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S. HRG. 102—185

THE LONDON ECONOMIC SUMMIT

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

JULY 9, 1991

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

46-776 WASHINGTON: 1991

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-035548-6

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

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TUESDAY, JULY 9, 1991

THE LONDON ECONOMIC SUMMIT

TUESDAY, JULY 9, 1991

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

The Committee met, pursuant to notice, at 9:38 a.m., in room SD–538, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senator Sarbanes, and Representatives Armey and Obey.

Also present: Lee Price, Chad Stone, Paul Taylor, Glen Rosselli, and Marc Chupka, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The Committee will come to order. I want to welcome everyone to the hearing this morning on the Economic Summit to be held in London next week. It comes at a time when the world faces some particularly challenging economic issues, and a consensus among the major industrial nations who constitute the G–7 Summit would be helpful in resolving those issues.

First, for instance, all but two of the seven countries attending the Summit have weak or declining economies. What should the heads of state do in an effort to improve economic prospects for their respective economies?

Second, the nations of Eastern Europe are going through difficult economic and political transitions. In fact, President Gorbachev will come to London to meet with the heads of state after the Economic Summit formally ends. How should the Summiteers respond to any appeal by the Soviets for financial and technical assistance? Could they do more to assist the transition of the other Eastern European nations toward democratic market-based societies? And some of those nations, in my judgement—I'm talking about the East European countries—have made really major efforts to move toward democratic market-based societies.

Third, regions of both the Soviet Union and Yugoslavia are seeking to bring economic ties with the West in conjunction with their goal of political independence. What should the response of the G–7 be to this request?

Last summer's Economic Summit in Houston called for a successful conclusion to the Uruguay Round of trade talks, that, in effect, papered over crucial differences in agricultural trade policy. Those talks broke down in December. The Congress recently extended the deadline for completion by two years. Should the Summit lay a more effective groundwork for trade negotiations?

In addition, there are growing concerns in the environmental area about such issues as global warming and the ozone layer. A major international conference on environmental issues will be held in Brazil next year. What should the Summit do to lay the groundwork for this meeting?

We are very pleased to have our three panelists with us this morning. Both Anthony Solomon and Richard Cooper have, in fact, helped prepare for economic summits in the past. Mr. Solomon is currently at the Institute for East-West Securities Studies. And Mr. Cooper is currently professor of international economics at Harvard University. Allan Meltzer, our third panelist, is presently a visiting scholar at the American Enterprise Institute.

Gentlemen, we are very pleased to have you here before the Committee today. Before I turn to you for your statements, I will yield to Congressman Armey, who is the ranking Republican Member of the Committee for any statement he may have, and then to Congressman Obey, who is with us this morning as well. Dick, please proceed.

Representative ARMEY. Thank you, Mr. Chairman. First of all, let me express my appreciation to you for having this hearing. It is a very important subject, and certainly one where I am looking forward to gaining some instruction.

I would like to read just the first paragraph of my opening statement, and then put the rest in the record so that we can get on with our panelists.

I want to welcome Mr. Solomon, and Professors Meltzer and Cooper this morning. A group of seven nations is meeting at a time when great promise meets reality. And it is the time when all nations have an immense interest in strengthening the world monetary system, as well as our world trading system. This strengthening, along with peace in the world, will provide the best possible environment for the development of a market-based economy by the people of the Soviet Union. We should do what we can to hasten the development of these markets in both Eastern Europe and the Soviet Union.

Today, we will hear different views on what effect we might have on this goal as a result of aid to the Soviet Government. Some of us have a concern that generously financing a government that has stifled free enterprise does may not speed the advent of markets.

I look forward to the discussion and ask to put the remainder of my remarks in the record.

[The written opening statement of Representative Armey follows:]

WRITTEN OPENING STATEMENT OF REPRESENTATIVE ARMEY

I want to welcome Mr. Solomon and Professors Meltzer and Cooper this morning. The Group of Seven nations is meeting at a time when great promise meets reality, and it is a time when all nations have an immense interest in strengthening the world monetary system as well as our world trading system. This strengthening, along with peace in the world, would provide the best possible environment for the development of a market-based economy by the people of the Soviet Union. We should do what we can to hasten the development of these markets in Eastern Europe and the Soviet Union. Today, we will hear different views on what effect we might have on this goal as a result of aid to the Soviet government rather than the Soviet market economy. Some of us have a concern that generously financing a government that stifled free-enterprise may not speed the advent of markets. I look forward to the discussion today.

The attendance of Soviet President Gorbachev at the G7 Summit will assure that the difficulties of the Soviet Union in the monetary area and their need for a tax and legal system that supports their efforts to enter the mainstream of the world trading system will be a focus of world attention. The problems of the Soviet monetary system in relation to the stress points in the international monetary system are an area of expertise for our three panelists. I would also like to hear some discussion of the tax and private property legal institutions that are necessary for a market-based economy to flourish. Additionally, the talks will rightfully focus on arms control and the future of the world trading system in a world order moving toward a much larger world market.

Many of the monetary issues were discussed when the central bank governors for the Group of Seven met on June 23 in London. With the move to lower interest rates by the Japanese, one of the most contentious issues of monetary policy will receive less focus during the G7 talks.

This opens the possibility for the G7 members to consider issues in the area of trade and commercial relations, for both among the G7 and the G7's trade with the USSR and Eastern Europe. Obstacles to the conclusion of the Uruguay Round of the GATT, and particularly the sticking points on agricultural trade, remain the most serious issues facing the economic future of the nations of the G7 and all nations in the world.

Additionally, the G7 Summit may focus on the "Harvard Plan" of Grigory Yavlinsky to assist the change by the USSR to a private-property free-market system. This plan is to be presented to the G7 leaders at the request of President Gorbachev and is in contrast to the "anti-crisis" plan of the Soviet prime minister, Valentin Pavlov. Although the two plans are alleged to be incompatible, both plans effect price liberalization, the right of Soviet companies to buy U.S. dollars, and eventual convertibility of the ruble. Both plans set up an independent private bank and seek to open the Soviet economy to private investment. Our panel today can help us to handle the economic intricacies of the Pavlov and Yavlinsky-Harvard reform plans for the Soviet Union. I am here to remind us that sometimes the way we can help most is by getting out of the way.

The dollar has continued to strengthen, despite the higher rates abroad. The recent decision by the Japanese to lower interest rates will reduce the importance of this issue for partisan political purposes.

The question that looms large in regards to the USSR (and to a much lesser extent, Germany) is: who is going to pay for the slow transition to a market economy? The USSR clearly wants the G7 nations to bear these costs. The Germans clearly want help for eastern Germany from the rest of the EC, and perhaps in the future, from the U.S. and Japan.

The Soviet Union appears to want to draw upon capital through such means as the IMF and World Bank as well as ask for special, direct assistance from the G7 nations. Soviet needs will remain the overwhelming concern in the world outlook. **This might be a time to sound the theme that American interests must have a central role in U.S. policies toward the Soviets. Also important is the need to provide some support to the Administration's position on concluding the Uruguay Round of the GATT and its "Enterprise for the Americas" program that is a logical extension of our improved commercial relations with Mexico and Canada.**

The assurance of the future of the world trading system can only be accomplished with a successful conclusion of the Uruguay Round. The Soviets need to foster an economy that can compete in the international trading system and attract international capital by meeting world market standards.

I find it interesting that Professors Meltzer and Cooper express in their testimony concern that massive aid might actually retard the development of markets in the USSR. Additionally, Professor Cooper, in his testimony, states that the United States "is beginning to recover from a mild recession."

Senator SARBANES. Thank you very much. Congressman Obey, please proceed.

Representative OBEY. No statement, Mr. Chairman. I would rather hear the witnesses' statements.

Senator SARBANES. OK, Mr. Solomon, why don't we start with you and move straight across the panel to Mr. Cooper and then to Mr. Meltzer.

STATEMENT OF ANTHONY SOLOMON, CHAIRMAN, ECONOMICS PROGRAM, INSTITUTE FOR EAST-WEST SECURITY STUDIES

Mr. SOLOMON. Thank you for inviting me testify today on the Summit meetings, both in general and in regard to next week's 1991 Summit in London.

The annual economic Summit meetings of the heads of government of the leading countries are dealing increasingly with political rather than economic issues. This trend should not be resisted, but a longer term core agenda of both political and economic issues for Summit meetings should be systematized; which will be supplemented by ad hoc problems, such as the question of Western assistance to the Soviet Union at this year's London Summit.

The trend to more political matters has two main reasons: Most heads of government are more comfortable discussing political issues, and the main agenda items of coordinating macroeconomic policies has been delegated to the G–7 Ministers of Finance, assisted by their deputies and central bank Governors. My major criticism of the way this has been handled historically and currently, at both the Summit and the ministerial levels, has been the off again-on again interest in coordinating macro policies.

The United States has been the most inconsistent, swinging from the negotiated conclusions of many, although not all, of the Summit meetings in the 1970s to an attitude of complete indifference during the early years of the Reagan administration.

A second criticism is that the International Monetary Fund's (IMF) role is limited to a sort of secretariat supplying analytical input. But it should play a generally larger role in the G–7 meetings and discussions. For example, the IMF is actually excluded from the G–7 meetings on exchange rate management.

Third, since the agreed G–7 deputies' meetings prepare the groundwork and basically determine the success of the ministers' meetings, the absence of central bank representatives in the deputies' meetings is a disadvantage.

This year's London Summit will be able to achieve very little in regard to coordination of macroeconomic policies because Germany, under increasing inflationary pressure, continues to resist U.S. Treasury efforts to persuade her to ease monetary policy and lower interest rates. In the past, I have been critical of German monetary policy in the past. But I believe Germany today has no reasonable alternative, given their current unification problems and since the government will not undertake further tightening of fiscal policy. Furthermore, in easing monetary policy at this time would likely result in a counterproductive and a further decline of the Deutsch-mark against the dollar—already 25 percent since February.

The Japanese will probably have a little more room in the months ahead to ease monetary policy, but they could not reasonably make a clear and certain commitment at the London Summit since their economy may turn out to need some continued monetary restraint.

However, I believe it would be feasible to agree at the London Summit to very substantial concerted central bank intervention as necessary to check further dollar strengthening damaging our trading position. Our economy needs more than ever the stimulus of strengthening our net exports. Concerted central bank intervention in support of exchange rate management has gone through curious lackadaisical periods of inactivity that have confused markets and added to unhelpful exchange rate movements.

Senator SARBANES. Mr. Solomon, I think if you would pull the microphone a little closer to you and speak right into it, it would be helpful.

Mr. SOLOMON. I turn now to the increasingly urgent need for international coordination of a "micro" problem; that is, supervision and regulation of securities markets, brokers and dealers, and investment banks. The London Summit, or at least next year's Summit, should take a clear initiative and be the catalyst for governments to strengthen and harmonize internationally their supervision under the sponsorship of central banks as the lead regulators, but with the participation of securities supervisors. The Basle Central Bank Committee has done a commendable job of international coordination of the supervision of commercial banks. A similar international coordination of supervision of nonbank financial institutions and global and financial markets in which they are the chief participants is urgently required. Clearance and settlement arrangements form part of the "plumbing" of financial markets and any breakdown can have serious consequences for the stability and efficiency of the system.

Also, during severe market disruptions, credit risks and liquidity problems spread rapidly. If the players—the nonbank financial institutions—are subject to consolidated supervision, and if central banks have access to full information on them, then there is a strong case for the central banks to broaden their activities and act as lenders of the last resort to investment banks and brokerage houses. The quantum leap during the 1980s in international capital mobility could create severe contingency problems, and prudent public authority should establish the necessary arrangements to contain them.

International trade is always on the core economic agenda of the Summit. But since we are at a make- or breakpoint in the Uruguay Round, this year's Summit should give clearer guidance to the negotiators and the usual rhetoric. The key would be general, but meaningful, language from France and Germany, displaying a political willingness to move toward more direct supplements to farmer income and less agricultural product price supports. The United States and Japan could also respond generally but concurrently in the agricultural and nonagricultural sectors.

Positive congressional action on the fast track of Uruguay and Mexican trade negotiations has won us some enhanced credibility, which can be built on at the London Summit.

An ad hoc agenda item this year, but will probably become a core agenda item for the next few years, is the problem and challenge of continuing Western assistance to Central and Eastern Europe. The heads of government and others in Poland, Hungary, and Czechoslovakia have expressed fears that assistance to the Soviet Union will cut into the assistance they hope to get from the West. Although the Summiteers will undoubtedly express appropriate reassurance on this point, those reassurances would be meaningful to the Central-East Europeans only if Western assistance to the Soviet Union could be channeled so as to help finance their exports to the Soviet Union.

The main economic problem of these countries is export trade. First, their intraregional trade, especially with the Soviets, is collapsing—more than a 50 percent decline so far and still falling. Second, they know that fuller market access for the European community will be more important to the successful reform of their economies than Western financial assistance.

They feel frustrated in both respects. On the first problem, collapsing intraregional trade, the London Summiteers might very well ask their ministers to look into the problem created by the fact that Western export credit to the Soviet Union and Eastern European countries are actually adding to the collapse of intraregional trade, since none of these countries have the resources to extend competitive credits on their exports to each other. If an even playing field for the exports of newly reforming East European countries is considered essential, then consideration might be given to a multilateral institution—such as the newly formed EBRD, which guarantees, with limits, the operations of the new national export credit institutions those countries have to set up. In addition, in my opinion, Poland, Hungary, and Czechoslovakia have to be encouraged to form a free trade area among themselves. And they should be reassured by the European Community that this, in itself, would not slow up any one of them from ultimately joining the European Community. A three-country free trade area would create a larger market to stimulate local and foreign investment.

On the second problem, greater access to the markets of the European Community—the importance of this cannot be sufficiently emphasized. Integration as Europeans—economically and in all the other ways—is the essential objective and ultimate lifesaver. The United States should bring to bear its admittedly limited influence on this question in the most effective way it can. Under the best conditions, these Central- East European economies will continue to decline for some time. And will almost certainly not begin meaningful positive growth until the middle of the decade.

In regard to the current Western financial assistance to Central and East European countries, their effectiveness is not what it should be. The diverse direction and condition of aid-flows require better coordination. Although the European Community is doing a good job on its own program encompassed under the title, PHARE, the Commission is not structured to coordinate effectively the G-24 Western countries' assistance. The World Bank, however, has the experience and structure to take this on; both in regard to technical, financial and project assistance, if the Summiteers were to so decide.

Finally, the question of the G–7 reply to Mr. Gorbachev's request at London for Western cooperation, including assistance. My work in the Soviet Union and in the region generally convinces me that the "grand bargain" being talked about at the time of writing this statement is not practical for many reasons. Perhaps, the most important reason being you cannot extend massive aid without meaningful economic IMF-type conditions that the Soviet leadership is presently and clearly incapable of fulfilling, and the consequent failure to disburse the promised money will unquestionably anger the Soviet people. They will consider the promise a Western trick, and it will play into the hands of those opposed to reform.

We constantly have to bear in mind that reform in the Soviet economy will be a tortuous and very long process, and we must be supportive in ways we can sustain over the very long run, notwithstanding twists and turns in the semi-chaotic developments that will characterize the changing republic-center struggles. It is not a lack of imagination, boldness, or good will to be critical of the so-called "grand bargain." It is to the contrary since certain things are predictable in the face of very unlikely assumptions that our aid can make the difference.

What Western assistance is sustainable and supportive over the long run? First, clearly technical assistance if reasonably focused and coordinated and not perceived by the Soviets as mutually contradictory—Gorbachev's frequent complaint. Second, humanitarian assistance in commonsensical ways. Third, Secretary Baker's singling out the oil and gas sector where Western oil company expertise, combined with Western public and private-sector investment, can produce practical results useful to the Soviets and to the world. I doubt, however, that Secretary Baker's other proposal to assist food production and distribution can work as well, since it is a less focused set of problems than the petroleum sector. And fourth and most controversial, I would recommend that, as time goes by, increasing project and program assistance of those republics that show growing capability to implement economic reform and that show sufficient movement to a market economy for economic resource allocation to work. We should not duck the fact that some republics will move faster than others and be better able to absorb larger project and program financial assistance. Some of the Western technical and humanitarian assistance can appropriately go through the Center or Federation Government. And there may even be, depending on the division of economic powers between the Center Government and republics that ultimately emerges, some specific project assistance through the Center Government that will make sense. But all this is still a long way off.

Outside the field of Western assistance to the Soviet Union, there are opportunities for broader cooperation between the West and the Soviets in trade, in combating environmental pollution, and in terrorism. Such two-way cooperation will be well received by the Soviet people, who are sensitive and ambivalent about Western assistance.

In general, the heads of the Summit Governments should make a greater effort to give leadership and broad guidance to their ministers and negotiators on various fronts. It should become routine that, aside from the permanent presence during the Summit meeting of foreign affairs and finance ministers, other authorities be called in for those agenda items under their competence—trade negotiators during the trade discussion; environmental and health ministers during those discussions; etc. And at succeeding Summit meetings, the heads of governments should review the progress made, or not made, since preceding Summits.

Thank you.

[The prepared statement of Mr. Solomon follows:]

PREPARED STATEMENT OF ANTHONY M. SOLOMON

Thank you for inviting me to testify today on the Summit meetings both in general and in regard to next week's 1991 Summit in London.

The annual economic Summit meetings of the heads of government of the leading countries are dealing increasingly with political rather than economic issues. This trend should not be resisted but a longer term core agenda of both political and economic issues for Summit meetings should be systematized - which will be supplemented by ad hoc problems, such as the question of Western assistance to the Soviet Union at this year's London Summit.

The trend to more political matters has two main reasons: most heads of government are more comfortable discussing political issues, and the main agenda item of coordinating macroeconomic policies has been delegated to the G-7 Ministers of Finance assisted by their deputies and Central Bank Governors. My major criticism of the way this has been handled historically and currently, at both the Summit and the Ministerial levels, has been the off again - on again interest in coordinating macro policies. The U.S. has been the most inconsistent - swinging from the negotiated conclusions of many (although not all) of the Summit meetings in the 1970's to an attitude of complete indifference during the early years of the Reagan administration. A second criticism is that the International Monetary Fund's role is limited to a sort of secretariat supplying analytical input and should play a generally larger role in the G-7 meetings and discussions - e.g. the IMF is actually excluded from the G-7 meetings on exchange rate management. Thirdly, since the agreed G-7 deputies meetings prepare the ground and basically determine the success or not of the Ministers meetings, the absence of central bank representatives in the deputies meetings is a disadvantage.

This year's London Summit will be able to achieve very little in regard to coordination of macroeconomic policies because Germany, under increasing inflationary pressure, continues to resist U.S. Treasury efforts to persuade her to ease monetary policy and lower interest rates. At times I have been critical of German monetary policy in the past but I believe Germany has no reasonable alternative given their current unification problems and since the government will not undertake a further tightening of fiscal policy. Furthermore, an easing of monetary policy at this time would likely result in a counter-productive further decline of the D-mark against the dollar (already 25% since February). The Japanese will probably have a little more room in the months ahead to ease monetary policy but could not reasonably make a clear and certain commitment at London since their economy may turn out to need some continued monetary restraint.

However, it would be feasible to agree at London to very substantial concerted central bank intervention to check further dollar strengthening, damaging our trading position. Our economy needs more than ever the stimulus of strengthening our net exports.

Concerted central bank intervention in support of exchange rate management has gone through curious lackadaisical periods of inactivity that have confused markets and added to unhelpful exchange rate movements.

I turn now to the increasingly urgent need for international coordination of a "micro" problem - i.e. supervision and regulation of securities markets, brokers and dealers, and investment banks. The London Summit - or at least next year's Summit - should take a clear initiative and be the catalyst for governments to strengthen and harmonize internationally their supervision under the sponsorship of central banks as the lead regulators but with the participation of securities supervisors. The Basle Central bank committee has done a commendable job of international coordination of supervision of commercial banks and a similar international coordination of supervision of non-bank financial institutions and global financial markets in which they are the chief participants is urgently required. "Clearance and settlement arrangements form part of the 'plumbing' of financial markets and any breakdown can have serious consequences for the stability and efficiency of the system."[1] Also, during severe market disruptions, credit risks and liquidity problems spread rapidly. If the players - the non-bank financial institutions - are subject to consolidated supervision and if central banks have access to full information on them, than there is a strong case for the central banks to broaden their activities and act a lender of last resort to investment banks and brokerage houses. The quantum leap during the eighties in international capital mobility could create severe contingency problems and prudent public authorities should establish the necessary arrangements to contain them.

International trade is always on the core economic agenda of the Summit but since we are at a make-or-break point in the Uruguay Round this year's Summit should give clearer guidance to the negotiators than the usual rhetoric. The key would be general but meaningful language from France and Germany displaying a political willingness to move toward more direct supplements to farmer income and less agricultural product price supports. The U.S. and Japan could respond generally but concretely also, in the agricultural and non-agricultural sectors. Positive Congressional action on the "fast track" Uruguay and Mexican trade negotiations has won us some enhanced credibility - which can be built on at the London Summit.

An ad hoc agenda item this year (that will probably become a core agenda item for the next few years) is the problem and challenge of continuing Western assistance to Central and Eastern Europe. The heads of government and others in Poland, Hungary, and Czechoslovakia have expressed fears that assistance to the Soviet Union will cut into the assistance they hope to get from the West. Although the Summiteers will undoubtedly express appropriate reassurances on this point, those reassurances would be meaningful to the Central/East Europeans only if Western assistance to the Soviet Union would be channeled so as to help finance _their_ exports

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[1] Report of the 20th Century Fund on the International Coordination of National Economic Policies, May 1991

to the Soviet Union. The main economic problem of these countries is export trade - first, their intra-regional trade, especially with the Soviets, is collapsing - more than a 50% decline so far and still falling; second, they know that fuller market access for their exports to the European Community will be more important to the successful reform of their economies than Western financial assistance. They feel frustrated in both respects.

On the first - collapsing intra-regional trade - the London Summiteers might very well ask their ministers to look into the problem created by the fact that Western export credits to the Soviet Union and to Eastern European countries are adding to the collapse of intra-regional trade since none of these countries have the resources to extend competitive credits on their exports to each other. If an "even playing field" for the exports of newly reforming East European countries is considered essential, then consideration might be given to a multilateral institution (such as the newly formed EBRD) guaranteeing, within limits, the operations of the new national export credit institutions those countries have to set up.

In addition, Poland, Hungary and Czechoslovakia have to be encouraged to form a free trade area among themselves and they should be reassured by the European Community that this, in itself, would not slow up anyone of them ultimately joining the European Community. A three-country free trade area would create a larger market to stimulate local and foreign investment.

On the second problem - greater access to the markets of the European Community - the importance of this cannot be sufficiently emphasized. Integration as Europeans, economically and in all the other ways is their essential objective and ultimate life saver. The U.S. should bring to bear its admittedly limited influence on this question in the most effective way it can. Under the best conditions, these Central/East European economies will continue to decline for sometime and will almost certainly not begin positive growth until the middle of the decade.

In regard to the current Western financial assistance to Central and East European countries, their effectiveness is not what it should be. The diverse directions and conditions of aid flows require better coordination; although the European Community is doing a good job on its own program encompassed under the "Phare" program, the Commission is not structured to coordinate effectively the G-24 Western countries' assistance. The World Bank has the experience and structure to take this on both in regard to technical, financial and project assistance, if the Summiteers were to so decide.

Finally, the question of the G-7 reply to Mr. Gorbachev's request at London for Western "cooperation" (including assistance). My work in the Soviet Union and in the region generally convinces me that the "Grand Bargain" being talked about at the time of writing this statement is not practical for many reasons, perhaps the most important being you cannot extend massive aid without meaningful economic IMF-type conditions that the Soviet leadership is presently clearly incapable of fulfilling the conditions - and that the consequent failure to disburse the promised money will unquestionably anger the Soviet people. They will consider the promise a Western "trick" and it will play into the hands of those opposed to reform.

We have to bear in mind constantly that reform in the Soviet economy will be a tortuous and very long process - and that we must be supportive in ways we can sustain over the very long run notwithstanding twists and turns in the semi-chaotic developments that will characterize the changing republic-center struggles. It is not a lack of imagination, boldness, or "good will" to be critical of the so-called "Grand Bargain" - it is the contrary since certain things are predictable in the face of very unlikely assumptions that our aid can "make the difference."

What Western assistance is sustainable and supportive over the long run? Clearly technical assistance if reasonably focused and coordinated - and not perceived by the Soviets as "mutually contradictory" (Gorbachev's frequent complaint). Secondly, humanitarian assistance in common sensical ways. Thirdly, Secretary Baker's singling out the oil and gas sector where Western oil company expertise combined with Western public and private sector investment can produce practical results useful to the Soviets and to the world. I doubt that Secretary Baker's other proposal to assist food production and distribution can work as well since it is a less focused set of problems than the petroleum sector. Fourthly - and most controversial - I would recommend as time goes by, increasing project and program assistance to those republics that show growing capability to implement economic reform and sufficient movement to a sufficiently market economy for economic resource allocation to work. We should not duck the fact that some republics will move faster than others and be better able to absorb larger project and program financial assistance. Some of the Western technical and humanitarian assistance can appropriately go through the Center or Federation government - there may even be (depending on the division of economic powers between the center and republics that ultimately emerges) some specific project assistance that will make sense.

Outside the field of Western assistance to the Soviet Union there are opportunities for broader cooperation between the West and the Soviets in trade, in combating environmental pollution and terrorism. Such two-way cooperation will be well received by the Soviet people who are sensitive and ambivalent about Western assistance.

In general, the heads of the Summit governments should make a greater effort to give leadership and broad guidance to their minister and negotiators on various fronts. It should become routine that aside from the permanent presence during the Summit meeting of foreign affairs and finance ministers that other authorities be called in for those agenda items under their competence - trade negotiators during the trade discussion, environmental and health ministers during those discussions, etc. And at succeeding Summit meetings, the heads of government should review the progress made, or not made, since preceding summits.

Senator SARBANES. Thank you very much, Mr. Solomon. Mr. Cooper, please proceed.

STATEMENT OF RICHARD N. COOPER, BOAS PROFESSOR OF INTERNATIONAL ECONOMICS AFFAIRS, AND EXECUTIVE DIRECTOR, CENTER FOR INTERNATIONAL AFFAIRS, HARVARD UNIVERSITY; CHAIRMAN, BOSTON FEDERAL RESERVE BANK

Mr. COOPER. Thank you very much, Mr. Chairman. I appreciate the opportunity to testify before the Joint Economic Committee on this important topic.

I have a statement longer than any of you want me to read. And with your permission, Mr. Chairman, I will just submit it for the record and draw on it selectively.

Senator SARBANES. Your prepared statement will be included in the record.

Mr. COOPER. Starting in the 1970s, five topic headings became standard for economic summits: macroeconomic management among the major countries participating; international monetary arrangements, especially as they bear on exchange rate management; preserving a liberal international trading system; coordinating energy policy; and economic relations between rich and developing countries.

As Anthony Solomon has said, the agenda of the Summits has broadened over time; partly because of the exigencies of particular issues, such as air hijacking; and partly because these political leaders are actually more comfortable talking about political rather than economic issues. But the five topics still remain the core of the annual Summit meetings. It is useful to reflect on what might be done under these headings today.

Without going through them one by one, my conclusion is that in the circumstances of 1991, there is not much to be done at the present time under four of the five headings. At the present time, I don't see a dramatic scope for agreements under the heading of macroeconomic management, exchange rate management, coordination of energy policies, or relations with developing countries. Not that these are not important issues, but the circumstances are not right at the moment for new initiatives under any of them.

The major exception is the trading area, where we still have the Uruguay Round hanging. It was, as you, Mr. Chairman, reminded us, given a rhetorical push forward at the Houston Summit; but then it ran into serious snags at the Ministerial Meeting less than 6 months later.

The key here is the willingness of the European Community to change the trajectory of its agricultural policy, on the one hand; and the willingness of the United States and other agricultural exporters to show somewhat more flexibility in responding to a genuine proposal by the

European Community, on the other hand. To the extent that the heads of government can give a push to removing that key roadblock, it would be all to the good.

There are, however, at least two issues that are not part of the standard agenda, which, I think, will be discussed at the London Summit and probably at several subsequent Summits. Tony Solomon has already discussed the question of aid to the Soviet Union. I will also address that. The other issue is global environmental concerns, especially in view of the fact that a large U.N. conference on the environment and development will be held in 1992; and the European countries have taken a politically aggressive lead with respect to some aspects of the global environment.

So let me say a little bit about each of those topics. President Gorbachev will meet with London Summiteers not at the Summit proper but with the same group. No doubt he will indicate some of his plans for both political and economic reform in the Soviet Union. He will also be trying to get some sense of how much financial support might be available to the Soviet Union from the Summit countries.

What happens in the Soviet Union is of the utmost importance for the world and especially for Europe. But in contrast to most Eastern European countries, there is as yet no consensus within the Soviet Union on where they want to end up. Vigorous and even vicious debate is still taking place over fundamental objectives, not merely over practical details of implementation. Western countries cannot determine the outcome of this debate. But insofar as we can influence it, we should try to be as helpful as possible to the reformers—those who desire democratization of the country and, since they are closely related, those who wish to move to a market economy with widespread private economic activity.

As far as I can tell, President Gorbachev, himself, is undecided on how far the reforms should go in spite of the fact that he has played a critical role in sustaining the reforms that have already occurred. Partly because of this ambivalence at the top, large unconditional assistance from the West would lead to procrastination in undertaking fundamental economic reform and should not be given.

On the other hand, assistance conditioned on fundamental reforms in the Soviet system of government and economic management runs the risk of provoking a nationalistic backlash, which the Soviet conservatives—that is, hardline communists who we use to call radicals—are already trying to provoke and exploit. So we face a tactical dilemma even if, in principle, we were willing to help substantially. Because of this dilemma, any proposals for serious reform must, in my view, come from the Soviets themselves. They cannot be imposed or cajoled by the West. If the Soviets do come forward with fundamental reforms, which Prime Minister Pavlov's Government has so far resisted, the West should be willing to respond positively in those instances where technical or financial resources can be especially helpful, or where they involve clear gains for the West.

I will identify three such areas, although they are not meant to be exclusive. First, if the Soviet Union were to undertake a massive conversion of its defense industry to nondefense production, the West should be prepared to help the process, providing both engineering and financial assistance in the form of exports. This would contribute not only to increasing the standard of living of the average Soviet citizen—a soviet objective—but would also reduce greatly the capacity of the Soviet Union to wage war without providing the West with substantial warning time in the form of rebuilding its defense industry. Since it would enhance our security directly, such assistance could legitimately come out of savings in our defense budget and in other Western countries.

Second, if the Soviet Union were to move to a convertible currency with all of the economic changes that would entail—a reformed price system and autonomous enterprises without subsidy operating to maximize financial return—then the West might consider helping to establish a stabilization fund as it did for Poland. Such a fund would bolster market confidence that convertibility of the currency, with the appropriate supporting conditions, could be held. At best, the stabilization fund would not actually be used. At worst, it would be drawn down by doubters. But if the supporting conditions were in fact appropriate, convertibility would hold and the fund could be reconstituted over time.

Third, technical and financial assistance, largely from our private sector, could be extended to the Soviet oil and gas industry; with a view to improving productivity of the fields and reducing waste in transport to market. The interest here of the West lies in diversifying sources of oil away from the still politically turbulent Middle East, an area of the world on which, during the coming years, we will become much more dependent, on the basis of current projections of world oil demand and supply.

In summary, Western leaders should listen attentively to what the Soviets propose and should offer encouragement if they like what they hear. But they should be wary about making financial commitments, except under careful conditions, that are clearly in the interests of the industrialized democracies.

A longer term issue that is likely to be raised by Europeans at the Summit concerns global climate change, which is one of several issues on the agenda of the 1992 UNCED. A number of European countries have already adopted emission targets for CO2 and other greenhouse gases. And they are likely in the future to press the United States and the Soviet Union to do the same.

Americans are properly cautious about embracing bold programs that involve heavy intrusion into the functioning of an economic and social system that relies predominantly on private initiatives—one that, on the whole, has been highly successful. Obviously, the prospect of environmental calamity will induce actions that would not otherwise be taken. But a cool assessment of the prospects of global change suggest that calamity is not likely within the next century and, therefore, that drastic and costly action is not warranted at present. However, our ignorance of the processes involved in climate change is vast, and certain remote possibilities could indeed be calamitous. An appropriate course of action, therefore, would involve three elements that all collaborate with other rich countries and with encouragement and help to the poor countries. First, we should launch a strong and comprehensive research program to reduce substantially our ignorance about the sources and nature of climate change. In particular, this would involve major programs on deep-ocean currents, on cloud formation, and on the destination of carbon emissions—over 40 percent of which we cannot account for. Expanded work on the global climate models is also desirable, especially to discover possible unpleasant surprise scenarios.

Second, we should launch a major program involving low-cost reduction in greenhouse gas emissions, on the grounds that there are ample other reasons to undertake most of the actions involved. Cutting back on CFCs, which is already agreed to preserve the ozone, will also mitigate greenhouse warming. Energy conservation would enhance energy security, reduce conventional pollutants, and so on. So we should take these so-called no-regret actions that would, in addition, have the benefit of attenuating such global warming as is going to occur.

Third, we should develop a program to enlarge the options for future generations if it turns out that greenhouse warming is as serious as some analysts contend. This would have several diverse components. First, developed countries should examine systematically the requirements of adaptation to climate change and position themselves to make it as smoothly as possible; for example, by enlarging seed banks and planning ecological migration corridors. They should also contribute to easier adaptation by poor countries by continuing to foster the economic development of those countries, since wealthy countries in most respects find it easier than poor ones to make necessary adaptations. Furthermore, development assistance now could be oriented more toward reducing the growth in future requirements for energy, insofar as this can be done without compromising the more important objective of achieving self-sustaining growth in these countries.

Finally, initial inspection suggests that several techniques of geoengineering might be effective and not too costly to offset the warming effects of higher greenhouse gas concentrations, should that become necessary. One approach would absorb carbon from the atmosphere, largely by encouraging plant growth in large parts of the oceans that are currently barren because of inadequate mineral nutrients, especially iron.

A second approach would reduce the incidence of sunlight on the surface of the earth by propelling particles of dust into the upper atmosphere. Space mirrors have sometimes been mentioned, but, on at least rough inspection, they appear not to be cost effective.

These and other promising lines of approach should be explored further; both to test their feasibility and cost effectiveness and to ascertain any undesirable side effects that they might have, with a view to providing possible sources of mitigation if, in the future, that should prove to be necessary—that is, if current best guesses about future climate warming prove to be too low.

In conclusion, the United States should be prepared at the Summit, since this issue is likely to be pressed by other countries, to propose a constructive agenda along the lines I've suggested rather than taking the position that nothing at all needs to be done at the present time.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Cooper follows:]

PREPARED STATEMENT OF RICHARD N. COOPER

Summit meetings of the heads of state or government of the leading industrialized democracies have been an annual event since 1975, when the chief executives of Britain, France, Germany, Japan, and the United States first met in Rambouillet at the invitation of French President Valery Giscard d'Estaing. The immediate issue was the world recession of 1975, along with exchange rate arrangements, and for a number of years the focus of the summits was management of the world economy. The executive leaders of Canada, Italy, and the European Community joined the group subsequently.

As a matter of custom, five topic headings became standard: macro-economic management (i.e. coordination of fiscal and monetary policy); international monetary arrangements, especially as they bear on exchange rate management; preserving a liberal international trading system; coordinating energy policy; and economic relations with developing countries. Over time, however, these political leaders understandably took up more political topics, starting with air hijacking and other forms of terrorism, including non-proliferation of nuclear weapons, how to pressure the Soviet Union out of Afghanistan, and a host of other issues.

The annual summits provide an occasion for the politically responsible leaders of the world's major industrialized nations to meet together periodically to share perceptions and perspectives on common problems that all their nations face. If they can from time to time agree on common or coordinated courses of action to deal with those common problems, that is all to the good. But the meetings themselves have value independently of any agreements that might be reached, and it would be a mistake for the public to come to expect, and therefore for the leaders to feel obliged to produce, important new decisions at every summit.

In July 1991 the United States is beginning to recover from a mild recession; Britain and Canada remain in recession; France and Italy are struggling to avoid recession; and Germany and Japan enjoy vigorous economic activity. Inflation seems well under control. World imbalances are declining, especially the large US trade deficit in goods and services and the large German and Japanese trade surpluses. There is little to discuss under the heading of macro-economic management, beyond the importance of keeping the recovery going. There is no consensus on reform of the international monetary system, either among academics or in the policy community. The important action here is in Europe, concerning the creation of a European Monetary Union.

The field of energy is momentarily quiescent, following the anxieties of 1990, and the prospects are for ample oil supplies for the next several years. So once again the pressure for aggressive actions to reduce dependence on Middle East oil is off; but they will return to haunt us later, as dependence for energy on a politically unstable area of the world continues to grow during the 1990s.

The main item under trade is completion of the Uruguay Round, and here in turn the key problem is whether the European Community can make a meaningful commitment to reduce production and export subsidies to agriculture, and whether the United States and other grain exporters are willing to reduce their Uruguay

Round objectives to accept it and to respond with reductions in their own farm support policies. The main long run problems for the world trading system are the tendency of the United States to define "unfair" trade practices unilaterally, usually not even considering whether the same standard could be applied to the United States; and and the tendency of the United States and the European Community to protect industries in decline for periods much longer than the natural turnover of the labor force would require.

Under the heading of North-South economic relations there is also little to discuss. Trade policy is under negotiation in the Uruguay Round. Debt relief is proceeding on a case-by-case basis. The US aid budget is hostage to the overall budget agreement and to Israel, thus greatly weakening any room for maneuver by the United States. And US population policy is hostage to an emotional debate in the United States which will have the consequence of leaving the world population by the middle of the next century several hundred million persons higher and more poorly educated and poorer than it need be, and than anyone wants, unless other rich countries make up for lack of US leadership and finance under this heading.

In mid-1991 many of these issues in any case would be crowded out by the explosive situation in Yugoslavia, which the leaders will surely want to discuss; by the gradual collapse of the economy and perhaps the political structure of the Soviet Union, something that in the abstract would be widely welcomed by many in the West, but that in reality poses a complex set of alternatives, many of which are not agreeable; and by the scheduling for 1992 of the United Nations Conference on the Environment and Development (UNCED), combined with growing consciousness in all rich countries of global environmental degradation. I will touch briefly on the latter two issues.

President Gorbachev will meet with the London summiteers and no doubt will indicate something of his plans for political and economic reform in the Soviet Union. He will try to get some sense of how much financial support might be available from the rich countries. What happens there is of the utmost importance for the world and especially for Europe. But in contrast to most eastern European countries there is as yet no consensus within the Soviet Union on where they want to end up. Vigorous and even vicious debate is still taking place over fundamental objectives, not merely over practical details of implementation. Western countries cannot determine the outcome. But insofar as we can influence it, we should try to be as helpful as possible to the reformers -- those who desire democratization of the country, and, since they are closely related, those who wish to move to a market economy with widespread private economic activity.

As far as I can tell, President Gorbachev himself is undecided on how far the reforms should go, in spite of the fact that he has played a critical role in sustaining the reforms that have already occurred. Partly because of this ambivalence at the top, large unconditional assistance from the West will lead to procrastination in undertaking fundamental economic reforms, and should not be given. On the other hand, assistance conditioned on fundamental reforms in the Soviet system of government and economic management runs the risk of provoking a nationalistic backlash, which the Soviet "conservatives" (i.e. hard-line communists) are already trying to provoke and exploit. So we face a tactical dilemma, even if in principle we were willing to help substantially.

Because of this dilemma, any proposals for serious reform must come from the Soviets themselves; they cannot be imposed or cajoled by the West. If the Soviets do come forward with fundamental reforms -- which Prime Minister Pavlov's government has so far resisted -- the West should be willing to respond positively in those instances where technical or financial resources can be especially helpful, or where it involves clear gains for the West. I would identify three such areas, although they are not meant to be exclusive. First, if the Soviet Union were to undertake a massive conversion of its defense industry to non-defense production, the West should be prepared to help the process, providing both engineering and financial assistance, in the form of export credits. This would contribute not only to increasing the standard of living of the average Soviet citizen, a Soviet objective, but would also reduce greatly the capacity of the Soviet Union to wage war without providing the West with substantial warning time in the form of rebuilding its defense industry. Such assistance could legitimately come out of savings in the defense budget of the United States and other western countries, since it would enhance our security.

Second, if the Soviet Union were to move to a convertible currency, with all the economic changes that should entail -- a reformed price system and autonomous enterprises without subsidy operating to maximize financial return -- then the West might consider helping to establish a stabilization fund, as it did for Poland. Such a fund would bolster market confidence that the convertibility of the currency, with appropriate supporting conditions, could be held. At best, the stabilization fund would not actually be used. At worst, it would be drawn down by doubters, but if the supporting conditions were in fact appropriate, convertibility would hold and the fund could be reconstituted over time.

Third, technical and financial assistance, largely private, could be extended to the Soviet oil and gas industry, with a view to improving productivity of the fields and reducing waste in transport to market. The interest of the West lies in diversifying sources of oil away from the Middle East.

In summary, western leaders should listen attentively to what the Soviets propose, and should offer encouragement if they like what they hear, but they should be wary about making financial commitments except under careful conditions that are clearly in the interests of the industrialized democracies.

A longer-term issue that is likely to be raised by Europeans at the summit concerns global climate change, one of several issues on the agenda of the 1992 UNCED. A number of European countries have already adopted CO2 emission targets, and they are likely in future to press the United States (and the Soviet Union) to do the same. Americans are cautious about embracing bold programs that involve heavy intrusion into the functioning of an economic and social system that relies predominantly on private initiatives and that on the whole has been highly successful. Obviously the prospect of environmental calamity will induce actions that would not otherwise be taken. A cool assessment of the prospects of global climate change suggest that calamity is not likely within the next century, and therefore that drastic and costly action is not warranted. However, our ignorance of the processes involved in climate change is vast, and certain remote possibilities could indeed be calamitous. An appropriate course of action, therefore, would involve three elements, all in collaboration with other rich countries and with encouragement and help to the poor countries:

1) Launch a strong and comprehensive research program to reduce substantially our ignorance about the sources and nature of climate change. In particular, this would involve major programs on deep ocean currents, on cloud formation, and on the destination of carbon emissions -- over 40 percent of the

total -- that we cannot now account for. Expanded work on the global climate models is also desirable, especially to discover possible unpleasant surprise outcomes.

2) Launch a major program toward low-cost reduction in greenhouse gas emissions, on the grounds that there are ample other reasons to undertake most of the actions involved (enhancement of energy security, reduction of conventional pollutants, preservation of ozone), and that they would attenuate such global warming as is going to occur.

3) Develop a program to enlarge options for future generations. This would have several diverse components. First, developed countries should examine systematically the requirements for adaptation to climate change, and position themselves to make it as smoothly as possible, for example through enlarging their seed banks and planning ecological migration corridors. They should also contribute to easier adaptation by developing countries by continuing to foster their economic development, since wealthy countries will find it easier than poor ones to make any necessary adaptations. Furthermore, development assistance now could be oriented more toward reducing the growth in future requirements for energy, insofar as this can be done without compromising the more important objective of achieving self-sustaining growth.

Finally, initial inspection suggests that several techniques of "geo-engineering" might be effective and not too costly to offset the warming effects of higher greenhouse gas concentrations. One approach would absorb carbon from the atmosphere, largely by encouraging plant growth in large parts of the oceans that are currently barren because of inadequate mineral nutrients, especially iron. A second approach would reduce the incidence of sunlight on the surface of the earth by propelling particles of dust into the upper atmosphere. (Space mirrors, in contrast, do not on quick inspection appear to be cost effective.) These and other promising lines of approach should be explored further, both to test their feasibility and cost effectiveness, and to ascertain any undesirable side effects that they may have, with a view to providing possible sources of mitigation if in the future that should prove to be warranted.

Recommendations along these lines, with supporting argumentation and evidence, are presented in a recent report by the National Academy of Sciences, Policy Implications of Greenhouse Warming (Evans Report), published in April.

Senator SARBANES. Thank you very much, Mr. Cooper. Mr. Meltzer, we would be happy to hear from you.

STATEMENT OF ALLAN H. MELTZER, JOHN M. OLIN UNIVERSITY PROFESSOR, CARNEGIE MELLION UNIVERSITY; AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. MELTZER. Thank you, Mr. Chairman. It's a pleasure to appear before this Committee. I'm going to depart from my written comments, which are focused on one particular topic, to answer some of the questions that you raised in your letter. I'm going to sketch responses to five topics and say a few words about global warming at the end.

First, the position of the world economy and the United States. I think we are in for a period of relatively slow growth with falling inflation. For the United States, it seems that there is a good prospect that we will have recovery and that this recovery, unlike some of our previous recoveries, will not be strongly consumption led. I think that's a relatively good thing. And we should look forward to a modest recovery with falling inflation, because a strong recovery that was consumption led would primarily be a recovery that would encourage imports of consumer durable goods from abroad and that would make our balance-of-trade problem worse again. A modest recovery with falling inflation will help us to solve two longstanding problems. One is the trade balance and the other is the overhang of inflation, from which we have suffered for more than 20 or 30 years. So, I regard the current policy in the United States as somewhat desirable in that it, I believe, will bring about a modest recovery with falling inflation.

On the second topic, I agree with my colleagues that trade is an urgent matter that comes up at the Summit; that the Uruguay Round is perhaps the most important topic on the agenda for the future development of the world economy and its sustained growth. If the next 20 years of progress in world economy is to be as good as the previous 20 years—or the previous 40 years—it must be based, in my judgment, on an expanding global trade system.

It would be helpful at the Summit if President Bush would lean hard on Chancellor Kohl and President Mitterand to accept tariffication in agriculture and to make the agricultural reforms that are so essential not only for us but, much more importantly, for other parts of the world. That way we can get an agreement on issues that are vital for us, such as intellectual property and financial and other services. And that would be important.

I repeat, the growth of the world economy and our own over the next 20 years is dependent very much on whether we are moderately successful in the Uruguay Round. That issue, in my opinion, is the most important one on which the Summit could exercise leadership.

On the third topic of coordination of policy between countries, this is subject to what, I believe, is considerable confusion. Usually, what people talk about is the coordination of actions. One country has faster money growth, the other slower. One country has more fiscal stimulus, the other less. Those actions have, I believe, largely failed. Most countries will not take actions that are against their own perceived interest in order to encourage or to help some other country. True policy coordination doesn't require such actions. What we need to do in the area of coordination is to find common objectives—medium-term strategies. Here the United States is the outlier, since Germany and Japan—the other principal currency countries—have already adopted medium-term strategies. For example, if the United States were to endorse a policy of low inflation, which is the policy of those other countries, we could achieve a great deal, both for ourselves and the world. It would be a mistake to confuse intervention with this broader set of objectives—currency intervention. What we can do by focusing on common medium-term strategies of low inflation is to provide for ourselves and for the world economy something that can only be achieved by collective agreement; namely, low inflation and greater currency stability. If currencies are not subject to changes in expected rates of inflation, they would be more stable. That decision doesn't require any coordination of action. It just requires commitment by each separate government for policies that are in their own interest and that also produce, if they're done collectively, benefits to the world.

On the fourth topic, which is, of course, the most attractive topic for discussion—the Soviet Union—my prepared statement is directed mainly at that issue. I believe, as do many others, that the critical discussions here lie in the Soviet Union. We cannot help them unless they are willing to help themselves. And if they are willing to help themselves, we should be open to the possibilities of what might be done to further their interests and ours. For them, the most important first steps are things in the nature of currency convertibility; opening of trade arrangements; privatization; establishment of a legal, financial, and accounting system; and all of those other institutional reforms that they have been slow to take.

Lending to the Soviet Union at this time would have three effects, which I believe are not in our interest. First, it would centralize the control in the hands of the current Government of the Soviet Union. What we would like to do if we're going to help the Soviet Union is to lend money to market-oriented firms once there is privatization.

Second, it would probably delay reform since the Soviet Union would then be in the position to continue to support its military and its bureaucracy rather than move decisively toward the market system.

And third, we would, since we are a debtor country, be selling assets in U.S. firms. That is, we would be selling land, buildings, assets and bonds in the United States in order to finance risky loans to the Soviet

Union. I do not believe that is in our interest. And as I said before, since it would encourage centralization and delay reform, it would not be in the interest of the Soviet Union either.

After privatization, progress can be made. Chile is an example of a country that has moved, largely through its own efforts, to privatize its assets and reform its economy. Chile is now able to sell securities in limited amounts in the international market. If the Soviet Union were to move along those lines, and in a dramatic way, we should be willing to see commercial lending to the Soviet Union in which bankers would risk their own money in the loans to the Soviet Union, perhaps with some form of guarantee. If we allow lending from government-to-government without risk to lenders, we risk the problem of another debt crisis; that is, a large piling up of debt and a waste of the money that would be lent to them.

We should also be concerned about humanitarian and technical problems and technical assistance to the Soviet Union, and we should encourage them in their reforms.

The fifth topic, Eastern Europe, is a more difficult question to discuss, because these are a mix of countries in very different positions. The great danger in many of these countries is that they have been slow to privatize, and, therefore, there is a great deal of waste of assets and sequestration of assets going on. And there is a risk of an Argentine-type inflation in many of these countries.

There are three different groups of countries, and to discuss them fully, one would need to distinguish between, for example, East Germany, where reform and help will come will come largely from West Germany. We can applaud the efforts of a second group of countries—Poland, Czechoslovakia, and Hungary—but we should be aware that privatization has moved very slowly in those countries and that many of their problems arise from that particular source. Finally, we should recognize that in countries like Romania, Bulgaria, Albania, and Yugoslavia there is not much that we can do until they move more toward democratic reforms and get their political structures in line. I'll be happy to expand my comments on that particular issue.

In conclusion, let me just say that on the environment I think the administration has it right. We should learn much more about the greenhouse problem and whether there is or will be such a problem before taking any action. I agree with Richard Cooper when he says that we should develop a strategy—we may or may not want to implement—sometime in the next century when we learn more about the costs and risks that are involved in global warming and in these other problems.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Meltzer follows:]

PREPARED STATEMENT OF ALLAN H. MELTZER

I speak today with considerable diffidence. I know little about the economy of the Soviet Union or about its monetary system. My training in economic research has taught me to be skeptical of instant experts, and I want to avoid appearing as one of them. Many such experts have come to the Soviet Union. Some of their advice may be useful, some not.

There are a few things about which I feel confident. One is that there is no blueprint, road map or design for bringing an economy from central planning to the market system in a series of carefully designed steps. Second, the major steps to be taken require that institutions be changed. You must learn to trust the public, and to let their signals guide resource allocation. Private property, a market system and competition provide a means by which those signals get transmitted. Third, you are unlikely to get to a well functioning market economy by half steps. You must be willing to make major structural changes.

You should know that there are successful and unsuccessful market economies. There is Argentina or Brazil, and there is the U.S., Germany, Japan, Taiwan or Hong Kong. The differences are enormous. Some are overly regulated and uncompetitive, and the state directs investment and produces inflation. The more successful countries seek to provide price stability and encourage competition.

To succeed, you do not have to adopt the details of the Japanese, German, U.S. or other model. But, you must adopt some rules that have been found to be successful. To avoid inflation, there must be a formal commitment that frees the central bank from financing the government or the state enterprises. You will not achieve price stability unless there are fiscal and other reforms. The goal of price stability is meaningless if most prices remain controlled. But, freeing prices is not enough. To get the benefits of the market system, you must permit, even encourage, competition among domestic suppliers, and between domestic and foreign suppliers. This means you must move toward much freer trade in goods and services.

I can summarize much of the rest of my comment in three words -- credibility, flexibility and applicability. After discussing each of these in turn, I will add a few words about the so-called monetary overhang that is said to be a problem for the Soviet Union.

Credibility

One of the most urgent tasks is to get people accustomed to using price signals -- relative prices changes -- to guide resource allocation. The monetary authority can best contribute to this task by assuring that the price signals are as clear as they can be. Price stability removes the problem of separating general and relative price changes and reduces the problem of separating temporary and permanent changes in the price level. The signals from demand, cost or productivity changes are then easier to interpret. The quality of the information provided by the price system improves. This in turn, increases efficiency.

In principle, there are several ways in which the monetary authority can maintain price stability. The principal alternatives are either fixing the exchange rate or adopting some fixed or adaptive rule for money growth. Either of these rules will work if the rule is consistent with price stability, and the public believes that the central bank will follow the rule. Neither rule guarantees success. A fixed exchange rate rule runs the risk that the exchange rate will not be consistent with price stability or, as Chile learned in the 1980s, that the real exchange rate is revalued. A monetary rule will have difficulty with velocity changes in a rapidly changing economic system.

Establishing credibility -- the belief that the central bank will follow the rule -- is a particularly difficult problem for the Soviet Union. Under the centralized planning system, the state bank financed not just the excess of spending over receipts in the government budget but in the budgets of all the enterprises. As we know from experience, if the state bank (or the central bank) continues to finance all budgets on demand, inflation will not be avoided, and credibility will not be established once prices are no longer controlled.

Credibility for the new monetary policy can be achieved most effectively if the new system is seen to be a major departure from the old, and the opportunities for discretion are severely restricted. The public must be convinced that the central bank and government will honor their commitment to avoid inflation. I suggest that this is done most effectively if you restrict the government's monetary role by establishing a monetary authority like the Hong Kong or Singapore Monetary Authority. In such systems the exchange rate is fixed. The authorities are empowered to issue money only if they receive convertible currency, and they must withdraw money when they lose convertible currency. They collect seigniorage, but they have no discretionary authority to change the quantity of money and no legal means of doing so. Money can only be issued to the extent that the country earns convertible currency.

This system has several advantages. Most important is the durability of the commitment. Like Ulysses, in the ancient Greek legend, you will have bound yourself tightly. There are other advantages. Let me spell out a few. First, the system focuses attention on the need to compete in world markets. Efficiency in international markets begets domestic efficiency, and increased domestic efficiency encourages exporting. Second, domestic prices would adjust toward world levels. If the exchange rate is fixed to the dollar or the mark, domestic commodity prices will move toward U.S. or German prices for goods of the same quality. Third, interest rates will fall toward the world level. At first there would be a risk premium but the premium would decline as confidence grows that the system will be maintained. Fourth, budget deficits would be limited. All borrowing, whether denominated in domestic or foreign currency, would have to be financed from domestic or foreign saving. The market would limit borrowing by raising the interest rate as borrowing increased.

The monetary authority would be limited to a few monetary functions. A banking authority, or financial market authority, would have the important task of developing and supervising a competitive banking and financial system to increase the efficiency with which savings are allocated and investment financed.

This would be a strong commitment. The closer you come to it, the more it will be believed. A mixed system in which the exchange rate is fixed but adjustable will be less credible. If people doubt your commitment to monetary stability they will charge risk premiums in interest rates and wages to pay for possible inflation.

Flexibility

Under the system of material balances and central planning, prices had no allocative role. Resource allocation and pricing were unrelated, and prices changed infrequently. In a market economy, prices change frequently and guide the allocation of resources. Price stability means that a broad based price index is stable, but individual prices change. Flexibility of individual prices lets the market respond to changes in relative demand or relative scarcity.

Flexible costs and prices can reduce fluctuations in employment and output. Developed markets contribute to price flexibility. In your country, where price and wage flexibility has been rare for decades, reliance on flexible prices and wages to signal the appropriate reallocation of resources is likely to develop slowly. People must learn to follow the signal. And they must learn that rising prices for the goods or services that they buy is not necessarily a sign of anti-social behavior by the sellers. We know from our own experience that this is a difficult lesson to learn. Large increases in the prices of consumer goods in the United States often lead to claims that speculators and profiteers are responsible for the rise and to calls for lower prices, controls or investigations. Large declines in price lead to demands for protection, subsidies or minimum prices. Government responses to these outcries typically reduce price flexibility, thereby making the economy less efficient and less competitive. The information provided by the price system to guide resource allocation is suppressed.

Applicability

Monetary reform is a useless gesture unless it is part of an economic reform that allows prices to adjust. Monetary reform and price flexibility should be parts of a comprehensive reform program that includes the establishment of open, competitive markets in a wide range of goods, services, labor and assets. For it is competition in a market economy that reduces monopoly power and induces self interested individuals to provide the social benefits that free markets generate. And, it is the right to keep the gains and the responsibility to accept losses that induces people to compete. Hence, establishment of private property and other institutions, such as accounting and legal systems that help to sustain competitive markets, must be part of the reform.

The United States and other private property, free market economies place many restrictions on property and markets. Some of these are introduced to equate private and social costs, as in the case of pollution, or to protect minors or others. Some are designed to redistribute income. The type of market system that is most likely to endure is a democratic, capitalist system with its tensions between efficiency, growth, and redistribution. Redistribution requires taxes, and high taxes reduce effort or shift activity away from established markets. Heavy intervention and redistribution reduce the likelihood of a successful transition to democratic capitalism.

Those who question the applicability of the market system to Eastern Europe or the Soviet Union typically do not have these restrictions in mind. Those who raise the issue of applicability question whether private property and competitive markets will produce growth, raise living standards and increase efficiency in their countries.

The argument often made is that experience and the established culture are so different in the Soviet Union that individuals will not respond to the type of incentives that have worked elsewhere. We know that this cannot be wholly true. People from all of the cultures and countries of the world have responded to market incentives in the United States and there is now additional experience in a wide variety of cultures. And the prevalence of "black markets" and other private arrangements suggests that entrepreneurs are not unknown in Eastern Europe and the Soviet Union. Increased competition is the way to get these entrepreneurs into more productive activities.

I believe that an important distinction is often neglected in discussions of applicability of the price system. Misleading language contributes. We talk about people "working for money," but, money is only a means of buying goods or assets. People produce and innovate to acquire goods, services and assets. That is why monetary reform alone is not sufficient. It must be part of a social and economic reform that puts toasters, washing machines, dryers, TVs, cars, houses and the like into stores in every city and village and provides an infrastructure that includes roads and electricity to make these durables useful to a large part of the population. Productive reform produces incentives by providing opportunities for accumulation and for improved living standards.

Monetary Overhang

President Gorbachev says that there is a "monetary overhang" equal to 100 billion rubles. Others suggest that the overhang is 3 or 4 times greater. A "monetary overhang" is a type of forced saving in the form of cash balances that people would spend if more goods and services were available. The concern is that, if prices are decontrolled, prices will rise as people seek to shift from money to goods. The fear that others will behave in this way encourages a flight from money, for the anticipated increase in prices will reduce future purchasing power. A sustained flight from money could produce hyperinflation.

There are two solutions to this problem -- increase the supply of goods or reduce the stock of outstanding money. Currently, in most of Eastern Europe, the first requires imports. The second calls on the government to withdraw money from circulation by selling assets, including housing, and state enterprises, or selling some type of indexed bond that pays a positive real rate of interest. If you replace the state bank with a monetary authority, as I have suggested, the bonds should be denominated in the currency to which domestic money is pegged.

I see no reason to choose between these alternatives. Governments should offer assets, including indexed bonds, to privatize ownership and absorb excess supplies of money. If the monetary authority fixes the exchange rate and maintains convertibility, the public can buy imported goods. Ten or twenty billion dollars of imported goods would absorb much of the overhang at the current market exchange rate. Once the public becomes convinced that the exchange rate will remain fixed and prices will remain stable, they will choose to increase cash balances. Thus, credible policies reduce monetary overhang both by withdrawing money from circulation and by increasing the demand for money.

Postscript, July 1991

The advice I gave almost a year ago has not been followed. No one will be surprised. The Soviet Union has continued to flounder without leadership or direction in economic affairs

The problem is theirs to solve, not ours. We can neither reform the Soviet economy nor purchase their acceptance of private property and a market system. Well-intentioned plans to lend money to the U.S.S.R. or to the individual republics are bound to waste resources, ours as well as theirs.

The reasons are clear. Loans to their government would strengthen the power of those governments over resource allocation. They would sustain central authorities. What is needed is the opposite--decentralization. Further, part of the loans to governments will be used to delay economic reforms, modernization, reductions in military spending, and privitization.

Our loans should be made, after privatization, to bona fide private corporations. They should be made commercially, not governmentally, by those willing to bear the risk.

We should offer assistance to privatization by offering technical assistance, including management training and training in the operation of a market economy. We should encourage them in their efforts, but our commitment should be limited to humanitarian aid and technical assistance.

Senator SARBANES. Thank you very much, Mr. Meltzer. I have to go vote, and I think it probably will make more sense if I yield to Congressman Obey and let him do his questioning. He could then go to Congressman Armey, and I will return as soon as I complete the vote.

Representative OBEY. Thank you, Mr. Chairman. Before I get to the question of aid to the Soviet Union or to the questions on the Polish situation, let me ask some basic questions about items that Mr. Solomon had in his testimony.

Mr. Solomon, first of all, you indicated that it would be feasible to agree at the London Summit to a very substantial concerted central bank intervention that would check further dollar strengthening damaging our trade position. I wonder if you would expand on that, and tell me how you know what kind of an effort you think is needed; whether it's really worth it?

Mr. SOLOMON. Well, there's always been a difference of view. Some economists and practitioners are skeptical that, in the longer run, the central bank intervention makes much difference. My own experience as Under Secretary of the Treasury—at a time of some very volatile movements in the dollar, and my intensive work on that with other central bankers when I was at the New York Fed—lead me to a conclusion that concerted central bank intervention by all the key central banks at strategic points can be enormously helpful in giving the markets a clue and a direction, because the markets are not reflecting basic trends. If they were, then central bank intervention would be meaningless. The markets, from time-to-time, are behaving completely irrationally. They are reacting to rumors and to corporate treasurers' moving massive funds because the rest of the sheep herd are beginning to do so, and they want to jump on the bandwagon. They don't want to be caught short. Now under those circumstances, where mass psychology and sheeplike movements are what are determining the foreign exchange rate movement, you can influence that enormously if the markets are impressed by concerted central bank intervention. We have had demonstrations of this from time to time. When it is not concerted, or when it is not adequate in scale, or when it is mishandled for any one of various tactical reasons, then the markets will shrug it off. As I said, my years as a practitioner in the Treasury and at the Fed have convinced me that it can play a useful role. Now, I happen to be involved in Wall Street this days. And I frequently hear reactions and comments about the very confusing lackadaisical central bank intervention that we've seen from time to time; where one of the three or two of the three key central banks—Germany, Japan, and the United States— will be acting in a very diffident style and sometimes making remarks to the contrary, while a third one will be intervening vigorously. Quite clearly, when it's not concerted, it's just not going to work.

The markets are confused at times. And even though I don't believe it's a panacea, I believe we would have been able to constrain and limit the 25 percent decline we've already had in the Deutsch Mark against the dollar; which, if it were to continue—as a lot of the people in the street do believe it will continue—would do more damage to our trade position and therefore to our overall economy. But I can't give you any guarantee. But I am convinced that the heads of government could give an important boost to their treasuries and central banks if they were to go on record, as well as to the markets, in terms of stabilizing and constraining the upward movement of the dollar through substantial concerted intervention. I think you'd see quite a sharp response in the market.

Representative OBEY. Are you suggesting that you think the decline in the Deutsch Mark has been inappropriate and should not continue, or do you think it should continue?

Mr. SOLOMON. I feel that some of the decline may be justified; some of the strengthening of the dollar may be justified. But quite clearly, if it continues, it will do substantial damage to our export trade as well as to the import-export balance. And I am concerned about it because I see no direction being given by governments or monetary authorities. There's a conspicuous silence these days. The markets are saying to themselves and to the corporate treasurers that the dollar is probably there if we're going to strengthen, and they jump on the bandwagon. We have seen the most incredible change in dollar balances in the last few months in holdings of dollar balances. That's basically what has explained this movement. It's a speculative short-term judgment by corporate treasurers and the people who advise them and people climbing on that bandwagon.

Representative OBEY. Mr. Cooper, you indicated in your statement that inflation seems well under control. By that, do you mean Germany as well?

Mr. COOPER. Yes, that was a general observation for Western countries. Obviously, the circumstances differ from country to country. Britain's rate of inflation is a good deal higher than it is here, but it's coming down. Germany's rate of inflation has risen somewhat and is higher than it was and is higher than many Germans would like. But I see that as a largely transitory phenomenon.

Representative OBEY. I'm sorry, would you say that again?

Mr. COOPER. I see that as a largely transitory phenomenon. I don't see German inflation being out of control.

Representative OBEY. So, let me ask you, in the next sentence in your statement, you indicated that world imbalances are declining; especially the large U.S. trade deficit in goods and services, and the large German and Japanese trade surpluses. Do you think that those developments are also transitory? Or do you think that they're more sustainable? And if so, why?

Mr. COOPER. Well, let me preface my answer by saying I actually attach less normative importance to these large imbalances than many people do. It is a natural and not undesirable feature of a world economy that is well-integrated, including capital movements, that there will be large imbalances in trade in goods and services. As long as Japan has much larger savings than it does domestic investment opportunities, it's going to be an exporter of capital. And that is not a bad thing from the rest of the world's point of view.

On the other hand, the large imbalances have fed protectionist pressures, especially in this country, which I consider undesirable. So, some decline from the big imbalances of the mid-1980s was desirable, and we've seen it in the last few years. A very substantial drop has occurred in the U.S. deficit—it's still large by historical standards—but much less than it was 2 or 3 years ago. More recently we've seen a very big drop in the German surplus that is largely associated with the unification of Germany. That can be expected to last for the next several years. I don't speak of the late 1990s.

I expect Japan's surplus to continue to be large just because it is a high saving and relatively low-investment nation. Until consumption levels rise in Japan to correspond to their high-income levels, Japan is going to be a net exporter of capital; hence, running a substantial trade surplus. As I've said, I don't see that as an undesirable thing from a world point of view.

Representative OBEY. Mr. Solomon, you discussed the situation with respect to the Uruguay Round and agricultural surpluses, and you indicated that if France and Germany displayed a political willingness to move toward more direct supplements to farmer income and less agricultural product price supports, the United States and Japan could then respond generally but concurrently in the agricultural and non-agricultural sectors. What kind of response—maybe I'm reading something into that that isn't there. In the response that you would envision in the agricultural sector, what kind of changes do you think we could and would make in the nature of our own farm programs?

Mr. SOLOMON. I think that broadly speaking there will be less distortion of agricultural trade and more opportunities for the United States and U.S. agriculture, as well, if all countries, including the United States as well as the Community, were—assuming they have a political need or a social need to give income support to, let's say, smaller farmers—to move in that direction as against import barriers and price supports, which severely limits trade and are a drain on the taxpayer. Therefore, even though we are much less at fault than the European Community—I'm not a detailed expert in the agricultural area at all—I believe that it would be appropriate if the Community would move in this direction and change the composition of its support for the farmers. And that we, to the extent we are guilty—and, as I say, we do it much less than the Community—should also move in the same direction.

Representative OBEY. But you don't have anything in mind in terms of the way commodity programs might be changed here?

Mr. SOLOMON. Well, again, I'm not an expert, but what clearly comes to mind is the peanut subsidy program. There are certain import quotas that I think affect dairy farmers in your state. And there are other—

Representative OBEY. The only thing affecting dairy farmers in my state is $9 milk.

Mr. SOLOMON. I'm sorry, I didn't hear that. What?

Representative OBEY. I said the only thing affecting dairy farmers in my state is $9 milk, which is about 35 percent lower than they have experienced any time in the last 2 years. But go ahead.

Mr. Solomon. Well, I just feel that I don't have anything specific in mind except that other people could identify quite easily—aside from peanuts, which comes to mind—where we have product price supports and where our assistance to the farmers takes the form of prices and higher cost for the taxpayer. It would be less costly if we were to give direct supplementary income aid to those small farmers that Congress believes merit it.

Representative OBEY. OK. You referred—you mentioned the need for fuller market access for Eastern European countries to the European Community. How likely do you think that is?

Mr. Solomon. Well, they're negotiating right now. And it's proving to be a very frictional process. I just came back from Czechoslovakia night before last and met with various Poles and Hungarians, as well. There is a general feeling of great disappointment at how the negotiations are going, but they're still hoping that they'll come out reasonably OK. It's in agriculture and textiles that they're running into the most grudging attitudes on the part of the Community negotiators. They feel in the long run, of course, that they want to be members of the Community. And I think the political odds are that they will be, because I believe there's a sufficient political will in Poland, Czechoslovakia, and Hungary to stick with the movement toward democracy and toward market economy. Under those circumstances, I don't believe that the Community will ultimately be able to resist—refuse them—full membership. It may take a full decade, though. But in the interim, under these associated trade agreements that they're negotiating, they are pressing for more access, and so far they're running into a lot of difficulty in getting it.

Representative OBEY. Sure are. One last question on the Polish debt situation. As you know, we have seen substantial government-to-government debt reduction with respect to Poland. At that time—or I should say before that debt reduction took place—the Polish debt was selling at about 18 cents on the dollar in the secondary markets. Now it's selling at about 30 cents. So, clearly the commercial bankers have been an indirect beneficiary of our actions with respect to official Polish debt.

Why shouldn't the subject of commercial debt relief for Poland be on the agenda when the G–7 gather?

Mr. Solomon. Well, I think that the Brady Plan should be encouraged in regard to the Polish commercial bank debt even though it is not as critical as it is in the case of Latin America; because, as you know, the commercial bank debt is a much smaller proportion of the total debt. But historically, we have taken the position that concessions made in the Paris Club on official debt should be more or less matched by the commercial backers. I think you know that there can be situations where that would not make sense. But generally speaking, I think it's a reasonable approach. I followed it in all the years that I was—both in State and Treasury—involved in debt negotiations at the Paris Club.

I don't see, myself, any reason why the Brady Plan should not be encouraged. I do not believe you can by fiat make the Summiteers do anything to impose a debt forgiveness. But the Brady Plan rather skillfully walks between certain banking horrors, so to speak. Because there's a guarantee involved on the new debt, even though it's reduced in volume, bankers do not feel they are forgiving the debt. They feel that they're getting an exchange of a debt instrument with a larger number on it for a smaller number; a new piece of paper, but a better quality piece of paper. Frequently, they do that in their private-sector dealings. That's why I think that the Brady Plan approach, which I had urged the commission that I chaired before Secretary Brady to put into effect, makes sense. It's an appropriate way to do it.

I don't know what the Summiteers could do. I suppose they could give a general kind of pat on the back toward encouraging Poland and commercial banks to get into the discussions on the Brady Plan. I, myself, am not familiar with the status of that. For all I know, there may be some discussions going on.

Representative Obey. Well, my understanding is that it's the British banks who have been very actively foot dragging. You would expect the Germans to be, but my understanding is that the British have been also. I guess I am skeptical that we are not going to see much in the way of commercial bank action without further government pressure. And I was just wondering whether you could see any significant likelihood of commercial debt reduction without some real jawboning by the involved governments.

Mr. Solomon. I'm not close enough to the Polish discussions on confidentially with the banks to be able to offer a comment. But it is true that in every one of the Brady Plan negotiations, certain banks of certain countries—and this will vary from country to country—have dragged their feet more than others. And I see why the British, having a larger position in Poland than they had in Latin America, would drag more in the case of Poland than in the case of Latin America. I don't think that's the last word necessarily

Representative Obey. Congressman Armey.

Representative ARMEY. Thank you, gentlemen, for your testimony. I found it encouraging in some instances and frustrating in the other, and I want to come back to that point.

I noticed, Professor Meltzer, that you hold the position of Olin Professor of Political Economy at Carnegie-Mellon.

Mr. MELTZER. Yes, sir.

Representative ARMEY. I always wondered is Olin, in this instance, related to Ohlin, the Swedish economist, who taught Keynes how to be an economist?

Mr. MELTZER. No, sir, this is Olin from St. Louis and New York, who ran the Olin Chemical Company.

Representative ARMEY. I was always fascinated by that great debate over German war reparations where the Swedes taught Keynes how to be a Keynesian. I'm not sure they did the world a favor in having done so. But nevertheless, it had a profound impact on my discipline of economics.

I have enough formal training and formal credentials in economics to have suffered terminal brain damage in that I do have a Ph.D. And I found myself, throughout all my formal years of study and practice as a professional economist, frustrated by the economics profession, especially as it relates to the formation of public policy. I finally resolved my frustration by hitting on what I call Armey's axiom number one—the market's rational, the Government's dumb. I've seen very little evidence over my lifetime to refute that point of view. In fact, I have seen great innovations in the discipline of economics brought on, by and large, by Buchanan and Tullock in the field of public choice economics; which I define as the study of the aberrant behavior of public policy-makers to verify the contention.

Now if I can switch from dumb governments for a moment—which I use for poetic purposes—to crazy; the psychologist defines crazy as continuing to do the same thing over and over and expecting different results. I believe that perhaps the economics profession, as it advises the Government, advises it to be more and more crazy. That is, to have more and more institutions, principles, policies, and procedures to try to regulate the private economy; all of which frustrate even the rational markets. And then when that fails to get the desired results, they try to develop new institutions at the international level to coordinate the irrational and inconsistent policies of the various separate domestic economies. Frustration, by the way, as defined by the psychologists, is trying to cause—to affect the result or cause—control over what is uncontrollable. So I'm not sure that my profession, especially post-Keynes, has done much more than develop crazy and frustrating behaviors in government.

Now that takes us to where we are today with this meeting of the G–7; which is, in my estimation, an effort to decide what new dimensions of craziness we might try to enforce upon the world. We now have in the United States a government that is totally incapable of exercising even the most fundamental rudiments of Keynesian countercyclical policy on its own behalf, because it has so hamstrung itself with a deficit that it simply doesn't have the options. The only Keynesian option that is left to us to inspire growth is to cut taxes, which is a Keynesian option. You may all recall one of the two fiscal policy options to encourage growth—cutting taxes. That, of course, was effectively taken away from us by something called the Byrd rule. We can't even do that anymore. So we have no ability to enact fiscal policy, even on our own behalf. Yet, here we are meeting with the G–7 countries trying to coordinate a macroeconomic fiscal effort on behalf of all of our countries. The Germans, of course, are fighting inflation, at least temporarily; and their fiscal policy options are limited.

As you pointed out, Mr. Meltzer, and you, too, Mr. Solomon, no nation is going to do something in terms of international cooperation that runs against its best self-interest; which is, of course, what has tied up the Uruguay Round of the GATT on the issue of agriculture.

We have just finished marking up a banking bill that may save or ruin the banking industry in the United States. Nobody knows for sure, but our worst fears are haunting us. And given the track record of government policymaking, we have no basis to be optimistic. And, yet, we want to try to coordinate our international monetary policy. We try to set, control, coordinate, and adjust international exchange rates.

Now my question is: What if one nation that had built itself to a position of prominence in the world economy, never before equaled, perhaps, in the history of the world—such as ours, in fact—dared to demonstrate the courage of its convictions? And, for example, with respect to the Uruguay Rounds and the problem we have there in agriculture, what if we dared to, in fact, reform agricultural policy along the the lines that you have suggested, Mr. Solomon; by way of cutting out the market distorting practices of import restrictions and price controls; and going, in fact, to the system of a direct income subsidy—perhaps, by way of the negative income tax concept—to the low-income farmers and help them instead, for a change, with our agriculture policy? Could we, in that instance, generate enough leverage in the world market by way of American free farmers using their full free capacity to produce whatever it is they choose in the world's markets; could we actually force the European Governments to adopt a deregulated farm policy and to fall back on the principles of comparative advantage in agriculture? Do you think not?

Mr. Solomon. I don't think we have that much leverage. The Community can raise the variable import levee and increase their export subsidies. But there's no constraint on them.

Representative Armey. Well, I don't know how many agricultural acres they have in Europe—in Germany or France, for example—where we have our two biggest problems. But we've got 60 million acres of agriculturally productive land in this country that's taken out of production by agricultural policies. It seems to me it would make a pretty big dent in their self-servingness.

Mr. SOLOMON. You could escalate a major trade war in agriculture without any question. But whether the European Community would then buckle in the way we would hope to see, or whether they would simply respond by raising their variable import levees and increasing their export subsidies, I think is a big question mark.

Representative ARMEY. Mr. Meltzer.

Mr. MELTZER. I would just like to say that they already spend a great deal. The average income of a farmer in Europe is now 50 percent subsidy from the government in one form or another. So the prospects that we would be able to export but that they would refuse to import are, I think, very good.

Representative ARMEY. Let me ask you. Obviously I've shown, I think, a very healthy disdain for government. I mean that basically it's just institutionally irrational. People trying to control other people's lives with still other people's money is just fundamental. No man spends another man's money as wisely as he spends his own. And it's very easy to bleed your heart with somebody else's money over somebody else's problems. So, nevertheless, there are certain things that are essential. My study of economic development tells me there are certain rules for fundamental necessities of development. I see Eastern Europe in the dilemma of the developing nations of 20 years ago. They have to shed themselves of institutions and traditions that have failed and adopt freedom. Wouldn't it be wiser for us to encourage them to understand the essential functions of government; to provide a stable political atmosphere when it is safe for individuals; to provide a system of private property; and to provide stable monetary system and a reliable system of justice? And then, as you said, Mr. Meltzer, in your paper, learn to trust the people. Perhaps, if we could encourage them to do that, we might be doing for the Eastern European nations the best we can do.

Mr. Meltzer. I agree with that. I gave the example of Chile, which, for a long time, was a pariah nation and therefore couldn't get any aid from the rest of the world. Yet, if we look at Latin America, they are the most successful redeveloping country. They have managed to not only get their political house in order, but they've also gotten their economic reforms in order. And the new government, that is, the democratically elected government, seems determined to maintain those market-oriented reforms. They did that mainly by their own efforts. They had to get rid of a lot of industries and convert them to industries that could compete on the world market. They've successfully done that. They now have, for the last 4 or 5 years, the highest growth rates of real output per capita in the history of the country. And that history, unlike many Latin American countries, goes back—we have records going back—more than 100 years for Chile. And they've done extremely well. And I believe they are now, as a result of their efforts, a lesson to Argentina, Brazil, and perhaps eventually to others in Latin America who see that the market economy is a better mechanism for development than all the protection and government interference that they have had for so many years. And that's the lesson for Eastern Europe. We cannot make Eastern Europe strong. It's up to the Eastern Europeans to make themselves strong and competitive.

Representative ARMEY. Thank you. I'll come back later, Mr. Chairman.

Senator SARBANES. Mr. Solomon, you and Mr. Cooper have prepared for Summits in the past. We never had these Summits before 1975, at least in this forum. The first one was at the invitation of Giscard d'Estaing, the French President. I would like to just leave the substantive agenda of this coming Summit to ask an even more basic question, and that is: What do you think of the G–7 as the forum for discussing these issues and the prominence, or almost dominance, that it seems now to have taken in formulation of policy? I can remember in the CEA we used to spend a lot of time working on the agenda of the OECD, and so forth. That involved many more countries. But now it has gotten down to these seven countries. What is your sense of how appropriate this is as a forum?

Mr. Solomon. They still have the June ministerial meeting at the OECD, and those countries are involved in discussing the same issues basically—the economic issues—that will be at the Summit the following month. I must confess to you that even though it's not terribly democratic in a certain sense, I think it reflects reality to have a small group of key countries, who have the major responsibility, lead the way in policy. In fact, I will go farther and say to you that there is informal coordination among the G–3—Germany, Japan, and the United States. There always has been and there will continue to be before a G–7 meeting. And basically, even though G–3 agreement can be modified if the others disagree, the G–3 agreement is still the basis for coming to some form of G–7 consensus. And I don't really know that there's an alternative. Everybody gets a chance to speak at the——

Senator SARBANES. There wasn't this type of Summit before 1975, and there was some fairly good coordination of the economic policy, as I recall, back in those times, wasn't there?

Mr. SOLOMON. The United States had a much clearer leadership role back in the 1960s and the early 1970s. And to some degree, the United States took a position—a strong position—a policy position. People fell into line. As other countries have increased their economic power, it's been necessary to do much more coordination and have more of a dialogue. I don't really see that we have an alternative to the kind of dialogue that we have at the moment.

Senator SARBANES. Mr. Cooper.

Mr. COOPER. I think these meetings are highly desirable. In addition to the reason that Mr. Solomon mentioned, they're desirable because they provide a focus once a year for drawing the attention of the heads of government to the international dimensions of their domestic policies. That was not typically done before 1975. Ministers of finance and foreign ministers were concerned about it; chairmen of the Council of Economic Advisers had to be; but Presidents didn't. They were always concerned about national security and major foreign policy issues but not about international economic issues.

As the world economy has become more integrated, the ramifications of domestic policy and events in the rest of the world for our country have gotten greater. The prospect of a Summit serves as an occasion for pulling the Government together on the international aspects of what would otherwise be considered economic policies; for briefing the President and getting him engaged.

The same process is just as important—perhaps even more important—in Japan; which, although a powerful trading country, has been very insular in its thinking about policy. Europeans, of course, have other forums for dealing within Europe, but the Summit forces them to look beyond Europe. So, I see it as a highly desirable process. It's worth noting that there are eight at these G–7 meetings. The President of the European Commission is present and is a kind of surrogate representative for the smaller European countries. There is always the question of where the boundary line should be. Of course, the country just excluded is not at all happy about its exclusion. But if it's not seven, it's going to be five or nine. So there will always to be some country that's just outside.

Senator SARBANES. Mr. Meltzer.

Mr. MELTZER. Let me state the other side. You've heard one side, the advantages. Let me state the other side, and then tell you a little bit about what happens in those closed meetings. They issue a statement——

Senator SARBANES. You see these pictures of all these leaders lined up outside some very impressive facade. Then there is some story about how they were jockeying as to who would stand next to whom. And there's this sort of——

Mr. MELTZER. ——and other important matters of that kind. Well, it's a giant press conference at which each one is speaking primarily to his domestic constituency rather than to the world constituency. And as such, it has all the disadvantages of a large press conference. That is, issues are not joined or discussed so much as they are papered over. Instead of focusing on a set of solutions to some of the world's problems or leadership being exercised, very often what happens is that we're reduced to the lowest common denominator—a policy statement that satisfies all the members of the group. There has been a little bit of research on what actually comes out. People have looked at the communiques and statements to see first what kind of promises were made and how many of them were kept. Most of the promises are so vague as not to be very easily scored, that is, as to whether they were followed or not. But to the extent that one can score them, the answer is that the batting average is relatively poor. Countries promise to do things, including our own, that they don't do. For example, we promised to reduce the budget deficit at several Summits or to take constructive action about the budget deficit. It may be a good or bad promise, but there isn't very much that is done about the particular problem. The same is true for other countries. So, the record of accomplishment is rather poor. I believe that the risk is that you reduce policy to the lowest common denominator; that is, you find those policy actions that everybody can agree on. And then nothing very much gets done about some of the major problems. One of the big ones at the moment would be, I think, trade policy.

Mr. COOPER. Can I make one more remark? I agree with Mr. Meltzer about the score. But I think that in considering these Summits, we have to consider not only what happens before the Summit, but also what are the public expectations of the Summits. I believe it is a mistake for governments and journalists to lead the public at large to the view that a Summit's success or failure hinges on its ability to reach concrete agreement, which can then be scored. It may be advantageous in a particular year, on a particular issue, to reach concrete agreements. They should be encouraged to do that when it is, but they should not feel obliged to reach agreements. The process is a useful one even if the only result is a bland communique saying we've met and discussed the following issues. We should not have such high expectations of every Summit that they feel obliged to produce a great stride forward for the world, and then, of course, it is a failure if they don't.

Senator SARBANES. What is your impression of how effective the followup is to these Summits?

Mr. COOPER. As Mr. Solomon said in his statement, one of the problems or advantages—depending on one's perspective—of the Summit process is that there is no systematic tracking of them. There's no secretariat.

Senator SARBANES. Do you think there should be a secretariat?

Mr. COOPER. Well, there are pros and cons on that aspect. As it is now, the government of the host country takes the lead in calling preparatory meetings and so forth. They typically look at last year's communique, but there's no systematic tracking of Summits from year to year. I see some advantages in the ad hocery [sic] and the informality of current procedures, precisely, because I believe expectations should be kept low about concrete decisions being made at Summits.

Mr. SOLOMON. I'd like to comment on that. I think it's disgraceful that there's no followup at times. I mean, I can remember at the Bonn

Summit, Chancellor Schmidt suggested at dinner an anti-hijacking statement that the heads of government put out. They all jumped on that enthusiastically and prepared a good statement. The statement called for national actions. There was absolutely no followup to speak of. There was no sense of embarrassment, because the media does not always discharge that function of reminding heads of government what they said the year before.

Now I also would be opposed to a secretariat because it gets a little too bureaucratic. But I think, though, that the Heads of Government could quite easily instruct their shepards, who prepare the next Summit, to give a report where they could call in their specific ministers who are in charge of certain areas where they feel—it doesn't have to be a followup on every single aspect, because some of them may not be—it may be too vague for that kind of a followup report. But we haven't seen any attempt at followup. I think it would be quite simple for them to focus on that if they wish to.

Senator SARBANES. Congressman Obey. [No response.]

Senator SARBANES. Congressman Armey, please proceed.

Representative ARMEY. It seems to me that in Eastern Europe and the Soviet Union there are fundamental problems with their monetary systems. In some cases, they barely exist. In some cases, currencies are not convertible. I have not specialized in monetary theory. It seems to me that you really have to come back to pretty fundamental things, don't you? In the final analysis, money works if it is generally acceptable as a means of payment. Now, whether that be domestically and then subsequently internationally, the reason we're willing to take the Japanese yen is because, in the final analysis, we know that if all other things fail we can bring it back to Japan. Should we do so, we will have something of value we can acquire with that Japanese money. Therefore, it is acceptable to me, and it's acceptable to you.

What must be done in the Eastern European countries is to build a reliable monetary system, which, of course, you must have if you're going to have development and growth. At the same time, you cannot endow your monetary unit with a generally acceptable status unless you have some substance to your economy. So this strikes me as a bit of a double bind for the Eastern European economies. Quite frankly, I see very little ability of the United States to subsidize the—what should I say—fiduciary underpinnings of any foreign currency, or the IMF, or the World Bank, or any of these other institutions that we have. I don't see much volition on the part of other nations. The Japanese are an enormously successful nation, largely, because they've never encumbered themselves by any activities that were efforts to feign altruism. They stuck to their own business and did so quite well. So it seems to me that that becomes a fundamental dilemma for the emerging Eastern European countries and one in which they can realistically expect no substantive assistance from the West, either in terms of individual nations or the international institutions developed by the West. I wonder if any of you would like to give me your opinion on that.

Mr. SOLOMON. As Mr. Cooper said in his testimony, the Polish Stabilization Fund—where we put up guarantees, not actual money—encouraged the Poles to take appropriate monetary-stabilization and macrostabilization measures. I think it was very useful. It's not running at deficit.

If the Soviet Union ever got far enough along, which is a long way to go on its reform on price liberalization, privatization, eliminating certain subsidies, the bulk of subsidies, etc.—there's so many things they have to do it's mind-boggling—where a stabilization fund would be a useful complement, then I think it would be an appropriate act. That could be done either through national guarantees or, possibly, through the IMF. If by then the Soviet Union was a member, it could be done through the IMF using its gold resources so it wouldn't be a burden on national taxpayers. The IMF has a very large stock of gold that is not used normally. It was earmarked on the first petroleum—I forget the technical name of it—but in 1973, 1974——

Mr. COOPER. It's the Oil Trust Fund.

Mr. SOLOMON. ——the Oil Trust Fund for developing countries who were hit by quadrupling the price of oil. The gold sits there because there's never been agreement within the fund on returning the gold to the donor countries or how else to use them. And, therefore, it is an asset that is not being used. But I would agree with your basic proposition, and I think everybody at this table would, Congressman Armey. But not on the question that every government, including the Soviets, has to undertake monetary stabilization and all those other related reform measures before one could consider coming up with substantial external assistance.

Mr. COOPER. It is worth recalling a historical point, which is that the United States provided a stabilization fund to the European currencies before they became convertible. They took too long, in my view, to move. It took them 8 years—from 1950 to 1958. But some Marshall Plan aid was put in as the capital of the European Payments Union. It's very scary for a country that is used to an extensive system of controls—in this case we're talking about controls on the use of foreign exchange—to suddenly go to a system in which the public has free access to foreign exchange; and, yet, it's highly desirable. Chile is just one of many examples. Incidentally, Mr. Meltzer exaggerates the performance of Chile. Chile has run a bold experiment in sensible economic plicy, but he exaggerates its outstanding performance. It actually has had a miserable performance over the last 15 years.

Mr. MELTZER. The last 5 years are excellent.

Mr. COOPER. After having gone through 10 years——

Mr. MELTZER. They made some mistakes along the way, that's correct. They made mistakes along the way, which these countries will also make.

Mr. COOPER. Sure, sure. But the point is, it's a very scary process. Yet, it's one in which not only the citizens of the countries but the people they deal with outside have an interest. And, therefore, when the conditions are right—and that, of course, is the critical caveat—then it seems to me there is an interest in helping out.

Mr. MELTZER. Let me take the other side of that, Congressman Armey, on two issues. One is the question of currency and one is the question of debt forgiveness, which Congressman Obey raised earlier.

On the question of currency, we don't need to provide them with dollars. There's a market. They can sell resources; they mine gold; they mine platinum; they have oil; and they have energy. They have other things that they can sell in the market if they want to get hard currency. They have plenty of resources to sell. They have assets in the country that they can sell. If they don't want to sell oil, they can sell oil wells. There's plenty of ways in which the Soviet Union can raise hard currency. What it has to do is to move in the direction it ought to want to move. Until it's willing to do that, our help—we agree on this panel—is not going to help them. After they agree to do that, they have lots of options. They have assets that they can sell and raise hard currency. And they'll find some people at a price who will take those assets, including gold, minerals, and all the rest.

On the issue of debt forgiveness, I would like to say to Congressman Obey that one of the great assets that a country has is its ability to borrow. When you default on your debts, you do things to your ability to borrow. From a world perspective, when we encourage people to default on their debts, we then say to many current countries: Look, if you're in trouble, the best thing to do is to get yourself into such serious trouble so that the creditors will wipe out your debt. That's going to have a very significant effect on the world capital markets by drying up the sources of lending from private lenders. If the lenders believe that that game is going to work in the way in which you seem to think it ought to work, there won't be much lending.

Senator SARBANES. You oppose the Brady Plan.

Mr. MELTZER. That's right. But Congressman Obey is talking about private forgiveness of debts.

Senator SARBANES. Do you oppose the Brady Plan?

Mr. MELTZER. I oppose aspects of the Brady Plan? Yes, I think parts of the Brady Plan are good and parts of the Brady Plan are not good——

Senator SARBANES. Well, which aspects do you oppose?

Mr. MELTZER. The parts of the Brady Plan I oppose are those parts that put the Government in the position of leaning on the private lenders to make judgments that they would not otherwise want to make about forgiveness of debt.

Senator SARBANES. So you are in favor of the forgiveness of debt if it can be portrayed as a private decision.

Mr. MELTZER. I believe that if the governments were out of the market and out of the negotiation, and the private lenders were told, make the best deal that you can, we would see—would long ago have seen—a resolution of the debt problem. What has happened is that the international lenders, the Paris Club, and the governments keep putting more money into the debt problem to make the debt problem—as they would say—work. I think that's a mistake. If the governments had been not involved in the problem, then I think the private lenders would have been pushed into a position where they would have had to make the best deal that they could have made. And that would have brought an end, or a much more rapid end, to the debt problem.

Representative ARMEY. Go ahead, Mr. Cooper. I have one last observation.

Mr. COOPER. I'd like to say something on this to smoke Mr. Meltzer out. We have a process in this country under the Bankruptcy Act—and other industrial countries all have similar arrangements—whereby the debtor and the creditors can get together and work out a deal. It is a purely private transaction. They can get together and work out a deal, but they do so against two conditions; which are, I think, very important. One is that if they don't work out their deal, a court will do it for them. Second, if I understand the law correctly, if 70 percent of the creditors agree on a proposition, the other 30 percent generally have to fall into line. Now there's a very serious problem at the international level of collective action because a single creditor can be a holdout. We do not have the counterpart internationally of the 70 percent rule. I think it's worth asking Mr. Meltzer if he disagrees with the 70 percent rule. And if he doesn't disagree with it, what he thinks the functional equivalent of it should be at the international level. That is where I see the role of the creditors' governments as being important in this otherwise private negotiation.

Mr. MELTZER. Let me answer that question and say that there is, of course, what you correctly point out as the problem of the free ride; or the person who holds out and figures that if everybody else defaults, then his debt is going to be very valuable, which is the question that Congressman Obey started with. So, of course, we need some kind of rule. But that's very different—vastly different—from what we've been doing since 1982. What we've been doing is lending more money through international agencies, like the World Bank and the International Monetary Fund, who pays the interest to the banks and discourages them from making private workout arrangements. That, I believe, has been a great mistake. What we should do is have a rule that says: There can't be free riders. We absoluely have to close that loophole. Then tell them: Make the best deal you can; you made the loan; it was a bad loan—turned out to be a bad loan—get what you can; salvage what you can; take real assets; exchange them for equity; do something; and get out of the problem.

Representative ARMEY. I would like to make a couple of concluding comments. John Kenneth Galbraith wrote in the only good book he ever wrote, "The Great Crash," that it was at this time the idiocy of man was most apparent for nothing was lost but money. Mankind has made an idiot of itself over money ever since time began in that it has had this retention of loyalty to what is historically the most worthless of all metals as its monetary base.

Gold has always fascinated me. In fact, it gave me Armey's axiom number two, which is that for something to serve as money it must be inherently useless. In the acquisition of debt, one does ordinarily commit assets as collateral. The Soviets, frankly, do have a great asset base in gold, oil, and other resources. If they want to acquire liquidity and if they want to move to a system—a workable economic system—of private economic enterprise, then they can actually accomplish both purposes by instituting a system of justice that allows for the private ownership of the means of production—private property. Then, they can put that up for collateral behind the borrowing of hard currency. It seems to me that the Soviets are, frankly, in a very good situation; perhaps, one that would be envied by many of the other Eastern European countries that they have looted and abused for the last 40 years.

I thank you, Mr. Chairman.

Senator SARBANES. Before I yield to Congressman Obey, I'll just point out that I think John Kenneth Galbraith has written a number of good books. [Laughter.] And, in fact, I think that there are many writers whose conclusions I may not agree with, but whose books I regard as very good books. Just for the record. [Laughter.]

Congressman Obey, please proceed.

Representative OBEY. I would say Mr. Galbraith has written more good books than the combined total written by anybody on this side of the table.

I'd simply say, Mr. Meltzer, that in your response to your comments concerning my statement earlier, I assume that you think that Western forgiveness of German debt at the end of World War II was a good thing. Or am I wrong?

Mr. MELTZER. I don't know enough about the details, so I can't comment.

Mr. Obey. Well, the details were simply that because we didn't want history to repeat itself in Germany, and we felt that there were some values more important than uncollectible debt, we, in fact, recognized reality in that the West forgave 60 percent of German debt—government to government. The United States forgave, as I recall, 80 percent, the

European allies somewhat less. It seems to me that that was a good investment. And it seems to me it didn't injure Germany's ability to get credit. It certainly didn't injure Germany's ability to recover economically or to become a strong power.

You indicate also that you don't believe in free riders. I would simply suggest right now that the entire commercial banking sector is, in fact, a free rider. Because with government-forgiveness-of-debt—if that's all there is—we wind up with the commercial banks, in fact, being the principal, while being a secondary beneficiary of the taxpayers writing off debt; which indeed would then make true your concern that we are using official debt—or we are using official sources of money to forgive debt, with the beneficiaries being private sources.

Mr. MELTZER. Let me respond by saying that there are, of course—let me grant your point in general without knowing enough about the specifics to be able to grant it in a specific case, but it probably comes under the general—certainly cases where one wants to forgive debt. That is, we're individuals; we do it very often. In bankruptcy, we take back less than we originally lent. That's a private transaction and people in the market understand that capitalism without losses is like religion without sin. You can't really have a very effective one without the other. So I have no problem with that idea. What I have a problem with is the idea of pushing people or forcing them to take losses when, in their own good judgement, they have not yet made up their mind to write the debt down or off. Second, I would say that the free rider problem, in the case of the international debt now, is largely, or at least partly, a result of the way in which the governments have been involved in the debt problem. I believe the writeoffs would have been larger and quicker, as I tried to say, if the governments had not been in the business through the IMF, the World Bank, and the Paris Club, of making additional loans to those countries. Banks would have recognized they had made a mistake. They would get together——

Representative OBEY. Are you talking about Poland?

Mr. MELTZER. I'm talking about just the general problem of debt.

Representative OBEY. Well, but my point is you used my name to make a general point. I never made a general point. The only discussion I ever raised was with respect to Poland——

Mr. MELTZER. Yes. But in your comments on Poland——

Mr. OBEY.——so that's what I'm trying to confine the discussion to. First, I would simply make the point that I, for one, am very happy to have been guilty of pushing European Governments, as well as my own, to recognize the necessity to move on the Polish debt question; because I don't know anybody who thought that debt was collectible. Second, it seems to me, that the West engaged in considerable largess with respect to the country that caused World War II, which resulted in millions and millions of people being killed and economies being destroyed. And since the Government that came to power in Poland after the war came into power with the acquiescence of the West, I didn't see the West or Western Governments trying to shut off loans to that Government in those days. It just seems to me, therefore, that we not only had an economic requirement but a moral obligation to see to it that the West did as much for the principle victim of World War II as we did for the perpetrator of World War II. And I don't apologize in the slightest for pushing other countries into recognizing their responsibility, including the Government of Germany.

Representative ARMEY. If I might make an observation, I think you're absolutely right. You go back to Mr. Solomon's point that when the G–7 folks get together they're going to talk about politics and not economics. The fact of the matter is, Poland, I think, is unique in a limited case that is not likely to be replicated in the rest of Eastern Europe, especially not likely to be replicated in the Soviet Union.

Senator SARBANES. Mr. Solomon.

Mr. SOLOMON. Mr. Chairman, I don't want to continue this debate any longer, but there are really two clarifications of, I think, wrong and inaccurate impressions that Mr. Meltzer has about the Brady Plan. One is that if the advisory committee representing all the bank creditors agrees on swapping the outstanding volume of a commercial bank for a smaller volume, but with guarantees from the World Bank, the Japanese, the IMF—there are various actors in this—that this is a typical commercial transaction. And this is the only way to handle it through pressure that they bring on the free riders. There is no legal way even if you passed a law. We looked into this very carefully. There is no way you can pass a law that says that there cannot be free riding, because each of these loan arrangements is part of a syndicate. Under the basic contractual arrangements of the syndicate, each bank creditor has the right to go along or not go along. If he doesn't go along, then the whole syndicate cannot go along. So there is just no practical way—I can assure Mr. Meltzer that this has been examined in great detail by all kinds of interested parties; private-sector lawyers, Congress, the U.S. Treasury, Federal Reserve—to pass a law.

Second, I want to emphasize once again that it is not forgiveness if a banker swaps a $1,000 piece of paper, which has no guarantees on it and on which debt service has been very poor because the creditor is in a very poor position, and if he swaps a $1,000 piece of paper like that for a $650 new piece of paper that has guarantees from good guarantors, he thinks he's doing a good commercial transaction. It's not debt forgiveness.

Now, Mr. Meltzer is correct that it would be inappropriate for governments to bring to bear enormous pressure on the private commercial bank creditors to go ahead and do this against their judgment. But what governments and central banks have done in each of these cases is they have simply put the larger advantages of this kind of an arrangement to the few free riders that there are. Basically, the real pressure on the free riders comes from the great majority of the other bank creditors, who say: Do you want to be isolated in the future? That's where the pressure has come. There's no way of handling a free rider that we can find other than that.

Mr. MELTZER. Precisely. That is the mechanism that I would have had in mind. Banks want to be members over a long period of time in these syndicates. And if they don't go along with the majority of the syndicate, then their chances of being able to enter into future profitable negotiations are reduced. That's the principal mechanism that works, and I don't understand the early part of the statement that said there is no mechanism. Now, of course, there is a mechanism. There is a mechanism of the marketplace and the long-run interests of the lenders.

Senator SARBANES. I didn't quite follow that. What conclusion do you draw from that observation?

Mr. MELTZER. That, in fact, what keeps people from being free riders and refusing to go along with the contract—particularly, if the bulk of the lenders have agreed on the contract—is that they want to be the member of another syndicate on a future day. And if they're recalcitrant, unwilling to cooperate, behave in such a way so as to extract their gains on a particular day at the expense of everyone else, then they will be ostracized from the syndicates; because they will be found to not be very cooperative members of the syndicate. That will hurt their long-run commercial interest. That's what gets them to agree.

Senator SARBANES. They don't have the framework for resolving these disputes that exist domestically in various countries under the bankruptcy procedure. Now, Mr. Meltzer, I think that you referred earlier to the bankruptcy procedures on purely private transactions or some such language as that. I didn't quite follow that because, it seems to me, the bankruptcy procedure is within a statutory framework judicially applied so that it puts a premium on the parties privately working out a resolution of the problem. But if they fail to do so, the problem will be resolved for them by the bankruptcy judge, and it will then have the force of law upon them. So, while the system works to try to maximize the private negotiation to arrive at an agreement and so forth, in the end—in failing to achieve that—the system works in order to, in effect, place a solution upon the parties. Isn't that correct?

Mr. MELTZER. That's correct.

Senator SARBANES. And that is through the use of public authority to do that.

Mr. MELTZER. Yes, that's correct. Analogies are always bad, and I apologize for using an analogy. But as I believe the record will show, most bankruptcy matters involving lending are not resolved through the efforts of the court to impose a solution on them. Most of them are resolved by the action of the private parties. Of course, one can argue that knowing that the presence of the court is there has an influence on their ability to reach an agreement. I believe that the same, or at least similar, effect could be achieved through the mechanism I described; that is, being a member of these lending syndicates. But that's a subject on which neither one of us can certainly do more than speculate.

Senator SARBANES. Anything else?

Representative ARMEY. No.

Senator SARBANES. Well, gentlemen, we thank you very much. It has been a very helpful panel. The Committee stands adjourned.

[Whereupon at 12:32 p.m., the Committee adjourned, subject to the call of the Chair.]

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