executive.

Mr. BERGSTEN. Jeff Sachs has a good record in some places. I have advised Korea and Taiwan, and both in the last year have cut their trade surpluses in half without any increase in the budget deficits. The mechanism has been primarily a very sharp rise in the value of their currencies, which alter their international competitive positions in the right direction.

That in turn has effects that spin through to their domestic economies, to their savings and private investment behavior. The underlying domestic relationships, of course, have to be changed if the external balance is changed. But it did not require increases in fiscal deficits. There are techniques that can do it in other ways.

Representative HAMILTON. Why did their currencies rise? Is it because of you and others advising that was the thing to do?

Mr. BERGSTEN. They recognized the wisdom in bringing their surpluses down sharply, not just to get the American trade negotiators off their back, although that was important, but for internal reasons as well. Big trade surpluses mean big expansions of the domestic monetary base. They have inflationary consequences. It means

that you are not getting the right pressures to upgrade your capital stock and improve you productivity.

So they saw the wisdom of the policy objective of reducing the surpluses. They basically went at it through managing their exchange rates in an upward direction. Both those countries manage their exchange rates. Their exchange rates are not driven by market forces. They were therefore in a position, I think desirably so, to be able to engineer a substantial appreciation of their currencies.

They were leaning with the wind. The market pressures were all in that direction. Money was trying to come in and buy their currencies because they were undervalued. They went with it. They let it happen. I think actually both Korea and Taiwan have obtained now fairly close to equilibrium levels, and the results have been dramatic just within a period of a year or two.

So it doesn't take budget deficits. It takes a variety of measures. It depends on what the country's situation is, and the exchange rate has a big role.

Mr. HORMATS. I would add one point. They were sitting on large reserves of dollars, which were depreciating in value, which was not exactly an appealing financial or political development.

The other thing is that they were getting pressure from their own people to have a higher standard of living, and rather than simply pile up dollars, they were providing more imports as a result of their changes in currencies.

Representative HAMILTON. We have a lot of ground to cover. I want to get some of these other things quickly, and I should yield now to Congressman Scheuer, who I am sure will cover some of the areas.

Representative SCHEUER. Thank you, Mr. Chairman.

Coming from my left to right, Mr. Hormats, you talked about the global environment. You talked about acid rain, greenhouse effect, global warming, and so forth. We know a lot about what can be done to ameliorate these problems. Most of them come from excess use of energy and excess use in general and excess use of fossil fuels in particular, which are very environmentally degrading. We know that conservation works. We have had spectacular successes in this country with conservation, both government encouraged and spontaneous, when the fuel prices went up in the early 1970's.

We know that there is a large bunch of options with alternate fuels, renewable fuels. We know that the automobile is a major source of the problem. We know that great progress has been made in other parts of the world, in France, Germany, Sweden, and Japan.

They have all produced prototype cars that go 80 or 85 miles per gallon in the city and 100 miles per gallon in the country. The Japanese have a car that goes 120 miles per gallon.

In this country there is no such development because gas is priced so cheaply it doesn't pay either the companies or the individual to make much of a capital investment in fuel efficient cars when gas costs \$1 or \$1.10 a gallon as compared to \$3 or \$4 a gallon around the world.

Time magazine, which is not a magazine for pointy headed intellectuals, came out in their January issue on the environment with

a suggestion of 50 cents a gallon tax on gas. That would help concentrate some minds on fuel efficiency, on conservation.

What can the summit do on the matter of the global environment unless they deal in some way or unless there is some consensus that individual countries have to make progress together in some of these specific remedial programs that are going to work?

And we know what they are. Science has not been standing still. We know how to make stationary energy users, manufacturing plants, and utilities virtually pollution free if they are willing to buy the scrubbers and the other high technology devices that, for example, Japan has applied across its country, across those Japanese islands.

To my knowledge—I believe I am correct—there is not a single energy producer, there is not a utility or manufacturing plant in Japan that spews forth these poisonous emissions.

How can we stop just dealing with these programs in general, with a lot of glittering generalities and innocuous platitudes, and get down to specific programs and coordinate an, let's say, industrial world program that really is going to work, that is really going to make incremental progress on these matters?

Mr. HORMATS. I think, Congressman Scheuer, you have put your finger on the key word. It has to be coordinated. There has to be a collective effort for one basic reason, and that is that if one country imposes very heavy cost on a given industry and the others don't there is a risk that that nation's industry will lose competitiveness internationally vis-a-vis the industries of other countries.

Therefore it is particularly important that countries do these things in a collective fashion. On ocean dumping, for instance, the question of whether you have dual hulls or single hulls for ships, a very important issue for dealing with the question of spills.

There are a lot of issues—the question of scrubbers, the cost of scrubbers. It is true that we understand, as you pointed out, the technology. But in order to make a difference everyone has to do these across the board in a relatively short period of time, and everyone should share the environmental burden in common.

That is where the summits come in.

Now, the other point—

Representative SCHEUER. Wait a minute. You say that is where the summit comes in. You said in your remarks that we can talk about these programs, these problems in general, but the summit is not an appropriate place to talk about them in particular.

Mr. HORMATS. These leaders are not technically sensitive to all of the various issues that go into dealing with any of these matters. What they can do is create an agenda, a future agenda for their ministers and for their officials to sit down at the various institutions where these are addressed.

Representative SCHEUER. And negotiate bilaterally?

Mr. HORMATS. Multilaterally. The Third World needs to be involved because they are the ones building new factories; one of the concerns is some of the factories are less environmentally sound than some of ours, and then there is the rain forest issue.

The one problem, of course, is that the current international institutions that deal with the environment are woefully inadequate—the United Nations' environmental programs among them.

These have to be bolstered. Either bolstering that institution or developing a new one is the sort of thing summits can address, and set the process in motion.

I would add one more point, and that is the linkage you have pointed out, Congressman Scheuer, between the environment and energy. It is energy and carbon monoxide emissions that causes a lot of these problems.

The danger is in the middle part of the 1990's we are going to be facing an acute energy dependence. That is going to be a big problem for the United States. Unless we are able to make sure that the environmental issues and the energy issues are developed hand in hand in the United States and internationally, we will face the danger of environmental policies first being so stringent that they increase our dependence on imported oil, and then at some point if our dependence becomes too dangerous, the whole thing could snap back and people say we need to increase domestic production and we are going to scrap a lot of these environmental programs.

So at some point soon—and the summit is the vehicle for doing this—we have to look at the urgent energy problem along with the urgent environmental problem and figure out a way of addressing both, because if we do one without the other we are going to get a major boomerang effect.

Representative SCHEUER. Do you see any possibility that the summit is going to make any moves toward encouraging the so-called debt-for-nature swaps as a part of dealing with global environmental problems and Third World debt problems?

Mr. HORMATS. I think so. I think it is a positive development. A lot of the problems of the Third World countries come from poverty. They dig up the rain forest. They burn the rain forest. They build factories without benefit of scrubbers because they are cheaper that way. Some ways of linking the debt relief to specific projects is already underway, and I am sure it can be expanded in a sensible fashion.

Representative SCHEUER. How do we institutionalize pressure or jawboning or arm twisting, or whatever, in the Third World on the principle of sustainable development, sustainable farming, sustainable harvesting of the forests, sustainable development that doesn't erode the resource base, farming that doesn't deplete the water tables, farming—in other words, we pump too much and we plough too much. We plough fields that ought to be left fallow, that ought to be left in pasture land, and we plough them and try to raise crops there. Too many people, too many animals try to live on a very fragile ecostructure, and the land finally collapses and reverts to desert, the same thing, the same process in effect of too intense—leading to deforestation. We need a global deforestation program.

How do we raise standards of environmental behavior working together both in the developed world—and that is linked to energy production and energy consumption—and in the developing world, which creates these awful phenomena—desertification, deforestation—that effects the global warming as a result of short-term analysis. It pays to cut and burn the Amazon forest on a 1- or 2-year timeframe. The economists tell us when you get to the 3-year timeframe then it pays to preserve the forest as an asset and har-

vest it on a sustainable basis, not cutting down the trees wantonly, not clear-cutting, but harvesting them on a sustainable yield basis, which also enables you to harvest oils and seeds and various products within the forest.

How do we get the developing world to take a sufficiently long-term financial—and I am talking about 4 or 5 years, not 50 years—that will induce them to develop their assets, their forest assets, their agriculture, their development on a sustainable basis?

Mr. HORMATS. It is one of the very tough dilemmas that development economists and leaders in these countries face.

Representative SCHEUER. Can we crank this all into debt reduction?

Mr. HORMATS. I don't think you can crank it all into debt reduction. The swap programs that have been developed are very limited in terms of specific types of projects. But I do think that there is greater scope for them, with particular emphasis on reforestation, for instance, where you can use a certain amount of the money to buy the seedlings to build new forests.

The key point again is short term/long term. What makes sense to an individual in the short term—he sees a tree, cuts it down, he gets the money. In the long term he is not going to have that tree to cut down or the product that the tree makes.

Representative SCHEUER. In the Wall Street Journal only a month or two ago, in an article on the Brazil rain forests, the head of development in the State of Rondonia said for us deforestation equals survival. Now, for them deforestation equals economic annihilation because they are killing the goose that laid the golden egg, but here was the minister of development in this State that includes hundreds of thousands of acres of tropical rain forest saying, in effect, that the pressures of poverty, the pressures of population explosion on us are so severe and so intense that deforestation equals survival. This is an economics minister talking.

Mr. HORMATS. Unless you give these people an incentive not to cut down the trees or an incentive to plant new trees or an alternative way of making money, then we are in deep trouble in these and other environmentally sensitive areas. They put their short-term survival, above the long-term environmental benefits of not cutting down the trees, for instance, or of not stripping the land.

There have to be economic incentives there. This is the reality which we have seen time and time again. And that is expensive. That is expensive for poor countries which don't have enough money to give its kids inoculations against smallpox. For them to give people money to plant new trees is a big luxury.

You see it all over Africa, all over the South Sahara. It is an enormous problem. This is the sort of issue which needs to be addressed. Summits are not going to be able to do all of it. But by pinpointing the issues, by focusing on the issues and asking ministers and finance ministers and environmental ministers to address these issues with greater urgency, they can at least make a contribution—not work out the solutions themselves but start the agenda moving at a higher level in a more purposeful way.

Representative SCHEUER. What are the institutions that you think it would take to create a global reforestation program?

Mr. HORMATS. I think you have to use the UNEP to a degree. The U.N. agencies have been at the forefront of what measures have already been taken, but they are very controversial. They are not seen to be particularly strong.

Representative SCHEUER. Could OECD play a role?

Mr. HORMATS. It could. It is an industrialized country group, and they could do a lot.

Representative SCHEUER. They represent almost all of the donors?

Mr. HORMATS. Yes, and the OECD and the Development Assistance Committee of the OECD could play a spearhead role in that area. But at some point you have to bring the Third World countries in to make them feel that they are part of it.

But you are right, the OECD and the DAC could take the lead. Then we have to give a lot more political weight to the effort in a global sense and show the developing countries that there is something in it for them. We are not just asking them to do something that we are not doing ourselves, which is another important question.

Representative SCHEUER. Thank you very much, Mr. Hormats.

Mr. Bergsten.

Mr. BERGSTEN. I agree with you, Congressman Scheuer, and Bob Hormats on most of the substance of what you said. But I would like to bring it back to the Paris summit and be a little more ambitious.

If we think back to the history of summits, there were in fact some in the late 1970's that addressed in great detail some of the very energy issues that you are now talking about. Indeed, if you think back to the critical change in U.S. domestic energy policy during that period, it was the decontrol of oil prices, and that derived from a pledge that President Carter made at the Bonn summit in 1978 as part of a multilateral package dealing with the whole array of international economic problems at the time.

Parenthetically, I would say again, in response to Jeff Sachs earlier, that all models of macroeconomic policy coordination miss linkages across the issues. At the 1978 summit the Germans made a growth commitment, the Japanese made a growth commitment, and the United States made an energy commitment. That does not show up in the models that Jeff Sachs or others do that pervade the literature that he talked about earlier. But I was involved, and Bob Hormats was involved. We can tell you those linkages were crucially important in helping the United States generate the internal political support to then move on what we should have done anyway on energy policy.

My point is that there have been summits in the past where relatively specific commitments have made on issues quite akin to those that you are now talking about.

As Bob Hormats said, environmental policy is to an important extent energy policy. I happen to be a strong supporter of an increased gasoline tax of exactly the type that you describe. I think it is what the doctor ordered to deal with some of our environmental problems, some of our urban congestion problems, our budget problems, and our trade problems. You can kill more birds with that one stone than almost any policy measure you can come up with.

Yet, we have great difficulty even getting it on the domestic political agenda. That is where summits could come in.

Suppose the other major countries came to the United States, as they did in 1978, and said, "There are some things that you want from us, and we have some things that we want from you. You tax gasoline at one-third the rate we do. That doesn't seem to make sense. It is bad for the environment and everybody's interest. That is something that we would like to see from you, and in return we are willing to do *a*, *b*, and *c* that you have in mind."

That is meaningful policy coordination. It doesn't show up in models that are purely macroeconomic, but it may move the world forward in dramatic ways, and I think deals of that type are quite possible. Indeed, with some leadership from the various countries that are trying to renew the substantive use of summits, you could do it.

I don't think it will happen next week, but I think it is the kind of thing that could be done if there was a renewed zeal and desire to use summits in the way that they were originally meant to be used and demonstrably have been used.

This is not a pipe dream. It is not theory. It has happened in practice. It has been controversial, but I think in those cases that I have mentioned the outcome was unambiguously favorable.

Representative SCHEUER. Mr. Bergsten, you appeared here about this time last year, and I recall your saying that we cannot continue paying \$7 or \$8 billion a month, borrowing \$7 or \$8 billion a month from countries abroad, and now, of course, it is up to \$10 billion a month, and you said, you know, the central banks of the world are not going to continue accepting—picking up our chits at this rate. In fact, at some point in time they may decide that they don't want to keep the chits they have now, and you said, you know, the central banks of the world are going to give this next administration whatever it is, 6 months, 8 months, 9 months. But more or less by the end of the congressional session, 8 or 9 months, by the time late summer or fall arrives, if they don't see a systematic, well thought out effort to drive that budget deficit down, they could be stopped—they could stop picking up—they could begin to think about the chits they already have.

Do you recall making that statement to the committee?

Mr. BERGSTEN. I not only recall making it, I repeat it in my testimony today without trying to be quite so precise on the date, but nevertheless I raised exactly the same question.

Representative SCHEUER. You gave us 6 or 8 or 9 months. I remember that very clearly.

Now, it seems as if nobody is listening, nobody is paying any attention. We just passed a budget resolution that was so full of intellectual dishonesty and fraud and absolute contempt for the public in the mistruths and untruths that are stated that it boggles the mind. One of the few people who protested was our chairman, Congressman Lee Hamilton, who made an eloquent, thoughtful, brilliant speech on the floor of the House, but nobody seems to be listening. We are more or less where we were a year ago, and the 6 or 8 or 9 months is fast upon us.

What is going to happen? How are those central bankers going to react—excuse me—when there is not really the slightest vestige,

not the slightest, as Congressman Lee Hamilton's speech on the floor of the House on that budget resolution eloquently stated, not the slightest vestige that either the executive branch or the legislative branch is really thinking about taking the tough, hard measures to get our economic act together? What is going to happen?

Mr. BERGSTEN. Well, I think you in the Congress and the administration did that phony budget at your peril, in political terms because of the consequences that could emerge, as well as in economic terms.

I cannot predict when precisely those chickens are going to come home to roost. What we do know historically is that imbalances of this type do not persist indefinitely. Either they are headed off by thoughtful policy action, or, more likely, they are forced into dramatic change by crisis.

We have had some crises in this episode already. Back in 1987 private foreign investment in the dollar did dry up. We had a period in the early part of the year when interest rates shot up by 300 basis points. Secretary Baker had to stop the decline of the dollar and negotiate the so-called Louvre agreement to try to stabilize the dollar because the hard landing was in fact starting to take place. However, at that time the central banks did come in.

The point I made a year ago and the point I would make even more strongly today is that we should not rely on the central banks to pick us up if in fact the private inflow does dry up again, and there are three reasons for that, as several of us have mentioned.

The main concern, or at least a rapidly growing concern, in most of the major countries abroad now is inflation. Their economies are growing well, but inflation is picking up, and that is why they are raising their interest rates. If the dollar starts to go into a fall, they are very unlikely, in my judgment, to pour out tens of billions of dollars' worth of yen and marks and Swiss francs to defend the dollar, which is what would be required, because that would add to inflation and particularly to inflationary expectations in their economies and run counter to their own objectives.

Second, because those countries have now achieved a good measure of domestically led economic growth, they are not relying on export expansion as they were. They are much more relaxed about their currencies rising. The Germans have said quite openly that they can take an exchange rate of 1.60 to 1.70 to the dollar, not the 2 to 1 it has been. The Japanese have talked publicly about being able to live with the yen at 100 to the dollar. They are not going to see their economy sink into the ocean as a result. They can cope with it.

The third thing is the time horizon. This was the point that I stressed a year ago, before the election. There was a kind of conspiracy among the central banks, if you want to put it that way, to skate through the U.S. election year because they knew that we were not going to deal with our budget problem in that period.

But the flip side of that conspiracy was an assumption that, once past the election, the United States would begin to deal with the budget. If what you said were to occur this year—and quite rightly, it looks like we will continue to see no serious U.S. budget action—I think that the rest of the world will at some point give up on us and say the internal deficit is going to remain forever—I agree

with Jeff Sachs to a large extent here—and therefore the external deficit will remain forever. Therefore you have to keep borrowing \$10 to \$15 billion a month, and at some point that process simply runs out of steam, and the expectation that it is running out of steam may mean that the decline comes much faster than it would otherwise.

I would not try to be precise on the dates. I would say only this—and I have said it to many people in the administration—that I think it is inconceivable that they could get through another 4-year period of continuing to rely on external capital in these amounts to finance our external and internal deficits. Therefore, it makes enormous sense politically as well as economically to take constructive, preemptive action to head off the day and at a time when the economy can least afford it.

Now, I stressed in my remarks today that the economy looks already like it is slowing down. Incidentally, that is why I think that we could take a dollar decline now even without a lot of budget action. I think the economy is slowing down anyway. That is going to free up resources that will permit us to improve the trade balance without putting renewed inflationary pressure on the economy.

There are timelags involved. A lower dollar now would mean a stronger trade performance 6 to 12 to 18 months from now, and by that time, I think, domestic demand will be growing much more slowly, and so an engineered decline of the dollar even by itself would be a desirable thing. However, as I said before, combining it with budget restraint is obviously much more desirable.

I would not try to be precise on the timing, but I think it is simply living in a fool's paradise to believe that we can continue indefinitely to go on with this process. It is true that the budget deficit has come down as a share of GNP. It is also true that if we go into a recession it is going to start rising again as a share of GNP, and we will come out at the other end of this particular business cycle with a much bigger problem than we had. And I think that somewhere in the course of that development a sharp, uncontrolled, destructive fall of the dollar is not only possible but a high probability.

Representative SCHEUER. Well, that leads me to the question of why aren't we capable of reacting as a society, Congress, the administration, to the clear facts before us? It is not as if the word hasn't gotten out. You have been an eloquent spokesman for this point of view, Bob. Bob Hormats has testified here time after time. You have all given us the same message.

Paul Kennedy's book, the MIT study, the dissected American society in the way of labor and government, industry and capital, how they interrelate, the analyzing of many, many, many profoundly basic structural changes that have to be made in the way that we conduct ourselves in terms of productivity and industrial muscle.

Benjamin Friedman spoke. The word is out. It is documented by scholars. It is documented by Congressmen and Senators. But yet we seem to passively accept our fate. We are an undeveloped country educationally. There isn't an industrial country in the world

that has our degree of adult illiteracy or our failure rate in producing literate, competent students. Not one.

We know that we have hundreds of thousands of kids from deprived backgrounds who if they don't get a Headstart experience to help them be learning ready by the time they hit the first grade those kids are almost mathematically predictable failures in school and dropouts. If they cannot learn to read, write, and count when the other kids do—there may be a lag of 3 or 4 or 5 years before they actually drop out, but they have dropped out psychologically, mentally, when they don't learn to read, write, and count. We know that.

Barbara Bush, the President's wife, a lovely, decent, and involved person, is a strong supporter of Headstart. She has been eloquent on television and the press. Yet this budget resolution provided Headstart moneys for less than one-sixth of the kids in our country who are educationally at risk, at dire risk. The cost-benefit payoff for every Headstart dollar spent is spectacular. It is on the order of 6 or 7 to 1.

How can our country sit by and let five-sixths of the kids who are urgently educationally at risk move toward almost sure education failure and dropout and all of the dire economic consequences that portends, including a 25-percent adult illiteracy rate? Why is it that our society is not able to listen to Bergsten and Hormats and Benjamin Friedman and Professor Paul Kennedy and the MIT report and react?

Mr. BERGSTEN. I think at the structural level it is like the Brazilians and the rain forest that we talked about a few moments ago. It is the short run versus the long run. We have warned repeatedly, as you say—and you have, too, and Chairman Hamilton has—about the longer run consequence of these developments, but in the short run everything seems to be fine. The economy is more or less going along well, and if we are doing it on a credit card financed by foreigners, all the better from the short-run point of view.

That says to me that the problem is one of leadership, and I place the problem squarely in the White House. I would by no means exonerate the Congress for its behavior in this area. It certainly has not been exemplary, but I do think that the President is the one U.S. official who has responsibility for looking at the national economy as a whole, particularly when the problem has such international dimensions as these we are talking about. It is really up to him to take the leadership role, to come to the Congress with a budget—or a Headstart program, or whatever it may be—that recognizes all of these global and nationwide interconnections and put it before the Congress and push it hard and try to bludgeon all of you into getting it agreed.

Presidential leadership in the recent past has taken the opposite line. Things are fine. Let's not rock the boat. Let's pursue various other objectives, and let's not worry about the longrun implications, or, conversely, let's take the view that all of the implications are not so serious as indicated and that we can continue to skate through forever.

But I think the structural reason—the political reason, if you will, though it is presumptuous to try to offer political analysis to a congressional committee—is that in fact in the short run things

have gone reasonably well. The costs are hypothetical, tangential, out there in the future. Some of us feel with a high degree of certainty that they are going to come down upon us, but we cannot prove it, and we cannot tell you exactly when it is going to happen. We cannot tell you exactly what form it is going to take. We can tell you that if it happens all hell breaks loose, and the costs are enormously heavy.

But that is a future uncertainty versus a current gratification, and I am afraid that in our society and our political system current gratification prevails.

Representative SCHEUER. Part of the current gratification, I suppose, is a country that consumes \$200 billion more of goods and services than it produces, made possible by a few countries overseas that produce a couple of hundred billion dollars more of goods and services than they consume, and they lend it to us.

Mr. BERGSTEN. It is lovely while it lasts.

Representative SCHEUER. It is lovely while it lasts, yes.

Mr. Sachs, do you have any reactions to what we have all been saying in the last few moments?

Mr. SACHS. Of course, I do. But actually I agree with almost everything that has been said in this case. Of course, we are living off the future. That is clear.

I think that—

Representative SCHEUER. That would be environmentally, economically in terms of our productivity, our ability to compete around the globe almost always?

Mr. SACHS. Yes, I think that is true. What alarms me even more, I should say, is I travel very extensively in the Third World. The extent of crisis in other parts of the world is at a desperate level now, a level that doesn't begin to be comprehended in this country, and that I find to be even a worse tragedy than the things that we have been talking about here.

There have been—there are approximately 875 million people living in countries that are renegotiating their debt right now. Every one of those countries, I think every one of those countries, is in very serious economic crises. These negotiations have been left to Citibank to play its usual tricks. They are not really going to give solutions on the debt. It is a real shame because the public is going to be led to believe that we have had solutions, that we finally have gotten to solutions, and I find the extent of decline and the extent of crisis absolutely alarming in the rest of the world.

We are living well here, and the problems that we talked about are real but we can take care of them without major effort. I would say it is not that we are shortsighted. We are in an extremely greedy period politically, just greedier than one can remember for decades, where there seems—it is not that many in Congress don't understand that Headstart is vital for these kids. They don't care. That is what it comes down to, or they won't or they don't tell their constituents that a few dollars more per year can make a material difference to the quality of our society. We can afford those changes with very minimal costs.

What alarms me is the extent to which the whole developed world has just shot away from almost all of the developing world with a very small exception—exception or important exception of

some East Asian developing countries, but when you look at Africa and Latin America and large parts of Asia and Eastern Europe, the extent of decline and the extent of political instability that is resulting is absolutely alarming, and yet we cannot even bring ourselves to this moment to take the first step of a serious response to the debt crisis because the Brady plan is not a serious response to the debt crisis.

Representative SCHEUER. Let me footnote what you are saying. UNICEF has published a study a few months ago on the effect of Third World debt payments on the quality of life in the Third World, and they have documented that in the last few years per capita GNP in the Third World has gone down about one-third. They have documented that there have been slashings of education and social service budgets throughout the Third World.

They have documented that at least a half million mothers have died in childbirth who would not have died in childbirth had it not been for the pressures of Third World debt payments on their countries. A half million kids have died from birth to one who would not have died had it not been for this pressure.

And the Third World debt crisis has—because they have decimated social service and health care expenditures there have been reduced funds for family planning so that the population increase has accelerated during this same period because of reductions in social spending and health services and what not. So the population increase, which is degenerative for a large part of this short-term financial framework that we are talking about, is responsible for the state of mind in which the government can say—where they can say that deforestation equals survival. It fills the property. It fills the pressures. It is increasing because of Third World debt pressures on their governments.

Mr. Chairman, thank you very much.

Representative HAMILTON. OK. We have a lot of ground to cover and a very few minutes to do it.

Why have summits fallen into disrepair?

Mr. Hormats, you talk about them being highly structured, too publicized. What has happened here? Why aren't they more productive now?

Mr. HORMATS. Let me draw a distinction between the summits of the 1970's and the summits of the 1980's.

In the 1970's, Presidents Ford and Carter used summits to try to push forward the international agenda and in some cases did so in a very effective way. Summits decided key questions relative to the Tokyo Round of trade negotiations, where progress was made as a result of the summits; they produced action on reducing energy dependence, on Third World assistance. In a number of areas summits were forceful events. That was partly because the leaders wanted to use them that way and partly because you had at least some leaders who were finance ministers, ministers who were eager to get into some of the macroeconomic issues.

In the 1980's what has tended to happen is that the summits were used largely—not entirely, but largely—as media events to reinforce to the national publics that their leaders were doing basically the right thing and were appreciated by their colleagues.

I don't think that is so much a fault of the summits. Leaders generally didn't use them very ambitiously. I believe that is going to change now.

Representative HAMILTON. Have they become too highly structured? The communique, is it drafted before they even go to the meeting, and this sort of thing?

Mr. HORMATS. It has been known to happen, but in many cases—

Mr. BERGSTEN. He used to draft it.

Mr. HORMATS. We tried. We tried. [Laughter.]

But if leaders want to change the communique, they can say that there are two or three items that are not addressed in as forceful or effective a way as they should have been. They will certainly change it. I can remember—

Representative HAMILTON. What we ought to strive for is to maximize the amount of time that the leaders have together alone to talk freely about the problems, is that right?

Mr. HORMATS. That is a big plus. If they can spend a lot of time talking about what is really on their minds instead of what they are programmed to talk about, it would be a plus.

Representative HAMILTON. And to minimize the number of formal occasions and the press opportunities, the photo opportunities?

Mr. HORMATS. The photo opportunities are relatively few, but the press opportunities—one of the problems is there is a briefing after every session. It is like doing a briefing on a football game between quarters. When you don't know the outcome, it takes a lot of time.

I would say "less structured." They need some structure. Otherwise, they will wander off.

Representative HAMILTON. I want to move ahead quickly because it is approaching 12 noon, and I know everybody has commitments.

Mr. BERGSTEN. Let me add, Mr. Chairman, very quickly that all of these procedural points are really a derivative from what I think is the basic reason why the summits have fallen into disrepair, which is a substantive point.

When President Reagan came into office, he really disliked the idea of international coordination. His Treasury officials said it very explicitly. They backed away from the entire panoply of devices that had been created in the 1970's for that purpose. They took the explicit view that if we did what was right at home, all else would fall into place, and they proceeded on that basis.

Now, they failed to perceive the fact that their policies would convert the United States from the world's biggest creditor to the world's biggest debtor in 3 years. They ignored the fact that their policies would create a \$150 billion trade deficit; they ignored the fact that the deficit would create protectionist pressures that ran directly counter to their own desires. But that was their explicit view.

Later in their administration, like previous administrations, they were driven back toward greater international cooperation, but they changed the whole nature of the summit process as a derivative from their substantive view.

Representative HAMILTON. Do you think that will change under President Bush?

Mr. BERGSTEN. I hope so. I don't think we know yet. We haven't yet seen whether this administration wants to return to serious, substantive international coordination.

I have to say at the moment the signs are not terribly promising, given what has happened on the currency front in the last 6 months, and given the inadequacies of the Brady plan on Third World debt. We have not yet seen any indication that the new administration is going to move back toward serious international economic coordination.

Representative HAMILTON. All right, let's pick up on the Brady plan for a minute and talk about the debt, and I want to take off on your comments, Mr. Sachs.

You thought that the fundamental flaw of the Brady plan, as I understood your view, was that it was voluntary, and you suggested in its place concerted action, and I don't understand the words "concerted action." What does that mean, and where does the clout come from? Where does the club come from? Why isn't concerted action still voluntary?

Mr. SACHS. This approach evolved from the so-called menu of options that Secretary Baker introduced a couple of years ago. Let each bank choose what it wants to do.

Representative HAMILTON. New money, debt equity swaps?

Mr. SACHS. New money, debt equity swaps.

Representative HAMILTON. OK.

Mr. SACHS. The idea was to make these agreements more and more complicated, and if a bank wanted an exit bond, fine, if a bank wanted to lend some money, fine, if a bank wanted to debt equity swap, fine.

In my view, this has taken us down a very unpromising path, precisely because what is needed now is a coordinated reaction where all banks do the same thing, and the simplest way, the way you do workouts historically, and I would say for hundreds of years the way that banks have done workouts like this, is you cut the interest rates down to levels that the debtor can reasonably service, and you do that on all of the debt, so that all banks share equally in whatever debt reduction has to be done.

Representative HAMILTON. I am interested in the mechanism, how you do it and how you enforce it.

Mr. SACHS. Now, the mechanism for doing it—I think we would be close to that in fact. I am not sure we need a full institutional change. What we need is a change of the ideas of our governments, to say we want you to go in there and negotiate debt reduction.

Our government has never really seriously taken that point of view, it seems to me, because Citibank from the first day has been saying we are not taking debt reduction and no one has challenged them. No one has said, what do you mean you are not taking debt reduction?

Representative HAMILTON. Hasn't Brady said there ought to be debt reduction?

Mr. SACHS. Not that every bank ought to do it. He says there ought to be debt reduction.

Representative HAMILTON. In general?

Mr. SACHS. He has asked nothing of any particular bank or nothing of all banks in specific, let's say.

Representative HAMILTON. Your view is the Treasury Secretary ought to be rather specific at this point?

Mr. SACHS. He doesn't have to name banks. He just has to name a general principle. I want all banks in there participating in the reduction of the debt.

Representative HAMILTON. Mr. Hormats, are you as pessimistic about the Brady plan as Mr. Sachs is?

Mr. HORMATS. I am not as pessimistic. First, I would make one point. Mr. Sachs said that summits ought to be used for this purpose. I think the summits are—one thing the United States will not do I can safely predict, nor should it, is use the summits to put enormous pressure on the banks in this area. The summits just are not vehicles for doing that, and the United States is not going to use the summits for that purpose. It is just not in the cards, and it is not the way summits work, nor should it be the way they work.

Representative HAMILTON. Mr. Sachs—I will let you go ahead, but, Mr. Sachs said earlier that he wants a policy statement saying that banks must contribute to the debt relief on, I think, an equal effort basis.

Mr. SACHS. Yes.

Representative HAMILTON. Something of that sort. And you are saying that the communique ought not to say that kind of thing?

Mr. HORMATS. No, I don't think it is appropriate. I think if you want to work with the banks you work with them in a private manner and don't use the summit to put public pressure on them with all seven heads of state involved. The banks are not going to respond well to that type of coercion. I just don't think it is appropriate in the summits.

Representative HAMILTON. Are they going to respond under the present system?

Mr. HORMATS. The fact is that so far there has been a gap, a large gap, between the Mexicans—let's use the Mexican example—and the banks. The gap has been narrowed. The negotiations are still going on. And I think that ultimately the process almost has to be voluntary on the part of the banks. I just don't think the government is prepared to or should exercise the sort of coercion that Mr. Sachs is talking about.

Representative HAMILTON. So you think then that the process of negotiation that is going on now, the Mexicans demanding a 55 percent discount and coming down to 45 percent and maybe down to 40 percent and the banks going up from whatever they started with, that is going to work out in an agreement?

Mr. HORMATS. It is hard to predict now. But at least the gap has been narrowed. I don't see any reason why it shouldn't be narrowed further in the months to come.

Representative HAMILTON. Go ahead, Mr. Sachs.

Mr. SACHS. I think we will reach an agreement. I just don't think it is going to be a good agreement. It should have some economic criteria to it, and I don't think it is going to have that kind of criteria, and there are many Mexicans in the Mexican Government that need—want an agreement that is politically validating for them so that they will reach an agreement.

The U.S. banks know that Citibank has said—it says every day—we are not doing debt reductions. So what kind of process are we in? We are in a very funny process.

Representative HAMILTON. Your four points in your prepared statement, Mr. Sachs, you get down to the fourth point, and I guess I don't understand it very well. It says, "Creditor governments should state publicly and clearly on behalf of a debtor country that if the banks delay in accepting a program of adequate debt reduction . . . , the official community will endorse the use of arrears for interim financing."

Is that the club?

Mr. SACHS. That is the essential club. If we don't get a deal, they cannot pay, so they won't pay, and that will delegitimize them at the IMF, at the World Bank, at the Paris Club.

Representative HAMILTON. What is "endorse the use of arrears for interim financing"?

Mr. SACHS. What it means basically if Mexico can only pay half the interest but if the contractual obligations are not reduced that Mexico will only pay half, and the other half will go into arrears, and with the arrears the IMF can give legal comfort to Mexico, for example, in being in arrears.

Representative HAMILTON. What is wrong with this approach?

Mr. HORMATS. That is essentially saying that you sanction a type of implicit default.

Mr. SACHS. Yes, exactly.

Mr. HORMATS. The IMF cannot give sanction. How can the IMF give them political sanction?

Mr. SACHS. The legal staff believes that it can under article VIII, section 2(b). It can say that exchange controls in which a country doesn't pay interest but are otherwise consistent with an IMF program are acceptable to the executive board of the IMF, and under the treaty obligations of all of the members of the IMF that would give legal comfort to the debtor—

Representative HAMILTON. The IMF becomes the club here?

Mr. SACHS. It is a very effective legal instrument. There are others that already exist in U.S. international law.

Mr. HORMATS. If you put the IMF in that position, you would have one heck of a legal problem in the United States and a big decline in support for the IMF.

Mr. SACHS. Everyone wants to do this so delicately, and of course it would be nice. Let's do it all nice, and let's not rock the boat. The extent of this crisis is beyond belief right now.

Three days ago I was in Argentina. The inflation rate is 1 million percent per year right now. There are about 5 million people just living on food handouts right now. What are we waiting for to take some serious action?

Yes, maybe there would be some political ramifications, but you know the world is really falling apart outside the industrial world. There is a great deal of this world that is just crumbling right now, and we are not responding to it, and I think that it is time that the IMF—the IMF was created to handle world crises like these. It was created by governments that full well remember the extent of human suffering during the Great Depression, and it was created

to be prepared to solve problems on a global scale like we have right now.

There are legal instruments that it has. It takes its authority from the United States and from the other creditor governments. It could act.

We are the ones telling it not to act. If you review Secretary Brady's speech on March 10, he said that he did not want the IMF interposing itself. That is what he meant. That was the code word. Don't go in there into those negotiations. We want you to lend some money, to give some enhancements, but he said explicitly—and this is what it means—he said we don't want you interjecting yourself, interposing yourself into the negotiations between the debtors and the banks, and essentially what that meant is that—we don't want that kind of pressure.

Well, we just should be done with the hand holding of our banks at this point.

I think there has been progress from the U.S. Treasury, but the crisis is deep, it is profound. We are going to reach an agreement—Mexico will reach an agreement which I don't believe will be satisfactory, or I am very worried that it will not be satisfactory, even though everybody will try to put the best face on it. But I can see that the process is one that is destructive of the economic needs and just goes to the bargaining capability of the various actors.

Representative SCHEUER. A brief question on that point, Mr. Sachs.

The international financial markets have made their decision on what has happened out there. They have in effect said a lot of bum loans were made, finger pointing, you know, can point to the banks, point to the governments, point to investors, corporations. A lot of bum loans were made in the 1970's, and the international financial markets have said these loans are not—these debts are not worth more than 30, 40, 50 cents on the dollar.

That is what the financial markets are telling us. That is the reality out there.

Why can't the IMF and the other international financial institutions say to the banks, look, your loans are not worth more than 30 or 40 cents on the dollar? So crank that reality into this process and do the necessary.

Why isn't that a reasonable thing for us to tell the international banking community that holds all of this debt, that mistakes were made, the debt is worth a fraction of what it was when it was first put on the books, reflect that and make your deals?

Mr. SACHS. It is. It is possible. It is reasonable. It is how we ought to proceed. It ought to be built into formal IMF programs with the understanding that countries can pay that amount, and above that, if there isn't debt reduction, well, there are not going to be payments, and we could have a very orderly process.

That is the closest we can come to bankruptcy law that I can see, that it would be orderly, it would be sensible, and it would be driven by economics, not by who bargains with whom and who has the inside track to the Treasury.

Representative HAMILTON. Let me pick up on your suggestion, Mr. Bergsten, about the successful Uruguay Round. You want that to occur in the GATT. Lester Thurow said that the GATT is dead.

Mr. BERGSTEN. I think on that one Lester Thurow is dead.

Representative HAMILTON. He is dead.

Mr. BERGSTEN. Yes.

Representative HAMILTON. OK.

Mr. HORMATS. I agree with Fred Bergsten.

Representative HAMILTON. You all agree to that?

Mr. SACHS. GATT is what we have. That is the negotiating forum. If that is dead, then we are in real trouble.

Mr. BERGSTEN. That was a ridiculous, irresponsible, though headline-catching statement.

Representative HAMILTON. It is good to get clean, precise testimony here. [Laughter.]

Representative SCHEUER. I wish Mr. Thurow were here to defend himself.

Mr. BERGSTEN. I would be happy to debate him on it.

Representative HAMILTON. The East-West business and Poland. I want to hit that a moment, too, because it seems to me that you have the President's proposal out there, which is relatively modest so far as the package is concerned—eliminating tariffs, stimulating private enterprise, encouraging U.S. firms to invest, loan guarantees by OPEC, and so forth.

What strikes me as I read all of that is that there is really not any aid in there, by and large. Now, the proposal may be that the President is going to go over there and recommend some forgiveness of debt. That is not anything like you are suggesting, Mr. Sachs, but the point is how do you tie the aid, the concessions, the elimination of tariffs, the OPEC guarantees, the package—Solidarity wants \$10 billion—how do you tie that to reform?

What has happened in Poland today so far is enormous changes on the political side, but nothing has happened on the economic side. The economy is an absolute mess, as you said a few minutes ago. We can't just go in there and start pumping aid into Poland without a fundamental restructuring of the economy.

How do you coordinate this aid and reform?

Mr. SACHS. Well, I should state from my understanding that the very last thing that Solidarity wants is a lot of money just pumped into Poland. They are worried sick that it is all going to be wasted, that it would be wasted as in the past, that unless there is a massive move away from the socialist economy to a market economy that none of this money can do any good, that the system is the problem, and what they are looking for is financial support to make a kind of transition that has literally never been made in history successfully at this point.

This is an extraordinarily difficult thing. I must tell you that many Solidarity top people said what should I read about this, and I had to tell them you are writing the book. There are no chapters anywhere. There is nothing to read about this process because it has never been done.

Now, I see the problem as a political one and, admittedly, a very sensitive one, and I can only speak on the economics. So let me do that, not on the broader East-West issues.

Solidarity is extremely frightened. They are the only legitimate political force in the country, with 80 percent of the vote.

Representative HAMILTON. But they are unwilling to govern?

Mr. SACHS. But they are saying should we go in and just do the dirty work of raising the food prices and all of the rest, to be thrown out by the hardliners or thrown out by our own people 6 months or 1 year down the road?

My belief—and I am speaking purely for myself—is that they must take responsibility now because they are the legitimate political force. In one way or another, some institutional means can be found for them to participate in a leadership role and that they would do so and that they would exit from my discussions personally and from what they write and what I believe—and what they say in public—they are willing to take extraordinarily strong steps of massive reform and massive shakeout.

Representative HAMILTON. But they are not the government.

Mr. SACHS. They are not now the government. You may know yesterday—

Representative HAMILTON. The United States cannot develop its policy on what Solidarity would like to do.

Mr. SACHS. That is right, so let me give the concrete answer. I was giving the background.

The background is that I think that there would be a great deal of leadership provided if there were some sense of the safety net, that loans would be forthcoming in a step-by-step process if this could go ahead.

Representative HAMILTON. And aid? You use the word “loan.”

Mr. SACHS. No, I don't think they are looking for aid. There are just small amounts of aid and not anything from the United States or anything significant, as I understand it.

What they have basically asked for is not \$10 billion in aid, by the way. It is a \$10 billion loan program, most of which is very conventional. It is an I-3 or IMF program, so-called extended fund facility, or extended arrangement now. It is World Bank lending, structural adjustment lending, and sectoral adjustment lending, and then it is bilateral credits from Japan and from Europe mainly, with some small contributions from the United States.

It is nothing extraordinary. It is the kind of package that we now give to a favored debtor that is undertaking strong reforms. It is a Venezuelan or Mexican style package, if I could call it that. That is what they are looking for, a statement of broad political support.

The problem is with the IMF if you don't have the support from the United States you can be negotiating for the next 3 years before you have satisfied some staff member that you are getting far enough along.

Representative HAMILTON. Is that loan that they are requesting, the \$10 billion figure, is that essential to economic reform in Poland?

Mr. SACHS. In my belief, yes.

Representative HAMILTON. They have to have it before they can get that economy moving?

Mr. SACHS. To get it restructured, let's say, not just getting it moving. I believe that the level of decline, decay, and social unrest is so great right now that we are courting a disaster if there isn't some financial safety net to help with the transition right now.

Now, the answer to the specific question is every bit of this money should be tranched, should come in stages over several

years, and should be tied to explicit progress and reform, but we have a vast international network mechanism to do that. We have sectoral adjustment loans at the World Bank. We have IMF programs, and so forth.

What I am suggesting is—

Representative HAMILTON. What does reform mean to you?

Mr. SACHS. Reform means in that case to turn the economy to a market economy, which would be a mixed economy. Many state enterprises would remain state enterprises, but operating in a market context, and others would be privatized, a unification of the exchange rate, stabilization.

I think all of these things really can be accomplished, and it will have vast significance in calming Europe and stabilizing a major threat to East-West relations.

Representative HAMILTON. I know I am jumping around a little bit, but I want to finish up.

Mr. Bergsten, in your prepared statement, you seem to cast some doubt on bilateral trade agreements.

Do you not like the United States-Israeli agreement, the United States-Canadian agreement?

Mr. BERGSTEN. I like the United States-Israeli and United States-Canada agreements. In fact, I testified strongly in support of them. I would not pursue any other bilateral agreements at this point in time.

Representative HAMILTON. Why not?

Mr. BERGSTEN. There are two reasons. I don't think there are any others out there that have any significant economic payoff to us. They would be small. They would take a lot of resources to work out, and I just think, in terms of the net benefits, that on their own merits they are not very impressive.

More importantly, however, I think that if the United States were to pursue more bilaterals now it would greatly divert attention away from the multilateral negotiations of the Uruguay Round. It would say to the world that we are not committed to the multilateral process. It would reinforce a perception going around that the world is headed toward a system of trading blocs. I believe that is a wrong perception, but if we start doing more bilaterals, it will feed it. It will undermine the GATT effort and then the GATT might be dead, and that would be a tragedy.

Representative HAMILTON. Mr. Hormats, you said in your testimony that you would like to see President Bush take an initiative at the Paris summit.

Do you have something specific in mind?

Mr. HORMATS. On East-West, yes, I do. I think much of what Jeff Sachs has indicated for a program for Poland would be a very positive thing for the President to put forward. He will have been to Poland and Hungary. There is a lot of interest now in supporting reforms in both of those countries. I would say an economic plan which is based on increased trade access, technical assistance, additional loans at this time would be very positive.

Representative HAMILTON. Mr. Bergsten, if the news that comes out of Paris is the East-West initiative, the Poland initiative, that would be a disappointment to you, wouldn't it?

Mr. BERGSTEN. That would be a disappointment, but not a bad thing in itself.

Representative HAMILTON. You are not against the initiative?

Mr. BERGSTEN. Such progress is highly desirable. But I think that they would have missed an opportunity.

Representative HAMILTON. Do you see it that way or not?

Mr. HORMATS. I think that there is room for initiatives or progress in several areas. This would be one of them, but addressing the potential deterioration of trade balance is a worthwhile thing. They could do that as well.

Representative HAMILTON. You had another statement I jotted down that we should not isolate China.

Mr. HORMATS. Yes.

Representative HAMILTON. Why not? They have been pretty repressive. They have been pretty bad, haven't they?

Mr. HORMATS. I accept all of that. I was in China last year. I met with Deng and Zhao Ziyang and Li Peng, all the leaders, and obviously I am extremely concerned and disappointed and saddened by what has happened. There is no question about that.

But China is a very important country in the long run, and I think that—

Representative HAMILTON. Is it important in an economic sense to us?

Mr. HORMATS. It is certainly important in the economic sense. It is important in a political and a strategic sense.

Representative HAMILTON. The trade is not all that much, though?

Mr. HORMATS. Trade is not all that much. The economics, shifts in terms of China's significance, are not enormous for the United States. They are for other countries, not for us. They are for the East Asians.

But it seems to me that what you want to do is support those elements in China which are supportive of the modernization process and in the future will continue to be supportive. An open China which gets information from the West, which trades with the West, which has financial contacts with the West is in the long run in our interest, while certain things, may have caused great grief for all of us, keep the channels open and keep working with the people who want to open up China over the long run.

Representative SCHEUER. Just one last question, Mr. Chairman.

Representative HAMILTON. Go ahead.

Representative SCHEUER. Mr. Sachs, you mentioned in your testimony that one of the problems with summits is that they point us toward others rather than at ourselves. The problem, Dear Brutus, is not in the stars, it is in ourselves.

How do we—and any of you who want to react to this—create the systems, the processes, the institutions that would create a joint consensus on the overall job to be done, both in the developed world and the developing world, create that pie, giving each country its slice of obligations, its duties, its obligations, its contribution, so that in addition to pointing at everybody else, pointing at the totality beyond us, each country would come away with a pretty clear conception, in rough terms, of the job that it had to do to create, to contribute to a total solution?

It wouldn't have to be in broad terms. It would have to be a fairly clear statement of what each country's obligations, functions, and duties were.

Mr. BERGSTEN. It is a very big question, but to answer you briefly, I think we are in a historic transition period, away from a U.S.-dominated world economy to a pluralistic world economy, where power is more equally shared among the United States, a coming United States of Europe, and Japan. The issue is to figure out for the first time in history how to manage the world economy by committee.

The United States now is eager to get the Japanese to pay for things, but very reluctant to cede much responsibility or clout to the Japanese. That just will not wash over time.

The Europeans are in a transition period, moving away from a potpourri of nation-states to what I think will be increasingly a unified entity for economic purposes. Already Europe is unified for many trade purposes. I think by 10 or 15 years from now it probably will be for most economic purposes as well.

But meanwhile, in this rather longish transition period, we are in a very messy situation where there is no country or region ready to step in and assume the leadership role the United States has played in terms of attitude, knowledge, point of view, et cetera. The United States, for the reasons we have been talking about, can no longer pay the costs of maintaining that role. Therefore, it tries to do Poland initiatives or Brady plans on the cheap, and the result is a mismatch. We are out of sync between our capabilities and our responsibilities, and that underlies the difficulty, I think, in answering your question. Because when people go to Paris or any international meeting they are basically trying to defend lingering, almost anachronistic national prerogatives. They are clearly not yet into a mode where some serious joint management has been structured and is in place, and in the meantime I think all you can do is try to work issue by issue to forge that kind of management.

When heavy crisis hit, when it is unambiguously clear that your back is to the wall and you have to respond, the countries do tend to get together fairly well. The firefighting capability has been pretty good. But in terms of preempting problems or creating new structures or dealing with problems before the barn gets burned, whether it is Third World debt or our own hard landing for the dollar, cooperation has been almost impossible to achieve.

So all I can say is that we should try to analyze each issue on its own, try to move gropingly in the right direction, as the officials are, and hope that over time, deductively, we will wind up in some kind of new system, from which then cooperation will flow more naturally. But in the meantime I really think it is a matter of slugging it out case by case, because we are in the midst of a historical transformation that really has no precedent.

Representative SCHEUER. Yes, Mr. Sachs.

Mr. SACHS. One thing that I would add—I agree with a great deal of what Fred Bergsten said—I think one shortcoming in the institutions right now is the absence of real participation from the developing world in almost all fora that are meaningful. In the IMF it is a creditor-dominated institution, even though all member

countries are represented, and probably should be in important ways.

The summit has up until now never met—or the G-7 leaders have never met as a group with leaders from a group of developing countries on the debt, for example. For many years the so-called Group of Eight in Latin America sent missives to the President of the United States saying we would love to meet you before the summit to talk about our problems, and they never received responses.

Now, I believe that President Mitterrand is going to meet with some heads of state from developing countries next week, but I think we don't have adequate fora right now where meaningful work can get done, where developing countries and developed countries sit down in ways to push forward concretely some of the issues at stake.

Now, of course, that is a matter of trying to control the agenda. The whole Brady plan was constructed, developed, and discussed without any organized participation from the developing world. It is a shocking lapse, in my view. Of course, that is supposed to be clever. We control the agenda. But it is not clever. We don't understand the problems as the developing countries understand them.

So we are missing a great deal of what is really happening by not listening carefully.

I think we should develop better means for better listening and better communication because while we can have some optimism that the industrial world is groping along and handling a lot of problems, I am not at all optimistic about large parts of the rest of the world, where I see the crisis extraordinarily deep and being neglected by us.

Mr. HORMATS. I just want to make a couple of points on this question. To take off on a point that Fred Bergsten made, one of the things that we have emphasized to the Germans and the Japanese and others is that we want greater burden sharing. What we are going to have to accept over a period of time is that greater burden sharing comes along with greater power sharing, and we are going to have to share power with them with respect to security issues, political issues, and economic issues.

Representative SCHEUER. This is the point Fred Bergsten made.

Mr. HORMATS. Yes. And I think that that power sharing is where we and they have qualms. We have not been willing to really share power. And for historical reasons, the Germans and the Japanese have been reluctant to accept a sort of broader power sharing.

That is going to change. The European Community, as it coalesces, is going to be not just an economic force but a political force and perhaps 10, 15 years down the road a security force as well—a sort of "second pillar" of NATO. We are going to have to learn to live with that type of world where we are part of the world, not on top of it where we are not dominating the process.

The Group of Seven process, and the Quad, are really transitional vehicles. The G-7 is really the board of directors of the global economy today. We may be the chairman of the board, but the board has some power. The summits really play that role. It is not something you would have had in the 1940's and the 1950's because it wouldn't have mattered. The United States would have called

the shots. If you can't call the shots, you have to work these things out collectively. And that is what the summit, that is what the G-7, that is what the Quad are doing. We have to learn to think as part of the world rather than as the dominant factor. And the other countries in turn have to learn to think as countries that have greater influence over the world than they now realize they have and share a greater portion of the burden. It is a tough transition, but it will happen.

Representative HAMILTON. Are we going to get hit on section 301 at the summit?

Mr. HORMATS. I think most of the hitting has been done.

Representative HAMILTON. Do all of you favor section 301? Is it a good move?

Mr. HORMATS. I think it is not as bad as it has been made out to be.

Mr. BERGSTEN. I think it depends how you use it.

Representative HAMILTON. How you use it.

Mr. BERGSTEN. If you use it to promote the Uruguay Round and to help open markets, and if you don't go unilateral with retaliation, it can push things in the right direction, but I think it depends totally on how it is used.

Representative HAMILTON. Mr. Sachs.

Mr. SACHS. If it is hardly used, it might not be too damaging, but I think it is terribly presumptuous in general.

Representative SCHEUER. It was a wonderful hearing, Mr. Chairman.

Representative HAMILTON. Really, we appreciate very much your presence and your testimony, your responses. I think it has been an excellent hearing.

The committee stands adjourned.

[Whereupon, at 12:22 p.m., the committee adjourned, subject to the call of the Chair.]

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