1221

S. HRG. 98-873, PT. 1

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

SECOND SESSION

PART 1

JANUARY 26 AND 31, AND FEBRUARY 2, 7, 9, AND 10, 1984

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

34-871 O WASHINGTON : 1984

1551

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of the Public Law 304, 79th Congress)

SENATE

ROGER W. JEPSEN, Iowa, *Chairman*
WILLIAM V. ROTH, JR., Delaware
JAMES ABDNOR, South Dakota
STEVEN D. SYMMS, Idaho
MACK MATTINGLY, Georgia
ALFONSE M. D'AMATO, New York
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

HOUSE OF REPRESENTATIVES

LEE H. HAMILTON, Indiana, *Vice Chairman*
GILLIS W. LONG, Louisiana
PARREN J. MITCHELL, Maryland
AUGUSTUS F. HAWKINS, California
DAVID R. OBEY, Wisconsin
JAMES H. SCHEUER, New York
CHALMERS P. WYLIE, Ohio
MARJORIE S. HOLT, Maryland
DANIEL E. LUNGREN, California
OLYMPIA J. SNOWE, Maine

BRUCE R. BARTLETT, *Executive Director*
JAMES K. GALBRAITH, *Deputy Director*

CONTENTS

WITNESSES AND STATEMENTS

Thursday, January 26, 1984

Tuesday, January 31, 1984

Thursday, February 2, 1984

Tuesday, February 7, 1984

Thursday, February 9, 1984

AFTERNOON SESSION

Friday, February 10, 1984

SUBMISSIONS FOR THE RECORD

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, JANUARY 26, 1984

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

The committee met, pursuant to notice, at 10 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Abdnor, and Proxmire; and Representatives Hamilton, Mitchell, Obey, Holt, and Snowe.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; and Charles H. Bradford, assistant director; and William R. Buechner, Christopher J. Frenze, and Dale Jahr, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Welcome, Secretary Regan. It is a privilege to have you appear before us today as the leadoff witness for the Joint Economic Committee hearings on the economic report. Your testimony will be a timely follow-up to the President's state of the Union address of last night.

We are all genuinely excited about the recovery so far. The slower pace of GNP growth—4.5 percent in the fourth quarter of 1983—was a welcome sign that the recovery is on a firm foundation and that there are no dangers of overheating. Clearly, inflation has been reigned in. The 3.8-percent increase in the Consumer Price Index in 1983 was the smallest rise in consumer prices since 1972. Unemployment is declining much faster than anyone thought possible a year ago. The 2.5 percentage point drop in the civilian unemployment rate from 10.7 in December 1982 to 8.2 percent in December 1983 represents the sharpest 1-year drop in unemployment in the post-war years. But even more importantly, 4 million more Americans are working now than they were in 1982. This is the largest single increase in civilian employment in the post-war years. All of these important economic indicators tell us that we have made great progress in the past year and that the economic outlook is very bright; the economic recovery is sustainable.

But the one black cloud looming over the horizon is the large budget deficit. I think we all agree that Federal deficits are a major economic problem. What we must decide is how we should deal with that problem. We, in Congress, have two choices. We can either spend less or tax more. But when we begin to make this choice, we must consider what is best for the economy. A major tax increase would be dangerous in terms of its effect on the recovery. What we must do, instead, is stop the excessive Federal spending which has created these deficits.

Mr. Secretary, we hope that you can enlighten us on the budget deficit problem and the prospect for good economic news in the years ahead and we look forward to your "state of the economy" report.

Congresswoman Holt, do you have any comments?

Representative HOLT. No, Mr. Chairman. I really have no comments. I would like to welcome the Secretary. I, too, am deeply concerned about the size of the deficit and am opposed to increasing taxes, and I was pleased to hear the President say that he is going to really encourage a bipartisan effort to sharpen the tools to decrease that deficit. So I look forward to hearing your comments today.

Senator JEPSEN. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Well, Mr. Chairman and Mr. Secretary, I wish I could join in this love feast, but unfortunately I cannot. I think the President is living in a dream world, a never-never land. There is just no way, it seems to me, that any objective, informed person could welcome the kind of economy we are in right now.

It is true that we have had a recovery from the recession. Of course, we have recovered from all recessions in the past. We will again. When we spend as much as we are spending and reduce revenues at the same time, of course, we have this kind of recovery with terrific deficits stimulating it. But it is like a fellow jumping out of a 20-story building and he is doing great when he passes the 10th floor on the way down. The bad news is going to be coming up and coming up with a vengeance in the future.

It seems to me the most serious mistake that we make and that the President made is in claiming any credit for getting inflation under control. The Federal Reserve Board has done something in that respect. The recession did a lot more and, of course, the real reason for inflation coming under control is, as I say, the recession. But this has been the most irresponsible combination of a President and a Congress that I have ever seen in the 26 years I have been here. It is a policy that certainly in the future is going to be inflationary and for us to take comfort in the fact that in the last year or so inflation has been behaving well it seems to me is ridiculous. If we had a Democratic President and you were on the outside, I think that you would have quite a different view of a policy that has brought us to this kind of a situation. I do not expect you to agree with what I have just said, but I am looking forward to the questions.

Senator JEPSEN. Congressman Hamilton.

Representative HAMILTON. I have no statement, Mr. Chairman, I welcome the Secretary and I am glad to have him here.

Senator JEPSEN. Mr. Secretary, please proceed.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Well, thank you, Mr. Chairman and members of the committee.

It is a pleasure to meet with you to discuss the state of the economy and the near-term economic outlook. The main features of the administration's economic approach were described last night by the President in his state of the Union message. Details on the budget for fiscal year 1985 and the President's 1984 Economic Report will be available next week. I will concentrate this morning on broad features of the current economic situation and our view of the future.

The rise last year in producer prices was the lowest in nearly 20 years. The increase in consumer prices in 1982 and 1983 were the lowest in more than a decade. Yet the economy grew strongly last year and the decline during the year in the rate of unemployment was larger than during any year in more than three decades. Unemployment remains too high, but is being reduced rapidly by the dynamic growth in the private sector.

It is too easily forgotten just how difficult the economic situation had become by the beginning of this decade and how much progress has been made in a few short years. While not all indicators showed improvement, the magnitude of the gains since 1980 in most key areas is striking indeed.

During 1980, real GNP actually fell. During 1983, it rose by 6.1 percent. Only 2 years in the last 20 have posted a larger gain.

During 1980, employment fell by about 400,000 persons. During 1983, it rose by 4 million, the second largest rise during a calendar year in more than three decades. Over 104 million Americans are at work, a record number.

In 1980, money compensation per hour—that is, wages plus fringes—rose by about 10.5 percent but that apparent gain and more besides was chewed up by inflation. Real compensation before taxes fell by about 2.5 percent in 1980 and by an estimated 3 percent in terms of take-home pay. Real compensation rose by 2.5 percent during 1983 before taxes and by more than 3 percent in terms of take-home pay. The real wage gains posted in 1982 and 1983 were the first since a narrow pretax increase was recorded in 1978.

During 1980, consumer prices rose by nearly 12½ percent. During last year, the rise was 3.8 percent. Chart 1 shows this is the best since 1972 when prices were artificially held down by price controls, and the best since 1967 for a year without price controls. As chart 2 shows, the rise in producer prices, or the Wholesale index, was only 0.6 percent in 1983, the best in nearly 20 years. You can see here, Mr. Chairman, how it actually slipped below the zero line in the early 1960's, then began to rise and continued to rise dramatically during that period of 1973 and 1974, decelerated again by the 1976 period, rose again by 1980, and since then the producer price index has fallen dramatically, almost to zero—0.6 of 1 percent.

In 1980, the bank prime rate of interest hit a peak of 21.5 percent by year end. Today the prime rate is 11 percent.

The administration emphasis on the control of inflation and the stimulation of private sector growth are paying dividends now in the form of more jobs and a rising standard of living. By 1980 we could only look back on a decade of steadily accelerating inflation and a declining rate of real growth. The prospects for the future were for more of the same. Now, there is a genuine basis for optimism in the U.S. economic future.

We believe the economic recovery is sustainable. The 6.1 percent real growth in 1983 was a good performance for the first year of the economic recovery.

Mr. Chairman, I am going to point now to chart 4 in the charts that you have, skipping over chart 3 for brevity.

This shows changes in real GNP over the quarters starting in 1982 and running to the present. You can see the sharp decline in early 1982, a slight recovery, then down again, and this I think is the more important thing, a rate of growth in 1983 that has been declining to a sustainable level.

Now in conjunction with a good inflation performance, this should reduce any concern that the economy is growing too fast. You can see it from 9.7 to 7.6 to the 4.5-percent range at that period.

The current situation is still complicated by large Federal budget deficits and large out-year deficit projections. It would be difficult to demonstrate that these deficits exerted any harmful effects last year or are very likely to do so this year, but at some stage, as the economy approaches capacity, there could be an unattractive choice between the crowding out of private borrowers or the monetization of Federal deficits. This unpalatable choice must be avoided by reducing the excessively high rate of growth in Federal spending.

Federal spending has been rising steadily as a proportion of GNP. Genuine lasting reduction in the growth rate of Federal spending has been very difficult to achieve. It will be doubly difficult in an election year for reasons which hardly require extended elaboration. Nonetheless, we must make a beginning, a downpayment, to show our continued determination to bring the outyear deficits down, but we must do so in a way consistent with the continuation of economic growth.

The President, Mr. Chairman, is sincerely interested in making a downpayment. That is why he called last night for bipartisan development of a downpayment deficit reduction plan. He would like this to be comprised of some of the less contentious spending cuts still pending before the Congress, combined with certain measures to close tax loopholes and additional outlay savings based on the Grace Commission. This downpayment could reduce the deficit by at least $100 billion over the next 3 years. Several suggestions will be forthcoming in the President's budget next week. Additional suggestions from the Congress would be welcome.

Assuming that this downpayment is made and that the Federal budget moves toward balance and that the Federal Reserve can achieve and maintain a relatively steady and moderate rate of advance of money, the opportunity will exist for a lengthy, sustained economic expansion. Now with a cyclical recovery well underway, it is time to give more attention to the long-run performance of the economy. We need to shape our policies over the longer term to reinvigorate the private sector. Some crucial steps have already been taken, primarily in the tax area.

Marginal income tax rates have been sharply reduced from the levels they would have reached under prior law, although some of the reductions from 1980 levels have already been offset by bracket creep and higher payroll tax rates. Work, saving and investment incentives have been enhanced, and the use of tax shelters and the underground economy discouraged.

Starting in 1985, taxpayers no longer will be pushed into higher and higher tax brackets by the combination of inflation and a progressive tax structure. We will not permit inflation to undo the incentives we have created.

The rates on capital gains have been reduced again on top of the reductions passed in 1978. This should greatly assist the private sector in raising needed capital.

The tax treatment of depreciation has been restructured so as to encourage capital spending. Formerly, the combination of inflation and historic cost accounting meant that depreciation allowances failed to keep pace with the rising replacement costs of capital.

ECONOMIC OUTLOOK

The strength of last year's recovery and the progress made against inflation reflect the flexibility and adaptability of our economic system when proper policies are followed. If the same policy direction is maintained in future years, the current recovery can be extended and a clear break can be made with the past. The long period of sluggish growth and rising inflation can be brought to an end.

The outlook for 1984 is very encouraging. The broad outlines of our economic projections have already been released and can be summarized briefly. Further details will be provided in the forthcoming 1985 budget and the economic report of the President.

Real GNP is projected to grow 4.5 percent between the fourth quarter of 1983 and the fourth quarter of 1984 and inflation of 5 percent is expected during 1984 as measured by the GNP deflator. There are no signs of any new outbreak of inflation.

The rate of unemployment is projected to decline further in 1984. The forecast shows the unemployment rate at 7.7 percent by the fourth quarter of the year. It is crucially important to keep the unemployment rate declining. High rates of unemployment impose heavy costs on individuals and the families involved.

SAVINGS FLOWS AND THE BUDGET DEFICIT

The Federal deficit was financed in 1983 without undue difficulty or extreme pressure on the financial markets. The financing needs of U.S. businesses and consumers have readily been met despite the deficit financing demands of the U.S. Government.

Improvement in the corporate financial picture has been a major influence. Corporate cash flow more than covered corporate capital expenditures last year and corporations sold a record volume of new stock issues. Hence, corporations were able to improve their balance sheets and increase their liquidity without making heavy net demands on the debt market.

Difficulties would indeed arise if the Federal deficit were to remain very large at a time when private demands for credit were also high and rising. This appears quite unlikely to be the case in 1984 and may not be the case in 1985, but the risk is there and should be avoided.

Our ability to deal effectively with the deficit problem has been hampered by basic confusion over the cause of the deficits. About half of the current Federal budget deficit is due to lingering effects of the recession. That portion of the deficit need not be a cause for lasting concern since it can be removed by the gradual recovery of the economy. However, the remaining deficit—sometimes termed structural—would be left to deal with even after a cyclical recovery. Unfortunately, this remaining structural deficit will rise over the next several years unless action is taken to curb it.

The structural deficit is not due to the 1981 tax cuts. Those tax cuts simply held the ratio of receipts to GNP in an accustomed historical range—18 to 20 percent of GNP. Taxes would have climbed to about 24 percent of GNP by 1988 in the absence of the 1981 tax cut and tax indexing. Reversal of those tax cuts would only impede the recovery.

The same important point can be made in very practical terms for individual taxpayers. Chart 9 of the charts you have, Mr. Chairman, and in my prepared statement, shows the situation for a family of four with a $25,000 income. If the 1980 tax law had simply been extended forward—that is the orange line—the real tax burden in 1982 dollars would have increased by nearly 25 percent by 1988, a rise of about $1,000 in 1982 dollars.

Under current law, the real tax burden of the family remains approximately constant as a proportion of income at about the 1980 level. Here is the 1980 level right across here, and you can see in this blue line that the tax cuts brought that down. Although there has been a slight rise in the outyears here, it stays in the 1980 range. That is the point I am making, Mr. Chairman, that these tax cuts have really kept the burden on the average taxpayer in the historical range. It has not been a real massive tax cut.

The deficit problem has been created by a failure to control Government spending, which has taken a steadily rising share of GNP. An accompanying table, table 6, summarizes the fiscal situation. The data are based on the midsession 1983 budget revisions with the contingency tax removed, and will differ only slightly from the numbers to be released next week. Receipts will average at or above historical levels over the next 5 years in spite of the Reagan tax cuts. Outlays are substantially above historical levels. High outlays, through a failure to control the growth of Federal spending and low GNP because of the recession are the source of the projected deficits.

The best way to cure the outyear budget deficit problem is to cut the growth of spending. Tax increases can be counterproductive. They reduce the aggregate pool of savings from which deficits must be financed and they reduce the growth of output by lowering the after-tax rate of return in the private sector. Similarly, Federal borrowing preempts a larger portion of the savings pool for Federal use and reduces the share of the savings pool available for the private sector investment and growth. The choice between taxing and borrowing is a choice between two undesirable alternatives. The necessities for that choice would not arise if Government spending were placed under effective control. The budgetary problem must be solved primarily on the spending side.

At the same time, we must encourage private sector savings to help finance the deficit and economic growth. The total savings pool will expand in the context of a prosperous economy which provides adequate incentives to work and save. In addition, there are steps which can be taken to expand the savings pool further.

Among the several tax initiatives in the President's budget for fiscal year 1985 are improvements in the tax treatment of women's retirement savings. We recommend that individual retirement accounts, the IRA's, that under current law are limited to $2,250 in the case of a married couple with only one earning spouse, be increased so that one-earner married couples may contribute up to $4,000 annually. This places the housewife on a par with those women employed in the marketplace. Further, the administration proposes that divorced individuals be permitted to treat taxable alimony as compensation in determining the IRA limitation.

Other major steps toward promoting savings incentives, efficiency and tax fairness can and should be taken in the years ahead. Yesterday, in his state of the Union message, the President directed me to develop a plan of action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base so that tax rates can be lowered. I will present a set of specific recommendations consistent with these objectives to the President by December 1984.

The dismal vision of a rising Federal deficit and a fixed amount of savings is faulty. But the deficit problem is real enough and it will not go away automatically. Further intensive efforts are needed on the spending side of the budget equation.

As the President stated last night, better control over Government spending can be achieved if better tools are made available. Toward that end, the President is requesting a constitutional amendment to require a balanced budget and a constitutional amendment to provide him with line item veto authority.

MONETARY POLICY AND THE ECONOMY

Monetary policy has contributed greatly toward reducing inflation. This was not costless, however. Sharp reductions in money growth are typically followed by declines in real output and employment, as well as prices. The reduction of inflation since 1980 may be the decisive turning point in a move back toward relative price stability, but more needs to be done by the Federal Reserve to avoid short-term volatility of money growth. The administration supports moderate, stable, noninflationary money growth rates. This is not always easy to achieve, but it is essential. In the latest episode, M1 grew at a very rapid 13½ percent rate between July 1982 and July 1983. Since July 1983, growth in M1 has slowed to a 3 to 4 percent annual rate. The Federal Reserve needs to avoid these extremes in monetary growth and also to remember that money affects the economy only after a lag in time, variously estimated but averaging somewhere from 3 to 6 months. The abrupt deceleration of growth in M1 after mid-1983 threatens to begin to exert a dampening influence on real economic activity.

I think you can see that, Mr. Chairman, in chart 12 of my prepared statement which shows the growth rate of real GNP and the money supply. The money supply is in red; real GNP is lagged by about 5 months. You can see how they tracked each other.

Now this chart only goes to the end of 1983. In the month of December, the money supply started to turn up. Whether or not that is permanent, only time will tell. That is, this line here has turned up [indicating], and that might mean that again we will have the leveling off that we predicted in the earlier charts for the growth in real GNP which we are estimating to be at about 4.5 fourth quarter 1984 over fourth quarter 1983.

Current economic statistics cannot guide us here. We must look ahead. Changing growth rates in money exert their main effect upon future levels of activity. By the time the problem appears in the current statistics, the damage has already been done. In spite of definitional changes in the last few years, M1 has tracked real GNP much more closely than M2 or M3.

Currently, the recovery shows no signs of overheating. A stable moderate growth rate of money and credit is important to keep the recovery proceeding at its recent sustainable, noninflationary pace.

Now in conclusion, Mr. Chairman, the groundwork for a period of long-term prosperity has been laid. The control of inflation and the tax cuts are beginning to generate a much more favorable climate for investment and growth. The economy is on an upward course and inflation has been greatly reduced. Unemployment fell sharply last year, but remains at too high a level.

Given the achievement of a stable rate of monetary growth and success in reducing an excessive rate of growth in spending, the economy can continue to prosper in the years ahead. The hard part is now behind us and the outlook for the future is better than it has been in many years.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Regan follows:]

PREPARED STATEMENT OF HON. DONALD T. REGAN

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you to discuss the state of the economy and the near-term economic outlook. The main features of the Administration's economic approach were described last night by the President in his State of the Union Message. Details on the Budget for Fiscal Year 1985 and the President's 1984 Economic Report will be available next week. I will concentrate this morning on broad features of the current economic situation and our view of the future.

The economy has made a strong recovery and is poised for a long period of expansion without a return to high and rising rates of inflation. This assumes that monetary policy will be geared to the long-run control of the price level and will avoid the wide short-run swings in monetary growth which have been so destabilizing in the past. Fiscal policy must aim at a gradual reduction of the Federal budget deficit by restraining the growth of spending and thereby enlarging the scope for private sector activity which is the only long-term source of growth in the tax base.

The foundation for a sustained period of economic expansion is now in place. The rise last year in producer prices was the lowest in nearly twenty years. The increases in consumer prices in 1982 and 1983 were the lowest in more than a decade. Yet the economy grew strongly last year and the decline during the year in the rate of unemployment was larger than during any year in more than three decades. Unemployment remains too high but is being reduced rapidly by the dynamic growth of the private sector. Productive jobs are being created, rather than the make-work charades under government auspices which have proved so ineffective in the past.

Economic Overview

It is too easily forgotten just how difficult the economic situation had become by the beginning of this decade and how much progress has been made in a few short years. Some key comparisons are summarized in an attached table (Table 1). In interpreting that table it should be recognized that 1980 was a year of recession and 1983 was a year of recovery. While not all indicators showed improvement, the magnitude of the gains since 1980 in most key areas is striking indeed.

- o During 1980, real GNP actually fell. During 1983 it rose by 6.1 percent. Only two years in the last twenty have posted a larger gain.

- o During 1980, employment fell by about 400 thousand persons. During 1983 it rose by 4 million, the second largest rise during a calendar year in more than three decades. Over 104 million Americans are at work, a record number.

- o In 1980, money compensation per hour (wages plus fringes) rose by about 10-1/2 percent but that apparent gain and more besides was chewed up by inflation. Real compensation before taxes fell by about 2-1/2 percent in 1980 and by an estimated 3 percent in terms of take-home pay. Real compensation rose by 2-1/2 percent during 1983 before tax and by more than 3 percent in terms of take-home pay. The real wage gains posted in 1982 and 1983 were the first since a narrow pre-tax increase was recorded in 1978.

- o During 1980, consumer prices rose by nearly 12-1/2 percent. During last year the rise was 3.8 percent, the best since 1972, when prices were artificially held down by price controls, and the best since 1967 for a year without price controls (Chart 1). The rise in producer prices was only 0.6 percent, the best in nearly twenty years (Chart 2).

- o In 1980, the bank prime rate of interest averaged 16.7 percent and hit a peak of 21-1/2 percent by year end. The prime rate is currently 11 percent.

The Administration emphasis on the control of inflation and the stimulation of private sector growth are paying dividends now in the form of more jobs and a rising standard of living. By 1980 we could only look back on a decade of steadily accelerating inflation and a declining rate of real growth. The prospects for the future were for more of the same. Now there is a genuine basis for optimism in the U.S. economic future.

The change for the better is clearly reflected in the performance of the U.S. stock market, up about 60 percent from mid-1982 and 80 percent from its 1980 lows. Confidence in the Administration's ability to continue restraining inflation, plus the more favorable tax treatment of income from capital and the outlook for high returns from economic growth have also induced a substantial net inflow of capital from abroad into a wide range of real and financial investments in this country. This inflow from abroad has expanded the pool of national savings and eased the pressure on our financial markets. More importantly, it reflects a fundamental judgment by foreign investors that U.S. economic policies are sound and that longer-term U.S. economic prospects have improved greatly in recent years.

The current situation is still complicated by the fact of large Federal budget deficits and the existence of large out-year deficit projections. It would be difficult to demonstrate that these deficits exerted any very harmful effects last year, or are likely to do so this year. But, large Federal budget deficits are potentially harmful as the economy approaches full utilization of its real and financial resources. At some stage, there could be an unattractive choice between the crowding-out of private borrowers on a sizable scale or the monetization of Federal deficits. This choice between unattractive alternatives must be avoided by reducing the excessively high rate of growth in Federal spending.

Federal spending has been rising steadily as a proportion of GNP. Genuine lasting reduction in the growth rate of Federal spending has proved to be very difficult to achieve. It would be doubly difficult in an election year for reasons which hardly require extended elaboration. But a beginning should be made, a sort of downpayment to show a continued determination to bring the outyear deficits down in a way consistent with the continuation of economic growth.

Monetary policy has contributed greatly toward the reduction of inflation. The reduction of inflation since 1980 may very well prove to have been the decisive turning point in a move back toward relative price stability. But more needs to be done by the Federal Reserve to avoid short-term volatility of monetary growth so that economic expansion may continue to generate rising employment, rising living standards, and rising Federal revenue.

Assuming that the Federal Reserve can achieve a relatively steady and moderate rate of advance in money and that the Federal budget can gradually be moved toward balance, the opportunity will exist for a lengthy, sustained expansion. It is time now with a cyclical recovery well under way to give more attention to the long-run performance of the economy. We need to shape our policies over the longer term to reinvigorate the private sector. Some crucial steps have already been taken, primarily in the tax area:

- o Marginal income tax rates have been sharply reduced from levels they otherwise would have reached under prior law, although some of the reductions from 1980 levels have already been offset by bracket creep and higher payroll tax rates. Work, saving and investment incentives have been enhanced, and the use of tax shelters and the underground economy discouraged.

- o Starting in 1985, taxpayers no longer will be pushed into higher and higher tax brackets by the combination of inflation and a progressive tax structure. We will not permit inflation to undo the incentives we have created.

- o The top income tax bracket rate has been reduced to 50 percent. Very high marginal tax rates merely result in reduced effort, or else drive effort off the books.

- o The rates on capital gains have been reduced again on top of the reductions put through in 1978. This should greatly assist the private sector in raising needed capital.

- o The tax treatment of depreciation has been restructured so as to encourage capital spending. Formerly, the combination of inflation and historic cost accounting meant that depreciation allowances failed to keep pace with the rising replacement costs of capital.

All in all, those rules of the economic game relating to rewards and incentives have been rewritten to bring them more in line with the needs of a market oriented economy, largely dependent upon private sector initiative. Similarly, the gradual drift toward greater and greater concentration of rule-making and decision-making in Washington is being reversed. There have been notable successes in deregulation -- of financial intermediaries, of energy prices, of trucking, and of airlines. Some of these were started by previous Administrations, but this Administration has pushed the deregulation program forward vigorously. The number of rules and regulations and the paper flow to Washington generally have been curbed in a substantial way. The year 1984 will be one of further reductions in Washington's involvement in the marketplace. The best insurance for strong long-run economic performance is to rely increasingly on market signals, not on a stream of bureaucratic directives from Washington.

<u>Economic Recovery in 1983</u>

Last year demonstrated the effectiveness of the Administration approach. The economy grew rapidly as it typically does in the first year of recovery and progress against inflation continued. As a result, the cycle of accelerating inflation that began in the mid-1960's has been interrupted. As shown in an accompanying chart (Chart 3), the rise in prices and unit labor costs was less last year than in the first year of any cyclical recovery since the upsurge in inflation began in the mid-1960's.

The rise last year in real GNP of 6 percent exceeded expectations. At the beginning of the year it was expected that real growth would be held down by the height of real interest rates which some traced to the size of the Federal budget deficit, and others to prior episodes of monetary volatility. While interest rates remained relatively high, they were down from 1981 and 1982 levels and the economy expanded vigorously. The quarterly pattern of growth in real GNP during 1982 and 1983 is shown in an accompanying chart (Chart 4).

At the beginning of 1983, the consensus of the private forecasting community was for real growth of roughly 4 percent during 1983. The Administration was even more cautious with a forecast of only a little over 3 percent real growth, although by mid-year we pushed our estimate up to 5-1/2 percent. The final result for the year was slightly above 6 percent. Real growth moderated to a 4-1/2 percent annual rate by the fourth quarter. In conjunction with good inflation performance, this should reduce any concern that may be felt about the economy's growing too fast.

At the beginning of last year the private consensus was that prices, as measured by the GNP deflator and the consumer price index would rise by 5 percent or a little more. The Administration shared that view. Actual performance was considerably better. The GNP deflator rose only a bit more than 4 percent during 1983. As mentioned earlier, the rise in consumer prices during the year was 3.8 percent, the best performance since 1972. The rise in producer prices was only 0.6 percent, the best in nearly twenty years (Table 2).

Last January the unemployment rate was close to 10-1/2 percent. Private forecasters projected a decline to the 10 percent range by the fourth quarter of last year. With its slower growth forecast, the Administration was also projecting an unemployment rate above 10 percent. Actual performance was, as we know, quite different. The rate for all workers, including the resident armed forces, hit 8.1 percent by December. The consensus economic forecast -- as exemplified by the projections of the Blue Chip panel of economists at major financial institutions, business corporations and academic research organizations -- did not call for our reaching those levels of the unemployment rate by the end of 1984, let alone 1983.

The bottom line of concern to workers and employers is the behavior of real wages and productivity. Workers want real wage gains, not the wheel-spinning that is characteristic of the inflationary process. For example, between 1972 and

34-871 O - 84 - 2

1982 real compensation per hour in the nonfarm business sector (wages plus fringes) did not rise at all on a pre-tax basis and actually fell after taxes despite a rise of about 130 percent in compensation expressed in money terms. For their part, employers are anxious to see gains in productivity since otherwise increases in money wages are reflected in rising prices, which the competitive situation may not permit, or come directly out of profits, which can eventually lead to business failure.

A dramatic change for the better has been taking place. As shown in an accompanying table (Table 3), both employees and employers gained in 1983. Growth in money compensation slowed but real wages rose -- as they did in 1982. This contrasts sharply with a double digit increase in money compensation in 1980 and an actual decline in real wages. Productivity gains increased in 1983 and the rise in unit labor costs was held to less than 2 percent -- a far cry from unit labor cost increases in the 10 to 11 percent range in 1979 and 1980.

Despite a widespread belief at the beginning of last year that the current expansion would be stunted, the actual performance compares favorably with earlier cyclical recoveries. An accompanying chart (Chart 5), compares last year's record for some key statistics with the average of post-Korean recoveries, excluding the short-lived 1980 recovery.

- Industrial production rose 15 percent in 1983, slightly more than the 13.5 percent gain averaged in previous recoveries.

- The composite index of leading indicators rose 16.2 percent in 1983, slightly more than the 15.5 percent averaged in previous recoveries.

- Manufacturing employment was up 5.8 percent, exceeding the 3.7 percent rise in earlier recoveries.

- Real retail sales were up 6.8 percent last year but are running a little behind the pace in earlier recoveries. Consumer confidence is at the highest level in more than a decade and the pace of consumer spending may pick up further.

Concern has also been expressed that the current expansion would be severely unbalanced because of the height of interest rates. Interest rates are higher than we would like to see them, but it seems that the downward movement of interest rates since early 1982 was more important than their levels. Consequently, the expansion during 1983 seemed to follow previous cyclical patterns fairly closely in terms of the contribution to total growth from the major sectors of the economy. An accompanying table (Table 4) shows the contributions to a typical recovery by real GNP components during the first year of cyclical recovery and the record in 1983. The differences in 1983 from the typical cyclical pattern were relatively minor except for net exports which were substantially lower than in prior recoveries.

Typically, the early stages of recovery are powered by: (1) a swing in inventory investment; (2) a resurgence in home-building activity; and (3) an increase in consumer spending. All three contributed importantly to growth in 1983. Business capital spending typically contributes but little to the early stages of recovery, but was stronger than normal last year, and can be expected to post a strong gain this year. To this point, there is little indication that the current expansion is unbalanced despite the fact that interest rates are at relatively high levels. The recovery should remain balanced if interest rates can resume their decline.

Credit Flows and Financial Markets

Interest rates were lower at the beginning of 1983 than at the beginning of 1982 and generally remained at those lower levels until about mid-year. At that time, however, rates rose somewhat and ended the year slightly higher, with most rates ending the year about 75 to 125 basis points above year earlier levels. For example, at year end, the 3-month Treasury bill rate stood at 8.97 percent, compared with 8.02 percent at the end of 1982. The 3-month commercial paper rate, representing the cost of short-term funds for business borrowers, was 9.51 percent at the end of the year, in contrast to 8.60 percent at the close of 1982. And the rate for new Aa-rated corporate bonds ended 1983 at 12.82 percent, up 75 basis points on balance over the year. Long-term Treasury bond yields, as represented by the 20-year rate, were up about 130 basis points over the course of 1983, and municipal bond yields rose only about 20 basis points in 1983.

Some rates did decline in 1983 however. The prime rate, for example, was 11 percent at year end, down from 11-1/2 percent at the end of 1982; and the rate for new conventional home mortgages declined from 13.62 percent to 13.48 percent over the year.

Although interest rate changes were relatively small on balance over 1983, credit markets were able to absorb a heavy volume of new borrowing in the year. In the first three quarters of the year -- the latest data available -- domestic nonfinancial borrowings were at an annual rate of $494 billion, about $100 billion above such borrowings in 1982. (See Table 5.) Most of the increase in domestic nonfinancial borrowing in 1983 represented a sharp rise in demands by households, largely in the form of home mortgages and consumer credit, and in borrowing by the U.S. Government. As may be seen in Table 5, the funds for the 1983 rise in borrowings by domestic nonfinancial concerns came primarily through financial intermediation at commercial banks and savings institutions, both of which benefitted from very heavy inflows of funds to new deposit accounts, especially MMDA's, in the first half of the year. More fundamentally, the larger supplies of funds to credit markets in 1983 reflected the ability of an expanding economy to generate large saving flows, even though the saving rate remained relatively low in 1983.

An important feature of the economic expansion up to now has been what might be termed its capacity for self-financing. The financing needs of U.S. businesses and consumers have readily been met in the financial markets, despite the deficit financing demands of the U.S. Government. Improvement in the corporate financial picture has been a major influence (Chart 5). Corporate cash flow more than covered corporate capital expenditures during the first three quarters of 1983; and, moreover, corporations sold a record volume of new stock issues. Hence, corporations were able to improve their balance sheets and increase their liquidity without making heavy net demands on the debt markets.

The health of business balance sheets has been one reason why those people who said large Federal deficits inevitably meant "crowding out" have been proven wrong. Those are the people who failed to recognize that the type of changes we have instituted in the tax laws -- shortened depreciation lives, liberalized tax credits, lowered capital gains taxes, and reduced marginal tax rates -- crowd <u>in</u> business profits. That situation may gradually change as corporate credit demands increase, but the 1983 experience should stand as an object lesson to those who view Federal deficits as a growing charge against a fixed amount of savings. In a dynamic, growing economy, the pool of savings is constantly being enlarged.

The Economic Outlook

The strength of last year's recovery and the progress made against inflation reflects the flexibility and adaptability of our economic system when proper policies are followed. The foundation for further expansion is securely in place. If the same policy direction is maintained in future years, the current recovery can be extended and a clear break can be made with the past. The long period of sluggish growth and rising inflation can be brought to an end.

The outlook for 1984 is very encouraging. The broad outlines of our economic projections have already been released and can be summarized briefly. Fuller details will be provided in the forthcoming 1985 Budget and the Economic Report of the President.

- Real GNP is projected to grow 4-1/2 percent between the fourth quarter of 1983 and the fourth quarter of 1984. That happens to be much the same real growth rate being carried in the Blue Chip consensus -- the panel of private economists at financial institutions, business corporations and academic research organizations. Some modest slowdown in growth is normal in the second year of cyclical expansions. The average rise of 6.8 percent in the first year of five previous expansions -- excluding the Korean War period and the short-lived 1980 recovery -- was followed by an average 3.8 percent advance in the second year. An economy as complex as ours does not run to a rigid cyclical timetable, but all things considered real growth in the 4-1/2 percent range over the four quarters of this year would appear to be a plausible outcome, assuming no international or monetary shocks.

- Inflation as measured by the GNP deflator is expected to edge up a little and a rise of 5 percent is expected during 1984, roughly a percentage point above this year's result. Some favorable factors, particularly in the food and energy areas, may not be present to the same degree in 1984 that they were this year. There are no signs, however, of any new outbreak of inflation. Productivity is rising and wage increases have moderated. While these factors are important, over any protracted period of time the key determinant of inflation is the rate of growth in money. If the Federal Reserve maintains a steady, moderate rate of growth in money, the recent good record of inflation can be extended.

- The rate of unemployment is projected to decline further in 1984. The forecast shows the unemployment rate at 7.7 percent by the fourth quarter of the year. It is crucially important to keep the unemployment rate declining. High rates of unemployment impose heavy costs on the individuals and families involved.

The composition of this year's gain in real output will probably change somewhat. The first year of an expansion typically receives a large boost from inventory investment. During 1983 inventory investment accounted for about two-fifths of the total rise in real GNP and a more modest contribution is likely this year. Residential construction is also unlikely to post gains on anything approaching last year's scale and may be relatively flat as is typical of the second year of expansion. On the other hand, business capital spending is gaining momentum and should make a strong contribution to growth in 1984. Net exports have been a large negative influence in recent quarters but should be less of a drag during the course of the year. State and local governments have moved into surplus and their expenditures may begin to grow a bit more rapidly. Growth in Federal outlays, on the other hand, will be under continuing downward pressure in view of the size of the deficit although the pattern of Commodity Credit Corporation outlays can sometimes obscure the underlying picture for short periods of time. The consumer, the driving force behind any strong economy, has benefitted from real wage gains and rising employment in addition to reduced marginal tax rates. High levels of consumer confidence and a reduced consumer debt burden suggest that the consumer sector will continue to be strong during 1984.

It must be obvious to all of us that economic forecasting is an uncertain art. There is always the potential for surprise. One can always draw up a list of things that could go wrong. In the present situation it might include such familiar items as: monetary slowdown and recession, an unexpected surge in budget deficits and crowding out or some international financial shock with domestic effects. These are not possibilities that can be dismissed out of hand, but they are not likely to happen either, and they surely do not constitute a barrier to continued expansion as long as policy reactions are sensible. Certainly, 1984 can be a very good year for the economy.

Savings Flows and the Budget Deficit

The Federal deficit was financed in 1983 without undue difficulty or extreme pressure on the financial markets. Most financial experts anticipate that 1984 will be a similar situation. Federal borrowing typically rises in recessions as tax receipts decline, but there is a compensating decline in private borrowing. The cyclical pattern is shown in an attached chart (Chart 7). In the early years of recovery, net corporate financing requirements remain modest and Federal borrowing requirements decline, or should decline with appropriate controls over Federal spending. This cyclical pattern is complicated in the current setting by longer-range projections of an enduring Federal deficit -- a so-called structural deficit. Difficulties would indeed arise if the Federal deficit were to remain very large at a time when private demands for credit were also high and rising. This appears quite unlikely to be the case in 1984, and may not be in 1985, but the risk is there and should be avoided.

Our ability to deal effectively with the deficit problem has been hampered by basic confusion over the cause of the deficits. About half of the current Federal budget deficit is due to lingering effects of the recession. That portion of the deficit need not be a cause for lasting concern since it can be removed by the gradual recovery of the economy. However, the remaining deficit -- sometimes termed structural -- would be left to deal with even after a cyclical recovery. Unfortunately, this remaining structural deficit will rise over the next several years unless action is taken to curb it.

The structural deficit is not due to the 1981 tax cuts. Those tax cuts simply held the ratio of receipts to GNP in an accustomed historical range -- 18% to 20% of GNP. Reversal of those tax cuts would only impede the recovery and turn the fiscal clock back to 1980. An accompanying chart (Chart 8) shows the rising Federal tax claim on GNP. By 1980 that claim had reached 20.1 percent of GNP and would have risen further to about 24 percent by 1988 in the absence of the 1981-82 tax cuts. The 1981 tax cuts and the tax indexing which becomes effective next year forestalled a further upward surge in the tax-GNP ratio but did not lower it below normal levels.

The same important point can be made in very practical terms for individual taxpayers. An accompanying chart (Chart 9) shows the situation for a family of four with a $25,000 income. If the 1980 tax law had simply been extended forward, their real tax burden (in 1982 dollars) would have increased by nearly 25% by 1988 -- a rise of about $1,000 in 1982 dollars. Under current law, the real tax burden of the family remains approximately constant as a proportion of income at about 1980 levels.

The deficit problem has been created by a failure to control government spending which has been a steadily rising ratio to GNP. An accompanying table (Table 6), summarizes the fiscal situation. The data are based on the Mid-Session 1983 Budget revisions (the contingency tax has been removed) and will differ only slightly from the numbers to be released next week. Receipts will average at or above historical levels over the next five years in spite of the Reagan tax cuts. Outlays are substantially above historical levels. High outlays, through a failure to control the growth of Federal spending, and low GNP, because of the recession, are the source of the projected deficits.

The best way to cure the out-year budget deficit problem is to cut the growth of spending. Spending is the ultimate source of crowding out (Chart 10). Tax increases do not help in any fundamental way. They reduce the aggregate pool of savings from which deficits must be financed and they reduce the growth of output by lowering the after-tax rate of return in the private sector. Similarly, Federal borrowing reduces the amount of the savings pool available for private sector investment and growth. The choice between taxing and borrowing is a choice between two undesirable alternatives. The necessity for that choice would not arise if government spending were placed under effective control. The budgetary problem must be solved primarily on the spending side.

It would appear to be very questionable how much actual progress has been made in controlling Federal spending. There is a widespread misapprehension that nondefense spending has been cut back sharply. Nothing could be further from the truth. An attached table (Table 6) compares the March 1981 budget projections for discretionary spending (total outlays less defense, social security, medicare and interest on the debt) with the projections a little more than two years later in the Mid-Session Review of the 1984 Budget. It shows that discretionary spending continues to run from $85 to $95 billion above the March 1981 targets. In conjunction with the recession-induced short-fall in receipts, this would appear to account more or less for the current budget deficit. There is still a need for further spending restraint.

At the same time, we must encourage private sector savings to help finance the deficit and economic growth. The total savings pool will expand in the context of a prosperous economy which provides adequate incentives to work and save. In addition, there are steps which can be taken to expand the savings pool further.

For example, among the several tax initiatives in the President's Budget for Fiscal Year 1985 are improvements in the tax treatment of women's retirement savings. We recommend that individual retirement accounts (IRAs), that under current law are limited to $2,250 in the case of a married couple with only one earning spouse, be increased so that one-earner married couples may contribute up to $4,000 annually. This places the housewife on a par with those women employed in the marketplace. Further, the Administration proposes that divorced individuals be permitted to treat taxable alimony as compensation in determining the IRA limitation.

Other major steps toward promoting savings incentives, efficiency and tax fairness can and should be taken in the years ahead. Yesterday, in his State of the Union Message, the President directed me to develop a plan of action to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base so that tax rates can be lowered. I will present a set of specific recommendations, consistent with these objectives, to the President by December, 1984.

The Treasury Department already has spent a good deal of time during 1982 and 1983 examining ways to make fundamental changes in our current tax structure. They have focused on the consumed income tax but have also begun study of the value added tax, a national sales tax, other forms of consumption taxes, and various forms of broad-based, low rate income taxes such as the flat tax.

At the President's direction, our study of these alternatives will be intensified over the next twelve months. By the end of the year, I expect that we will have a single set of concrete recommendations for fundamental changes in our present income tax structure that will make our system of taxation more simple, more fair, and more efficient.

During this year of study we will have to deal with some very difficult issues associated with any radical transformation of the income tax structure. Some tough and unpopular decisions will be part of the price to pay for a simple, equitable system of taxation.

The dismal vision of a rising Federal deficit and a fixed amount of savings is faulty. But the deficit problem is real enough and it will not go away automatically. Further intensive efforts are needed on the spending-side of the budget equation.

As the President stated last night, better control over government spending can be achieved if better tools are made available. Toward that end, the President is requesting a Constitutional Amendment to require a balanced budget, and a Constitutional Amendment to provide him with line item veto authority.

Monetary Volatility and the Economy

A stable expansion of the economy will require a steady growth of the money supply at a moderate, non-inflationary pace. The challenge now to the monetary authorities is to avoid the extreme volatility of monetary growth that has been characteristic of recent experience.

There can be no doubt that monetary growth has been volatile by any standard. Empirical work at the Treasury suggests that this monetary volatility may account for 200 to 300 basis points (2 to 3 percentage points) of the level of short-term interest rates. Because of monetary volatility, the Federal Reserve target ranges for M1 have not meant as much as they could have. In the 206 weeks since the fourth quarter of 1979 when the Federal Reserve began to place greater emphasis on growth of the monetary aggregates, M1 has been within the target range only 41 weeks, just about 20 percent of the time. Monthly growth rates in M1 have ranged from a 26 percent annual rate of increase to a -24 percent rate. The Federal Reserve contends that very short-term fluctuations in M1, such as weekly and monthly oscillations, are of little or no consequence. But over more extended periods of time, the money supply has either run ahead too strongly or slowed to a crawl. This is shown in an accompanying chart (Chart 11).

A few examples of these wide and destabilizing swings in monetary growth should be noted:

- o After increasing the money supply at nearly a 12 percent annual rate in early 1981, the Federal Reserve put on the monetary brakes. M1 grew at less than a 2 percent annual rate from April to October 1981 (on the basis of the data available at the time M1 actually fell) and the economy went into recession.
- o After rebounding to a 14 percent annual rate in late 1981 and early 1982, the growth of M1 slowed abruptly to 3 percent from January to July 1982. Interest rates remained at very high levels and the recession deepened.
- o Instead of easing in a cautious, controlled fashion, the Federal Reserve veered over to a very rapid 13-1/2 percent rate of growth in M1 in the next twelve months -- July 1982 to July 1983.
- o Since last July M1 has grown at only about a 2-1/2 percent annual rate. This abrupt deceleration could begin to pose a threat to the recovery if it were to continue very much longer.

M1 has alternated between very high and very low growth rates for extended periods of time. These extremes in monetary growth should be avoided.

It is also important to note that money affects the economy only after a lag in time, variously estimated but averaging somewhere from three to six months. Current economic statistics cannot guide us here; we must look ahead. By the time the problem appears in the current statistics, the damage has already been done.

In spite of definitional changes, M1 has tracked real GNP much more closely than M2 or M3. Chart 12 shows the close relationship between the growth rate of M1 and growth in real GNP several months later. Currently, the recovery shows no signs of overheating. A stable, moderate growth rate of money and credit is important to keep the recovery proceeding at its recent sustainable, non-inflationary pace.

<u>The International Economy</u>

Let me turn now to a look outside our borders. Economic recovery has begun abroad and will be strengthening and spreading this year. In 1982 real GNP in the industrial countries as a whole did not grow at all. Last year, led by the U.S. recovery, we estimate that real growth was over 2 percent on an annual average basis. This year we are projecting about 4 percent real output growth on a weighted average basis for the industrial world. Even excluding the United States, average growth should be about 3 percent. This will be the best growth performance since 1978 for the industrial countries as a whole. In fact, it will be a more solid performance than we had in the late 1970's because the current world recovery is taking place with sharply reduced inflation. In contrast, in the late 1970's inflation was accelerating, and this accelerating inflation soon helped to put an end to real growth.

This is not to say that all is well. Unemployment remains high, and has not come down yet in Europe the way it has here. A large number of the less developed countries still suffer from very low growth rates. Even in the case of the LDCs, though, I am encouraged by prospects for considerably improved growth performance this year. I should also note that the greatest difficulties have occurred for the countries, particularly in Latin America and Africa, which have had serious financial problems. Most of the developing countries in Asia have been able to record continued high growth in the last few years. While financial problems remain for many countries, the partnership of governments, banks and the IMF has been successful in dealing with these problems. With the experience gained, it should be possible to continue adjustment and expand growth this year.

The United States has played a crucial role as a catalyst in fostering the world recovery. At the psychological level, the strong and highly visible U.S. advance last year was an effective counter to the pessimism about industrial country recovery which was particularly widespread in Europe. The optimism engendered by the U.S. recovery has, in a way that is difficult to quantify, stimulated domestic sources of growth in the industrial countries abroad. While some skepticism remains, the prospects in Europe have looked better from the second half of 1983 on. Germany in particular has had a recovery that has surprised many observers there.

The United States has also stimulated world recovery through its growing merchandise trade deficits. In the first eleven months of 1983, U.S. imports from non-OPEC LDCs rose nearly $9 billion. In the same period our trade balance with Western Europe moved $5-1/2 billion in their favor. These changes have assisted recovery in these countries. As the latest OECD report on the U.S. economy says, "strong non-inflationary growth in the United States has made an important contribution to the stabilization of the world economy."

More and more, people are recognizing that world recovery is underway and that the United States is a beneficial force in it. But we are still hearing the argument that high U.S. interest rates are hindering recovery abroad. Now if this means the level of U.S. interest rates, the argument is odd indeed. Between the end of 1980 and the end of 1983 U.S. short-term interest rates fell by almost one-half -- a greater percentage decline and a greater absolute decline than in any other Summit country.

But perhaps the argument pertains to interest rate differentials, with the point being that other countries have had to maintain interest rate differentials with U.S. financial instruments in order to protect their exchange rates. Once again the argument is defective, since between the end of 1980 and the end of 1983 short-term interest rate differentials between the dollar and each of the other Summit country currencies moved against the dollar. If these countries had kept the differential between U.S. interest rates and their own interest rates constant over the past three years, they would have been able to lower their own interest rates more than they did, in some cases by very large amounts.

A key reason why interest rates have not fallen more rapidly abroad is fear of inflation. Over the past three years, consumer price inflation has fallen more in the United States than in any of the other Summit countries. Monetary growth has been above target in France, Germany and Japan, and close to the upper end of a 7-11 percent target range in the UK. Even in countries which have achieved low inflation rates, to have allowed more rapid monetary growth in order to reduce interest rate levels, might well have been considered unwise from the perspective of inflation control.

It is far from clear that, if only U.S. interest rates were lower, other countries could simply lower their rates. Faster money growth abroad could conceivably produce higher interest rates due to fears of higher inflation, rather than sustainable real growth. It is, therefore, hard to understand the argument that U.S. interest rates are damaging foreign economies. On the contrary, by fostering a recovery and contributing to stronger trade balances abroad, the United States is helping to raise, not lower, growth in the rest of the world.

Encouraging Long-Term Growth

The groundwork for a period of long-term prosperity has been laid. The tough issues of breaking inflation, restoring productivity growth, returning investment and work incentives to the marketplace through a reduced government role and putting the economy back on a growth path have been faced. The hard part is now behind us and the outlook for the future is better than it has been in many years.

Yet we continue to hear cries for an industrial policy, a vague term that some feel embodies the solution to the natural problems of an ever-changing economic environment. Industrial policy has been variously defined, but basically means that government should select certain industries for special support to produce an industrial structure different from what the market would have produced. Government bureaus should assist those industries showing the greatest promise, while propping up those having difficulties. Proponents of industrial policy promote it as the way to assure the economy's long-term ability to grow and adapt.

There is no argument that the sluggish economic performance of the last decade resulted in sectoral problems and industrial distress. Rising trade deficits brought demands for government protection for affected industries. It was clear that there was a need for higher rates of real growth. However, careful examination of the industrial policy concept shows that it is more likely to entangle the economy once again in a web of government interference, which could only slow growth, rather than to foster an environment in which the economy can respond smoothly and rapidly to the changing demands of the market place.

If we examine the premises on which the case for industrial policy is based, we will find that they are faulty and thus lead to the faulty conclusion that industrial policy can solve the problems faced by the U.S. economy. A first argument for the need for industrial policy is the understandably alarming belief that America is in process of deindustrializing -- that the U.S. manufacturing sector is slipping relative to other nations. In fact, the slower growth of manufacturing compared to overall GNP is a pattern that has repeated itself throughout the industrial world. Indeed, correcting for the business cycle, manufacturing in the United States roughly held its share of GNP during the 1970's. While employment in manufacturing did decline, this decrease was largely a result of productivity gains that freed up labor for the dramatic expansion of employment and output in the service sector.

Secondly, advocates of industrial policy look to the admittedly impressive economic progress of Japan and attribute that to the industrial policy followed by its Ministry of International Trade and Industry (MITI). While MITI has had its successes, it has also made serious errors, including trying to prevent Honda from entering the auto market, attempting to discourage Sony from focusing efforts on transistors, and devoting far more scarce capital to the steel industry than could profitably be employed. The more likely sources of the admirable growth of the Japanese economy are the nation's favorable tax treatment and resulting high rates of saving and investment, and the ingenuity of its private entrepreneurs.

Another point used to support the case for industrial policy is that somehow Washington can make better business decisions than can business. This is surely among the least plausible arguments. Anyone who has worked in the business world, as I have, knows the difficulty of assessing swings in consumer sentiment, or the impacts of technological breakthroughs, moves by the competition both here and abroad, or erratic government policies. It seems highly unlikely that a Federal agency would be in a better position to make decisions regarding the fate of an industry than those whose livelihoods are tied to that industry.

Industrial policy advocates recommend that the government be responsible for allocation of capital to the most rewarding industries. They suggest that capital should be concentrated in high-value-added, high-wage industries. But the result of this would be to force displaced labor to crowd into the low-tech, low-wage jobs that would be passed over by capital allocation. The only excuse for directing capital is to see that it would flow to the most rewarding projects. But that is the function of the free market, which is more sensitive to industry conditions than any government computer and less biased than any government bureaucrat.

Finally, there are those who seek through industrial policy some sort of beneficent government agency that would assist those industries showing the greater promise while propping up those having difficulties. But in the political atmosphere which rightfully characterizes a democracy, industrial policy would be subjected to special interest pleadings. Even a supposedly balanced council of government, business, and labor may have admirable goals of maximization of financial return or humanization of the workplace but would ultimately be at the mercy of some 15,000 lobbyists plying their trade in Washington. A rationally conceived tax deduction or subsidy for one industry on the grounds of economic efficiency would become a tax deduction or subsidy for all on the grounds of equity. Protection for one would become protection for all.

The views of the industrial policy advocates are not entirely new nor untested. We already have a huge array of government programs which build infrastructure, support education and retraining, and direct investment funds. In 1983 budget spending for education, training, housing, energy, transportation, community development, public works, and commercial and agricultural subsidies was more than $50 billion. Federal credit programs for these purposes include direct loans of about $47 billion and loan guarantee commitments of about $84 billion. Special treatment for income from, or investment in, the above areas is estimated to amount to over $115 billion. Yet criticisms concerning the overgrown size of Federal lending activities, the complexity of the tax code, and the waste and inefficiency of Federal spending are legion. How could we expect that experience with an even broader program of industrial policy would be better?

My skepticism regarding the promise of industrial policy is not intended to deny that problems exist in the U.S. economy which need to be resolved. Unemployment remains too high and there are industries that do not yet have a firm footing in recovery. But I would argue that the solutions to these problems lie in letting the marketplace pick the winners and losers, in a growing, dynamic economy, rather than having the Federal government reallocate resources in the static economy of limited resources apparently envisioned by the industrial policy advocates.

The economy is continually changing. The buggy-whip went out with horsedrawn carriages and the adding machines with which some of us once worked have been made obsolete by handheld calculators and personal computers. Instead of attempting to smooth the transitions such as these through an industrial policy, fraught with the problems discussed above, the Administration has chosen an incentive-oriented, free-market, pro-growth policy.

Rather than reallocating private sector resources, our program is designed to expand them by reducing Federal spending and government regulation. By limiting Federal intrusion in the market place, additional funds can be relinquished to both consumers and investors. Lowered tax rates on individuals and business have already begun to restore incentives to work, save, and invest. Accelerated depreciation on plant and equipment will do much more in the long run for ailing companies than attempts by Washington to reallocate capital.

The results of our policies have become evident over the past year. We have seen a sharp reduction in both inflation and interest rates. As the fundamentals of business investment have improved, there has been a dramatic increase in equity formation and the generation of venture capital. Job growth has surged.

The Administration has taken other steps geared at assuring the economy of long-term growth. The President has appointed a Commission on Industrial Competitiveness to review such subjects as research and development, education and job training, among others. The Justice Department has taken a new course in antitrust policy in order to promote cooperative research and development efforts by companies in the same industry. And we are targeting job training programs to assist in preparing the long-term unemployed for private, rather than public sector, jobs.

These steps are geared to promote growth but not to put the Federal government in the business of business. All evidence points to the fact that our program is working. To attempt greater Federal involvement through industrial policy would be a major step backward.

Conclusion

Substantial progress has been made during the last few years. The control of inflation and the tax cuts are beginning to generate a much more favorable climate for investment and growth. The economy is on an upward course and inflation has been greatly reduced. Unemployment fell sharply last year but remains at too high a level. Given the achievement of a stable, moderate path of monetary growth and success in reducing an excessive rate of growth in spending, the economy can continue to prosper in the years ahead. This environment of reduced inflation, higher real growth, and improved economic incentives should facilitate the natural restructuring which can be expected to occur in any healthy, dynamic economy. An attempt to devise an industrial policy to be carried out by Federal agencies in Washington would represent a tragic step backwards. An increase in government intervention could only be expected to slow economic growth by hindering the workings of the free market.

Table 1

SOME KEY COMPARISONS 1980 AND 1983

	1980	1983
Growth in real GNP (in percent)	—0.8	6.1
Growth in civilian employment (millions)	—0.3	4.0
Growth in real wages plus fringes (in percent)	—1.6	2.6*
Rise in consumer prices (in percent)	12.4	3.8
Prime rate of interest (in percent, fourth quarter)	16.7	11.0

*Real compensation per hour.
Four quarters ending in 1983-III.

34-871 O - 84 - 3

Table 2

RECENT PROGRESS AGAINST INFLATION

(percent change during the year)*

	1979	1980	1981	1982	1983
GNP: Implicit Price Deflator	8.2	10.2	8.7	4.4	4.1
Consumer price index	13.3	12.4	8.9	3.9	3.8
Producer price index	12.8	11.8	7.1	3.7	0.6

* Fourth quarter to fourth quarter for the GNP deflator and December to December for consumer and producer prices.

January 24, 1984 A41

Table 3

COMPENSATION, PRODUCTIVITY AND UNIT LABOR COSTS, NONFARM BUSINESS SECTOR, 1979 - 1983

(percent change from fourth quarter of previous year)

	Nominal Compensation	Real Compensation	Productivity	Unit Labor Costs
1978	8.9	—0.1	0.3	8.6
1979	9.2	—3.2	—2.1	11.6
1980	10.8	—1.6	0.2	10.5
1981	9.0	—0.5	1.2	7.7
1982	7.2	2.6	0.8	6.3
1983*	5.3	2.6	3.6	1.6

* Four quarter change ending in 1983-III

January 24, 1984 A310

Table 4

PATTERN OF GNP GROWTH IN THE FIRST YEAR OF PREVIOUS RECOVERIES* COMPARED WITH 1983

	In Percentage Points		As Proportion of Total	
	Previous Recoveries	1983	Previous Recoveries	1983
Real GNP	6.8	6.1	——	——
Consumer spending	3.6	3.6	53	59
Business capital spending	0.5	1.2	7	20
Residential construction	1.0	1.0	15	16
State and local purchases	0.5	0.1	7	2
Federal purchases	—0.2	—0.5	—3	—8
Inventory investment	1.8	2.0	26	33
Net Exports	—0.4	—1.4	—6	—23

* Post-Korean War recoveries excluding the short-lived 1980 recovery.

Note: Components may not add because of rounding.

January 25, 1984 A311

Table 5

FUNDS RAISED BY DOMESTIC NONFINANCIAL BORROWERS IN U. S. CREDIT MARKETS

(Billions of $)

	1982	1983*
Private Domestic Nonfinancial	234.1	288.1
State and Local Government	36.3	42.7
Households	86.3	149.4
Nonfinancial Business	111.5	96.0
U. S. Government	161.3	205.9
Total	395.4	494.0

FUNDS SUPPLIED TO DOMESTIC NONFINANCIAL BORROWERS IN U. S. CREDIT MARKETS

(Billions of $)

	1982	1983*
Private Financial Intermediaries	271.2	359.8
Commercial Banks	108.5	122.7
Savings Institutions	30.6	129.2
Other	132.1	107.9
Private Domestic Nonfinancial Investors	99.7	97.3
Other	24.5	36.9
Total	395.4	494.0

* First 3 quarters at a seasonally adjusted annual rate.

Source: Federal Reserve Flow of Funds

January 24, 1984-A312

Table 6

OUTLAYS AND RECEIPTS AS PERCENT OF GNP

	Receipts	Outlays *
1984-1988 **	19.3	23.5
1983	18.6	25.0
1982	20.2	24.4
1981	20.8	23.5
1980	20.1	22.9
1975-1979 (avg.)	19,0	22.1
1964-1974 (avg.)	18.7	19.8

* Including off-budget spending.

** Mid-Session Review estimate. Receipts exclude contingency tax.

Table 7

WHERE IS THE PROGRESS IN REDUCING SPENDING?

Discretionary Spending*
(billions of dollars)

	1983	1984	1985	1986
Mid-Session 1983**	$283.3	$276.3	$286.0	$295.4
March 1981 Budget	215.2	205.8	213.2	224.1
Increase ($ billion)	68.1	70.5	72.8	71.3
Increase (percent)	31.6%	34.3%	34.1%	31.8%

* Total Federal spending excluding defense, social security, medicare, and interest on the debt net of trust fund receipts.

** Current services basis.

January 25, 1984-A68

Chart 1

CONSUMER PRICE INDEX

(Monthly Data, Percent Change from Year Earlier)

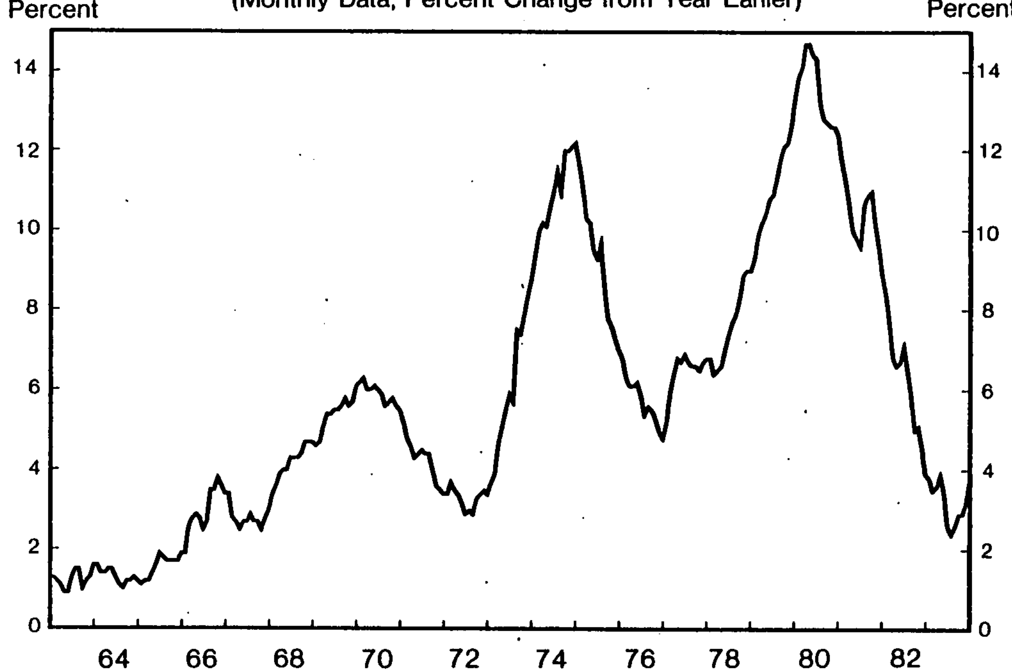


Chart 2

PRODUCER PRICE INDEX

(Monthly Data, Percent Change from Year Earlier)

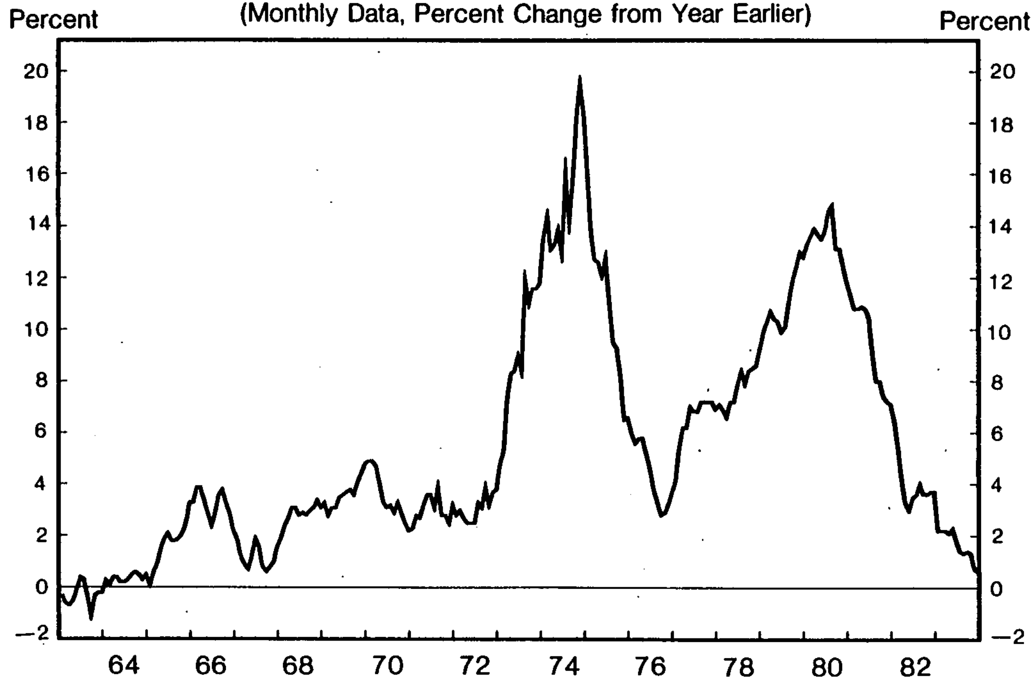
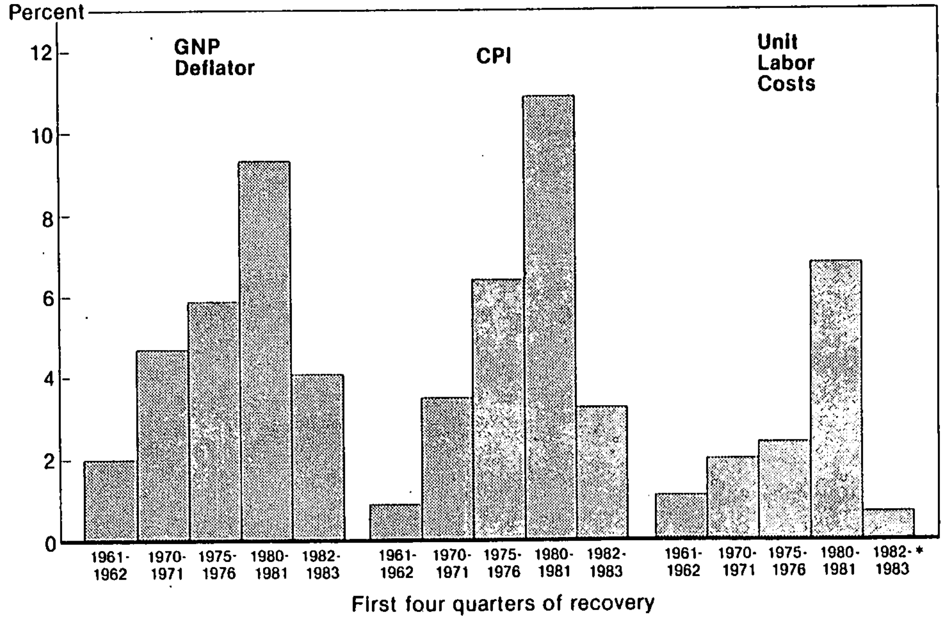


Chart 3

GROWTH OF PRICES AND UNIT LABOR COSTS IN THE FIRST YEAR OF RECENT CYCLICAL RECOVERIES



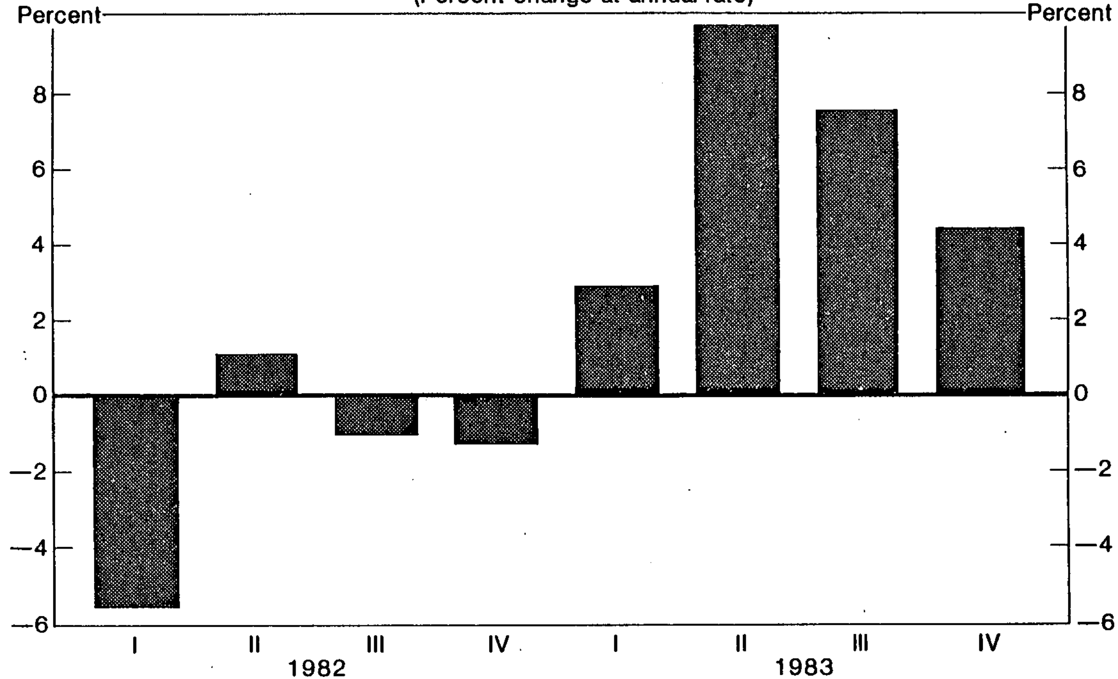
*First three quarters of the cyclical recovery.

January 25, 1984-A308

Chart 4

RECENT CHANGES IN REAL GNP

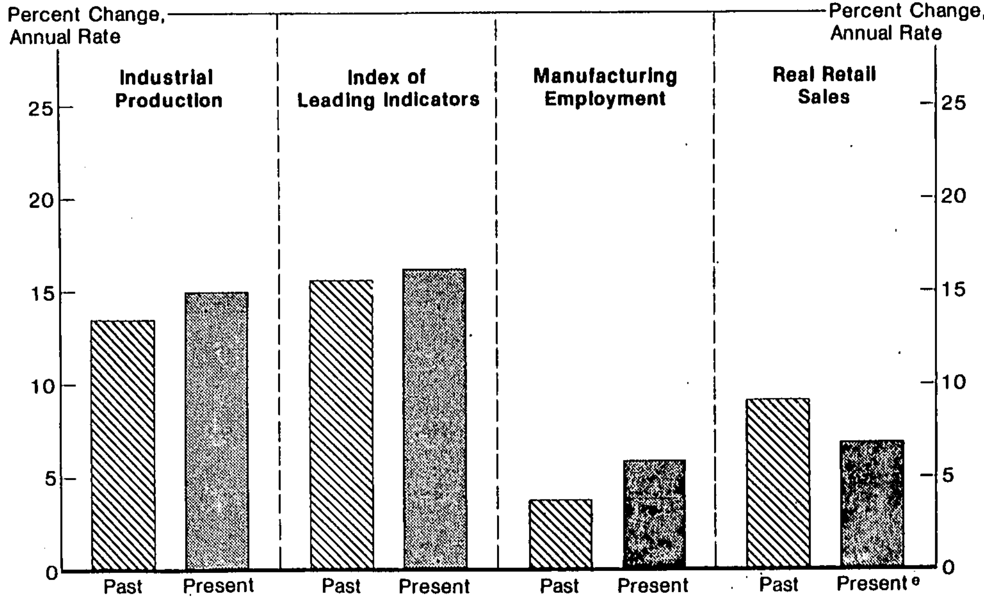
(Percent change at annual rate)



January 11, 1984-A49

Chart 5

COMPARISON OF THIS RECOVERY WITH PREVIOUS RECOVERIES*



*Post-Korean War recoveries excluding one short-lived 1980 recovery. First 13 months for industrial production and real retail sales, 12 months for the other two series.

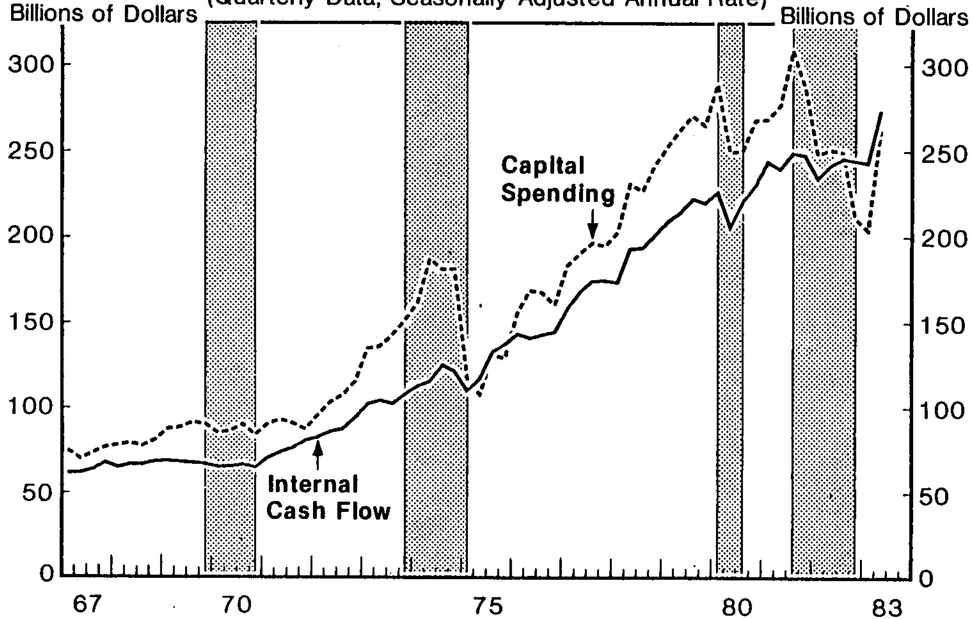
(e)-estimated.

January 12, 1984-A44

Chart 6

EXTERNAL CORPORATE FINANCING REQUIREMENTS

(Quarterly Data, Seasonally Adjusted Annual Rate)

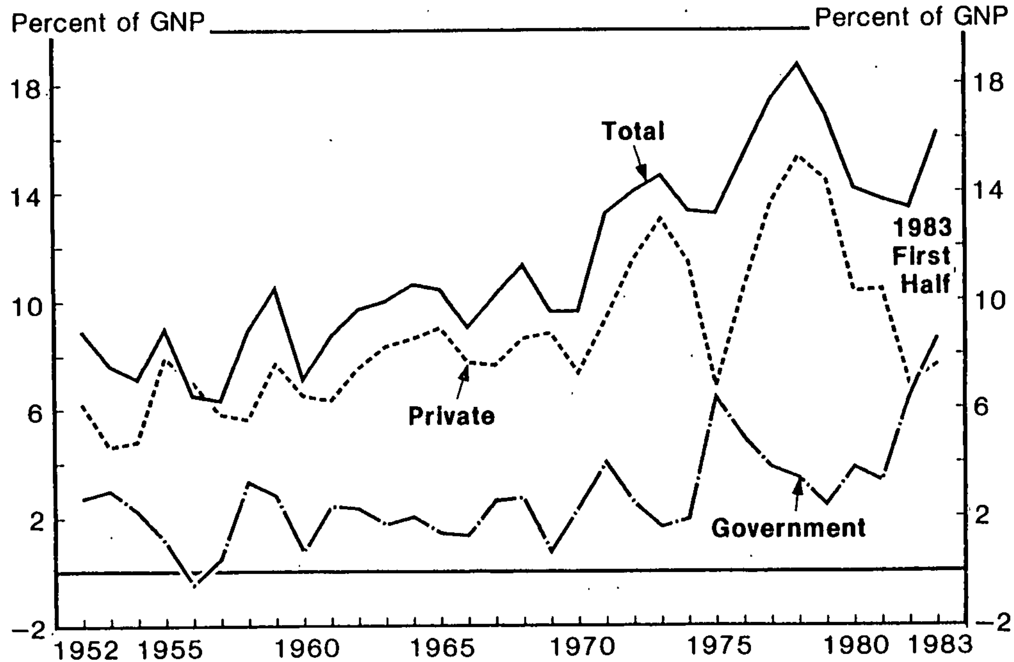


Source: Federal Reserve flow of funds accounts.

October 1983-A64

Chart 7

GOVERNMENT SECTOR AND PRIVATE SECTOR BORROWING*

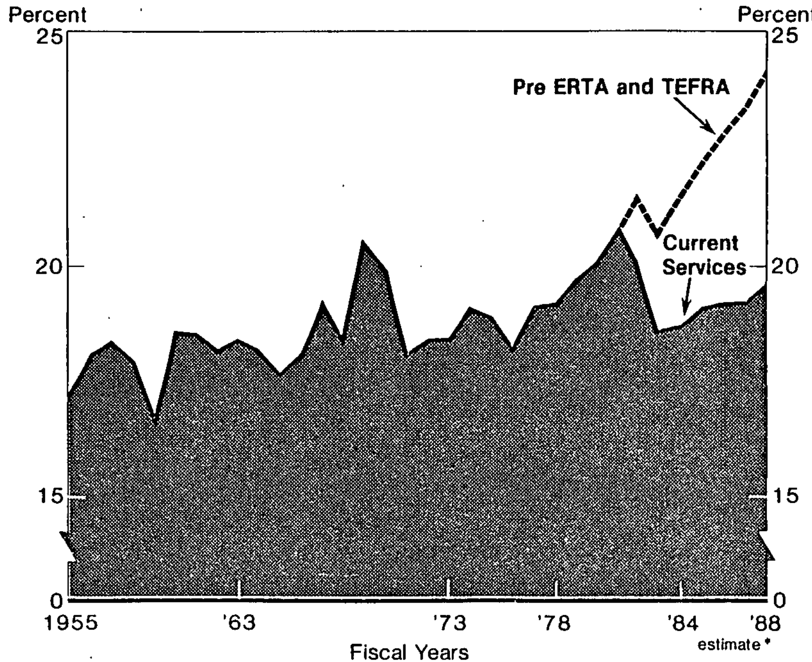


*By Nonfinancial Sectors

October 24, 1983-A244a

Chart 8

FEDERAL TAX CLAIM ON GNP, 1955-1988



* For FY 84-88. From Mid-Session Review of the 1984 Budget.

January 24, 1984-A21

Chart 9

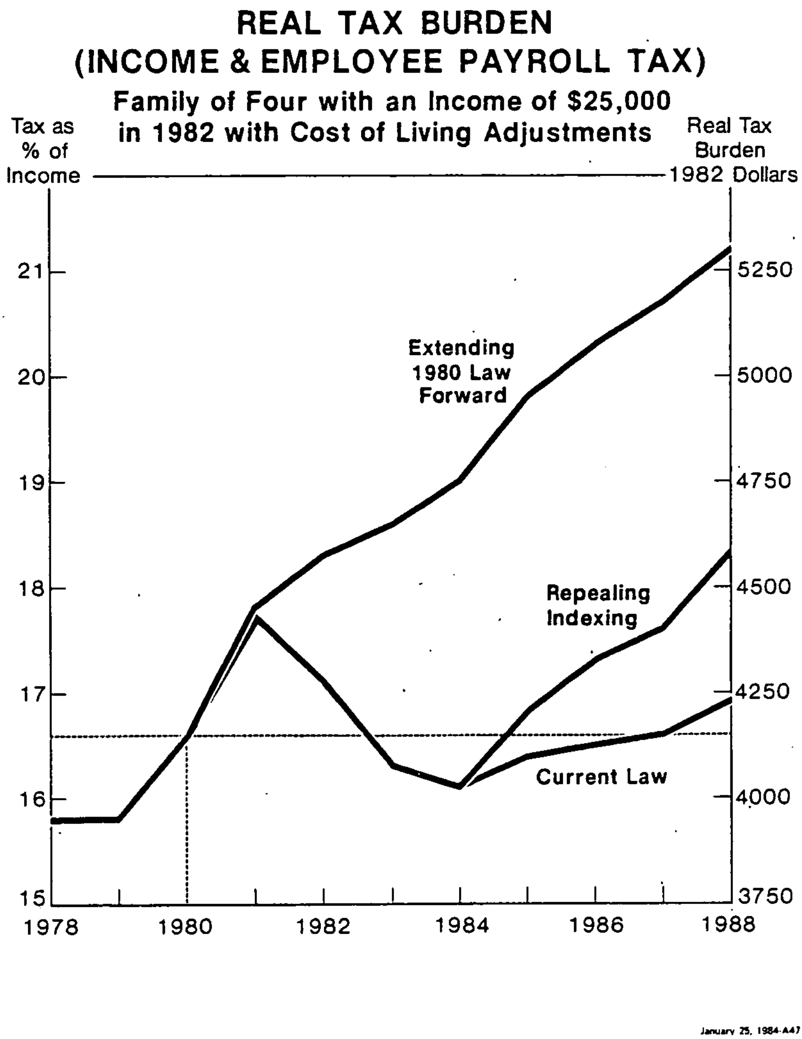
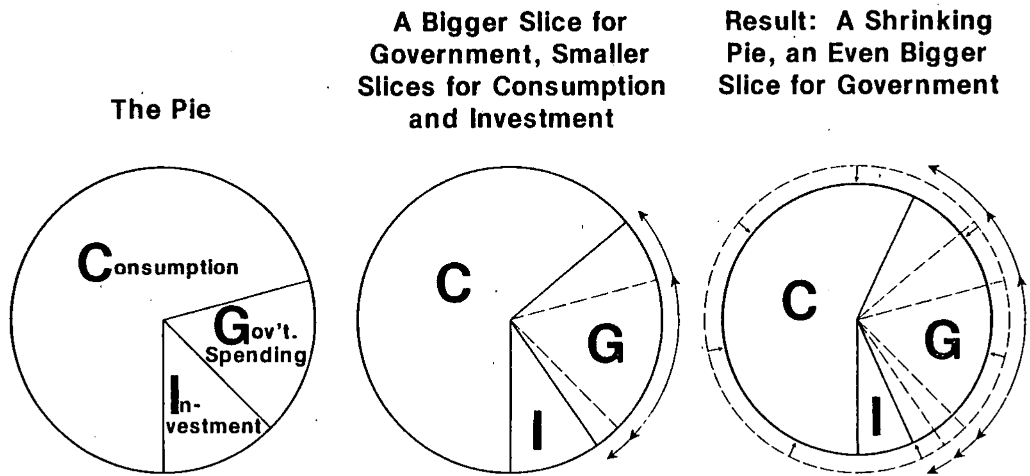

REAL TAX BURDEN
(INCOME & EMPLOYEE PAYROLL TAX)
Family of Four with an Income of $25,000
in 1982 with Cost of Living Adjustments
Tax as % of Income
Real Tax Burden 1982 Dollars
21
20
19
18
17
16
15
5250
5000
4750
4500
4250
4000
3750
1978
1980
1982
1984
1986
1988
Extending 1980 Law Forward
Repealing Indexing
Current Law
January 25, 1984-A47

Chart 10

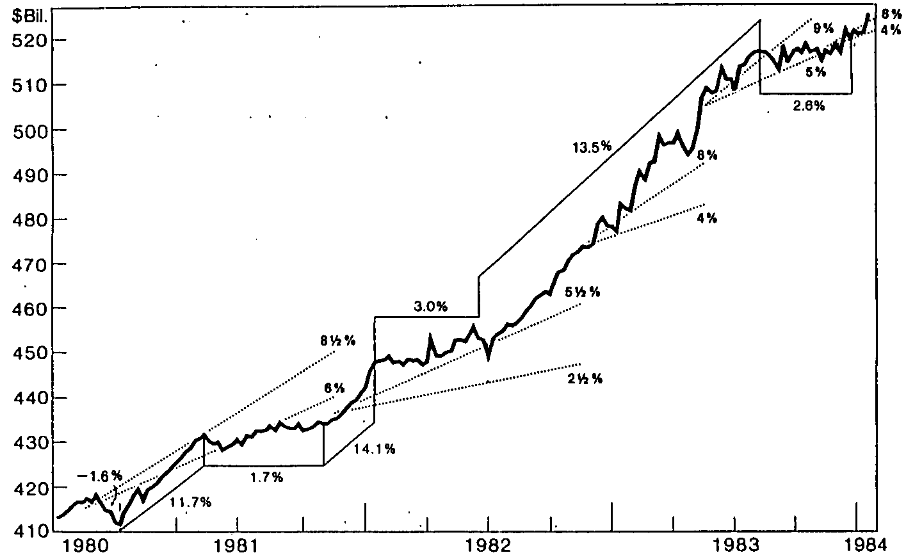
GOVERNMENT SPENDING DOES THE "CROWDING OUT"



34-871 O - 84 - 4

Chart 11

M1 VERSUS TARGET RANGE*

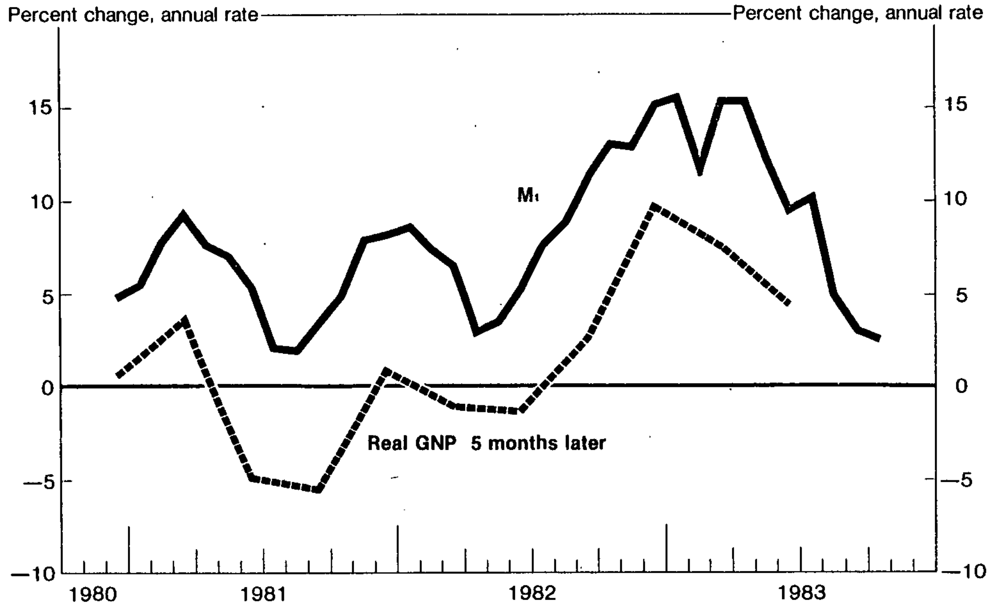


* M1 data:weekly averages, seasonally adjusted.
Fed target ranges: seasonally adjusted simple annual rates based on quarterly averages.
Period-to-period growth: seasonally adjusted compound annual rates based on monthly averages.
Tentative 1984 M1 target range (4% - 8%), as announced by the Federal Reserve in July 1983.

January 24, 1984 A300a

Chart 12

GROWTH OF REAL GNP AND MONEY SUPPLY (M_1)*



* M_1 smoothed by a centered 5 month moving average.

January 20, 1984 A304

Senator JEPSEN. Thank you, Mr. Secretary.

I noted that the long overdue recognition of a career homemaker as an equal partner in the family financial endeavors is being recommended and that it be corrected in a full IRA allowance. I would expect and hope that it will have early and quick approval in all the committees and by both sides of the aisle in both houses.

You mentioned the necessity to have some stability in the growth of M1. We have talked about that time and time again. We have asked Mr. Volcker how to bring that about or why we have these extremes where it seems we have the pedal all the way to the floor and at the same time the brake is all the way to the floor. I never have received a satisfactory explanation that would lead one to believe that we can have stability in the M1 growth.

In fact, to the contrary the answers would lead one to believe that the Fed is not sure it can provide for that.

Do you believe that the Federal Reserve can avoid these extremes in growth and, if so, how would you recommend that they get this stability? We will be probing this again when Chairman Volcker appears before this committee next week.

Secretary REGAN. Well, there is no doubt this is a difficult task in an economy as large as ours with money constantly changing or the concept of money changing.

The Fed did have some difficulty in late 1982 and early 1983 because of the changing climate brought on by deregulation of different types of bank accounts, and innovations from the private sector that influenced how people could maintain their savings, all of which affected the definition of money. Most of that is behind us, however, at this point.

There is one thing coming up in February that may cause a little static in the figures for a short period of time, and that is the contemporaneous reserve reporting wherein banks will be more on a current basis in trying to keep their reserves in line with transactions, or checkable accounts.

But I think, Mr. Chairman, that the Fed now—with all the experience it has gained since 1979—should be able to target things a lot better. I do not say that they can keep on a week-to-week basis, perhaps not even on a month-to-month basis, exactly on target, but certainly they can stay within a couple of percentage points of their target range. I do not think they have to go all the way one way and then all the way the other way.

Senator JEPSEN. Thank you. I just have one more question, and I will advise the committee that because of the large number of members here and the interest, we will have a 5-minute rule. I respectfully hope that we can all follow it.

Mr. Secretary, we are all confronted by the performance of the stock market. As a former Merrill Lynch executive, perhaps you could enlighten us. Practically every single move in the market, however slight or great, is attributed by the media and stock market analysis to interest rates. When the market goes up, it is due to anticipated interest rate drops. When the market goes down, it is due to worry about rising interest rates. If it does not move at all, it is due to the uncertainty about which way interest rates are going to move.

Are interest rates the only thing that matter and, if not, what other factors affect the market? Finally, would you please tell us what you think the stock market will do this year?

Secretary REGAN. Mr. Chairman, based upon 35 years of following the stock market, I have to let you in on a secret. There are a multitude of things that affect the stock market, not just interest rates, and no one knows for sure at any one day, except for some unusual event, what it is that affected the stock market that particular day. But reporters have to write, Wall Street pundits have to put out columns, forecasters have to forecast, so they all search for reasons. They could be right or they could be wrong about what particular thing is affecting the market at any particular moment.

I would say at this particular time that there are two main factors affecting the stock market. As you pointed out, interest rates are one of them. The other is earnings and what is the earnings outlook over the future. When you buy a stock you are buying a future stream of earnings from which you hope to get a future stream of dividends and you have to weigh the relative value of what that future stream is worth.

So the market tries to analyze all of the factors—national, international, economic, psychological, and the like—in order to arrive at conclusions. These are conclusions of millions of people, not just one individual and not just a group of individuals. So you have in the market a real reflection of many shades of opinion.

If the forecast that we have—which by the way is right in line with most forecasts for this year—holds true, you are going to have good earnings for corporations. If there are good earnings, people will buy those earnings and probably will give them a value even higher than they are now.

So long range, you can see that the market, based upon that type of forecast, would do well.

Senator JEPSEN. I thank you.

Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

We welcome you, Mr. Secretary, and I want to say that I am a little bit confused about your position and Mr. Stockman's position on spending.

You say in your prepared statement that the budgetary problem must be solved primarily on the spending side, and certainly one of the themes of the President's speech last night was to be tough on the spending side.

Now Mr. Stockman seems to be saying, in the Fortune interview and other places, that we have already cut as much as we can cut; we are down to what he calls the "legislative hard core"; no major cuts can be made.

How do you propose to get these $200 billion to $300 billion deficits down primarily on the spending side if your own budget expert in the administration says you cannot make any more major cuts in spending?

Secretary REGAN. Well, Congressman Hamilton, let me put it this way. I will let Mr. Stockman describe his point of view to you at whatever time he appears before this group.

Representative HAMILTON. It would be helpful if we had a single administration view.

Secretary REGAN. Well, I think the President reflects the administration's view and he enunciated that last night.

Representative HAMILTON. And Mr. Stockman does not?

Secretary REGAN. The President is the administration.

From the point of view of the budget deficits—I do not know where you got that $300 billion figure. It does not show in any of the data that we have. We are assuming a base line of about $200 billion. It all depends upon what the economic forecast is, how you see interest rates over the future and the like.

Representative HAMILTON. Let us not argue about the size of the deficit. The Congressional Budget Office, where I got the figure you asked about, is going to come out with a projection of $325 billion by the end of the decade, but I do not want to argue about whether it is $300 or $200 billion. I want to know where you are going to get——

Secretary REGAN. I disagree with that CBO projection and I am not even sure they are coming out with it because they declined to confirm it when we called to ask them how they got that $325 billion figure.

Representative HAMILTON. Let us not quibble over $300 or $200 billion. What I want to know, Mr. Secretary, is where are you going to make the major spending cuts that have to be made if you are going to get this deficit down to a reasonable size?

Secretary REGAN. Well, now, first of all, as I said in my prepared statement, there are two types of deficits—structural and cyclical. Regarding the cyclical deficit, the rule of thumb is about $25 to $30 billion increase in the deficit for each 1 percentage point increase in the unemployment rate. With unemployment now at 8.1 or 8.2 percent and full employment somewhere in the 5.5- or 6-percent range, obviously if we were at full employment, you would drop 2.5 percentage points times $30 billion; that is nearly half of the deficit, the $180 billion we have estimated.

As far as revenues are concerned, they will be rising annually, to the 8- to 9-percent area during this same period.

Representative HAMILTON. Mr. Secretary, the comment in your prepared statement is that the budgetary problem must be solved primarily on the spending side.

Secretary REGAN. I am coming to that, Congressman Hamilton, if you will give me a chance.

Representative HAMILTON. I know that, but you are telling me about projections on growth. I understand that. It makes all the difference what kind of assumptions you make. You still have to get——

Secretary REGAN. You are challenging me to come up with $200 billion in cuts, and I am telling you that $200 billion in cuts is not needed. That is the point I am trying to get to.

Representative HAMILTON. I want to know where specifically you are going to make the major cuts that are going to be necessary.

Secretary REGAN. I will tell you that, Congressman Hamilton, if I may continue.

Representative HAMILTON. Very good. I am looking forward to it.

Secretary REGAN. All right. Now, Congressman Hamilton, what we need is about $80 to $90 billion in cuts. Those cuts can be made, in my judgment, in Federal spending as we go along. We are approaching the trillion dollar area in spending. I think we can cut that down by cutting throughout the budget. We can cut in all areas of the budget. That is why we have asked to get a downpayment on the deficit reduction and we have stated that everything can be discussed.

Representative HAMILTON. Does that include defense spending?

Secretary REGAN. Everything can be discussed and can be worked on.

Representative HAMILTON. Where are you recommending that we cut the budget to get $100 billion or something in that magnitude spending cut?

Secretary REGAN. Congressman Hamilton, we are about to enter into discussions with the Congress regarding that. We have some specific proposals that will come out next week. I do not think I, or the administration, should be going into negotiations with Congress setting out a baseline at this particular moment, but there are areas where cuts can be made. For example, in reconciliation, we all saw how shifting the COLA's affected the various pension plans. We have shown also where there are additional cuts to be made in some of the spending programs. We have the Grace Commission which has identified over $400 billion in savings. Now maybe some of that is pie in the sky, but nonetheless, there is enough in the Grace Commission report that can certainly be put into effect.

Representative HAMILTON. There are all kinds of recommendations around, Mr. Secretary, and what I am looking to from you are specific recommendations on cutting the Federal budget by $100 billion or whatever you think the magnitude of the cut ought to be. And what you are telling me is that the whole budget is open. Everybody would agree with that statement. Nobody would take exception to it.

Thank you, Mr. Chairman.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. Thank you, Mr. Chairman.

Well, I certainly feel that the President's message last night was an inspiring one to all of us in the Congress to try to take a long, hard look at the budget and the spending of the Government and try to find ways to bring that down. I know for the 12 years I have been here I have struggled with trying to find places that we can reduce the rate of growth and have even prepared budgets that attempted to do that. So I think it can be done and I think the key to the whole thing—and I think this is what the Secretary said to us this morning—is that we, as representatives of the people of this country, have to sit down and find a way to slow down that rate of growth without hurting the people, and I believe that we can do it.

Then when you talk about defense, that is what, 7 percent of the gross national product, less than 30 percent of the budget—it cannot come there. It has to come from the other spending. And I feel very strongly that the Secretary is absolutely correct in his statement that we cannot increase taxation at this time because it will be a drag on the economy.

I feel that the way to go is to keep the economic growth stabilized.

Mr. Secretary, with that soapbox statement, do you feel that there is merit in the idea of a bipartisan commission? I know we have one piece of legislation in the House, the Coyne-Wylie resolution, that we have 120 cosponsors for now, to set up a real bipartisan commission along the lines of the Kissinger Commission—we hate to resort to government by commission—but to sit down and really take a look at how we can bring this revenue and spending together somewhere along the line. We cannot go on at the rate that we have been doing over the past years.

Do you think that is possible? Do you believe that we can find ways to reconcile those two things?

Secretary REGAN. I think, Congresswoman Holt, that we can find ways to cut the budget. My own preference would be not to have a formal commission in the sense of a Kissinger Commission or a Greenspan Commission which would imply a lengthy period of time, a lot of outside people, a big staff, a full report, a lot of open hearings and that type of thing.

I think we have an effective mechanism now. It is called the Budget Committees of the House and the Senate and the Appropriations Committees of the House and the Senate, the Ways and Means Committee, and the Finance Committee. I think those are effective media for handling this budget if the process is allowed to work.

That is why we have suggested this smaller working group to try to do the thing quickly as a downpayment, to see if there is truly a bipartisan effort whether we can get at the problem. It will take a bipartisan approach, however. We cannot do it by ourselves. The other side cannot do it by itself. The Congress cannot do it by itself. It is going to take work with the administration and the administration cannot do it alone.

I think, in reference to what Representative Hamilton was saying about my associate, Mr. Stockman, that Mr. Stockman was complaining more about the congressional will. I think he has broken his lance up here a little bit over the 3 years he has been trying to get some of these things through the Congress and he gets a little discouraged.

Representative HOLT. Well, Mr. Secretary, we all have. That is the point I am making. It has been almost impossible. The budget process has not worked. The reconciliation process has not worked. We are going to have to resort to something really stringent to force us to sit down and decide and it seems to me that if we had a real working group that could come back after the Presidential election then, if President Reagan is reelected, this would be a blueprint for him; if Mr. Mondale is elected, I am going to Switzerland, but anyway, he would have a plan that he could follow.

Secretary REGAN. Well, I would say that we would prefer to try it this way. We all know that there are going to be some tough political choices that have to be made in order to cut the Federal budget. Somebody is going to find the rate of growth in his or her particular program is not going to be the same as he or she wants. I do not think we have to amputate, cut off completely, any one particular program, but I think the rate of growth in all programs has to be moderated. This will require tough choices, and that is what we are testing. We want to see if the Congress has the political will to join with us to do it. That is why we have suggested this working group, not a full commission, but a working group composed of Congressmen, and Senators, as well as people from the Administration.

We tried it in 1982, you will recall, on maybe a little larger scale, with "The Gang of 17." It almost worked. At least we got the tax side of it right. We got TEFRA out. I am not sure we got the cuts out. But nevertheless, I think that if we try again this year and keep the word downpayment in mind that we could get started. Then, perhaps in 1985, when the new Congress comes back, this Administration could then work with Congress in order to try to get the tough decisions made in 1985.

Representative HOLT. Thank you.

Senator JEPSEN. Senator Proxmire.

Senator PROXMIRE. Secretary Regan, last night the President did and you have been talking about inflation coming down and the implication is very clear and obvious that the President is claiming credit for that, at least considerable credit.

At the same time, we now have, as we all know, the worst deficit by far, in the history of the United States, the worst deficit in peacetime even in relationships to our much larger gross national product than it has ever been, $197 billion, about 6 percent of our gross national product.

Can you name a single action or any actions at all by the President that significantly reduced inflation or recommendations he has made that have had any effect on inflation?

Secretary REGAN. Well, certainly.

Senator PROXMIRE. What?

Secretary REGAN. Well, first of all, I believe that there are some $315 to $320 billion of domestic spending cuts that were made from the Carter baseline of 1981. Obviously, we had to work with the Congress in doing that.

I would also say that as far as monetary policy is concerned——

Senator PROXMIRE. Well, now wait, before we get on monetary policy and fiscal policy, you say that substantial cuts were made in the domestic—this is the entire budget. The President has recommended increases in military spending so that we now have a spending figure that is higher than it was in the Carter administration. After all, the budget is the President's responsibility—the recommendations are the President's responsibility right across the board—is it not?

Secretary REGAN. Sure, but I think, Senator, that if you take a look at the defense line, the defense spending this year will not be far from the outlay request for fiscal year 1985 of the fiscal year 1982 Carter budget. That budget called in 1985 for something in the neighborhood of $270 billion of spending for DOD and I suspect that is right about what we are going to come in with in 1985.

Senator PROXMIRE. But nevertheless, we are faced with a $197 billion deficit in 1983, $180 billion deficit is the projected deficit in 1984, and because of the fiscal policy altogether which the President has recommended, both taxing and spending, we are faced with these deficits which certainly have an inflationary effect.

I am asking you to indicate one overall area where the President has had anything like a comparable impact in holding down prices.

What I am saying is that the Federal Reserve Board on monetary policy certainly did have a very decisive effect on inflation, no question about it, but the Federal Reserve Board, as we all know, is independent and operates independently. Sometimes you have been critical of it and sometimes you have been supportive, but neither you nor I, or anybody else, can take credit for what the Federal Reserve Board does.

Secretary REGAN. Well, then do not let us take the blame for what they did because if they caused inflation to go down, they caused it to go up. If they caused prices to go down, they caused prices to go up. If the Federal Reserve caused the recession, then they caused at least half of the deficit, because that much of the deficit is cyclical. If they caused 10.7 percent unemployment, which is 4 or 5 percentage points above full employment, they caused about $125 billion of that deficit. You cannot blame that on the President, by your line of reasoning.

Senator PROXMIRE. Well, you are saying exactly what I am saying, no question about it.

Secretary REGAN. What I am getting at is these are not the President's deficits. You are saying the $197 billion is caused by the President. What I am telling you is that none of that——

Senator PROXMIRE. The President and the Congress together are responsible for the deficit. The Federal Reserve Board can have influence on monetary but you know as well as I do, Mr. Secretary, that the Federal Reserve Board can do nothing about the deficit except come up here and talk a little about it.

Secretary REGAN. They can cause it, Senator, by the massive unemployment that they caused and the recession they caused, by your own reasoning. If they tighten the money supply and cause a recession and there is subsequent unemployment, do not tell me that they are not responsible for it. So if they are responsible for the unemployment, they are responsible for the deficit that unemployment causes because of lack of growth in GNP and the subsequent lack of revenues coming into the Federal Treasury.

Senator PROXMIRE. But my argument with you, Mr. Secretary, is that the deficit that we suffer now is not as you explained it to Representative Hamilton. After all, we had about the same level of unemployment in 1983 as we had in all of 1982, 9.5 compared to 9.7 percent. We had almost a doubling of the deficit during that period. We are going to have a dropoff of 2 percent, according to your forecast here, of 7.8-percent unemployment in 1984, but very little reduction in the deficit even by your very optimistic projections. So you have a situation here where the President has recommended a spending program and a tax program that has given us a colossal deficit and my question to you, which you very gracefully and effectively avoided, is what has the President done to get inflation under control? Name a single action he has taken. I am saying that he is following a policy that is going to be very inflationary in the future.

The OMB estimated that inflation in the future is going to be 10 percent. They told the Grace Commission when they operated to operate on the assumption that we would have a 10-percent inflation. This is the administration's budget office.

Secretary REGAN. Well, all I can tell you is that the administration's official projection of unemployment under which the budget was made, does not call for anything like that. It calls for full employment by 1988. I do not know where that 9.7 actual unemployment rate for 1983 came from, but I recall the last figure that came out was 8.2 percent for December.

Senator PROXMIRE. Well, you are talking about the December figure. I am talking about the overall figure for the year and if you are comparing the deficits you have to figure the entire year effect, not what happened in December.

Secretary REGAN. True, but it did not stay at 9.7 for the entire year.

Senator PROXMIRE. No, it did not. It was above 9.7 in January and below 9.7 percent in December.

Secretary REGAN. Right.

Senator PROXMIRE. So the proper figure is the figure for the year, is it not?

Secretary REGAN. Yes, but it was not 9.7 for the entire course of the year is what I am getting at. However, that is a detail.

What we are saying is that that unemployment rate was caused by a recession. It was not caused by this administration. I think you have to agree to that. After all, that recession officially started in July 1981——

Senator PROXMIRE. My time is up, but the enormous increase between the deficit between 1982 and 1983 when you had roughly the same year-by-year level of unemployment was a result of a fiscal policy which the administration recommended and the Congress carried out.

Secretary REGAN. No, absolutely not, because part of that was caused by the reduced GNP due to the recession and the resulting reduction in revenues and an increase in outlays.

Senator PROXMIRE. You are saying we had reduced GNP in 1983 over 1982?

Secretary REGAN. The level of GNP was not as strong as it would have been without the recession. The low level in GNP in 1983 was due to that recession and revenues depend on the level of GNP.

Senator PROXMIRE. My time is up, Mr. Chairman.

Senator JEPSEN. Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Chairman. Welcome, Mr. Secretary.

I thought the President's message last night was truly outstanding. It deserved to be upbeat considering what has happened over the past year. However, the President failed to mention one very important segment of this economy, a segment that I am very involved with, a segment that this committee felt was important enough that we formed a subcommittee with which to deal with agricultural problems. I am very disappointed that the President omitted agriculture from his speech.

Secretary Regan, I think agriculture has to come under consideration. Farmers are not rejoicing or sharing in this economic recovery. And I, for one, am concerned a great deal.

Agriculture is a vital segment of this economy and it should not be kept a secret. I want the people of this country to know the great contribution this great industry is making to our country.

Thanks to the farmer, 230 million Americans have available the greatest variety, best quality food for the least cost of any people in the world.

I think it was just last week that somebody in the Commerce Department stated that the GNP for 1983 would have been almost 1 percent higher if our farmers had not idled their land under PIK or suffered a drought.

I have no quick or easy answer. I just want to make the point that this is a serious situation that must be recognized. I hope you will go back and tell the President of my concern about the economic conditions out on the farm.

Secretary REGAN. Well, Senator, obviously, the President is very concerned about agriculture. It is one of the things that is a key ingredient in our economy.

The President, as we all do in giving speeches, has a time limitation and a theme limitation. The President could have, in his state of the Union message, run through an entire list and mentioned more issues in the economy and the international scene and the like. He chose a thematic expression last night to illustrate the four pillars on which he thinks we should be able to build for the future. Accordingly, many things were not mentioned, not just agriculture; such things as trade, both domestic and international, our trade deficits and things of that nature, labor, labor training, more on unemployment and things to reduce unemployment. There are many things that could have been mentioned.

Those will be mentioned and discussed in the President's economic message which accompanies the budget in its submission and the report of the chairman of the CEA. So the President's economic message will discuss these things in detail.

He had to make some choices last night. He chose one instead of the other. There was no intended slight to any particular segment of the economy.

Senator ABDNOR. That is what I tried to explain to my friends in the press. But it is pretty hard to justify when the President is telling us everything is rosy while the farmers in my State are having a tough time. I would like to move onto another theme. Over a year ago when Congressman Reuss was the chairman, this committee made sure that all the doom and gloom hit the news. Everybody heard all the sad stories and predictions.

But, now the picture is brighter—far brighter than anybody on this committee or anybody downtown had dreamed it would be. And, I think a lot of credit should go to the President and his programs and I do not know of many people who could quarrel with that.

We all agree that we have deficits. And, I am happy to see that everybody is concerned. Three years ago deficit spending didn't seem to be as big a part of everyone's life as it is now. Today, we are being asked "Where do we cut?" and not "Do we cut?"

Well, I do not blame the President for not telling us where to cut. I remember 1½ years ago he mentioned something about social security and all its problems. I also remember listening for 2 days while every candidate talked about all the harm the President was going to do to our elderly. I then went home to help my House colleague on his campaign and had to listen to everyone's fears.

And of course, after the election, after a lot of Republicans had been defeated because of the social security issue, we come back to Washington and came up with a Social Security Program of which we are all very proud.

Somehow I believe that this is a little bit of the trouble this time. The President probably does not have enough confidence in this Congress to do what we have to do. If we really wanted to cut those deficits, we would all admit that we have to cut the growth in entitlements and defense. I am ready to talk when anybody else is.

Let me ask you. If we made $25 billion cuts in entitlements and defense, wouldn't that automatically also result in a big cut in our interest cost, because if we did that not only would we have less debt to pay interest on, we would give the people in the money markets and on Wall Street a concrete signal that we are serious about doing something about this deficit. Don't you think interest rates might drop 1 or 2 points?

Secretary REGAN. I am convinced they would, Senator.

Senator ABDNOR. Would that not make quite a difference in our budget and what we could do?

Secretary REGAN. Certainly it does.

Senator ABDNOR. What would a 2-percent drop in interest rates do to our deficit with our $1.5 trillion Federal debt, not counting all the off-budget spending we do?

Secretary REGAN. About $30 billion, as a matter of fact.

Senator ABDNOR. I think we ought to think about what such a move would do to our deficit and interest rates. I am pretty bitter about the charges I had to take on Social Security. But before I will recommend to the President that he specify cuts, I want some assurance that the other side will sincerely be included in these cuts. I still remember the ad mentioned earlier that was done by the other party that said "Come in, Mr. Olson. Have a chair. I'm sorry to have to tell you that we are going to have to cut your Social Security because of President Reagan and the Republicans . . ." Do I have to go on? It scared everybody over 60 years old. And now we have this kind of stuff going on about the budget and medicare. If this Congress is serious about cutting deficits, by golly, let us do it. I will work with them any time of the day.

Senator JEPSEN. Congressman Mitchell.

Representative MITCHELL. Mr. Secretary, I am the gentle, quiet member of this committee and I know you expected me to raise some questions about employment, but I will not. The President treated the unemployment issue with one sentence in his speech last night and I guess that if he could handle it that way, I should not bring up the topic of the 9.5 million Americans out of work, 2 million of whom are black. I will not address my questions in that area since I want to be in sync with the President. He is oblivious to the problem and I will try to comply with his desire.

I do want to ask you a couple questions about trade. What was our balance of trade deficit in 1982?

Secretary REGAN. Somewhere in the $20 to $30 billion range.

Representative MITCHELL. $20 or $30 billion?

Secretary REGAN. Yes.

Representative MITCHELL. What was the balance of trade deficit in 1983?

Secretary REGAN. In 1983, the balance of trade was up around $60 billion.

Representative MITCHELL. It is a little more than that now.

Secretary REGAN. Excuse me.

Representative MITCHELL. $70 billion maybe.

Secretary REGAN. We are projecting close to $100 billion for 1984.

Representative MITCHELL. A constant increase in the balance of trade deficit under this administration?

Secretary REGAN. That is not current services; that is balance of trade.

Representative MITCHELL. I told you I am the gentle one. You are overwhelming with your personality, but let me pursue this issue in my own plodding way.

You are saying that there has been a constant increase in the balance of trade deficits since this administration took office; is that correct?

Secretary REGAN. Yes.

Representative MITCHELL. Some critics are saying that it is an inflated American dollar that has contributed to the balance of trade deficit. Do you agree with that?

Secretary REGAN. The high dollar has contributed, yes.

Representative MITCHELL. It has.

Secretary REGAN. How much, I do not know.

Representative MITCHELL. But it has contributed?

Secretary REGAN. Yes.

Representative MITCHELL. So we have two things, a constant increase in the balance of trade deficit under this administration which obviously hurts the economy, and an admission that the inflated American dollar contributes to that balance of trade.

If those two things are true, what, if anything, does the administration plan to do? I will wait until you read your notes. If those two things are true, what, if anything, does the administration intend to do to rectify those two situations?

Secretary REGAN. Well, first of all, we did not make the strong dollar on our own.

Representative MITCHELL. Mr. Secretary, please, I am not making any accusations. You agreed with me on two basic sets of facts. All I want to know is what does the administration plan to do to rectify the situation? I am not assessing blame. I just want to know what are the future plans?

Secretary REGAN. We do not have to take blame for a strong dollar. We should take credit for the strong dollar, Congressman Mitchell, because you will recall that in the late 1970's, people were decrying the weak dollar and saying that we should have a strong dollar. A strong dollar reflects a strong economy at home.

Representative MITCHELL. Be patient with me—I think in terms of blocks of thoughts. You just said that the strong dollar impacts negatively to some extent, on our balance of trade deficit. What do you plan to do about the balance of trade deficits that have grown under this administration? If you admit that the inflated American dollar is hurting America's balance of trade deficit or causing it, what do you intend to do? That is all.

Secretary REGAN. There is a difference. You are using a term, Congressman Mitchell, that I am not familiar with—an inflated dollar.

Representative MITCHELL. Well, overvalued. You can use any word you choose.

Secretary REGAN. It is not an inflated dollar. What I am trying to suggest to you is we have a strong dollar because we have a healthy economy at home that has put 104 million Americans to work, more Americans than at any time. I am suggesting to you that because we have a strong political system over here we have become a haven for dollars fleeing from other economies that are much weaker than ours or where there is political unrest. This is what has caused the strong dollar.

As we have that strong dollar, it makes our exports a lot less competitive with those of other industrialized nations.

Representative MITCHELL. I agree.

Secretary REGAN. Now do you want us to weaken the political system?

Representative MITCHELL. No, I do not want you to do that. I want you to answer the question. That is all.

Secretary REGAN. Well, these are the ways—I am showing you what we could do and the dangers of what we could do. If we did inflate our economy—go back to 13.5-percent inflation we inherited in 1980—we would again have a weak dollar and we would make our exports a lot more competitive. That would get our trade deficit down.

Representative MITCHELL. Thank you. Is that your answer?

Secretary REGAN. That is not my answer. What I am saying to you is, I think we can make ourselves more productive here at home in order to make our economy stronger, and there is no doubt that as our rate of growth comes down and the rate of growth of other nations increases, their economies will look a lot better to investors than ours does. The net result of that is that dollars will flow to them rather than to us. That weakens our dollar in relation to them and that is how we get it down.

Representative MITCHELL. My time is up. Just think about the other question, that I wanted to raise and cannot raise now, and that is the extent of foreign investment in this country. If that were capriciously withdrawn suddenly, would we be talking about a robust economy and the kind of growth that allegedly goes with this economic recovery?

What I am saying is a lot of the so-called recovery we are witnessing is because of foreign investment in this country rather than some other factor.

Thank you for my short period of time.

Secretary REGAN. May I comment, Mr. Chairman, on that?

Senator JEPSEN. Yes.

Secretary REGAN. That is true, Mr. Congressman, but I doubt if, first, it would be withdrawn capriciously. People who invest, invest very carefully, not capriciously; and second, if they were to withdraw their money, that would weaken the dollar and, accordingly, our trade deficit would go down, which is what you want.

Representative MITCHELL. It would also weaken the economy. Thank you very much.

Secretary REGAN. Not necessarily.
Representative MITCHELL. Oh, yes, it would.
Secretary REGAN. Not necessarily. It depends upon how much capital we have over here for investment, Mr. Mitchell.
Senator JEPSEN. Congresswoman Snowe.
Representative SNOWE. Thank you, Mr. Chairman.
Mr. Secretary, there is no question we are enjoying a smoother ride today than we were a year ago, but the——
Secretary REGAN. You may be; not me. [Laughter.]
Representative SNOWE. In any event, we get a big problem as far as the future is concerned and I think that is the big question, whether or not this recovery can be sustained into the future beyond 1984, and I think certain factors are present today that might not be there in 1985, and that is what I wanted to ask you.
Today, if we do not reduce the deficits, the present deficits in 1984 and beyond, to a reasonable level, what can we then expect for 1985?
Secretary REGAN. Well, if we do not get a handle on our deficits and if they remain large this year, larger than they have to remain, and into next year and beyond, interest rates are going to stay high. I would think also that gradually we are going to get into the situation I described in my prepared statement where the demand for the U.S. Government for funds will really be in competition with the demands for business and the net result will be not enough money to go around and the subsequent faltering of the economy, or worse yet, high inflation if we try to monetize the deficit and provide sufficient funds for both through the money system.
Representative SNOWE. Well, as you know, expectations on the future of the economy depend largely on the anticipated actions or inaction by the President and the Congress and in this case the President has chosen not to recommend a contingency tax plan as he did a year ago.
Could you elaborate on why the administration chose not to do that and what kind of message that sends to the financial community? Does it suggest that the President obviously is only going to reduce spending, but is that realistic and is that going to solve the problems in the future in terms of what we can expect in terms of the improvement of the economy?
Secretary REGAN. Well, we put that contingency tax on the table last year contingent upon a lot of cuts being made and other conditions. It was quite obvious that was laughed out of existence. I think is had a half-life of about 24 hours before it was entirely rejected by most of the Congress. Accordingly, it was felt useless to suggest that again this year if it were rejected last year.
So we have decided this year as far as revenues are concerned to concentrate on loophole closings and things of that nature and to match those in some fashion with spending cuts. We hope we can achieve these in a bipartisan effort and will see if we can get a start on deficit reduction.
Representative SNOWE. Did the President not suggest in his message last night that these tax reforms would be recommended by you by December of 1984? I mean is it not important to have those forthcoming now and not by the end of this year? We obviously have to send a message that real interest rates are still high and

we can expect further problems or inevitable confrontation between the private sectors' borrowing and the Federal Treasury's at some point and it seems to me that that has to be done now. I think that is the importance of suggesting something just beyond spending cuts which obviously are important but I think it is going to require realistically a combination.

Secretary REGAN. Well, I expect that even if we could work fast enough to come up quickly with a report on the very complicted subject of changing the entire Tax Code of the United States, trying to simplify it, or coming up with a brand new tax system, such as a flat tax or consumption tax or some other type of tax, to engage in a debate and try to get something passed before this session of Congress adjourns would be practically impossible.

What we are suggesting is that we can make the downpayment this year and go on to next year. I firmly believe—after chatting with many people in the financial markets, not just Wall Street, but throughout this country and indeed in many of the world's capitals—no one expects much to be done this year. What they want to make sure of is that we are sincere about doing something next year. They would like to see a downpayment this year, but they definitely want real action next year, and I think in a less strident political atmosphere of 1985 perhaps we could accomplish that.

Representative SNOWE. Thank you.

Senator JEPSEN. Representative Obey.

Representative OBEY. Thank you, Mr. Chairman.

Mr. Secretary, it is good to see you again. I wish that you would convey my sense of admiration to the President for his speech last night. I know he is not a lawyer by trade, but he really ought to be because he proved again last night that he can make absolutely the best defense for a bad case of anybody I have ever seen in my life.

The thing that caught my interest most of all was his reference to the item veto. I agree with your prepared statement this morning that the best way to get at the deficit is the way you put it, by cuts in the growth of spending. I think that is generally agreed to be the best way to deal with the problem.

I would like to make you an offer. As you know, there is some doubt about whether you need a constitutional amendment or you can do it in a statutory way. What would you say if we tried this: If the administration were to agree to a 1-year freeze on the military side and in return for that the Congress would give the President on a 1-year basis on all appropriation bills the right to item veto. We would then have a situation in which we would have the freeze that Senator Hollings is talking about on the military side for 1 year; it is not going to kill anybody; we would have the opportunity for the President to control on the domestic side what the actual spending levels would be; and then we would know what we could realistically get from growth and what we could realistically get from revenues.

What would be wrong with a deal like that?

Secretary REGAN. Well, first of all, a year freeze on military—let me see if I understand you. You mean on budget authority, on outlay or what? Because once you have started some of these programs, in effect, as you know, then the spending gradually grows.

Representative OBEY. Well, the President has recision authority. We can work that out.

Secretary REGAN. Well, we have had 3 years of budget authority increasing each year. These programs are now underway. Ships are being built. Guns are being made. Do we stop that? Is that what you are talking about?

Representative OBEY. Let me give it to your way and let you pick whether you want it to be authority or outlays. I do not want to get involved in a side argument that is off the point of my question.

You said the best way to stop the deficit growth is to stop the spending growth. The largest discretionary spending growth in the budget is in the defense area. If we were to get out of the administration a 1-year freeze on the military budget, would they be willing to consider that in return for getting a 1-year right to item veto every appropriation bill?

Secretary REGAN. What about making it symmetrical? That is, you are saying freeze military. That is not cutting the growth in spending. That is cutting spending, period. That is no growth. You are suggesting no growth in military spending but growth in the other things. What about making it symmetrical?

Representative OBEY. What do you mean by symmetrical? I am giving the President an item veto.

Secretary REGAN. The same rate of growth or something of that nature.

Representative OBEY. Well, the President has the authority if he would have the authority to item veto any appropriation bill, he woud be getting what he asked for last night.

Secretary REGAN. Well, not under your plan.

Representative OBEY. Why not?

Secretary REGAN. Because you say you would freeze military. He has not suggested any freeze in military.

Representative OBEY. I recommend that—I mean I recognize that. I understand that.

Secretary REGAN. What about just the line authority and then let him pick and choose where he wants to cut?

Representative OBEY. Well, the President was elected to be President, not king. [Laughter.]

Secretary REGAN. Admittedly, but on the other hand, the President is the one that has to make these decisions to carry this out.

Representative OBEY. Well, then, let me ask you this.

Secretary REGAN. There is no way we can get from here to there. You know that as well as I do, Congressman Obey, not in one year.

Representative OBEY. What would you say, then, since you are asking for a constitutional amendment which would bind all future Presidents, what would you say to a sense of the Congress resolution which asks the President to go back and submit a budget which was a commonsense budget under his own definition last night?

Secretary REGAN. If the resolution would bind the Congress, that if the President sent it up they would accept it.

Representative OBEY. If we give the President the item veto that I am talking about, he would have his way.

Secretary REGAN. No, no, no. Why would the Congress not automatically accept it? If they are going to challenge the President

34-871 O - 84 - 5

that way and say, "Send us a balanced budget," if he sends you one, why would you not accept it?

Representative OBEY. What I am trying to get at is you seem to want an item veto. It seems to me the President does have an item veto authority over the recommendations of his own Cabinet officers. I do not see him exercising that veto..

Secretary REGAN. Well, now wait a minute. I think the President has pretty well kept the budgets that he has submitted fairly restrictive, but in no case in 3 years of submissions—and I dare say it is going to happen the fourth time—has the Congress accepted what the President sent up.

Representative OBEY. Well, my time is up, Mr. Secretary. Let me simply say that—and I do not want to go into the laundry list of quotations I have from you and others saying that your program is now in place, but let me just suggest that it seems to me disingenuous at best for someone to suggest that we ought to have a constitutional limitation on a future President which an existing President is not willing to follow in practice as a method of demonstrating responsible Government or commonsense budgeting as he defined last night.

Secretary REGAN. I would say the executive branch would accept it if the legislative branch would accept it. I do not see the Congress moving in its budgets anywhere near a balanced budget.

Representative OBEY. Mr. Secretary, if you want a balanced budget, you have an obligation to propose one.

Secretary REGAN. Well, I think——

Representative OBEY. Which do we take seriously, the speech last night or the budget you send down? We cannot take both seriously.

Secretary REGAN. We came up last year with a contingency tax matches with some spending cuts and——

Representative OBEY. You told us if we followed your 1982 program that we would have a balanced budget by this year. We followed your 1982 program. Where is your balanced budget?

Secretary REGAN. In the meantime, you must admit, a recession caused by the previous administration and the Federal Reserve came into effect in July. The budget that you are talking about was presented in February of 1981 and did not go into effect until October of 1981. A recession had already begun in July of 1981.

Representative OBEY. If the Federal Reserve caused a recession, why did you rehire Mr. Volcker?

Secretary REGAN. Because he was the obvious choice of a lot of people.

Representative OBEY. Including the only one who counts.

Thank you.

Representative HOLT. Mr. Chairman, may I just follow on with a comment out of order with unanimous consent?

Representative MITCHELL. Is it out of order?

Representative HOLT. I am asking unanimous consent to be out of order.

Congressman Obey and Mr. Secretary, I do not think that the Congress followed the President's budgetary suggestions. He got part of it but he had to make a lot of compromises. It was not absolutely the program that the President offered to the Congress.

Representative OBEY. Let me just say that it sure did not feel like a compromise at the time.

Senator JEPSEN. The President proposes and the Congress disposes. The history of Congress on disciplined spending has been compared to putting Dracula in charge of the blood bank. I think anything, including a constitutional amendment, that will put starch in the backbone of the Congress, which is the only one that is authorized to get the budget under control, is long overdue. I hope that since the Senate passed the amendment for a balanced budget, the House would act on it this session. It would be a good signal to send that I think that everybody in the country would applaud it.

Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

Just a question about the downpayment, Mr. Secretary. I have seen press reports indicating that you are asking for $100 billion spending reduction, $20 billion in the coming fiscal year, $30 billion in 1986, and $50 billion in 1987. I do not know if that is correct or not. Is that what you mean when you say "downpayment," or are you talking about something in addition to that in reductions?

Secretary REGAN. It is the $100 billion more or less, along that line, Congressman Hamilton.

Representative HAMILTON. The second question relates to the President's mention of your responsibility to come forward with a tax plan next year.

We have had the fair tax proposal introduced by Senator Bradley and Congressman Gephardt. I wonder if we could have your reaction to that proposal and whether you think that would be among the plans that you would look at very seriously as you begin that study?

Secretary REGAN. First of all, let me assure you that we would take a look, a very serious look, at what Senator Bradley and Congressman Gephardt have come up with. That is an interesting plan. A quick analysis of it that I made, and my staff is doing a more detailed analysis, is that they seem to come down pretty hard on capital formation. They do get their rates down, but I am not sure that it would give us the capital formation we would need in the future. I want to study it more from that angle.

I am sure also that they account for future inflation in a way that can prevent some of the excesses that the current code has as far as inflation is concerned.

We will be studying just about any proposal that has ever been made to see which among them seems to make the most sense and is something we could suggest to the President.

Representative HAMILTON. Well, I have been in the Congress for a few years. I have never seen the Congress deal with the Tax Code in any other than a fairly incremental way. We have never taken radically different steps in dealing with the Tax Code. To make the kind of switch that I think the President was suggesting last night, and certainly the kind of switch represented by Bradley-Gephardt, would be a very, very major switch in the way we tax ourselves in this country.

That raises a question of whether there is the kind of political support and political push on the part of this administration, or any administration to carry out what would really be a radical restructuring of the Tax Code of the United States.

Secretary REGAN. Well, a couple of observations on that. You are dead right in saying that the Congress usually deals with this in increments and so does the administration.

Second, to have a radical reform, however, is something whose time might be coming. I know that a lot of my predecessors in this job have all told me that by the time they leave office a more simple tax code certainly has a great deal of appeal and charm to them and most of them become advocates of some type of simplified system.

There is no doubt that there again it will require bipartisan approval. We have to come to terms with the transitional rules that might accompany such a simplification. Most people have made investment decisions one way or another based on the Tax Code. If we suddenly change the code, what are we going to do about plans that people have already made? We have to be very careful. That is why it is going to take time.

Representative HAMILTON. Thank you, Mr. Chairman.

Senator JEPSEN. Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Chairman.

Again, I am concerned about agriculture because of interest rates. Being a farmer and borrowing like I do and having been one for a long time and the outlay of money and most of these people do not get any return until fall at the time they harvest their crops.

I want to ask, what are the prospects for farm credit. Is there going to be enough money to loan funds or is there enough credit to go around?

Secretary REGAN. I think there are enough funds to go around. I do not see any real problem there at this particular time. Noticing the amount of funds that are available from the regional and smaller banks, I think that they have enough money. The question, of course, is going to be the price factor.

Senator ABDNOR. What will the interest rates be?

Secretary REGAN. Hopefully, sooner or later, the money market is going to reflect the lower inflationary atmosphere that we have been enjoying over the past couple years and, if the Fed stays on-target and the Congress and the administration make a determined effort to have a more sane fiscal policy, I suspect that interest rates will come down.

Senator ABDNOR. Well, all I can say is if the farmer ever saw a 16- or 17-percent return on their investments you would have one of the most prosperous economies going and that would cause a great improvement, and that is just not there.

Let me ask you this. We talk about farm programs and we are all searching—and Lord knows we need one—but do you not think that the Federal deficit is probably affecting not only credit but the conditions of the financial straits of agriculture—the high deficits, the high interest rates—that is probably one of the most important problems they have and inflation killed them. They are a little better off now, but, Mr. Secretary, they are hurting. Let me tell you. I do not know even the best of farmers today that are not in a bind for a dollar. So you have to give some attention to this.

Secretary REGAN. Well, coming back to what Congressman Mitchell had to say about trade deficits, one of the major causes of our trade deficit is the lack of export markets for our farm products. It is way down because we had the embargo for so many years and became an unreliable supplier. There is no doubt in my mind that we lost markets to Western Europe, to Australia, to Canada, and other grain and wheat producing areas. Now we hope to recapture those, but it is going to take some time.

Senator ABDNOR. And 40 percent of what we produce has to be exported so it is certainly a great, great concern and if we are going to solve the problems that has to be part of it. Thank you.

Senator JEPSEN. Senator Proxmire.

Senator PROXMIRE. Mr. Secretary, last night President Reagan in his state of the Union message made two suggestions as I recall on taxes. The first you have dealt with, he wanted you to recommend changes in the Tax Code and you have told us that that would be recommended one month after the election in December. And I think that may be wise politically, although we would welcome getting it in advance of that.

Now, in addition, he said that we should close certain loopholes in the Tax Code, that the Treasury, he said, has said are worthy of support. Now if anyone can come up with specifics in that area, it is you, as Secretary of the Treasury. So what specific loopholes in the tax law should we close and how much would they bring in?

Secretary REGAN. Well, last year we submitted a list which we are resubmitting this year. It called for closing of loopholes of about $31 billion, as I recall, over a 3-year period. We may have some additional ones to add.

Senator PROXMIRE. $10 billion a year. Roughly, what are one or two principal changes?

Secretary REGAN. Well, first of all, investment tax credits for nonprofit organizations. This has been typical where communities or institutions—such as Atlanta and various other places, or Bennington College—suggested selling off their buildings and then leasing them back in order to give the tax credit to those who do the leasing. It is that type of thing that we think are loopholes that were unintended and should be closed.

Senator PROXMIRE. And they would be about $10 billion a year, about $30 billion over 3 years?

Secretary REGAN. That is right.

Senator PROXMIRE. The President also referred to less contentious spending cuts that we might be able to reduce this year for the 1985 budget. What did he have in mind? Are there specific spending cuts that you can tell us about?

Secretary REGAN. Well, I think that last year, again, one of the cuts suggested within the administration—unfortunately, there was a breakdown somewhere in getting this into the legislation through both Houses of Congress—was slipping the COLA's on the civilian retirees, Federal and veterans, and——

Senator PROXMIRE. And that is less contentious?

Secretary REGAN. Pardon?

Senator PROXMIRE. You say that is one of the less contentious cuts? Would you say that is less contentious?

Secretary REGAN. Well, you bit the bullet——

Senator PROXMIRE. You had better talk to my retirees in Wisconsin.

Secretary REGAN. You bit the bullet on social security. All this does is harmonize or make it symmetrical with what you did in social security. That is one of the ones. That was passed, by the way, by the House last year.

Senator PROXMIRE. Well, you are talking about a further reduction.

Secretary REGAN. No, no, no; this is the same one. It passed the House last year. It did not pass the Senate. Accordingly, was never enacted into law. So we are suggesting that we go back to some of those things that were in the reconciliation.

Senator PROXMIRE. Now you had a very interesting response to Congressman Obey in your exchange with him. You asked whether the Congress would accept a symmetrical freeze of defense and nondefense spending. I take it you would favor that approach to reducing the deficit.

Secretary REGAN. No. I just wanted to draw out Mr. Obey in his thinking.

Senator PROXMIRE. Oh, you would not favor that?

Secretary REGAN. What I am suggesting is——

Senator PROXMIRE. You do not think it is fair that you should be that fair?

Secretary REGAN. Well, Let us go back to my original point on this working group. I said that everything is on the table and we would like to hear suggestions from the congressional representatives as to where they think cuts could be made.

Senator PROXMIRE. Well, do you not recognize that there is no way Congress can accept further cuts—and there have been some very painful cuts in domestic programs—unless the administration will agree to reducing the rate of increase—just the rate of increase—in military spending, which the President has asked for, a 17 percent rate of increase, 13 percent average inflation—certainly, any kind of fair negotiations, it would seem to me, would require the President to come down on that rate of increase substantially.

Secretary REGAN. Well, the Grace Commission has made quite a few suggestions in that area. If they are feasible—and I am not an expert in that area—but if they are feasible and doable, that for one thing would cut the rate of spending in military.

Senator PROXMIRE. Now, almost precisely a year ago on January 24, the New York Times quoted an astute observer of our economic problems and that observer said, and I quote:

> I have to say that perceptions become the reality. Financial markets are afraid that huge deficits will mean higher rates of interest in the United States. As a result, the interest rates are not coming down to the extent that we want. So, therefore, we have to deal with these deficits.

He concluded. "One is to have less spending, and two is to increase revenues."

Now, Mr. Secretary, the speaker being quoted was the present Secretary of the Treasury whose initials are Donald Regan. Now where is he now when we need him?

Secretary REGAN. Right here. I am telling you the same thing.

Senator PROXMIRE. You have not been telling us what substantial increase in revenues there would be.

Secretary REGAN. We are going to have substantial increases in revenues. There is about an 8-percent to 9-percent rate of growth in revenues, Federal revenues, year on year over the next 4 to 5 years, depending upon what economic assumptions you make. Certainly in 1985 we will have at least that much increase in revenues over what we had in the 1984 fiscal year.

Now, that being the case, we will have increased revenues. We are suggesting some of these loophole closings, $31 billion, that I just mentioned.

Senator PROXMIRE. $10 billion a year.

Secretary REGAN. $10 billion a year, and certainly as long as we do not spend it, that will reduce the deficit by $10 billion. Couple that with what we are saying in the way of spending cuts and you do get those deficits to come down.

Senator JEPSEN. Excuse me. I note the House has a vote. Congressman Mitchell.

Representative MITCHELL. Just one more question from this gentle member of the committee. I am fascinated by this discussion on line item vetoes. I am one of the few nonlawyers in the House. I am sort of a social psychologist and I imagine if you ask for something it is because you want to do something with that which you get. If the President is asking for a line item veto, there must be some particular programs he wants to destroy. I know if I were President and got line item veto, I would start off with the B-1 bomber, the MX missile, and go right down the line.

What are the ones that the President has? Is it child nutrition programs, housing for the poor? What is his hit list?

Secretary REGAN. I think, Congressman Mitchell, that, not being a lawyer myself, I can somewhat agree with you that I am not sure of the niceties of the law in here, but there have been many programs in which the Congress has added sums of money over and above what the President has suggested. I know of very few programs that the President has recommended doing away with entirely, and I doubt if with a line item veto he would do away with things entirely.

What would happen probably is that he would x out something that would then be returned to the Congress for them to come back with a sum more toward his liking. I believe that is exactly what happens in most of the States.

Representative MITCHELL. But you cannot deal with specifics. Let me put it another way. Is the hit list plan a secret plan sort of hidden down in the bowels of the White House somewhere, or are you privy to it?

Secretary REGAN. Well, there is no hit list as such. I think that is kind of a cheap shot.

Representative MITCHELL. I withdraw that then. I would not want to offer a cheap shot.

Secretary REGAN. Well, I did not think you did. That is why I suggested it.

Representative MITCHELL. No.

Secretary REGAN. I would say that we would have to see what sort of budget it is that the Congress would send to the President if he had a line item veto. They might be more cautious on what they did with the budget, knowing that he had that power.

Representative MITCHELL. I wish I did not have to go. Really I just enjoy talking with you so much.

Secretary REGAN. I enjoy talking with you, too.

Representative MITCHELL. Ask him if they can give you a little more information on the hit list. You are a member of the cabinet. Thank you.

Senator JEPSEN. Congressman Obey.

Representative OBEY. Mr. Secretary, may I just ask one question?

Senator JEPSEN. Before this Congressman leaves, I might suggest that we use Senator Proxmire's list of Golden Fleece awards he has given in the past; that might be one place to take inventory and start.

Congressman Obey.

Representative OBEY. I would just like to ask you one question for the record, Mr. Secretary.

It is my understanding that the Grace Commission used in their computation of their numbers the assumption that inflation would be increasing about 10 percent a year. If that is not correct, please for the record spell out what was the assumption. I think that is correct.

Second, if that is correct, would you recompute the estimated savings that would be made by the Grace Commission if we were to have an inflation rate estimated by the administration rather than the Grace Commission?

Secretary REGAN. I do not promise to do the latter. I am not sure how much work is involved in going through all of their numbers, but I will try to come up with a ball park number for you.

Representative OBEY. If the President is asking us to assess the Grace Commission recommendations, we ought to do it based on the President's own economic assumptions.

Senator PROXMIRE. We would also like to get your response—if I could just interrupt for a minute—I understand that there is a calculation that if it's a 6-percent inflation their economies would be reduced by 30 percent—would there be a very substantial reduction?

Secretary REGAN. I will be glad to answer that for the record, as well.

Senator PROXMIRE. Thank you.

[The written response of Secretary Regan to oral questions posed by Representative Obey and Senator Proxmire follows:]

WRITTEN RESPONSE OF HON. DONALD T. REGAN TO ORAL QUESTIONS POSED BY REPRESENTATIVE OBEY AND SENATOR PROXMIRE

Question: (Obey) The Grace Commission used in the computation of their numbers the assumption that inflation would be increasing about 10 percent a year. If that is not correct, please spell out for the record what was the assumption?

Secondly, if that is correct would you recompute the estimated savings that would be made by the Grace Commission if we were to have an inflation rate estimated by the Administration rather than the Grace Commission.

Finally, (Proxmire) I understand that there's a calculation that if its a 6 percent inflation rate their economies would be reduced by 30 percent.

Answer: The Grace Commission did assume a 10 percent inflation rate in calculating the full cost savings for the second and third years subsequent to implementing the PPSSCC recommendations. The Commission solicited the advice of the business community for an inflation assumption and was advised to use 10 percent as compared with the nearly 14 percent inflation rate at the time the Commission started its work in the Spring of 1982. Overstating the inflation rate would boost the estimated savings but not nearly as much as Senator Proxmire said. An example will illustrate this.

Assume that there are two programs for which savings are estimated. The first saving estimate is $100 in the first year; the second saving is $225 in the first year. In each case the estimated saving is inflated first by 10 percent per year, or the amount assumed by the Grace Commission. In the second case, each saving is inflated by a 4.5 percent inflation rate or the approximate amount assumed for inflation in the President's budget.

As shown in the illustration below, the difference between the total saving estimates for the two examples is about 5 percent and not the 30 percent noted by Senator Proxmire.

Inflation Rate	Year 1	Year 2	Year 3	Total
10%	$ 100.00	$ 110.00	$ 121.00	$ 331.00
	225.00	247.50	272.25	744.75
Total	$ 325.00	$ 357.50	$ 393.25	$1,075.75
4.5%	$ 100.00	$ 104.50	$ 109.20	$ 313.70
	225.00	235.12	245.70	705.82
Total	$ 325.00	$ 339.62	$ 354.90	$1,019.52
Total difference				$56.23

Percent difference $56.23/$1075.75 = 5.2%

This example is consistent with estimates made by the Grace Commission. Adjusting each of its saving recommendations for varying inflation rates, the Commission calculated that at a 5 percent inflation rate, which is close to the assumption used in the President's 1985 budget, the estimated savings would be $404.2 billion as compared with the $424 billion of savings with 10 percent inflation. This is approximately 5 percent less savings, a reduction from the published estimate but not an inordinately large reduction and considerably less than the 30 percent cited by Senator Proxmire. The table below shows the Commission's estimates of savings for varying rates of inflation.

Inflation Rate	Amount of Savings (in billions)
5%	$ 404.2
6	408.2
7	412.2
8	416.3
9	420.3
10	424.4

Although the $424.4 billion estimate of savings is somewhat overstated, the Commission has stated that it made several conservative assumptions that would offset a substantial part of this overstatement. For example, in estimating the level of spending in the second and third years for the various saving recommendations, the Commission did not assume any program growth for each item. The only increase allowed was for inflation, i.e., real outlays were held constant. Since demographic and other factors normally increase the amount of real spending for many government activities, this assumption would understate the amount of savings that could be realized by the Commission's recommendations.

Another example concerns the estimate for interest payments. The Commission calculated interest cost savings only for the lower debt that would result from $66 billion of estimated cash acceleration opportunities if the government collected its monies more expeditiously. The Commission did not include in the total saving estimate the lower interest cost resulting from the lower debt due to other cost saving and revenue enhancement opportunities.

On the other hand, the estimated savings for pension related and other longer term recommendations are probably somewhat overstated. The savings from these recommendations would not be realized until several years in the future. In order to convert future savings to present value terms the Commission used a 6 percent discount rate. Since the inflation rate was overstated by about 6 percent, the actual discount rate was probably close to zero.

In conclusion, the high inflation rate assumption and a low discount rate tend to overstate the total estimated savings. The conservative assumptions for other factors, however, act in the opposite direction and tend to understate the savings estimates. In spite of these so-called flaws in methodology, there are still plenty of viable and realistic savings that can be gained from the Grace Commission recommendations.

Senator JEPSEN. I thank you, Mr. Secretary—in the jargon of the banks of the Potomac here—for taking the time out of your busy schedule to be here with us today.

The committee is recessed.

[Whereupon, at 11:40 a.m., the committee recessed, to reconvene at 10 a.m., Tuesday, January 31, 1984.]

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, JANUARY 31, 1984

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

The committee met, pursuant to recess, at 10 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Abdnor, Mattingly, and Proxmire; and Representative Hamilton.

Also present: James K. Galbraith, deputy director; Ruth Kurtz, Sandra Mazur, Robert J. Tosterud, and Dale Jahr, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. I would like to welcome Ambassador Brock. It is a privilege to have you appear before us today to take part in the committee's hearings on the economic report.

In recent years, four out of every five new manufacturing jobs created in this country were linked to export sales. Exports have accounted for a substantial share of agricultural jobs and a growing share of jobs in service industries.

But since the early seventies, the United States has been importing more than it exports. The chronic trade deficits of the seventies nearly doubled in 1982 and for each of the last 2 years, the value of both manufactured and agricultural exports actually declined. Now we are hearing projections that the trade deficit will reach $100 billion in 1984.

There are several possible causes of our international trade problems: The pace of the recovery abroad, the international debt problem, unfair trade practices, exchange rates, and the U.S. industrial competitiveness which is so closely linked to our trade performance. We welcome your advice and your comments on how we might cope with any one or all of these problems, Mr. Ambassador.

Broadening the recovery to include trade is vital to continued employment growth and to sustaining our current economic recovery. We look forward to your testimony this morning and hope you can shed some light on our current trade problems.

Now the very distinguished vice chairman of this committee, Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman. We welcome Ambassador Brock and look forward to his testimony.

Senator JEPSEN. Is there anyone else on the panel who desires to make any opening remarks?

[No response.]

Senator JEPSEN. Welcome again, Ambassador, and you may proceed in any way you so desire.

STATEMENT OF HON. WILLIAM E. BROCK, U.S. TRADE REPRESENTATIVE

Ambassador BROCK. Thank you. First, let me express my gratitude. This is one of those unique committees of Congress that has a perspective and overview that I, having served on it, greatly appreciate its value and I am grateful for the opportunity to be with you.

You sketched the problem, Mr. Chairman. There are not any easy answers. Most of the news you read about trade these days is very negative. Trade balance and balance-of-payments deficits are increasing, international rules are not being applied effectively, subsidy wars and quota restrictions threaten increasingly, and, of course, the prospect of legislation such as local content still looms. While all these problems are serious, I think we often fail to assess the real benefits the United States has achieved through a system of increasingly liberalized trade—free trade.

Imports tend to lower prices for retail and corporate consumers and of course put pressure on U.S. firms to invest more and to innovate and increase productivity. The effect has been to make our friends more competitive. Exports, on the other hand, have allowed us to expand production in our most productive industries and help firms generate investment funds for innovation and new product development.

Trade has increased our national income and raised America's living standards. Thus, as we consider the specific problems that we must overcome in trade, it is important that we do so from the perspective of what an open trading system has done for the American economy and the American people.

As we are all aware, our merchandise trade balance has been deteriorating significantly since the beginning of the current recovery. My own forecast is that the deficit will exceed $100 billion by the end of 1984. A deficit this size is obviously a matter of serious concern. It is the weak link in our economic recovery because it reduces domestic growth. Furthermore, jobs in trade-related positions are being lost through substantial increases in imports. These increases in imports are compounding the pressures on vulnerable sectors of the U.S. economy, especially on industries like auto, steel, textiles, and footwear. And, domestic firms and workers under strong import competition have reacted to our increasing trade deficit by stepping up calls for import relief.

The foreign exchange value of the dollar is a key matter of concern. In effective terms, the dollar has risen 40 percent since 1978. As a result, otherwise competitive U.S. producers are being priced out of our own, as well as foreign markets, by the overvalued dollar.

A strong recovery, political stability, and high interest rates have attracted funds from abroad pushing the dollar up to its current level. Some of the actions that have been suggested to moderate the dollar run against the basic philosophy of this administration, especially interventionist actions aimed at targeting the dollar's value.

We do have to deal with the profound trade effects resulting from the exceptionally strong dollar.

Let me cite another factor, and that is the weakness of foreign demand for our exports. The deterioration of our trade position is in part attributable to an earlier and stronger recovery here in the United States than abroad. This is a normal circumstance in a world recovery as the economic leader draws imports from the rest of the world before demand for its exports rises. As the rest of the world experiences a stronger recovery—and we hope it is soon—it will begin to boost our exports and improve our trade position. The weak economic expansion abroad in 1984 and even in 1985, however, could slow the improvement of our trade position and our own recovery. This is particularly true with respect to Europe where economic rigidities, subsidies, and excessive economic interference by governments in a number of industries are sapping the dynamics of the continent. This is also true in many developing countries suffering under the burden of unprecedented foreign indebtedness.

Although there is little we can directly do to affect the internal policies of foreign nations which reduce their economic performance, we can pursue cooperative efforts to get the trade-in-growth engine of the world economy functioning again. The most important challenge we face in the area of trade policy is, in fact, to start world trade growing once more.

Nowhere is this clearer than in the case of the high-debt LDCs. Because of serious problems in servicing the massive debt, many developing countries had to cut back imports as much as 20 to 30 percent. The debt situation has particular problems for our own exports. Well over one-third of the LDC debt and some of the most sever problems in debt servicing are found in Latin America where the United States has particularly strong trading interests.

In order to once again expand those imports, the high debt LDC's will have to increase their foreign exchange resources through higher exports, foreign investment, multilateral assistance, and better access to trade financing. Secretary Don Regan and I have worked hard to develop a better coordination between the trade and finance officials worldwide as the linkage between the indebtedness of these countries and their trade practices has grown and become recognized.

Our bilateral efforts have met with some success in Japan as witnessed by Prime Minister Nakasone's announcement of liberalization measures, including the agreement on trade in semiconductors and last week's progress in gaining access for telecommunications equipment. And yesterday, in fact, I signed the NTT agreement with Prime Minister Obi.

Problems with the European Community, however, are more intractable. The world recession of the last 3 years accelerated the trend toward increased use of subsidies and market restrictions in a number of Community member countries. While it would be misleading to understate the difficulty of our current bilateral trade policy in Europe, I am confident that in the long term we will reach understandings on even the most sensitive of these issues.

Multilaterally, efforts are underway in both the OECD and the GATT to implement commitments to roll back trade restrictions. Two specific proposals that have been agreed to, and on which we will be consulting with the Congress, are the acceleration of tariff cuts negotiated in the Tokyo Round of MTN and the elimination of barriers to imports from the poorest of the least developed countries.

We are determined to make the GATT codes on nontariff issues workable and enforceable. As our trading partners realize that we intend to use these understandings as serious vehicles for resolving specific problems, the GATT will become the organization it was meant to be. In this connection, we are also preparing the groundwork with our trading partners for a new round of trade negotiations that will hopefully commence sometime in the middle 1980's.

As we look a little further down the road, the key trade policy issue we will face together with other industrial nations, is the adjustment of our economies to long-term economic change. These changes include the expansion of automation in industry, the worldwide overproduction of agricultural products, the new growth potential of our economy in high technology goods and services, and the expansion of exports from the newly industrializing countries, the so-called NICs, like Brazil, Korea, and Singapore. The key question is how the necessary adjustments can be brought about without imposing unacceptable human costs on the workers who are displaced from their current jobs.

The strong capacity of our economy for employment expansion rests heavily on the fact that there are many sectors and activities which can and do generate significant job gains. These sectors are increasingly in the area of high technology and services like health care and professional, business, and information services.

Technological advances in manufacturing processes likewise have enabled U.S. factory workers to increase their output enormously. While the number of manufacturing jobs increased by only 5 percent during the 1970's, reaching 20 million in 1980, the physical output of the Nation's factories increased by 38 percent.

Productivity gains which are driven largely by advances in technology have created new kinds of jobs. As the factories have been automated, fewer people labor in front of heavy machinery and more are engaged in design and data processing.

Where problems do arise, they are related to the fact that adjustment to more dynamic activities does not always take place easily or painlessly, and the Government is called upon for relief or assistance. However, without better understanding of the causes of adjustment pressures being felt in the economy, some public remedies to the path of adjustment may in fact contribute to the ailment. This can often be the case when the prescription is for a dose of protection against foreign competition.

One element of the cure does stand out clearly. Increased rates of savings and investment would further facilitate adjustment to changing economic realities. For a number of basic industries under competitive pressure, increased investment in automation and new production techniques is a significant hope for restoring competitiveness.

We have always relied on the inventiveness and enterprising spirit of the American people and on the operation of markets to achieve the world's most productive economy, and that we now have.

Government, of course, has an important role to play, both in assuring a stable economic environment as well as enforcing international and domestic legal protection when imports unfairly injure U.S. producers.

Nor should Government ignore the pain caused by economic change in regional and occupational groupings of our Nation. Many workers in heavily impacted regions have not found suitable employment or have had to accept lower-paying jobs. The growth of long-term unemployment due to mismatches between the skills of the job seeker and the requirements of the marketplace presents a major challenge for our Government. Special attention must be devoted to the plight of such displaced workers through better information on job opportunities, retraining, and other vocational assistance as well as other forms of Government aid, where appropriate. The President has shown leadership in this area in seeking last year a tenfold increase in funds to be provided under the Job Training Partnership Act. This was an important first step in responding to a crucial public policy issue.

While I have stressed the need for accepting and adjusting to fundamental changes in technology and the world economy, this should not be confused with workers who are suffering from the effects of unfair import competition. Frequently our firms and workers are placed under competitive pressure because of foreign subsidies and other unfair governmental practices abroad. These practices have surged in recent years because many of the same basic industries worldwide are facing the need for difficult adjustment throughout the industrial world. No administration has been more vigorous than ours in aggressively enforcing U.S. trade laws to prevent unwarranted injury to U.S. producers. Our preferred option remains to work with our trading partners in scaling back such practices and reducing trade barriers, but we have also made it clear that if cooperation is not forthcoming, we will not hesitate to rely on the remedies provided under GATT rules and our domestic law.

The U.S. economy has shown that it can recover from economic adversity with a forward-looking trade policy geared toward a system of open markets. Working with the Congress, we can assure that foreign trade and trade policy lend maximum support to the expansion of our economy and to the living standards of the American people in the years to come.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Brock follows:]

34-871 O - 84 - 6

PREPARED STATEMENT OF HON. WILLIAM E. BROCK

I am pleased to be with you this morning to discuss U.S. foreign trade and the challenges we face in the coming months and years.

Most of the news you read today about trade is quite negative. Trade and balance-of-payments deficits are increasing; international rules are not being applied effectively; subsidy wars and quota restrictions threaten increasingly; and, of course, the prospect of local content legislation still looms. While all these problems are serious, I think we often fail to assess the real benefits the United States has achieved through a system of free trade.

We have the world's most open market because we believe that competition is the foundation of economic strength. We are not burdened by the social traditions of government ownership or control of industry which inevitably lead to costly subsidies, stagnant management and economic waste. Competition has encouraged innovation, adjustment, investment and employment in our economy. During the 1970s, the U.S. economy generated 20 million new jobs despite a period of relative stagnation resulting from the energy crisis. Americans refused to stand still. Open competition provided us with the incentive to develop new technologies, deregulate sectors of the economy and encourage an economic adjustment led by new, rapidly growing industries.

In some cases, the growth of imports has created real problems. But too little attention has been given to the positive side. Imports tend to lower prices to both retail and corporate consumers. Imports have created pressure on U.S. firms to invest more, to innovate, and to increase productivity. The effect has been to make our firms more competitive. Exports, on the other hand, have allowed us to expand production in our most productive industries and helped firms generate investment funds for innovation and new product development. Both exports and imports have increased our national income and raised American living standards.

It is no wonder that the United States has pulled dramatically out of the recession at a time when many of our important trading partners are achieving only sluggish growth at best. Thus, as we consider the specific problems that must be overcome in trade, I believe it is important that we do so from the perspective of what an open trading system has done for the American economy.

Today I would like to address several matters of importance to our economy and its trading system. I will discuss the U.S. trade deficit and dollar exchange rate; the LDC debt and need to stimulate world trade; and from a longer-term perspective the importance of adjustment to economic change for trade and growth.

Trade Deficit and Exchange Rate

As we are all aware, our merchandise trade balance has been deteriorating significantly since the beginning of the current recovery. Our own forecast is that the deficit may reach $100 billion by the end of 1984. A deficit this size is obviously a matter of serious concern. It is the weak link in our economic recovery. The drop in GNP expansion from an average rate of 8.7 percent in the second and third quarters of 1983 to 4.5 percent in the fourth quarter was in part attributable to our deteriorating trade balance which cuts domestic growth. Furthermore, notwithstanding the rapid drop in the overall unemployment from the recession peak of 10.8 percent to last month's 8.2 percent, jobs in trade-related positions are being lost through substantial increases in imports. These increases in imports are compounding the pressures on vulnerable sectors of the U.S. economy, especially in industries like, autos, steel, textiles and footwear. And, domestic firms and workers under strong import competition have reacted to our increasing trade deficit by stepping up calls for import relief.

The foreign exchange value of the dollar is a key matter of concern. Since 1978, the dollar has risen 14 percent against the yen, 27 percent against the German mark and 69 percent against the French franc. In effective terms the dollar has risen a 40 percent. As a result, otherwise competitive U.S. producers are being priced out of our own as well as foreign markets by an overvalued dollar.

Several factors are acting to strengthen the dollar. The United States certainly represents a stable, safe haven for foreign capital. Strong economic recovery and an open foreign investment policy further encourage foreign investers to move funds here. The demands of the budget deficit on the financial markets affects interest rates, providing more incentive to the influx of foreign capital. This movement of funds from abroad into our markets has pushed the dollar up to its current level and, in effect, represents U.S. borrowing from abroad which finances our trade deficits.

Forecasters for well over a year predicted an imminent easing of the dollar's value. Events, however, have proved them wrong so regularly, that there is now great caution with regard to the near term outlook for the dollar. Nevertheless, the current deterioration of our trade and payments balances suggest that the dollar's exchange value must ease sooner or later. Some of the actions that have been suggested to moderate the dollar run against the basic philosophy of this Administration, especially interventionist actions aimed at targeting the dollar's value. At the same time we must deal with the profound trade effects resulting from a very strong dollar.

World Trade Growth and LDC Debt

Another factor hurting our foreign trade is the weakness of foreign demand for our exports. The oil crisis of 1979/80 and the need to break the world inflationary spiral which it aggravated, resulted in several years of world-wide recession. As a result, world trade declined by 1 percent in 1981, dropped another 6 percent in 1982, and grew only 1 percent in 1983. The deterioration of our trade position is in part attributable to an earlier and stronger recovery here in the United States than abroad. This is a normal circumstance in a world recovery as the economic leader draws imports from the rest of the world before demand for its exports rises. As the rest of the world experiences a stronger recovery, it will begin to boost our exports and improve our trade position. The weak outlook for economic expansion abroad in 1984 and even in 1985, however, could slow the improvement of our trade position. This is particularly true with respect to Europe where economic rigidities, subsidies and excessive economic interference by governments in a number of industries are sapping the dynamicism of the continent. This is also true in many developing countries suffering under the burden of unprecedented foreign indebtedness.

Stronger growth abroad would help improve our trade balance and reduce trade tensions. Throughout most of the post-war period, world trade was an engine of growth, expanding faster than world GNP and therefore stimulating world-wide economic expansion. Although there is little we can directly do to affect the internal policies of foreign nations which reduce their economic performance, we can pursue cooperative efforts to get the trade-and-growth engine of the world economy functioning again. The most important challenge we face in the area of trade policy is, in fact, to start world trade growing once more.

There is wide recognition that international trade, investment and monetary policies need to be focused on the expansion of trade. In the current economic environment there is a particularly close relationship between trade and finance. No where is this clearer than in the case of the high debt LDCs.

North-south trade grew faster than any other area of trade in the 1970s, providing a major stimulus to economic growth world wide. U.S. trade with the developing countries grew so rapidly during the 1970s that, even excluding petroleum, their share of our worldwide trade rose from roughly a quarter to a third.

Rising oil prices and the world recession after 1979, however, left a number of non-oil LDCs with serious debt problems. The external debt of these countries reached $664 billion in 1983, up $52 billion from the previous year. Because of serious problems in servicing such massive debt, many developing countries have had to cut back imports by as much as 20 to 40 percent.

The debt situation has particular problems for our own exports. Well over one third of the LDC debt and some of the severest problems in debt servicing are found in Latin America where the United States has particularly strong trading interests. The efforts of these countries to trim their imports has been strongly felt by U.S. exporters. From 1981 to 1983 our trade balance with the eight high debt Latin American countries deteriorated by a staggering $20 billion from a surplus of $5.8 billion to a deficit of $14.5 billion. This accounts for over two-thirds of the deterioration in our total trade deficit with the world in these two years.

In order to once again expand their imports, the high-debt LDCs will have to increase their foreign exchange resources through higher exports, foreign investment, multilateral assistance and better access to trade financing. Secretary Regan and I have worked hard to develop a better coordination between the trade and finance officials worldwide as the linkage between the indebtedness of these countries and their trade practices has grown. It has been especially important that financial and other measures taken to assist high debt LDCs support a rapid recovery of world trade. We have provided Eximbank guarantees and insurance and Commodity Credit Corporation guarantees to finance LDC trade, thus enabling them to import essential goods. The Eximbank has provided expanded packages of guarantees for both Brazil and Mexico. We have also supported the use of bridge financing, increased resources for IMF loan programs, and the reduction of barriers to foreign investment in these countries. Above all, however, the recovery of these countries depends on their ability to export which in turn depends on their ability to obtain market access in the developed countries.

Indeed, from the trade policy point of view, the near term challenge is to reverse the recent trend toward increasing trade restrictions and to begin the process of reducing barriers. Such actions would ease the debt servicing burden of the non-oil LDCs, stimulate growth in the industrial as well as the developing world and reopen the increasingly restricted markets facing our exporters. We are currently pursuing the objective of barrier reduction along several paths.

Our bilateral efforts in this area, have met with some success in Japan as witnessed by Prime Minister Nakasone's announcement of liberalization measures, including the agreement on trade in semi-conductors and last week's progress in gaining access for telecommunications equipment. Problems with the European Community, however, are more intractable. The world recession of the last three years accelerated the trend toward increased use of subsidies and market restrictions in a number of Community members. We should not lose sight of the fact, however, that Europe has been one of our most important trading partners over the years. While it would be misleading to understate the difficulty of our current bilateral trade problems, I am confident that in the long term we will reach understandings on even the most sensitive of these issues.

Multilaterally, efforts are underway in both the OECD and the GATT to implement commitments to roll back trade restrictions, which were agreed at the November 1982 GATT Ministerial, the May 1983 OECD Ministerial and the Williamsburg Economic Summit. We have also agreed to the acceleration of tariff cuts negotiated in the Tokyo Round of Multilateral Trade Negotiations and to the elimination of barriers to imports from the least developed countries.

We are determined to make the GATT Codes on non-tariff issues workable and enforceable. My office has pursued a large number of individual cases arising from these understandings. As our trading partners realize that we intend to use these understandings as serious vehicles for resolving specific problems, the GATT will become the organization it was meant to be. We also intend to strengthen the GATT by expanding Code coverage, particularly to services, which constitute an increasing share of international trade. In this connection, we are preparing the groundwork with our trading partners for a new round of trade negotiations that hopefully will commence sometime in the middle 1980s.

Adjustment

As we look a little further down the road, the key trade policy issue we will face together with other industrial nations is the adjustment of our economies to long-term economic change. Such changes include the expansion of automation in industry, the world-wide overproduction of agricultural products, the new growth potential of our economy in high technology goods and services, and the expansion of exports from the newly industrializing countries, the so-called NICs, like Brazil, Korea and Singapore. The key question is how the necessary adjustments can be brought about without imposing unacceptable human costs on the workers who are displaced from their current jobs.

Specific sectors such as steel, autos and textiles are experiencing significant and permanent losses in employment. To a significant degree, the decline in employment in these industries is the result of domestic factors, such as automation of production, saturation of mature markets, changes in technology and consumer tastes, and adjustments to higher energy costs. Competition from increased imports is an additional factor. To a large extent our economy is self-adjusting, and many, if not all, such changes occur without raising serious policy concerns. Millions of individual decisions are made daily adjusting investment, career, research, corporate, and financial planning to the changing signals from our well-functioning markets.

The capacity of our economy to create 20 million additional jobs in a decade or 4 million jobs in the last 12 months is evidence of our success in adjusting to change, and our ability to expand employment opportunities is the envy of much of the world. In the European Community, for example, employment today is no higher than a decade ago with the result that the European unemployment rate has increased in every year since 1973 and stands well above our own.

The strong capacity of our economy for employment expansion rests heavily on the fact that there are many sectors and activities which can and do generate significant job gains. These sectors are increasingly in the area of high technology and services like health care and professional, business, and information services.

In manufacturing, fewer people labor in front of heavy machinery, and more are engaged in design and data processing. In offices, the advent of the word processor has produced major efficiencies. A wide range of more sophisticated computer applications has created a highly competitive market for computer programmers and operators. As the computer and other aspects of productivity-enhancing automation work their way into production processes, engineers and technicians capable of bridging the gap between the old and the new technologies are in strong demand. Health technicians trained to operate sophisticated medical equipment are finding their skills in heavy demand, and the health boom has fueled rapid growth in job opportunities for nurses, physical therapists, psychiatric aides and other health practitioners. In New England, former textile and shoe workers found new employment in assembling computers and other advanced electronic equipment.

The continuing redeployment of capital and labor that these and similar changes have entailed have strengthened our economy and our standing in the world. The health revolution, for example, has not only improved our physical well-being but also provided a strong exporting success story, as American medical equipment, knowhow and health services are in much demand throughout the world. Similarly, U.S. advancements in agricultural productivity and techniques over the last 20 years have led to trade surpluses in farm machinery and chemical fertilizers.

Technological advances in manufacturing processes likewise have enabled U.S. factory workers to increase their output enormously. While the number of manufacturing jobs increased by only 5 percent during the 1970s, reaching 20.3 million in 1980, the physical output of the nation's factories increased by 38 percent. Chemical producers, for example, increased their output by 72 percent, while employment grew less than 6 percent. Textiles mills' output gained 24 percent, while employment shrank by 13 percent. Food processors lost 4 percent of their work force while increasing output by 37 percent. And paper producers raised output by 39 percent while dropping 2 percent of their employees.

Productivity gains in these and other industries, driven largely by advances in technology, have created new kinds of jobs. As factories have been automated, employment has risen among the makers of industrial robots and other sophisticated production equipment. The rapid spread of microprocessors has created many new jobs in the manufacture of semiconductor chips. And new medical technologies have helped fuel the demand for health care, again boosting employment. Furthermore, the drive for efficiency by manufacturing and other goods-producing firms has led them to increase their purchase and use of business services thus increasing jobs in the U.S. service sector. It is now estimated that such business services supplied to mining, agriculture and industry account for an amazing 25 percent of our gross national product.

Where problems do arise, they are related to the fact that adjustment to more dynamic activities does not always take place easily or painlessly. The role of public policy in easing the human costs and facilitating the transition of displaced workers to new activities, where such assistance is required, has been evolving in recent years from supplemental unemployment compensation to more meaningful efforts toward job training assistance. A necessary step in dealing with the human problems of adjustment is to understand better the nature and causes of the changes going on in our economy. Without better understanding, some public policy remedies to the pain of adjustment may in fact contribute to the ailment. This can often be the case when the prescription is for a dose of protection against foreign competition. The President's Annual Report to the Congress on the Trade Agreements Program this year will provide an extensive and detailed analysis of the causes of change in our economy and hopefully stimulate further discussion of this vital aspect of our economic expansion.

One element of the cure does stand out clearly. Increased rates of saving and investment would further facilitate adjustment to changing economic realities. For a number of our basic industries under competitive pressure, increased investment in automation and new production techniques is a significant hope for restoring competitiveness. Likewise, the ability of sectors with strong growth potential to rapidly expand jobs and output will be influenced by the cost and availability of credit. We must be able to exploit the market opportunities created by new technologies and realize the full potential for new jobs in these areas. The continued availability of credit for investment in industrial research and development and new plant and equipment is crucial to this change. Measures of the last several years to increase the incentive for business to invest are beginning to have positive results. The recovery of business investment from the recession is running at an above average rate for economic recoveries. For the time being, borrowing from abroad through private capital inflows is helping the recovery of U.S. business investment. Over a longer period, however, national saving is a constraint on the level of investment and, despite attempts to improve performance, our national saving rate remains among the lowest in the industrial world.

American industry more than ever understands the need for investment in new technologies and increased automation. This is especially true for those U.S. industries under direct pressure from highly competitive foreign producers. The best chance for our basic industries to meet foreign competition is to raise labor productivity and cut costs through aggressive automation. In the end, fewer U.S. jobs will be lost through plant modernization than if we attempt to protect producers and remove their market incentive to invest in the most advanced technologies to meet the foreign competition.

We have always relied on the inventiveness and enterprising spirit of the American people and on the operation of markets to achieve the world's most productive economy. Government, of course, has an important role to play both in assuring a stable economic environment as well as enforcing international and domestic legal protection when imports unfairly injure U.S. producers. Among the specific domestic policies vital to our ability to adjust and grow, I would include a stable monetary policy as the basis of non-inflationary growth. I would include the removal of specific government interferences with the marketplace where they reduce efficiency and competitiveness without providing appropriate social benefit. In a similar vein, I would also include removal of government disincentives to export where they do not appropriately serve a worthwhile national purpose. And I would include review of economic policy options to increase the U.S. saving and investment rates and encourage private sector spending on research and development.

34-871 O - 84 - 7

Government cannot ignore the pain caused by economic change in regional and occupational groupings of our nation. Many workers in heavily impacted regions have not found suitable employment or have had to accept lower paying jobs. The plight of those who lose their jobs in regions of our country suffering from a concentration of plant closings is all the worse when their skills no longer match the changing nature of jobs and the demands of the work place. The growth of long term unemployment due to mismatches between the skills of the job seeker and the requirements of the marketplace presents a major challenge for our Government. Special attention must be devoted to the plight of such displaced workers through better information on job opportunities, retraining and other vocational assistance as well as other forms of government aid, where appropriate. The President has shown leadership in this area in seeking last year a tenfold increase in funds to be provided under the Job Training Partnership Act. This was an important first step in responding to a crucial public policy issue.

While I have stressed the need of accepting and adjusting to fundamental changes in technology and the world economy, this should not be confused with workers who are suffering from the effects of unfair import competition. Frequently our firms and workers are placed under competitive pressure because of foreign subsidies and other unfair governmental practices abroad. These practices have surged in recent years because many of the same basic industries are facing the need for difficult adjustments throughout the industrial world. It is one thing to begin adjusting to changes in fundamental economic realities but no American industry should be required to adjust to unfair competition from foreign treasuries. No Administration has been more vigorous than ours in aggressively enforcing U.S. trade laws to prevent unwarranted injury to U.S. producers. Our preferred option remains to work together with our trading partners in scaling back such practices and reducing trade barriers in coming years. But we have also made it clear that if cooperation is not forthcoming, we will not hesitate to rely on the remedies provided under GATT rules and our domestic law.

The strong U.S. recovery and our ability to adjust innovatively to economic change are products of the competitive spirit that has made this country great. President Reagan has led the process of restoring our economy to the sources of its vitality. This has been accomplished through the reduction in tax and regulatory burdens and a return to price stability after a decade and a half of inflationary spiral. These policies are beginning to pay off. Problems still remain, as we are all aware. But, we have shown the resolve to deal with them decisively. The recent recession led inevitably to increased protectionist sentiment in many quarters. I continue to believe that the best course of action is not protectionism, but the aggressive enforcement of our trade laws and the reduction of foreign barriers and subsidies that limit our export opportunities. The U.S. economy has shown that it can recover from economic adversity with a forward looking trade policy geared toward a system of open markets. Working with the Congress, we can assure that foreign trade and trade policy lend maximum support to the expansion of our economy and to the living standards of the American people in the years to come.

Senator JEPSEN. Thank you, Mr. Ambassador.

I was pleased to see the report in this morning's paper on an agreement with Japan to renew the NTT, the Nippon Telegraph and Telephone purchasing arrangement. I have been reading both directly and a little bit in between the lines—maybe it is hopeful thinking on my part or wishful thinking—that Japan has been quite concerned about the trade deficit and has sent people here to visit and talk about it and maybe reexamine and reflect on some of their attitudes and particular posture in the past.

Do you sense a change for the better in the interest of our Japanese trading partners? I think they are beginning to think that maybe if we are not healthy here their wonderful markets they have had are also going to lose their health; and so now they are taking a very serious look at things.

Is that an accurate assessment of what is going on?

Ambassador BROCK. Yes, it is. I think it is particularly accurate at the top and the bottom. We need to be very sure it gets to the middle where many business decisions are made by individual corporations and bureaucrats. But there is not one moment's doubt in my mind that the Prime Minister, Mr. Nakasone, and his cabinet—his MITI minister and Foreign Minister and others involved in the trade area—have made a commitment to try to deal with this trade problem.

We are making progress in conversations in a whole range of issues ranging from bilateral agreements such as the telecommunications one which we signed yesterday, which is a much stronger and significantly improved agreement from that which we had before, to other tariff and nontariff areas in a whole range of subject matters.

The problem with Japan is going to take longer than any of us would like, though, Senator, for a very simple reason. They have been doing it a different way for 30 years and we have to change some habits that are deeply engrained. There still is a sense on the part of a large number of Japanese people that it is better to import raw materials and export finished goods and not to import, on a competitive basis. That has to change. It is an attitudinal process as well as a legal process. But we are making progress. I do think the leadership of that government and the consumers of Japan have made that decision. Now it must be communicated to others.

Senator JEPSEN. By comparison, we are coming into a new era of trade relations with China, at least it appears. Is there anything that we have learned from our years of negotiating and maybe being outnegotiated sometimes with Japan that we might find valuable?

Ambassador BROCK. Yes. It is not just what we have learned from Japan but what we have learned in our approach for process. I hope that we have learned very well that when you start off by dealing with a country that is much weaker—and Japan was at one time or China is now—you tend to try to give them a greater opportunity than you give the more advanced competitors, that is not illogical. It makes sense. But you have to be sure that there is a regular process by which they mature into full responsibility and acceptance of the trading rules. I think you simply have to be very clear in what you say and how you deal with countries. You cannot say, We are going to try to give you something special," and never explain that there is going to be an end to that. That is not honest and that is not honest to our people.

There are tremendous business prospects in Asia; China is one of those exciting areas that offers a great deal of hope for us.

Senator JEPSEN. Finally, Mr. Ambassador, I get, it seems, mixed signals from the administration as to what is going on. The good news part of it is I recall not too long ago, when we had a meeting in Brussels, I believe it was with regard to corn gluten and others that we had Brock, Block, Shultz, Baldrige—was there a fifth one?

Ambassador BROCK. Don Regan.

Senator JEPSEN. Don Regan, Secretary of the Treasury.

Ambassador BROCK. It sounds like our economic law team.

Senator JEPSEN. I have not seen an assembly of cabinet folks, I do not think ever before in history to put so much emphasis on trade, and the agriculture community was very grateful for that emphasis. The value as well as the volume of U.S. agricultural exports have declined for 2 years in a row. Our surplus dropped from $23.8 billion in 1982 to $18.4 billion last year, and we all know what expanded exports mean to U.S. agriculture if they are going to have their share in economic recovery. Yet, this administration is cutting or recommending cutting its export credit programs.

What are the prospects for agriculture exports in 1984, especially in light of the reduced Federal support; and what type of Federal support and promotion programs have proved to be the most efficient in expanding agricultural export sales?

In brief, will you give me a bird's eye view on projections of what we might expect in 1984 by way of promotion of agricultural products?

Ambassador BROCK. I think 1984 is going to be a tough year, Mr. Chairman. The biggest single problem our farmers face is the exceptionally high value of the U.S. dollar and agricultural products are the most price-sensitive products in the world. One to two cents a bushel is more than enough margin to shift from one supplier to another one.

We have a circumstance in which the relative value of the dollar vis-a-vis other currencies has gone up close to 40 percent in the last few years. That has put almost an intolerance burden on the most efficient agricultural producers in the world. It is not going to be comfortable out there this year. We are going to have tough sledding trying to compete. We happen to have the best products. We are so productive that we can still compete, but I think it is going to be a year of not much growth; maybe a bit, but not much until we can get our deficits under control in this country and begin to deal with the excessive valuation of the dollar.

Senator JEPSEN. I think I have taken my share of time. I really want to explore that and we will come back to it if somebody else does not do it until it gets to be my turn again to exchange ideas with you, but the relation between value of the dollar and our trade problems is just on everybody's lips. I have met with groups and individuals in the last couple of months, everyone from producer to distributor, to processor, or whatever it may be, and all up and down the line in all areas, not just agriculture. Everybody asks the same thing: What are you going to do about it? So sometime today I want to get, if someone else does not, I am going to ask you, what are we going to do about it.

Ambassador BROCK. Senator, you have been doing pretty well. You need a little help up here.

Senator JEPSEN. Congressman Hamilton.

Representative HAMILTON. Mr. Ambassador, I guess I just do not understand this Japanese deficit problem, our trade deficit with the Japanese. I sat down yesterday with Foreign Minister Obi, and he talked about how Japan favors open markets—how they do not have any trade barriers, how they do not have any tariff barriers, how they do not have any nontariff barriers, how they support an open market system and how they support free trade. Then I pick up the paper this morning and I see that a State Department official is quoted as saying, "We have to have some openings of the Japanese markets."

I know we have had a very, very large trade deficit with them for a long number of years. I think it is now around $21 billion.

It seems to me there is kind of a pattern that goes on here in our Japanese relationship. We complain about a barrier or barriers. The Japanese come along and make some adjustments, but the trade deficit continues. Then we get exercised about it and we complain about other trade barriers, tariff or nontariff barriers, and the Japanese accommodate us again with some kind of moves, but the trade deficit continues.

We have not seemed to be able to make any appreciable gain in reducing that deficit over a period of a long time. I do not know how long it has been, 10 years maybe.

Why is that? I just do not understand it. Is the Japanese market really closed to our businessmen? Is it because we are not competitive? Is it because, as you suggested a moment ago, the Japanese leadership cannot implement their policies because of resistance in the bureaucracy? I just have a difficult time understanding this Japanese trade deficit problem.

Ambassador BROCK. You are not alone. It is difficult. But the answer to each of the questions is yes. All of those have played a part. Japan, for 30 years, maintained a very high level of protection for aging industries, for infant industries, for large, medium, and small.

They have in the last few years begun to move away from that, but there remain problem areas. I cite for you the example of the Japanese citrus quota which is symbolic. It is not a great deal of dollar volume but it is very symbolic in this country because it illustrates the frustration people feel toward Japan. Why should there be absolute finite quotas of one shipload of product in areas like citrus?

Hopefully, we will make some progress on that issue, but there is no assurance of that yet.

In the depressed industries of Japan, as they describe them, the same group we would call the adjustment industries or those that would be affected by industrial policy as is being proposed here. But the industries that are in trouble because they lag behind in productivity in the world sense—of those depressed industries in Japan, only the aluminum industry really allows full competition from external countries such as ours.

In other areas, while we have a better product and a better price in the whole woods product area, for example, we do not sell very much in most of those areas in Japan.

The Japanese Government says it has no barriers. It if does not have any barriers, then there are some effective emotional barriers or psychological or social barriers. Something is keeping us from competing when the marketplace would say that we would be competitive.

So there are problems of that sort. I do think that at least part of the problem has been that the story has been so well told about Japan and its barriers that many businesses in this country have simply taken that as gospel and said, "Why go there? Let me try to go to Indonesia or Spain or somewhere else to compete." We have not tried as hard as we should. That is part of it, but that really is not the whole answer.

Representative HAMILTON. Suppose Japan knocked out all of its trade barriers, tariff and nontariff. What kind of an impact would that have on the trade deficit?

Ambassador BROCK. At best, it would cut it in half.

Representative HAMILTON. Cut it in half?

Ambassador BROCK. At best. The other half of it is in terms of competitive strength or our competitive ability, and I will give you the example of the automobile industry because it is one we spent so much time talking about. Japan is producing a car that is at least a couple thousand dollars per unit cheaper than the U.S. car. It is not being sold any cheaper here because when you put quotas on them, even voluntary quotas as the Japanese have done, all you do is make it more profitable to do business on the units that you are selling.

I have had American dealers tell me that they have increased the price of their Japanese cars by $2,000 a unit so they do not have to tell the people they will not sell them. They just reduce their clients by that number and they make that much more profit because of the import restraints.

Representative HAMILTON. Let me ask you a question in another area. Is the European Community going to go ahead with the limitations on the nongrain feeds, the corn gluten feed?

Ambassador BROCK. That is their present indication. We are in conversations with them on the subject.

Representative HAMILTON. Now if that were to occur, are we considering some measure in response?

Ambassador BROCK. Yes, sir.

Representative HAMILTON. Would you care to identify what those measures might be?

Ambassador BROCK. No, sir; but I will suggest that under the GATT procedures they have a right to withdraw and then to offer compensation. They have asked for discussions. We will have those discussions and we will hear what they have to offer. If it is inadequate, then we are within our rights to impose other actions on them of a magnitude to offset the damage we suffer.

Representative HAMILTON. Now there is a good bit of talk in the press about the administration perhaps granting some kind of import relief to the steel industry, and if that is done, it has been speculated that the European Community would lift its quota restraints on carbon steel.

Do you think that the European Community is going to go ahead with retaliatory measures for any restriction we put on steel imports?

Ambassador BROCK. Yes, I think they are, in the area of specialty steel. We did negotiate—I think both sides did sincerely and in good faith—but we were unsuccessful in reaching an agreement on compensation. Because we did take an action of limiting their specialty steel sales in this country both by quota and by tariff, they exercised their GATT rights, and when we were unable to agree on a compensation formula they then apparently chose to impose what they call retaliation.

Representative HAMILTON. I will conclude with this. Are we headed for a kind of a managed trade arrangement with steel very much as we now have with textiles? Is that the direction that the steel market is tending?

Ambassador BROCK. I hope not; very much I hope not. It is the most difficult area of trade at the moment for us because there simply is no free trade in the world anywhere that I can find and I have been looking for 3 years. It is brutally affected by government intervention and Europe has very tight restraints on what they import from small as well as large countries. There are subsidies. Every type of government intervention you could possibly devise applies to the steel industry, and it is an intensely difficult and complicated area. It is very hard to cope with within the traditional approach. We are trying to do it in the traditional fashion. It has been very, very difficult for us.

Representative HAMILTON. Thank you, Mr. Ambassador.

Senator JEPSEN. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

Mr. Ambassador, I agree that the traditional approach is not working and that there is little if no free trade left in the world today. We simply have more trade coming in than we have going out. While I am concerned about Japanese cars coming into the

United States, I am more concerned about how we are going to get trade going the other way. I have been here 3 years just like you and I still ask how do we turn it around? I have a couple questions I would like to ask you about suggestions. We hold these hearings and nothing ever gets done. Everything is getting worse each day in the trade world because we have been whipped everywhere we go in negotiations.

In this country we keep talking about fiscal policy, monetary policy and defense policy. Trade policy is not factored in adequately when discussing these other issues. It seems to me that what we have to do is get the President to debate the trade issue at the same level of importance as other economic issues are discussed. In other words, trade policy is as important as fiscal policy, monetary policy, and defense policy.

I would like to ask you, do you not think that it is a good idea to have the President folded more into this equation than what he has been over the last 3 years?

Ambassador BROCK. I certainly agree that it is important to elevate trade policy. It is just one of the fundamental elements of our economic well-being and it will be for the rest of our natural lives.

I frankly cannot suggest to you that the President is insufficiently involved. He is very directly involved. We had a long session yesterday on precisely this subject with the Secretary of State, the Secretary of the Treasury, and the senior White House staff. The President and I discussed these kinds of issues and what we are going to have to do this year.

Senator MATTINGLY. Before you continue, let me interject exactly what I am talking about. In the area of unfair subsidies or unfair barriers, the President should really become the chief negotiator in efforts to have those barriers and subsidies rolled back. In other words, instead of constantly sending flocks of people off to different countries for trade talks where very little may be achieved, it could be more productive to have the President more involved in your negotiations.

Ambassador BROCK. I would love to have him.

Senator MATTINGLY. Do you think he would enhance your position in negotiations?

Ambassador BROCK. I would love to have his help, but there are other elements that he has got to be involved with.

Senator MATTINGLY. But do you not agree that we have experienced recovery in many areas of the economy in this country except in the area of trade and this does impact on——

Ambassador BROCK. Except in the area of Federal deficit. That is what is compounding our trade problem. If we really want to go to one root of the problem, we really have to deal with the fact that we cannot keep our interest rates down and therefore reduce the surge of money into this country.

Senator MATTINGLY. Which brings up the other culprit—the high price of the dollar.

Ambassador BROCK. You are exactly right.

Senator MATTINGLY. Now, given the high value of the dollar, why do we not consider the use of countertrade until such time as the dollar falls to a more equitable level to where domestic producers can compete in the world markets?

Ambassador BROCK. We have. The difficulty with that is that countertrade implies that the Government would do the trading.

Senator MATTINGLY. I take that back—just barter then, just straight bartering.

Ambassador BROCK. There is nothing wrong with barter as long as it is done in the private enterprise sector where people can make a profit at it. I do not have any objections to that.

Senator MATTINGLY. Do you think a more favorable trade balance would be created if more people in this country bartered?

Ambassador BROCK. Yes, it could help, and you are beginning to see a good deal of that. If you talk with some of the national trading companies—Sears' export trading company, for example, is getting into a sizable amount of this kind of business because they see this as an excellent opportunity. In this country, we have never done much of that. Other countries have done a lot and I do not have any objection to the private enterprise system responding to that kind of opportunity.

Senator MATTINGLY. Do you think our Government could be helpful in directing the private sector to the appropriate people in order to encourage them to utilize barter?

Ambassador BROCK. Absolutely.

Senator MATTINGLY. The last quick question here is, what type of legislative initiatives do you think would be effective to promote U.S. trade?

Ambassador BROCK. I want to try not to sound negative, but there are times when the less done, the better. I am afraid with the atomsphere of a campaign year and all of the current protectionist pressures, that good legislation that was well intended could take on a protectionist coloration and do this country a great deal of harm. So I would urge caution.

Having said that we do need Congress to act on a number of initiatives this year. For example, in December of 1982, my authority to negotiate any tariff reductions expired and it has not been extended. That really does not make sense because my job is to negotiate the elimination of trade barriers. The Congress would still retain final approval or disapproval over what has been negotiated, but it lets me have an additional tool. That would be a very useful tool if we could get it back.

In addition, the generalized system of preferences or GSP program expires in January 1985. We will seek to have this program extended and amended for a 10-year period. The GSP program, as you may know, allows lesser developed countries to export certain goods to the United States duty-free. The United States is the only industrialized country in the world that has not made this type of tariff preference program for LDC's permanent. All other developed countries have permanent tariff preference programs.

Also, we will seek changes this year to the Domestic International Sales Corporation tax provisions, or DISC, so as to make this export tax incentive compatible with our obligations under the GATT and thereby remove a long-standing source of disagreement between the United States and the European Community.

Finally, Mr. Chairman, there are other legislative issues on which my office will be working, such as an acceleration to the tariff reductions which were agreed to under the Tokyo Round of the multilateral trade negotiations in the late 1970's; expanded product coverage under the GATT aircraft agreement; and reform amendments to the Foreign Corrupt Practices Act of FCPA. Our most important legislative priorities for 1984, however, are to regain broad tariff negotiating authority, and to extend the GSP program for 10 years.

Senator MATTINGLY. I agree with you. I think the less we do in this place, the better off we are too. Let me just repeat that in efforts to promote U.S. exports and to increase public awareness of barter as a means to trade, I think the President is and would be the best communicator of this message. While I believe he is concerned about trade, I would just like for him to get more involved with our allies and our trading partners to convince them that the unfair barriers and subsidies that they impose hurt all of us. Perhaps the elimination of such barriers would also help to reduce their deficits.

Ambassador BROCK. I very much agree with that and I should have said earlier that the great bulk of the substance of the President's trip to Japan was trade and I think we got a good deal out of that. The President will be going to China this spring and that trip has a significant trade component. We have the London Summit coming up and that will also be a great opportunity for the President to do precisely what you are suggesting. So it is something that we all have to play a role in.

I should commend the Senate, for example, for its proposed modification of the Foreign Corrupt Practices Act. That has been a very contentious, difficult issue for U.S. exporters, but we have come up with some good language that our legislators can deal with that will make the law more workable and understandable. Such reforms shall help our exports.

Senator MATTINGLY. Do you think the intent of the trade acts that originally created our trade organization and the concepts on which U.S trade is based has shifted over the past?

Ambassador BROCK. I think the intent remains valid. I am not sure that some of the substance has not changed.

Senator MATTINGLY. Thank you.

Senator JEPSEN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Ambassador Brock, I am delighted to see you back. Of course, you served with great distinction in the Senate for years and you and I were together on the Senate Banking Committee and worked together on legislation.

I am unhappy you mentioned the Foreign Corrupt Practices Act at the end there. That is the Proxmire Act. It is one of my proudest achievements and I think it is the best thing that we have done in foreign trade in years. I hope we keep it exactly the way it is. We are the only country that prohibits bribery in our foreign sales or foreign procurement and I think it is a great example to the world and I think it has strengthened, if anything, our trade position.

The difficulty is—and you said it very well, although you say it briefly—you have 5,000 words here which are fine words, but there are only 50 words that I think really hit the heart of it. They are on page 4, where you say, "The demands of the budget deficit on the financial markets affects interest rates, providing more incentive to the influx of foreign capital. This movement of funds from abroad in to our markets has pushed the dollar up to its current level" and you have come back to that in answering questions.

There is a chart up here that shows what has happened to the dollar and the trade deficit, the value of the dollar going up and, of course, it is keeping pace with the trade deficit. What we should have on that chart also, of course, is the fiscal deficit that is driving it up. And I am delighted that you put the emphasis you put on it there.

I am also looking forward to our President's budget which is coming tomorrow which is going to tell us that we are going to have a $180 billion deficit, the biggest deficit we ever had in the history of this country by far except the deficit we just had in 1983. It seems to me that that really further complicates your job.

When I came in here this morning you were sitting in the outer room and I said I thought you had the toughest, meanest, cruelest job of anybody in the administration, and the reason for it was because the deficit has done what it has done to foreign trade.

What I do not see in your statement—and I think it is a fine statement—I do not see in it any emphasis on initiative either in the Congress or by the President to cut that deficit. It seems to me that is the heart of your problem.

Ambassador BROCK. That is putting it about as clearly as you can. You are absolutely right. It is the heart of the problem. By the way, you are going to have to get another chart next year because the next bar is going to be off that chart.

Senator PROXMIRE. You are talking about 1985?

Ambassador BROCK. Yes. If I had to quantify it, unless something changes pretty dramatically and quickly, it is going to be worse.

Senator PROXMIRE. Let me just interrupt at that point. That means, as I understand it, and we have had varying estimates, that when we have a $100 billion deficit compared with a balance of trade that we are losing—I have heard estimates of 2 to 2½ million jobs. Is that an overestimate?

Ambassador BROCK. It is difficult to answer because one must look at the specific industries.

Senator PROXMIRE. Well, at $25,000 a job, it would be around 2 million.

Ambassador BROCK. Yes. There are certainly that many jobs affected, there is no question about it. If you look at it in terms of the U.S. GNP, when you are talking about a deficit of this magnitude you are talking about a defict of close to 3 percent of GNP. In other words, we would have that additional domestic productions, if there were no deficit. So you can quantify it either in terms of GNP or jobs. It is true that the deficit is the largest single item in the equation, it is not the only one, but it is one of the largest factors, in my judgment.

Senator PROXMIRE. So if we reduce the deficit by whatever means, hopefully cutting spending, but increasing the revenues or whatever we do to reduce the deficit, it is going to help solve the problem of the trade deficit, too?

Ambassador BROCK. Yes.

Senator PROXMIRE. And it will be the primary beneficiary there. As I understand it, for example, if the value of the dollar should improve—I should say should be reduced by 20 percent, would that not have the same effect as cutting prices for people who are buying from this country by 20 percent?

Ambassador BROCK. Absolutely.

Senator PROXMIRE. So that our exports would therefore be that much more competitive?

Ambassador BROCK. Yes. However, you have to be careful because there is a price whichever way it goes. One of the pluses that you get from the surge of imports because of the strong dollar is that those imports are coming in because they are cheap. Relatively, they are priced below U.S. market prices because of the weak yen or the weak lira or the weak franc.

Now that has been of great value to us in our fight against inflation. What will happen is that you will pay a price if the dollar were to go down very fast, say 20 percent, our imports would be priced 20 percent higher and that will kick our inflation rate back up.

Senator PROXMIRE. Is there not a countervailing effect because if we do it by reducing the deficit because the deficit is also inflationary, and that might—it would seem to me that would probably overwhelm any inflationary effect of higher import prices.

Ambassador BROCK. I happen to think it would. I think the net effect of the deficit reduction would be to pull down the price of the dollar.

Senator PROXMIRE. Now in your prepared statement you discuss another element of this that is too often neglected but is important, and that is, if we could increase our savings rate that that would be helpful. For example, the Japanese I understand run a very high Federal deficit but they have a much higher savings rate than we have and for that reason the value of the yen has not been adversely affected by their deficits as the value of the dollar has been by ours.

The difficulty, however, is when we go over to the next page of your prepared statement and you have four proposals there, specific domestic policies we should follow. You have (1) stable monetary policy; (2) remove the specific government interference in the marketplace; (3) remove the government disincentives to export; (4) increase U.S. savings and investment.

It seems to me that the big element ought to be to reduce the deficit, and that is certainly a domestic kind of specific policy that we should follow that would help you more than anything else.

Ambassador BROCK. I thought I had said that. We are now getting down to the breakout points, but I accept the comments.

It is not possible, Senator, to finance any deficit if you do not have any savings.

Senator PROXMIRE. If you do not have any what?

Ambassador BROCK. Any savings. And what we have is a circumstance where our deficit at this percent of GNP is apparently tolerable—I do not think it is ever healthy, but it is tolerable in other countries. Japan's deficit in terms of GNP is quite often higher than ours. In Europe, it is almost invariably higher than ours. But they have a higher rate of savings, particularly in Japan.

When you have that much additional savings by people, corporations, profits, you create a capital pool that is large enough to finance the Federal excess without impinging upon your future through higher interest rates.

Now our effective interest rates are about double what they are in Japan and in net terms after inflation, and that simply says that we are going to pull the money into this country from Japan and we do. Everybody talks about Japan being the economic miracle, but the Japanese have been investing in the United States because it is a better place to invest with these interest rates, and that is incredible.

Senator PROXMIRE. You see, the problem here is that when you talk about savings you seem to be talking about private savings. National savings, it seems to me, includes both private and Government savings.

Ambassador BROCK. I agree.

Senator PROXMIRE. Of course, we have such a colossal amount of Government dissavings, although we have some savings by the State and local governments and too low a level of savings by private individuals, the dissavings by the Federal Government throws it all out of kilter.

Ambassador BROCK. That is true.

Senator PROXMIRE. So that our objective should be, as you properly indicate, to cut the budget deficit, and you would agree that that would be the best thing we could do to help the trade picture?

Ambassador BROCK. I think anybody in this administration would agree with that.

Senator PROXMIRE. Well, now yesterday—no, it was the last witness who appeared before us, Treasury Secretary Regan—he said that he thought that the strong dollar was a good thing. He wanted to take credit for the strong dollar.

Ambassador BROCK. You are talking about how strong. Of course, it is good. It is good because it reduces the price of our imports. It helps us against inflation considerably. It has reduced the price of imported oil. All of those are good things to happen.

The question is, How strong and when do you reach that point of diminution of return? I happen to think we may have crossed over that point.

Senator PROXMIRE. I wonder if it is a kind of macho reaction, you know—Secretary Regan is a wonderful fellow. He is also a former Marine. He likes strength. When you say strong, he is for it. It is like one way we could get the Republicans involved in what I thought was a very constructive agricultural program was to call it a soil bank. When we said "bank," wow, they are for that. Who is not for strength? Nobody wants a weak dollar, nobody wants a wimpy dollar. We want one that is really macho.

So I think if we could find some other word for the strong dollar—somebody tried to call it an inflated dollar the other day and Secretary Regan argued with that—but if we could find some other word we might make a lot of progress.

Ambassador BROCK. Well, we had a wimpy dollar in the previous administration [Laughter.]

Senator PROXMIRE. Well, we did not have some of the problems we have here.

Ambassador BROCK. No, but our problems were much worse domestically. We had 21-percent interest rates and 14-percent inflation and you and I both know that was intolerable.

The point is, the pendulum does go too far. It will get back to that center point where we are again the most productive country. We are still the most productive country in the world. We are just outpriced at the moment by external practices and the dollar is a problem.

Senator PROXMIRE. And the deficit is a problem.

Thank you, Mr. Chairman.

Senator JEPSEN. There is going to be an understandable, I guess, political temptation to pile everything negative together and whip things into a political frenzy. That is not a new technique. Deficits needs to be pointed out. I think while we are airing things here—and Senator Proxmire has certainly shed some light and illumination on this—we are talking about a deficit of the budget. The deficit has had an effect on interest rates, that is true; and on the dollar, and that is true; but is it not also true that our low inflation rate and our political stability have had also a very dramatic effect on the dollar?

Ambassador BROCK. Absolutely.

Senator JEPSEN. So the trade deficit is not simply a result of budget deficits. I kind of heard that here this morning and I do not think that is quite a total accurate framing of our trade deficit problem is it?

Ambassador BROCK. No, and I thought I said there are important other factors. If I did not make that clear, I want to make it clear now.

In looking at the dollar itself, I had the chief of state of a very significant country tell me, "We are trying to adjust our currency and strengthen it vis-a-vis the dollar," but he said, "It is very difficult. Every time there is a Korean airliner shot down or some ministry is bombed in Burma and there is an atmosphere of world crisis, the dollar goes up and it wipes out what we have been trying to do."

We are in the world's crisis currency. We are the world's reserve currency. We are the safe haven for world investment because we are doing better than anybody else. So there is a plus side.

Senator JEPSEN. A lot of folks are not only trying to get into this country personally but they are sending their money in by the boatload and there are some things we must be doing right. It is hard to find out what it is from what you are hearing now, but we are doing some things right in this country.

Ambassador BROCK. We are doing things very right.

Senator JEPSEN. The rest of the world thinks so.

Ambassador BROCK. We have three-fourths of the problem solved. We have one-fourth to do, but we are working on that.

Senator JEPSEN. I might just take a second, Mr. Ambassador—and Senator Abdnor, if you will bear with me just a second—I would like to go back to this agricultural exports and note that there is a trade surplus in agricultural exports. Is the primary area where we have a trade surplus agricultural exports?

Ambassador BROCK. No, but it is the largest single one in the goods area.

Senator JEPSEN. Then, let us explore this growing chorus from special interest for trade protectionism that is much talked about. Understandably, historically and otherwise, you can understand this growing chorus for special import protection and it becomes more difficult to ignore it during an election year, but each time we respond to any type of special interest industy with trade protection we seem to attract retaliation against the one largest single export industry, the one that has contributed the single largest amount of dollars to the surplus side of things, and that is agriculture.

Now when you talk about shooting ourselves in the foot, how can we deal with special interests without having agriculture bear all the costs? Is there any way we are going to be able to do that? We had a tough time with embargos and we finally got a President who now, without having to think about it, will say we are not going to put in a grain embargo every time something happens, because we hurt ourselves more than we hurt anybody else. That is very simple and it is easy for everybody to understand. He is the first one, Republican or Democrat, who has come down the pike for a number of years that evidently seems to understand.

Now we have this cry for domestic content legislation and other legislation that is going to shoot agriculture in the foot. How can we confront this and how do we handle this? Do you have any recommendations? What is your feeling about it?

Ambassador BROCK. You have to confront it. It is not just domestic content. It is the whole range of measures where you and this body, on both sides of the Hill, are being asked to intervene to protect some individuals, but you never are told by the proponents who pays. And it seems to me that you have to ask the question, who is going to pay for this particular protection? Is it my corn farmers or my chemical workers? Is it my electricians or my soybean producers? Somebody has to pay for all of this.

And what is the cause of the problem? We have laws that are pretty effective, both domestic and international, to deal with unfair trade. The laws are on the books and if we are not enforcing them then we can be held to account in this administration, like anybody else; that is going to be the case this November. People will judge whether we are doing what we are supposed to do.

But there is a difference between taking an action under a law on unfair trade and imposing new barriers where there is no evidence of foreign unfair trade practices or domestic injury.

Let me give you an example on steel. You have been offered a steel quota bill this year and asked that we hold imports to 15 percent of U.S. production. Senator, in the last 2 years, steel imports have gone down, not up—substantially down, by about 20 percent.

What is happening is that we are using less steel. Ford automobiles weigh 1,000 pounds less per average car than they did 5 years ago. We are talking about ceramic engines. We are shifting into plastics on gears, new industrial plastics. All of these things are taking their toll.

But can cannot put the whole burden on the trade aspect of the equation unless you are willing to say to some group of Americans, "We are sorry, but we are going to take care of this group and you are going to have to pay with the loss of jobs, loss of exports, loss of your earnings capacity." And when people are faced with that kind of analysis, maybe we will stop talking about all these facile protectionist excuses for action.

Senator JEPSEN. It is certainly sort of a lefthanded slap or direct insult at the productivity of the American worker and the know how that we have here. Instead of figuring out all these things, I think we would be going back to those horrible 1970's where everything that had character was bad, and everything that was big was bad, and everything that profited was bad. We are reaping what we sowed in some of that period, with your breakup of Ma Bell, and everybody is saying now, do not fix it if it is not broken.

Ambassador BROCK. You are going to be faced with many of those questions this year. The argument now is that we substitute the wisdom of the bureaucracy a so-called industrial policy for the wisdom of the market and of 200 million Americans. It is the same thing. It is protectionism. It is just a new code word.

Senator JEPSEN. Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Chairman.

Welcome, Mr. Ambassador. I am sorry I am so late getting here.

Last week, I was in Chicago with Senator Jepsen and we heard some agricultural economist talking about the future of agriculture for next year and it was not too rosy. I gather you might have mentioned that today yourself, which does not spell good news at all for agriculture and the farmer. I am sure the chairman was asking you what was going through my mind.

If you really had a free hand to do what you wanted to do to promote agricultural trade, what could you do, I mean, is there anything that comes to mind that you could do from your position if you were the one to make policy that could be done to improve the situation? To really get things going in agriculture, it has to be through the export market. That is all there is to it. What is it going to take? How are we going to crack the markets in Japan and China and Russia, one of the biggest purchasers of our products?

Now the agricultural beef quota thing with Japan expires on March 31, does it not? Does it look better? Have we got anything we can do to improve that situation? Do you know of anything you could do to bring about an improvement in our agricultural trade? I know we all have our problems with being parochial depending on where we come from, but what are your thoughts on that? Maybe you have been talking about it all morning before I got here.

Ambassador BROCK. In trade terms, we are doing what I would like to do if I were free to do it. We are negotiating with the Japanese. We have the possibility of making some progress. I do not know how to give you any number on the odds because I will not know that until we have completed the talks, but I think we have at least some possibility of making some progress.

The odds in Europe are more difficult with the action on corn gluten because they simply feel that they cannot have a community common agricultural policy without export subsidies. We do not object to what they do domestically. We have already made that public. But we do object to their exporting their problems, and that is what they are proposing to do.

Senator ABDNOR. Why do they feel so strongly when America tries to do the same thing? They were very unhappy with us on the Egyptian grain sale. Do they feel that we should just sit back and let it happen?

Ambassador BROCK. I imagine they think that we will do that forever and obviously we are not going to do that. We just can not.

Senator ABDNOR. I do not think we can. The picture is pretty bleak. I know the agricultural picture back in the Midwest and these people are really in tough shape. What is the percent of the people in Europe in agriculture?

Ambassador BROCK. Probably it would run on an average, across-the-board, at around 8 percent. There are some countries that run up to 12 percent.

Senator ABDNOR. That means that 92 percent are doing something else.

Ambassador BROCK. Yes.

Senator ABDNOR. And as I have looked at some of the budgets of the various countries the last few years, their agriculture subsidy is far exceeding what we are putting into agriculture, except maybe this last year. I realize this was highly unusual in our expenditures for agriculture, but are not the rest of the people in these countries getting a little unhappy? I know England had some trouble at one time. Do you see Europe having trouble with this?

Ambassador BROCK. Yes, and I do think the budget is the driving question for performance and this gives us something to hope for. They really can not afford to do what they are doing and they know that. They just do not know how to stop because it is very, very difficult politically to do so.

But, Senator, I would remind you that we have the same problem.

Senator ABDNOR. You bet.

Ambassador BROCK. If we wanted to really go after other countries in the world, the one way to do it would be to eliminate or reduce the support programs here and we would absolutely drive their budgets through the roof because they simply could not pay the differential.

We have tried in this administration to suggest some changes and we will continue to do that, but that is one area where we have made less progress than I would like to see.

Senator ABDNOR. There is only one thing wrong with that. There is a point where our farmers can not produce much less than they are producing.

Ambassador BROCK. I understand that.

Senator ABDNOR. It is a problem and it must be equally as great with them.

Well, how about a country like Japan on beef? Are they going to be as difficult with us on imports of beef to Japan as they have been in the past? That does represent some kind of an outlet.

Ambassador BROCK. They are not easy to negotiate with. We are having talks. We have not been successful in moving them sufficiently to any position that we can live with yet.

Senator ABDNOR. In your view, what is our best hope in the future to sell to? The developing countries?

Ambassador BROCK. Yes. That is your biggest new market opportunity and that will continue to grow.

Senator ABDNOR. How long before they are going to be in a position to buy from us?

Ambassador BROCK. That is coming. We are doing much better there. Our problems have been in the Middle East and, or course, the competition from subsidies. That is where we have been most damaged.

In Latin America, the problem has been frankly the debt burden those countries have which has been devastating to their ability to pay for anything. And the one area where we do see substantial improvement opportunity is in Asia and the Pacific region.

Senator ABDNOR. Well, time will tell. I have had a number of letters and contacts from people back home about this trade agreement we have made in textiles with China. Many of my grain people feel that is really going to have an adverse effect on the shipping of grain crops; that China is going to retaliate by maybe not purchasing wheat. Do you think there is a possibility of that?

Ambassador BROCK. No, sir. We went through that agony last year. That is over and behind us now.

Senator ABDNOR. What you did this time you feel they are willing to accept?

Ambassador BROCK. We have done it in a fair fashion and in a way that was within the rules and I think both sides understand the difficulty in that area. I am hopeful that we have laid that one to rest for a while.

Senator ABDNOR. Well, I have taken up my 5 minutes.

Senator JEPSEN. If you have anything else, go ahead.

Senator ABDNOR. No, thank you.

Senator JEPSEN. Mr. Ambassador, I would like to explore possible Government actions to remedy the trade deficit.

Is the Government, first of all, in a position to strengthen our trade performance?

Ambassador BROCK. Well, I am not sure that I know how to answer the question. We have taken more trade actions under U.S. law than any administration in history. We have taken more cases to GATT than any administration in history.

Senator JEPSEN. Let me be more specific. Excuse me for interrupting. Are there any Government policies that could be altered that would substantially, in your opinion, improve our trade performance, or does the solution of our trade problems depend principally on adjustments in the private sector such as management decisions and on international developments such as LDC austerity measures over which we have no control?

Ambassador BROCK. I frankly do not believe there is any trade change that would have a major impact on our competitive circumstance. If you want to have an impact on the longer term, the issues are fundamentally macroeconomic—the deficit, the rate of personal savings, the incentives for people to save and invest in this country, a substantial strengthening of our educational process—and those are the things that give American business and American workers a chance to compete and, most importantly, a willingness to keep our markets open so that competition can force us to adjust and to improve our productivity. If we do not have that competition, protectionism will kill us and we will get fat and sloppy and we cannot afford that.

Senator JEPSEN. We have some growing competition now, do we not, in our economic recovery?

Ambassador BROCK. Absolutely.

Senator JEPSEN. You know, a lot of people have asked me in the last 4 months—service clubs and other various interest groups as I have addressed them, "Give me a report on what the Congress did in the last session," and I found upon reflecting on that and developing that that the report on what Congress did not do in the last session was much better than what the Congress did do.

Ambassador BROCK. That is quite often the case.

Senator JEPSEN. I think maybe what I hear you saying is in the trade deficit area and trade policies and so on, it might well be that what the Congress does not do by the way of laying on layers of protectionism and getting stampeded in this election year is important.

Ambassador BROCK. Absolutely; yes, sir. I really am saying that. They can make it much, much worse. That could break the back of the system. I wonder how many times we have to relearn from history. In 1922, we passed a significant increase in tariffs and then we decided to expand our markets overseas by increasing the money supply and lending people money so that they could buy our products, even though they could not sell to us, and then we compounded the felony in 1930 with the so-called tariff and within 10 years we had the worst depression the world has ever seen. We can not do that again.

Senator JEPSEN. Strong centralization of government where you have a group of folks that somehow or another with some special wisdom, whether it comes from drinking this Potomac water or wherever it comes from, feel they know better how to manage people's money and know what best to do with it. Therefore you tax it and take more away, and then you sent it back, and on the roundtrip it is kind of like giving yourself a blood transfusion from one arm to another, and you cut a hole in the tube and you lose an awful lot going from one arm to another. In fact, in many programs 91 or 92 percent of every dollar somehow gets lost, with all the good ideas of taking it from people and bringing it here and processing it and sending it back to do some good, and you end up with about 8 cents worth. Whereas, if you left it alone and tried to use some Yankee ingenuity and creativity plus a little persuasion and good old-fashioned selling, you could have gotten a lot more mileage out of the dollar if you left it in a social project on a local basis.

We do know, however, that government's role as a partner with our economic sector and all of our various industries in this country, rather than an adversay which for many years we seemed to be developing here, again in the late 1960's and 1970's, is a very key role. Would you agree to that? In other words, we have Japan certainly just practically hand-in-glove as a government working together with their folks. We find a similar situation in the European Community, even though they may get caught up short here and do themselves in if things continue. A slight change in the feed grain programs in this country could absolutely change rather quickly and rather dramatically the entire European Community's posture and attitude about things.

Ambassador BROCK. Absolutely.

Senator JEPSEN. And the trade suddenly would take a turn, as it did in the early 1970's, from one of being sort of sluggish to just really moving up for us.

My question I guess is, How do we grab and hold on until some of those things start to bust loose? And that is about where we are now.

Ambassador BROCK. I would suggest that what we have to do, though, is to hold on this year and maybe next year against all the protectionist proposals to "save" us in the short term. It is going to be very difficult. The pressure is going to be enormous on you and all your colleagues. But if we try to come up with a quick fix in the short term we are going to make it much worse in the long term.

If you look at that chart, 1985 is going to be, in my judgment, worse. If you look at it 1986, 1987, 1988, it is going to be much better and we are going to have in the latter half of this decade and into the 1990's, if we hold and do not make mistakes now, a spectacular opportunity in world trade, in agriculture, in manufactured products, and in services.

Senator JEPSEN. Not only that, but in our own country this transition from heavy industry to the service and high tech that we keep hearing about and we know is taking place and so on, that does not preclude research and what needs to be done in the agricultural community. I do not share necessarily the feeling that all is hopeless that some writers and some leaders of some farm groups do, because the State of Virginia, I have been told, for example, consumes more agricultural products as a State and is therefore a customer that is bigger—the State of Virginia is a bigger customer of agricultural products than the entire European Community.

Ambassador BROCK. That is probably true.

Senator JEPSEN. We sometimes are looking way out here and across the oceans and so on to resolve some of our problems when they are right here in our own backyard. We have research in the area of food to feed people just in the corn industry alone—I just had a brief meeting this morning and I am going to have a number of additional meetings with regard to development of lysine in corn, for example, which is used to feed people and is available, and it is possible now to grow specifically high lysine crops which will produce about the same amount per bushel as others and unlimited. The packaging that we have today, the technology in packaging—we put the milk in the bos and put it in the cupboard or put it in a room and store it in a building or whatever and take it out 8 or 9 months or maybe a year from now—steaks 4 or 5 years from now—they will be just like the day you put them in there.

We do not hear about some of these things because part of the problem in this world has been the distribution of a lot of these products that we have and it is kind of tough when we are trying to feed people in Ethiopia and we have the Ethiopian Government shooting us down and blocking us and preventing us from getting through to their own people, and it is kind of hard to figure out.

The way we have distributed it and handled it, if you have it standing too long in one place it spoils and it does not do anybody any good.

Ambassador BROCK. You are right.

Senator JEPSEN. Senator Abdnor.

Senator ABDNOR. Just briefly, just let me say that it is encouraging to hear you talk about the years down the road and maybe things will become brighter. I do want to commend you for the work you are doing in this area and while progress is slow sometimes, I know there have been some substantial changes. You have had things turned around and it takes time. I am sure you are working on a number of areas, but I just cannot help but think about the Export-Import Bank. We talk about what can we do to promote more agricultural products; that we need to do more financing through there. Is it not 5-percent interest, for instance, for Boeing Aircraft when they sell their aircraft? Do they not get a 5-percent rate?

Ambassador BROCK. Not anymore.

Senator ABDNOR. I am all for Boeing and I voted a number of times for things for it, but we can not turn around and help them make their sales at 5-percent interest while my people out in the other part of the country have got to pay a number of percentage points more for their interest. I want to give you a little example. The motorcycle is quite an item out in South Dakota. Did not the International Trade Commission just put a 45-percent tariff on motorcycles coming into this country?

Ambassador BROCK. Yes.

Senator ABDNOR. That works on both sides. Is Japan not going to get awfully unhappy about that? Nobody around here seems very concerned except those people who buy those small motorcycles.

Ambassador BROCK. They were just the large motorcycles; the ones that we buy from Japan, by and large, are not competitive with what we produce.

Senator ABDNOR. Well, I hope you are gradually weeding all this out and getting it on an equitable basis.

Ambassador BROCK. I hope so. We are trying.

Senator ABDNOR. I do not know of a man who is better able to shoulder the problems and do the job you are doing. I commend you for it and thank you.

Ambassador BROCK. Thank you very much.

Senator JEPSEN. Mr. Ambassador, do you have any statement in closing that you would like to make?

Ambassador BROCK. No, sir. I thank the committee for the interest and attention. We have a problem. We ought to work together to solve it and we need a lot of help.

Senator JEPSEN. Instead of pointing the finger and trying to fix blame, we all ought to join hands and try to resolve it, if we can do it. Thank you, Mr. Ambassador.

The committee is recessed.

[Whereupon, at 11:30 a.m., the committee recessed, to reconvene at 10:30 a.m., Thursday, February 2, 1984.]

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 2, 1984

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

The committee met, pursuant to recess, at 10:30 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Abdnor, and Proxmire; and Representatives Hamilton, Hawkins, Obey, Scheuer, Wylie, Holt, Lungren, and Snowe.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; Richard F. Kaufman, assistant director-general counsel; and Christopher J. Frenze, Robert R. Davis, William R. Buechner, and Paul B. Manchester, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Mr. Feldstein, Mr. Niskanen, and Mr. Poole, it is a pleasure to have the members of the Council of Economic Advisers before us today. We look forward to your first public statements on the 1984 Economic Report of the President, especially since the economy has rebounded with such vitality after a prolonged period of declining fortunes.

The track record of the last year is impressive. Unemployment declined a record 2½ percent from its recession peak to 8.2 percent in December 1983, and the prospect of continued improvement is most encouraging.

Four million jobs were created in the last year as real gross national product increased 6.1 percent, the largest 1-year increase in output since 1976.

Capacity utilization increased from a recession low of 69.6 percent to 79.4 percent in December, only 3 percent below the average of the last 20 years.

Just as encouraging as the gains in employment and output is the continued moderation in inflation. The Consumer Price Index advanced only 3.8 percent from December 1982 to December 1983.

When coupled with the final stage of the income tax rate reduction, the stable price situation allowed real disposable personal income to advance over 5 percent during the first 12 months of recovery.

We have climbed out of the hole of the recession and are heading for new high ground. While we had some idea that the economic situation was improving 1 year ago, the strength of the recovery has surprised all but the most optimistic of the observers.

As I have indicated time and time again across the country, it is one of the best kept secrets in this country.

However, now is not the time for complacency. The Government still spends too much of the private sector's money. What is worse, preoccupation with budget deficits per se rather than the Government spending that maintains the budget deficits has led to renewed pleas to escalate income tax rates.

This shopworn, misguided suggestion overlooks the facts that tax rate relief has made a substantial contribution to improved productivity and the longevity of the economic recovery.

Also, the economy remains afflicted by a roller coaster monetary policy that often obscures and detracts from fundamental improvements that are being made in our economic potential. We must end the climate of uncertainty generated by monetary policy that makes sound longer run economic policies doubly difficult to implement.

Gentlemen, I would appreciate your candid views regarding the scope of our economic successes and your assessment of our unforseen future pitfalls. And when I make that statement, Mr. Feldstein, I know that you always do give very candid views, and I appreciate that, respect it, and admire it.

So we are looking forward to hearing from you today.

Mr. FELDSTEIN. Thank you very much.

Senator JEPSEN. Now, my distinguished vice chairman, Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Mr. Feldstein, we are delighted to have you here with us this morning and look forward to your testimony.

Senator JEPSEN. Senator Proxmire.

Senator PROXMIRE. No statement. Thank you.

Senator JEPSEN. Senator Abdnor has not arrived yet, so I will take this opportunity to place the Senator's written opening statement in the record at this point.

[The written opening statement of Senator Abdnor follows:]

Written Opening Statement of Hon. James Abdnor

I, TOO, WOULD LIKE TO EXTEND MY WARM WELCOME TO DRS. FELDSTEIN, NISKANEN AND POOLE. IT IS ALWAYS A PLEASURE FOR ME TO PARTICIPATE IN A FORUM INVOLVING OUR COMMITTEE'S 'TWIN' OR ADMINISTRATIVE BRANCH COUNTERPART.

DR. FELDSTEIN, I HAVE TO GIVE YOU CREDIT FOR YOUR BOLD STAND ON THE DEFICIT PROBLEM. LAST WEEK WE HEARD FROM YOUR SPARRING PARTNER ON THE DEFICIT, SECRETARY REGAN. NOW IT IS YOUR TURN TO SHARE YOUR INSIGHTS ON THE CONDITION OF THE ECONOMY. I WOULD GUESS THAT MUCH OF THE DISCUSSION TODAY WILL CENTER ON THE DEFICIT, AND THAT IS FINE WITH ME.

IT SEEMS TO ME THAT SOME MEMBERS OF THIS COMMITTEE AND THE CONGRESS INTEND TO MAKE IT A POLITICAL ISSUE AND INTEND TO SPREAD BLAME TWO DIFFERENT WAYS. FIRST, THEY WILL BLAME REPUBLICANS FOR THE DEFICIT AND TRY TO MAKE US BELIEVE THAT REPUBLICANS ARE RESPONSIBLE FOR EVERY SINGLE DOLLAR OF OUR $1.3 TRILLION NATIONAL DEBT. SECOND, THEY WILL BLAME THE DEFICIT FOR EVERY SINGLE ECONOMIC WOE WE CURRENTLY ARE EXPERIENCING. I WOULDN'T EVEN BE SURPRISED IF SOMEONE HERE TODAY BLAMES UNEMPLOYMENT ON THE DEFICIT, EVEN THOUGH INCREASED GOVERNMENT SPENDING THROUGH BORROWING OR MONEY CREATION IS THOUGHT TO BE STIMULATIVE AND JOB-CREATING IN THE SHORT RUN.

THEN NEXT DECEMBER, THROUGH SOME OUT-OF-THIS-WORLD REVELATION, ALL OF A SUDDEN THE DEFICIT PROBLEM WILL BE A BIPARTISAN ISSUE AND WILL RECEIVE BIPARTISAN ATTENTION AND COOPERATION. WELL, I FOR ONE WILL NOT TOLERATE POLITICAL SCARE-TACTICS ON THIS ISSUE. SOLVING THE DEFICIT DILEMMA IS AS CRUCIAL TO THE ECONOMIC SAFETY AND WELFARE OF OUR PEOPLE AS THE SOCIAL SECURITY PROBLEM WAS LAST YEAR. AND ALL OF US HERE REMEMBER TOO WELL THAT THE SHAMEFUL LIES AND DISTORTIONS BEFORE THE NOVEMBER, 1982, ELECTION MELTED INTO JOYOUS EMBRACES OF POLITICAL FOES WHO JOINED TOGETHER TO SAVE THE DAY. THE AMERICAN PUBLIC CERTAINLY DOES NOT DESERVE THAT KIND OF TRICKERY AGAIN.

FORTUNATELY, ALL OF US HERE EASILY CAN REACH AN AGREEMENT ON ONE STATEMENT: THE AMERICAN PUBLIC AND THE AMERICAN ECONOMY WOULD BE IN BETTER SHAPE RIGHT NOW IF WE HAD NO DEFICIT OR IF IT WAS SMALLER. THAT PART IS EASY. THE HARD PART IS AGREEING ON A WAY TO REDUCE IT. LET US START TODAY BY ENGAGING IN A CONSTRUCTIVE EXCHANGE OF IDEAS, NOT A CONFRONTATION.

I LOOK FORWARD TO QUESTIONING THE PRESTIGIOUS MEMBERS OF THE COUNCIL OF ECONOMIC ADVISORS. I THANK THEM FOR APPEARING BEFORE US TODAY.

Senator JEPSEN. Mr. Feldstein, please proceed as you wish.

STATEMENT OF HON. MARTIN FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY WILLIAM A. NISKANEN, JR., AND WILLIAM POOLE, MEMBERS

Mr. FELDSTEIN. Thank you, Mr. Chairman. I am very pleased to be with this distinguished committee today. This is the second occasion on which I have had the honor to present the Economic Report of the President together with the Annual Report of the Council of Economic Advisers. I will begin by discussing the economic outlook and will then summarize the contents of our annual report.

THE ECONOMIC OUTLOOK

The experience in 1983

The near-term economic outlook is now far brighter and more certain than it was when I presented the administration's forecast to this committee 1 year ago. There was then no clear evidence that an economic recovery had begun. The most recent available monthly evidence on production, employment, and real sales had continued to show declines.

We nevertheless believed, in early January 1983, when last year's projections were being completed, that the economy would soon turn around and that a recovery would probably begin in the first quarter of 1983. I did warn this committee, however, when I appeared here at this time last year, that uncertainty about the starting date of the recovery made the forecast for the year as a whole particularly uncertain. More specifically, I said the following about 1983:

> The rate of economic growth in 1983 as a whole depends critically on just when the recovery begins. Our forecast of a 3.1-percent increase in real GNP between the fourth quarter of 1982 and the fourth quarter of 1983 reflects a balance of probabilities of different possible outcomes. If the recession reached bottom in December, and the level of economic activity rises in January, the rate of real growth for the year as a whole could be significantly greater than three percent. If the recovery begins in January, I would not be at all surprised to see 5 percent real GNP growth in 1983. But if the start of the recovery is delayed until April or May, the real growth could be less than 2 percent.

At that time, many private forecasters had a similarly cautious view of the prospects for 1983. The mean of the real growth rates projected by the 44 economists questioned in the December/January 1983 Blue Chip Survey was a 4.1 percent rate of growth in 1983.

We now know that economic activity reached bottom in November and began to rise with the December figures. As a result of this starting date, the growth of real GNP far exceeded most predictions and reached an estimated 6.1 percent between the fourth quarter of 1982 and the fourth quarter of 1983.

The economic performance in 1983 was very strong in a number of ways. Total employment rose by 4 million between December 1982 and December 1983. The unemployment rate fell by a dramatic 2.5 percentage points, the largest 12-month decline since 1951–52.

It was especially gratifying that this solid recovery was accompanied by a very modest rate of inflation. The implicit price deflator for GNP rose 4.1 percent between the fourth quarter of 1982 and the final quarter of 1983. The consumer price index rose only 3.8 percent between December 1982 and December 1983 and the producer price index rose a remarkably slight 0.6 percent during these same 12 months. All in all, 1983 was an excellent year for the American economy.

The outlook for 1984-89

The administration's new economic projections for 1984 through 1989 are shown in tables 1 and 2. Our current economic assumptions repeat last year's projections that the economy will experience strong growth with declining inflation over the next 6 years.

Real GNP is projected to grow 4.5 percent between the fourth quarter of 1983 and the fourth quarter of 1984. The inflation rate, as measured by the GNP deflator, is projected to be 5 percent over the same period. This coincides with the administration's projections in the midsession review prepared in June of last year, and with last February's inflation projection. It represents an increase of one-half percent from the growth rate projected in the outlook that I presented here last February.

[Tables 1 and 2 follow:]

TABLE 1.—6-YEAR ECONOMIC ASSUMPTIONS: GROWTH RATES

	Fourth quarter to fourth quarter	Year to year
Real GNP growth rate:		
1984	4.5	5.3
1985	4.0	4.1
1986	4.0	4.0
1987	4.0	4.0
1988	4.0	4.0
1989	3.7	3.9
Inflation GNP deflator:		
1984	5.0	4.5
1985	4.7	4.8
1986	4.4	4.5
1987	4.1	4.2
1988	3.8	3.9
1989	3.5	3.6
Nominal GNP growth rate:		
1984	9.7	10.0
1985	8.9	9.1
1986	8.6	8.7
1987	8.3	8.4
1988	8.0	8.1
1989	7.4	7.6

TABLE 2.—6-YEAR ECONOMIC ASSUMPTIONS: LEVELS

	Calendar year	Fourth quarter	Fiscal year
Real GNP growth rate (1972 dollars):			
1984	1,616.0	1,641.3	1,598.3
1985	1,682.2	1,707.0	1,665.7
1986	1,749.5	1,775.3	1,732.4
1987	1,819.5	1,846.3	1,801.7

TABLE 2.—6-YEAR ECONOMIC ASSUMPTIONS: LEVELS—Continued

	Calendar year	Fourth quarter	Fiscal year
1988	1,892.3	1,920.2	1,873.8
1989	1,965.7	1,992.3	1,947.7
GNP deflator (1972=100):			
1984	225.4	229.4	222.7
1985	236.2	240.3	233.5
1986	246.9	250.9	244.2
1987	257.3	261.1	254.7
1988	267.4	271.1	264.9
1989	277.0	280.6	274.6
Nominal GNP growth rate:			
1984	3,642.4	3,766.8	3,558.9
1985	3,973.8	4,101.6	3,890.1
1986	4,319.2	4,453.5	4,231.3
1987	4,681.2	4,821.4	4,589.3
1988	5,059.0	5,205.1	4,963.0
1989	5,444.9	5,589.4	5,348.8

	Total unemployement rate		91-day Treasury bill	
	Annual average	Final quarter	Annual average	Final quarter
1984	7.8	7.7	8.5	8.3
1985	7.6	7.5	7.7	7.5
1986	7.3	7.2	7.1	6.9
1987	6.8	6.5	6.2	6.0
1988	6.1	5.8	5.5	5.3
1989	5.7	5.7	5.0	5.0

Mr. FELDSTEIN. For 1985 through 1988, real GNP is projected to grow at 4.0 percent annually, the same growth rate that we projected for these 4 years in our outlook of 1 year ago. We assume that capacity is approached at the end of this period and that real GNP in 1989 is then projected to grow at 3.75 percent.

These growth rates are associated with a substantially improved outlook for unemployment in recent months; the average unemployment rate for 1984 is now projected to be 7.8 percent. The current projection of the unemployment rate indicates that unemployment will decline gradually to a rate of 5.7 percent in 1989. This reflects the completion of the cyclical recovery and the effects of the administration's enacted and proposed employment policies in reducing the structural unemployment rate.

Another unexpectedly favorable development in recent months has been the rapid decline in inflation. Inflation, as measured by the GNP deflator, has been less in 1983 than the 4.6 percent anticipated in the midsession review. Although we continue to project a 5.0-percent rise in the 1984 GNP deflator, the inflation rate is then projected to decline gradually but steadily to 3.5 percent by 1989.

The combination of falling inflation and declining budget deficits imply that nominal and real interest rates will also decline. Our projections assume that the interest rate on 3-month Treasury bills declines from the current level of nearly 9 percent to 5 percent in 1989.

The administration's projections for 1984 are very similar to the thinking of most private economists. The consensus of the 45 economists in the January 1984 survey indicated a real GNP growth rate of 4.4 percent from the fourth quarter of 1983 to the fourth quarter of 1984, almost identical to the administration's projected 4.5 percent rate. Similarly, the Blue Chip consensus indicates a GNP deflator increase of 5.2 percent in 1984, also almost identical to the administration's 5-percent rate of inflation.

Our projections for 1984 are consistent with the recent pace of economic activity, with the sizable fiscal stimulus of an approximately $140 billion structural deficit, and with the expectation that the money supply will continue to grow enough to support nominal GNP growth of nearly 10 percent.

The administration's economic assumptions for 1985 and beyond must be interpreted with care because they are conceptually different from the type of forecast that private economists make and, presumably, from the forecasts of the Congressional Budget Office. There are two quite important differences.

Conditional forecasts

First, our economic assumptions for 1985 through 1989 are based on the premise that legislative action will reduce budget deficits sharply in the years ahead. More specifically, in the current situation, this means that the bipartisan negotiations will be fruitful and will reduce the deficit by about $100 billion or more over the next few years. Of course, even if the negotiations are fully successful, the future budget deficits would remain too large. The Congress must therefore also enact legislation that will be proposed in 1985 to slash deficits sharply before the end of the decade, moving the budget closer to balance. If such deficit reductions are not enacted, the interest rates are not likely to fall over the next 5 years as we have projected and growth of real GNP is likely to be slower than we have assumed. Moreover, larger deficits might induce a monetary policy that raises the rate of inflation in the years ahead.

If there is legislative action to reduce future budget deficits sharply as we have assumed, the administration's projected performance of the economy provides a plausible picture of our economic future. The administration's projections imply that the average annual rate of growth of real GNP in the 7 years from the business cycle trough in the final quarter of 1982 to the final quarter of 1989 will be 4.3 percent. By comparison, the first 7 years after the previous business cycle troughs in all of the pastwar recessions—except the 1980 trough since we do not yet have 7 years of experience—had average annual growth rates of 4 percent. The difference of 0.3 percent a year between our projections and previous experience is not large and it is certainly not unreasonable as a response to the improved monetary and fiscal policies that we assume for the remainder of the decade.

Most private forecasters currently project that deficits will be reduced after 1984 but not by as much as the administration assumes. Many of these forecasters also believe that monetary policy will not be as conducive to noninflationary growth as we have assumed. Their forecasters point to lower growth of real GNP and higher inflation than the administration's projections. More specifically, in the Blue Chip Survey of leading private forecasters, the projected level of real GNP in 1989 is 3.7-percent lower than the level projected by the administration. This represents a difference of 0.6 percent as the average annual rate of growth between 1983 and 1989. With the same rate of inflation, the slower growth implies that the level of GNP in 1989 would be $203 billion less than the $5,445 billion projected by the administration for that year.

The 5-percent rise in the GNP deflator that the administration projects for 1984 is very close to the average of 5.2 percent projected by the private forecasters in the most recent—January 1984—Blue Chip Survey. After 1984, the administration forecasts that the inflation rate will fall by 0.3 percent a year to 3.5 percent in 1989. Since the private forecasters do not currently anticipate sharply falling deficits and an anti-inflationary monetary policy, they project that the rate of increase of the GNP deflator will remain between 5 and 6 percent for the remainder of the decade.

Different assumptions about deficits and inflation account for the difference between the administration's projected path of interest rates and the future interest rates that are now implied by the financial futures markets and the yields on securities of different maturities. Sharply falling deficits should reduce the real interest rate while declining inflation should shrink the inflation premium in the market interest rate. The administration's projection of a 5 percent interest rate on 91-day Treasury bills in 1989 implies a real interest rate of 1.8 percent, a level that is actually higher than the 1.3 percent average real T-bill rate during the last 30 years. In contrast, the financial markets are currently less sanguine about the effects of deficits and inflation on interest rates. The Treasury bill futures market and the yield curve for Treasury securities implies that financial markets expect the interest rates on Treasury securities to rise over the next few years.

In summary, the difference between the administration's economic projections and most private forecasts is basically due to conflicting assumptions about future fiscal and monetary policies rather than to any difference of opinions about the way that the economy operates. I believe that if most private economists accepted the premise of sharply declining deficits and a sound monetary policy, they would forecast more robust growth and lower inflation. Similarly, if we had to base our projections on the assumption that Congress would not enact this year's budget recommendations and a further major deficit reduction package in 1985 and that the Federal Reserve would not pursue a sound monetary policy over the coming years, we would be forced to project slower growth and rising inflation.

Long-term focus

The second important difference between the administration's economic projections and private forecasts is that our strategy is to focus on the overall trend in real GNP and not to forecast year-to-year fluctuations. We forecast a 4-percent rate of growth of real GNP in each year from 1985 through 1988 even though we recognize that there will be some years in which real growth exceeds 4 percent and others in which it is less than 4 percent. We do not claim to have the ability to forecast these year-to-year oscillations in the future.

I would emphasize, as I did last year, that such year-to-year detail is unnecessary for the purpose of shaping the budget and guiding the evolution of Government programs. If economic activity exceeds our projections in some future year, the resulting budget deficit in that year will be smaller than we forecast; conversely, if the economy is weaker than we project in some future year, that year's deficit will be larger. Such cyclical fluctuations in the deficit along the path toward budget balance are not inappropriate.

The experience of the past year has served to underline the inherent uncertainty of all economic forecasts. The extent to which the uncertainty of a forecast impairs its usefulness depends on the purpose for which the forecast is intended. A business that wants to use an economic forecast to plan its near-term production and inventories would need a forecast that provides quite accurate short-term detail. A government that is adjusting monetary and fiscal policies continuously in an attempt to prevent unwanted fluctuations in real GNP would also need more accurate forecasts than we believe are possible.

The primary purpose of the administration's economic projections is to serve as a basis for long-term budget planning. We believe that the accuracy and nature of our projections are adequate to that task. The projections clearly imply that substantial legislative changes to reduce the deficit will be needed in future years if the budget is to be moved into balance or near balance before the end of the decade.

THE ECONOMIC REPORT

I will now turn to a brief summary of the six chapters of the 1984 Economic Report of the President.

The strategy of economic policy

The first chapter of the report focuses on three basic facets of the administration's long-term economic strategy: Monetary policy, spending policy, and tax policy. The fourth general aspect of the administration's economic strategy—the elimination of unnecessary regulations—was discussed at length in the last year's report.

A sound monetary policy has achieved a sharp decline in inflation during the past 3 years. The rate of increase of the GNP deflator fell from 10.2 percent in 1980 to 4.1 percent in 1983.

The basic challenge to monetary policy in 1983 was to adjust the monetary growth targets to the new regulatory environment. The changes in financial regulations in December 1982 and January 1983 made it virtually impossible to interpret the narrow money aggregates during the first several months of the year. The Federal Reserve's approach to the very difficult task of adjusting monetary policy to the new environment permitted major adjustments to occur in 1983 with minimal disruption in the financial markets. The currently available statistics indicate that, at the end of the year, each of the three monetary aggregates were within its target range.

All too often at this stage of an economic recovery, as growth slows from the unsustainable pace of the recovery's first year, political pressures have built to try to reduce interest rates through an excessively expansionary monetary policy. The administration will stand firm against such pressures. We believe that a sustainable economic recovery can best be achieved by gradually decreasing the target ranges for money growth over the next several years.

The second major aspect of the administration's economic strategy is to reduce the burden of Government domestic spending. The report traces the rapid growth of such spending since 1960 and shows how in the past 4 years, for the first time in half a century, total real appropriations for domestic programs have significantly decreased and total Federal spending on all nondefense programs has begun to take a declining share of the Nation's potential output.

Table 3 shows the budget receipts and outlays as a percentage of GNP. For 1984 through 1989, these figures reflect the current services levels of nondefense outlays, the defense outlays proposed in the administration's 1984 budget, and the administration's most recent economic assumptions.

Line 4 shows that total nondefense spending—excluding net interest on the national debt—reached a peak of 15.4 percent of GNP in 1983 and is now declining rapidly to 13.4 percent of GNP in 1986 and 12.6 percent in 1989. When the social security and medicare outlays that are financed by the payroll tax are excluded—line 5—spending will have decreased from 9.3 percent of GNP in 1980 to 7.5 percent in the current fiscal year. A continuation of the current services level will reduce these outlays to 6.7 percent of GNP in 1986 and only 5.8 percent in 1989.

[Table 3 follows:]

TABLE 3.—BUDGET RECEIPTS AND OUTLAYS

[Percents of GNP; by fiscal years]

	Actual						Current services						Policy
	1960	1970	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1989
1. Total outlays	18.5	20.2	22.4	22.8	23.8	24.7	24.0	24.3	24.1	23.8	23.4	23.0	22.1
2. National defense	9.7	8.4	5.2	5.5	6.1	6.5	6.7	7.3	7.6	7.7	7.7	7.8	7.6
3. Net interest	1.4	1.5	2.0	2.4	2.8	2.8	3.0	3.0	3.0	3.0	2.8	2.6	2.4
4. Other	7.5	10.3	15.1	15.0	15.0	15.4	14.3	14.0	13.4	13.1	12.9	12.6	12.1
5. Non-OASDHI	5.1	6.5	9.3	8.8	8.4	8.4	7.5	7.2	6.7	6.4	6.2	5.8	5.5
6. OASDHI	2.3	3.8	5.8	6.2	6.6	6.9	6.8	6.7	6.7	6.7	6.7	6.7	6.6
7. Social security	2.3	3.1	4.6	4.8	5.1	5.3	5.0	4.9	4.8	4.8	4.7	4.7	4.6
8. Medicare	0.0	0.6	1.2	1.4	1.5	1.6	1.7	1.8	1.9	1.9	2.0	2.1	1.9
9. Total receipts	18.6	19.9	20.1	20.8	20.2	18.6	18.7	19.0	19.0	19.0	19.3	19.4	19.8
10. OASDHI	2.1	3.9	5.3	5.6	5.8	5.7	5.9	6.1	6.1	6.2	6.5	6.6	6.7
11. Other	16.4	16.0	14.8	15.2	14.4	12.9	12.9	12.9	12.9	12.9	12.9	12.8	13.1
12. Deficit	−0.1	0.3	2.3	2.0	3.6	6.1	5.3	5.3	5.1	4.8	4.1	3.6	2.3
13. GNP	97.9	968.8	2,575.8	2,882.0	3,057.3	3,228.8	3,558.7	3,890.1	4,231.3	4,589.3	4,963.0	5,348.8	5,348.8

Mr. FELDSTEIN. The third principal part of the administration's economic strategy is to reduce the tax burden and restructure the tax system. The Report reviews the 1981 tax changes that have reduced by 36 percent the Federal income tax that is now paid by a median income family. The share of GNP taken by all taxes other than the social security payroll tax has declined from 14.8 percent of GNP in 1980 to 12.9 percent of GNP in the current fiscal year.

The Report emphasizes that, in addition to reducing tax rates, the reforms since 1980 have improved the quality of the tax system by focusing the tax reductions on two-earner families, on business investment, on very high marginal tax rates, and on income that is saved. As a result of the universal extension of eligibility for individual retirement accounts and the increased limits on IRA and Keogh accounts, the income tax system has now been virtually transformed into a consumption tax for the majority of Americans.

The first chapter concludes with a discussion of the serious potential problem of a long string of huge budget deficits. The Report discusses the effect of accumulating deficits on the national debt and notes that the projected deficits could raise the Government's annual interest bill by as much as $100 billion by 1989 if there is not significant legislative action.

The most important long-term economic effect of the prospective budget deficits would be to absorb a large fraction of domestic saving, and thereby to reduce the rate of capital formation and the potential long-term growth of the economy. The crowding out of investment is temporarily reduced by an inflow of capital from abroad. This year, that capital inflow is likely to finance about half of all net investment in the United States. It is however a very mixed blessing since it implies a merchandise trade deficit that is likely to rise this year to more than $100 billion.

Although the budget deficit in 1984 contributes to the current level of demand and economic activity, the projected string of future deficits raises the present real long-term interest rate above what it would otherwise have been, crowding out activity in key interest-sensitive sectors and causing the recovery to be lopsided. No one can predict in detail the effects of a continuing series of large deficits. But the longer that such deficits are expected to persist, the greater are the risks to our economic future.

It is clear that enacting legislation to reduce future budget deficits must be at the top of Congress' agenda in both 1984 and 1985. The President has proposed a bipartisan negotiation to reduce the projected deficits by about $100 billion over the next 3 years. This is only the first step, a downpayment on the total deficit reductions that must be achieved by legislative action after the election.

The United States in the world economy

The second chapter of the Report discusses the international context of the American economy. The strong U.S. recovery is helping to pull the entire world economy out of recession. However, the nature of the world recovery is distorted by the persistence of high real interest rates and a high exchange value of the dollar. As a result, the recovery is distributed unevenly across sectors of the U.S. economy and across countries in the world.

U.S. industries that export, or that compete with imports, are not sharing fully in the recovery. This is clearly reflected in the record U.S. trade deficits. The recent increases in the trade deficit have three causes. First, the rapid growth of U.S. income is causing imports to increase rapidly. Second, a number of Latin American countries that are normally important buyers of U.S. exports have had to cut expenditures back sharply as a result of severe debt problems. Third, and most important, the high value of the dollar has made it difficult for U.S. firms to compete in world markets.

The high value of the dollar is a result of capital inflows from abroad, which in turn have three causes: Expected inflation has fallen in the United States relative to other countries; real interest rates have risen relative to abroad, largely as a result of the large U.S. budget deficit; and the United States has beccome a safe haven for capital fleeing instability in other parts of the world. In addition to the negative effects of the trade deficit, there are also positive effects of the capital inflow. It has kept U.S. real interest rates from rising as much as they otherwise would, and thus has reduced the crowding out of U.S. business investment and other interest-sensitive sectors. Furthermore, the high value of the dollar has reduced import prices and thus helped to bring down inflation.

The administration opposes efforts to reduce the trade deficit by Government intervention in the marketplace. Intervention in product markets—through tariffs, quotes, or other trade measures to protect specific industries—imposes costs on consumers and on other industries that outweigh the benefits to the protected industries. They also invite retaliation from abroad. Intervention in financial markets with the aim of bringing down the value of the dollar is unlikely to be successful. Even if such efforts were successful, it would be at the cost of higher U.S. interest rates. The only way to help our export- and import-competing industries without at the same time hurting our interest-sensitive industries is to pursue sound macroeconomic policies. Reduction of the budget deficit would bring down real interest rates and the value of the dollar, better allowing U.S. industry to compete in world markets.

The U.S. recovery is being transmitted to other countries through increased U.S. demand for foreign goods. However, only the Canadian economy is growing as rapidly as ours. Several European countries are lagging behind.

Japan's economic performance continues to be impressive. However, the popular belief that gains by Japanese exporters account disproportionately for losses by U.S. firms is greatly exaggerated. Though all foreign exporters gain competitiveness when their currencies depreciate, the yen has depreciated against the dollar much less than have the European currencies. Moreover, the deterioration since 1981 in the U.S. trade balance with Japan accounts for less than one-eighth of the deterioration in the overall U.S. trade balance.

In many Latin American countries, trade balances have improved dramatically over the past 2 years. It is not so much that their exports have risen; it is more that their imports have fallen. Slashing imports is the only way these countries have in the short run to obtain the foreign exchange they need to meet their debt obligations.

Some of the problem debtors in Latin America, Asia, and Africa have come a long way in the past year toward making necessary economic adjustments. The example of Mexico stands out in this regard. With continued adjustment by the debtors, and with continued cooperation on the part of the International Monetary Fund, the creditor banks, and the United States and other creditor governments, these countries will eventually regain financial health. But as of 1984, the progress that has been made has largely been at the expense of unsustainable decreases in consumption, investment, and inventories of imported inputs in the debtor countries. Future progress will have to take the form of export-led growth. A continued strong recovery in the industrialized countries is crucial if the exports of the debtor countries are to increase. It is also important that we not erect protectionist barriers to shut out the products that they have to sell.

Industrial policy

The third chapter of the report discusses the claim that the United States is "deindustrializing" and needs a central Government agency to coordinate a new industrial policy with tripartite advisory councils and with a Government development bank to channel money to industries that are deemed to be receiving inadequate capital from the private sector. This chapter suggests that industrial policy advocates have misdiagnosed our problems and suggested cures that are unlikely to succeed.

In fact, the United States is not "deindustrializing." Since 1950, output, employment, and capital in our manufacturing sector have grown steadily. Between 1973 and 1980, the United States was the only major industrial country to experience growth in manufacturing employment. Although employment and capital have grown more slowly in manufacturing than in other sectors of the U.S. economy, output has kept pace, and in 1980, it was the same share of GNP as in 1950.

U.S. manufacturing, as a whole, does face short-term problems associated with the recession and with the very strong dollar. The solution to these problems is sound monetary and fiscal policies and not industrial policies that focus on specific industries. Although there are certain industries that face serious long-term problems, the adjustments required will be best achieved without detailed Government interference.

The chapter examines the experience with industrial policy in Japan and in Europe. It also examines the primary reasons that have been offered for adopting an industrial policy in the United States. The analysis concludes that an industrial policy that increased the Government's role in the economy would be counterproductive.

Agriculture

The fourth chapter discusses the role of agriculture in the American economy, an important subject that has not received extensive treatment in the Economic Report for several years.

American agriculture is so productive that only 3.1 percent of the labor force are now directly engaged in farming. They produce enough to feed the domestic population at low cost and still export

25 percent of all their sales. These farm exports generate 20 percent of all export earnings of the United States.

Despite these successes, all is not well with American agriculture. Farm export earnings have fallen for the last 2 years. Recent entrants and farmers who have recently expanded their businesses have experienced cash flow difficulties. The number of farm bankruptcies, while still well below that for nonfarm businesses, has increased substantially.

In fiscal year 1983, U.S. Government outlays for farm price and income support programs totaled $18.9 billion, an increase of $12.3 billion since 1981. To this must be added another 9.4 billion dollar's worth of payment-in-kind commodities committed in 1983 to compensate farmers for cutting back their acreage. These programs cost taxpayers on the average almost $12,000 for each of the 2.4 million American farms.

Our farm price and income support policies were designed in the 1930's to deal with the problems of farmers during the Great Depression when farm incomes averaged only 40 percent of those in the economy as a whole. The gap between farm and nonfarm income levels has narrowed in the meantime to an 88-percent average over the past decade.

As the farm-nonfarm income gap has closed, an important structural change has occurred. Almost three-fourths of American farms are small with annual sales of less than $40,000. These are not generally full time commercial operations. They produce only a small share of national farm production, and, on average, have negative net income from farming.

The remaining farms, which have annual sales of over $40,000, produce 87 percent of total farm output. These 690,000 commercial farms had average 1982 annual gross receipts of $189,000, average assets of about $1 million, and average equity of about $800,000. They received 78 percent of all direct Government price and income support payments in 1982, making up 11 percent of their net farm income.

In the 1970's, the value of U.S. farm exports increased more than five times, and the fraction of farm sales that were exported more than doubled. The global recession that began in 1981, the very strong dollar, and the U.S. farm price supports that have been set above the market clearing level, have caused our share of world farm trade and the value of our farm exports to fall. The U.S. agricultural policies that reduce production and exports raise the world price of the affected commodities. This in turn makes it easier for foreign governments to subsidize the production of agricultural products that compete with us in foreign markets. The chapter indicates how a more market-oriented approach to farm price and income support policies could assist American farmers and American consumers.

Financial market deregulation

The fifth chapter considers the deregulation of financial markets in recent years. The deregulation of interest rates has been a substantial benefit to individual savers and has had significant effects on financial institutions. There are now several unsettled issues about the future of financial regulation. The chapter deals with three of these in particular: restrictions on entry into new geographic markets and nonmarket lines of business; the reform of deposit insurance; and the reform of the regulatory structure to reduce the overlap and duplication of function among numerous State and Federal authorities. It is clear that further steps toward deregulation, if done in an appropriate way, can improve the financial markets and aid the American economy.

Review of 1983 and outlook

The Report ends with a chapter that reviews the economic developments in 1983 and discusses the economic outlook for the remainder of the decade.

REDUCING THE DEFICIT

To conclude this testimony, I want to comment briefly on the President's proposal for bipartisan negotiations on the budget. I believe that rapid completion of these negotiations and enactment of tax and spending proposals is a crucial first step in dealing with the deficit. A downpayment of this sort and a commitment to future action to reduce deficits significantly would be clear evidence that the Congress and the administration can work together to reduce prospective budget deficits. It would be a welcome indication that the seriousness of the deficit problem is recognized and that the remaining problem will be dealt with rapidly after the election. Nothing could better strengthen the confidence of financial investors and improve the prospects for a sound recovery with declining interest rates.

Thank you, Mr. Chairman.

Senator JEPSEN. Thank you, Mr. Feldstein.

In your statement, you refer to the achievements of a sound monetary policy, whatever that is. I would like to explore that.

We talk about stability, we talk about consistency, we talk about a monetary policy that provides a supply of money that is in consistent borders, and yet we do not seem to be hitting that mark very well.

Is stability or consistency in the Federal Reserve Board being able to have a fixed amount of money coming into the economy, is that an important thing?

Mr. FELDSTEIN. It certainly is. But I would say the Federal Reserve has done quite a good job, especially in a complicated circumstance of changing financial regulations that we had this year.

Senator JEPSEN. Well, I intend to ask Mr. Volcker the same thing a week from today, as to whether the Federal Reserve has done a good job in this.

Now, let us look at the record. For instance, 6-month M1 growth rates had a high of 10 percent and a low of 2 percent in 1981; a high of 10 percent and a low of 5 percent in 1982. Now in 1983 they had a high of 15 percent and a low of 4 percent.

In each case these variations in money growth were translated into variations in gross national product growth.

Now, is this what you call sound monetary policy?

Mr. FELDSTEIN. If you look at the M1 growth this year you have to interpret it in light of the changes in banking regulations, the dramatic effects of the MMDA's—the money market deposit accounts—SuperNow accounts, which made the interpretation of M1, M2 in the first half of this year very difficult, when literally hundreds of billions of dollars came from other sources into the money market deposit accounts over a matter of just a few months. That was not an abnormal growth of money: That was a change in the way people hold their assets in an environment in which a new and attractive deposit account has been created by the Congress.

I think that the Federal Reserve rightly reset its target after that M1 target was reset in July for a period beginning in the second quarter of the year and the Fed ended the year in that target.

Similarly, M2 and M3 targets were reset after that initial period of rapid money growth associated with the change in instruments that were available, and again the year ended with M2 and M3 in the target range.

Senator JEPSEN. In several places you have mentioned the role of budget deficits in raising real interest rates. However, real rates of return on long-term bonds declined sharply during 1982, even though Federal deficits doubled from an annual rate of nearly $100 billion in early 1982 to over $200 billion at the end of 1982.

Now, during 1983 the deficits fell without a perceptible effect on long-term interest rates. Does this not imply that budget deficits are maybe a secondary factor in determining interest rates?

Mr. FELDSTEIN. I do not think so. The reason we have real rates that are as high as they are now is primarily because the amount of saving that is available net after the Government borrowings is extremely small. We have to reduce borrowing by private borrowers and to attract additional savings from the rest of the world. The way in which that happens is by a high real interest rate.

Senator JEPSEN. Mr. Poole, you are an established expert on monetary policy.

Would you comment on the role of monetary versus fiscal policy in the last recession and the present recovery? To what extent are Federal Reserve policies a threat to the continuation of the recovery?

Mr. POOLE. In my opinion, there is a great deal of evidence that unstable money growth historically has been related to business cycle fluctuations. There is, as Mr. Feldstein was emphasizing, a particular difficulty in understanding what happened in 1983, and of 1982 as well, because of the introduction of the new accounts.

I believe that the full evidence on that matter will not be available for some time, until we see how it all works out. But in general, I think that correct policy is to stabilize money growth within a relatively narrow range.

Senator JEPSEN. I have advised the committee that we will have a 5-minute rule because of the numbers here today. My 5 minutes is up.

Our vice chairman, Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Mr. Feldstein, I think the distinguishing feature of the President's budget is that it does not address the deficit problem, and I therefore think it is not a careful, responsible document.

It does not play any role in trying to put forward a plan to reduce the deficit in a very significant and substantial way, and I think the President is unwilling to tackle the deficit problem in 1984 in a really serious way. I also think that you are underestimating the ability and the willingness of Congress to deal with the problem of the deficits.

I do not absolve leadership of the Congress or the rest of us from responsibility here. We bear our share of the blame. But I do think that now is the time when we really need Presidential leadership to put forward not a proposal for a bipartisan commission, but very specific plans for the reduction of these deficits. I think it is in the interest of the President, Congress, and the Nation that that be done and that we start on a deficit reduction plan now.

In my judgment, it is going to take spending reductions and tax increases, perhaps on a 1-to-1 ratio—something like that to get it done.

I just want to say to you, rather than ask a question at this point, that I think you are seriously underestimating the role of Presidential leadership in dealing with this problem, and the importance of it.

When I read in the papers, as I did this morning, and Mr. Stockman says we are going to have some tough bullets to bite in 1985, and that we will come back next year with a proposal, and you suggest the same thing in the closing words of your statement, and the President says in the budget message, "to those who say we must raise taxes I say wait"—this does not suggest to us that he is not going to propose increased taxes; he is just saying that now is not the time to do it.

I am saying that I think now is the time for Presidential leadership. It is very hard to move this body, the U.S. Congress, on these very difficult issues unless we have that kind of vigorous Presidential leadership.

Mr. FELDSTEIN. May I comment?

Representative HAMILTON. Yes, sir.

Mr. FELDSTEIN. I think we have a serious problem with the budget process. Last year there was a growing recognition that we have a very serious deficit problem ahead.

The President proposed a budget which would have cut the deficit by 1988 to 1½ percent of GNP, approximately equal amounts, one-of-one, taxes, and spending. Nothing happened. It just led to a stalemate.

We do not have the kind of budget process that our European friends have, in which government proposes a budget and it can count on the Parliament to enact it.

We tried last year putting forward a bold budget, one that called for sharp reductions in spending, increases in tax revenue, and it failed, and I think if it failed in 1983 a proposal of that sort is doomed even more to failure in an election year.

What the President has done——

Representative HAMILTON. Let me stop you if I may.

I really think that is a mistaken preception. I do not think you can say that 1984, just because it is a political year, will be less effective. Everybody said we would not deal with the social security problem, but we dealt with it.

Mr. FELDSTEIN. In 1983.

Representative HAMILTON. Look what we did on the tax increase. We increased taxes in an election year.

So what I am telling you is that my preception of what is happening here in the Congress is very different from the perception of the administration.

I think there is a willingness to deal with it, even in a tough year.

Mr. FELDSTEIN. Well, I hope so, and actually I believe so, and I believe these negotiations can work. I think we are making it as clear as we can that everything is on the table. Everything is negotiable, and we expect that the results of these negotiations will include additional tax revenue.

A major part of that $100-plus billion will have to be additional tax revenue. It does not mean increasing marginal tax rates, but by closing tax loopholes we can get a substantial amount of additional revenue.

We expect that the defense requests will have to be part of the negotiation. We expect that cuts in domestic spending will be part.

So I think that you are right. I think there is a widespread feeling in the Congress and in the administration that something has to be done, and I think if we can make serious progress—I would like to see more than $100 billion in these negotiations—if we can make serious progress now and make it clear that we all understand that this is a downpayment, that more has to be done in 1985, than I think that will do a great deal to build up confidence in the financial markets among business investors.

Representative HAMILTON. Thank you, Mr. Chairman. My time has expired.

Senator JEPSEN. Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Chairman.

I just want to say that during my days in the House there is no one I respected any more than the Congressman who just spoke. I know he is very, very sincere in what he says, and I think all of us are when we talk about the subject of deficits.

But still I can see the concern on the part of one side or another taking the leadership in these cuts because of the potential danger in the political area.

You mentioned a minute ago social security. Last week I made a tirade on what happened in social security. I recall when it was brought up by the President, we all wished on my side of the aisle he could have taken that back because it was going to cost us seats.

I believe if he comes forth with a comprehensive reform of entitlements we will have to listen to the same rhetoric we heard on social security. We all say he has got to cut entitlements because that is one of the major areas of Government, along with defense, if we are to make real progress on the deficit. Hopefully, interest rates will come down if we lower spending.

Yet who is going to be the first one to suggest what entitlements we are going to cut? Maybe what it takes is the leadership of the Democrats and the Republicans in both Houses and the chairman and the ranking member of both the Finance Committee and the Ways and Means Committee to come to some consensus on this issue so the markets can see we are really sincere. I am talking about a real reduction in the deficit and not just rhetoric.

I do not think anyone is against cutting the deficit, but we better put our cards on the table and forget the politics. It is not hard if we really want to cut the deficit. The leadership of our parties can get together if they are really sincere.

I think we have got to show a little accountability. I think the time has arrived for us to take some real steps to reduce the deficit.

I guess I voted for the budget concept at the time, but it really has not worked out that well. There was a time when we allowed the President the power of impoundment. We had it from the day Government started clear up into the 1970's. But we took that away, and maybe we would be better off if we had let him have that power.

Let me ask you, how do you respond to giving the President temporary impoundment authority as a measure to control Federal spending?

If this Congress will not cut it, maybe he will. I have never heard anyone say President Reagan did not have the fortitude to stand up and make the difficult decisions. I think he has made an awfully lot of difficult decisions that many people would not have made if they were President.

Do you think it is a good idea to give him the power of impoundment?

Mr. FELDSTEIN. I think it could be helpful. I think the proposal that Senator Armstrong made that almost passed last time would be a way of helping the President control the composition and the amount of the budget.

Senator ABDNOR. Do you think it would work if we gave him a percentage of impoundment authority based on a percentage of the total spending, and if so, where would you set at—5, 10, or 20 percent?

Mr. FELDSTEIN. I would not want to put a number on it, but I think that is one way in which we could get some further reduction in the areas that are subject to individual appropriations.

That might be the kind of thing that these negotiations, when they get underway, could consider, to have a certain percentage of impoundment or decision authority available for the President to come down from whatever levels are enacted.

Senator ABDNOR. Well, in a sense, we would have some authority up here because we would be sending the appropriations levels from the Congress, and if we do not want to cut them, then maybe we could let him have the authority.

What would be the adverse effect, do you think, of granting impoundment?

Mr. FELDSTEIN. Since I am in favor of it, I am not sure I can be a very good witness in telling you what the adverse effects are.

Senator ABDNOR. Now the discussion focuses on the line item veto. I am not wild about that. I think over the years that impoundment worked pretty well.

We want the power, but none of us seems to want to move. We can do anything we want to with that budget. We cannot just blame the people on the Hill or the President for spending too much money. We can change it. Let us come up with some suggestions.

It takes suggestions from both sides, from both Houses, and I think from the rhetoric I heard—and I think a lot of it is sincere—the time has arrived to quit making talk. Let us come up with some ideas.

Thank you.

Senator JEPSEN. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Mr. Feldstein, I want to say before I start how much I have admired your conduct of recent months while you have come under a barrage of criticism for not adhering to somebody else's standards of political "playing the ball." You have been an economist; you have done honor to your profession; you have sustained the integrity of your profession; and you have played a very noble and admirable role.

I do not happen to share all of your views on economics. We come from somewhat different portions of the economic spectrum, but that is totally beside the point.

The point is that you are a professional, and you have stuck to your guns, and you have given the President and the country and the Congress your best advice, and you called your shots as you have seen them, and you haven't caviled to any particular political dogma.

Mr. FELDSTEIN. Thank you.

Representative SCHEUER. And as a guy whose first job in the Federal Government back in the early 1940's was as a junior economist at the level of P-1, which was $2,000 a year, well overpaid I might say, as a junior economist with the north and west coast sections of the Pan American Branch of the Board of Economic Warfare, so I think I can qualify at least as sort of a people's economist.

I am proud—deeply proud of your conduct, and if there was a solid and unbroken row of empty chairs on the other side of the aisle here in the first half hour of your testimony, I am a little bemused at what kind of a signal we were supposed to receive.

But in my opinion, every one of those empty chairs, if they bespoke some kind of organized signal, was an additional badge of honor for you.

Representative LUNGREN. Would the gentleman yield?

We had a Republican conference that was scheduled at the same time, and we tried to get over here as soon as possible, and I hope you would not read anything more into it than that.

Representative HOLT. And we had Secretary Weinberger before the Armed Services Committee, and I tried to make an appearance there.

Senator ABDNOR. And I was talking to Mr. Ruckleshaus. We think your acid rain up in your part of the country is quite a concern. [Laughter.]

Representative HOLT. We, too, commend the gentleman who has appeared here today. I think he is doing a very fine and outstanding job.

Senator JEPSEN. Well, I hope now we can get on with the committee meeting. [Laughter.]

Representative SCHEUER. If I misinterpreted or possibly misinterpreted those empty chairs, I will make a personal apology to my colleagues.

Representative HOLT. We will accept it.

Representative SCHEUER. My words of commendation and admiration for this fellow and the noble way in which this gentleman has withstood political pressures over many, many months remain in place.

And having said all that then, Mr. Feldstein, reading the two budgets for 1983 and 1984—excuse me—1984 and 1985, in your 1984 budget there were words that it must be bipartisan; overcoming the deficits and putting the Government's house in order will require the best efforts of all of us. It must be fair, must be prudent, must be realistic.

Now, getting to 1985 we seem to find almost exactly the same rhetoric. The budget must be bipartisan; overcoming the deficits and putting the Government's house in order will require everybody's best efforts. It must be fair, must be prudent. It must be realistic. Exactly the same rhetoric.

But last year, Mr. Feldstein, the administration presented a budget which included a spending freeze, defense cuts, a tax increase, and this year none of those were included.

It is hard for me to understand how this budget which they claim is fair, bipartisan, prudent, and realistic, which contains none of these specific, solid, thoughtful measures that you and others apparently crafted last year, how that can be considered as real.

Do you believe that budget is fair, bipartisan, prudent, and realistic, and do you think particularly it is prudent when you have taken us by the hand up to 1989 and shown us that we are going to be facing a $261 billion deficit without an iota of a sense of program or mission as to how we are going to reduce those deficits to manage more proportions?

I must say I am simply tilling over the ground a little bit that Congressman Hamilton plowed a little more skillfully.

Mr. FELDSTEIN. Let me give a very brief answer. I think that the budget is only a starting point. I think it is inadequate to do the full job.

I think that is why, after seeing the problems we had last year, the President decided that the best thing to do was to indicate a goal—$100 billion—indicate a philosophy. Everything is negotiable. Indicate a timetable as fast as possible, the next month or 6 weeks, and call upon the Democrats and Republicans, Congress, and the Senate, to come up, sit down and work something out, and I think that can do the job.

I think if that does not happen we are failing this country.

Representative SCHEUER. Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman.

Judging from the comments you heard today, I think you noticed how nonpolitical this year has already begun, and if you want to see how nonpolitical it is, I ought to send over to you the document that has emerged in the Foreign Affairs Committee in the House on Lebanon, which unfortunately has a tremendous political side to it.

Mr. Feldstein, I am sure you do not mind if some of us happen to disagree with you. We respect your position as an economist, and so forth, but I am one of those—maybe the only one here—who is not happy that "everything is on the table."

Every year, everything is on the table, and the only thing I know that comes off the table that has really resulted in some decision is that taxes go up.

Last year, we were told that we were going to strike this great deal with the Congress, we will have $98 billion in tax increases and have a 3-for-1 spending cut.

We got the $98 billion tax increases. Depending on whose analysis you use, we either got in spending cuts or we got 57 cents in spending cuts, or some people even suggest we got an increase in spending for every dollar increase in taxes, and I know that you want to be open and you want to be forthcoming and you want to compromise, but I am just afraid this compromise thing goes one way.

Is there any concern on your part on the size of the taxes as a percentage of the GNP, or is that something we no longer consider important?

I know from the most microeconomic analysis you can get, talking to people, they happen to think that they are taxed at very high rates, and when I look at figures, they are taxed at very high rates.

And if our answer to everything is, we will put everything on the table, but inevitably it is going to include tax increase, when we are just whomping people right now with a tax increase of social security, what are we to say to them? Just wait until next year, we are going to increase taxes? If we do not do it this year?

Is there a concern you have as a percentage of the gross national product that is taken in taxes?

Mr. FELDSTEIN. Yes, there is. I am concerned about that, and I do think that obviously can get to a point where it can do a great deal of harm to the economy.

Of course, it depends on what kind of taxes we have. Some taxes do more harm than others, and think in the last few years we have been making changes which reduce the adverse effects on the economy of raising the taxes we do raise on things.

Changes in the tax treatment of two-earner families reduces the burden of collecting the taxes we collect. More favorable tax treatment of savings meet with the same total revenue and there is less adverse effect.

Representative LUNGREN. I agree with you on that.

On the other side, we have social security taxes going up on those same people.

Mr. FELDSTEIN. Yes, but of course, particularly in the lower end of the income distribution, the social security taxes that are paid are returned ultimately more or less dollar for dollar.

Representative LUNGREN. Is there any percentage of GNP that we ought to be concerned about being taken in taxes?

Mr. FELDSTEIN. Yes. But I do not know what it is, and I know that if we can not get our spending down in the years ahead—we are projecting now roughly 23 percent of GNP for spending, and we are projecting about 19½ percent GNP for taxes, and I know those two numbers should be brought together, and it is more important that they be brought together that we eliminate the deficit than a specific level of taxation.

Representative LUNGREN. If we were to take the political dimension out of it; that is, if we were to come up with a budget that you could enact because we had a parliamentary system and you recommended it to the President and he accepted it and then we would pass it, would you go for spending cuts or tax increases?

Mr. FELDSTEIN. Well, I do not think that that is a very realistic question. I think that the fact that we assume as we go into these negotiations—and the only way we are going to make the kind of progress that has to be made now is to accept tax revenue increases—well, the tax revenue increases do not mean a higher tax rate. It certainly does not mean higher tax rates across the board for everybody.

The President makes a very sharp distinction between raising people's marginal tax rates and reducing the tax loopholes.

Representative LUNGREN. I understand that. But when you tell me everything is on the table, I take you at your word, and that means everything is on the table.

Mr. FELDSTEIN. Everything is on the table, and yet the general guideline, as the President indicated in the state of the Union address, is a desire to deal with the less contentious issues.

As Senator Dole and Congressman Rostenkowski have said, I believe, on television yesterday, without having to raise taxes across the board, simply by closing loopholes, we could easily find half or more of the $100 billion we have set as a goal for these negotiations.

Representative LUNGREN. Does that include postponing or eliminating the indexing?

Mr. FELDSTEIN. I know the President feels very strongly about indexing. He certainly does not feel it is what we would call one of the less contentious items.

Representative LUNGREN. I hope we take that off the table, frankly, because that hits the low and middle income people. It does not hit the high income person at all.

Mr. FELDSTEIN. Personally, I think it would be a bad thing to eliminate indexing or to postpone indexing. I think that is one of the major accomplishments of tax reform over the last few years.

But the statement that everything is on the table does not mean we are going to do everything. It means we are prepared to talk about everything, explain our reasons about everything, but to be very clear, the administration's expectations are that if there is $100 billion or more of deficit reduction over the next 3 years that is going to include a significant amount of tax revenue—not higher marginal tax rates necessarily but higher revenue, as well as cutting defense spending from what we would otherwise want to have.

Representative LUNGREN. Thank you.

Representative WYLIE [presiding]. Thank you very much, Congressman Lungren.

The chairman asked me to express his regret that he had a conflict. He is going to a meeting with the President.

Mr. FELDSTEIN. The kind of conflict that takes priority.

Representative WYLIE. This meeting is important, not that that is more important, but there is a conflict in that regard.

In reference to the statement early this morning, we all have conflicts this morning, unfortunately, and I left the meeting to come here.

I happen to think you are right about the deficits and the need to do whatever is necessary to bring them down. But we are glad to have you here.

Senator Proxmire.

Senator PROXMIRE. Thank you, Congressman.

Mr. Feldstein, I want to join both my colleagues, Congressman Scheuer and Congressman Hamilton. There is no question you have done yourself proud—your profession proud, and the country is proud of you and Mr. Poole and Mr. Niskanen, that you have done a remarkable job in the most painful and difficult circumstances, and you are going to return to Harvard in a few months with your head high. I am sure it will be a lot easier up there dealing with President Bok than dealing with President Reagan.

But I also want to endorse the statement by Representative Hamilton which is absolutely right on target. We do need, regardless of what happened last year—the President just has to come back and propose a program that he supports, even though it is an election year. I know it is hard to do.

I proposed—of course, I am just one, a minority Senator—but I proposed a program that would cut spending by $100 billion by 1988 and raise the revenues by $100 billion in 1988, and other Members of Congress have done the same.

But the President really has to take the initiative before we get anything done in this town, and you know it. So I would hope the President does not just say everything is on the table and we are going to negotiate if we can get together.

So it seems to me it is——

Mr. FELDSTEIN. I must say, I hope that it will not be used as an excuse that will lead to a breakdown in these negotiations because I think the President did put forward a long list of spending cuts, tax increases last year, and nothing happened.

I think it really is important that people get together and agree to do the negotiation and we do produce deficit cuts out of the list you and Senator Dole and Chairman Rostenkowski have had and out of the things that were in the House and the Senate reconciliation bills last year. I think we can pull the $100 billion or significantly more for the next 3 years.

Senator PROXMIRE. But the budget is really the document that he sends to us, and he tells us this is what he wants. He has got some changes in the budget that would help a little bit to reduce the deficit over what it would be if he did not make the recommendation, but they really are minor. That is what we have to go on, and I would hope that he would reconsider and do more than just say we have to have a meeting, everything is on the table.

And Secretary Regan comes before us, and I asked him about cutting military spending, and he said, well, no, he is against that.

I asked him about taxes other than a few minor changes in the Tax Code. No, that is something else.

Mr. FELDSTEIN. I cannot believe Secretary Regan said that. He and I appeared together yesterday before a large press conference. We briefed a number of different groups yesterday together, and on every occasion he repeated the President's words that everything is negotiable, that we understand that that involves going below the budget authority requests for defense as well as nondefense programs.

Senator PROXMIRE. What I really want to get at in my question, although I really do not have much time, and I will come back in a second round, is the utter absolute unrealism of the projections that you make and the administration makes.

In 1981, the Office of Management and Budget estimated the deficit would be $29 billion, and in 1982 it was $109 billion. In 1982, they estimated $92 billion, and it turned out to be $195 billion. And I predict for this $180 billion budget it is going to be exceeded by much deficit; it is going to be exceeded by a much bigger figure, perhaps as much as $250 billion or $300 billion.

And, the reason for that is because you, as a fine economist—I cannot understand how you can argue that we should take the steps you propose we take, and I favor those steps. I favor reducing Federal spending, and I favor increasing Federal revenues. But you and I—you know far better than I do, from your many years, that that does not stimulate the economy.

If you are going to do that, if you are going to get off this terrific deficit that we have at the present time, there is going to be a period of pain. You are going to have to pay for it. If we take more out of the economy than we put into the economy, we will slow it down.

Mr. FELDSTEIN. It depends on the timing. I think if there were a substantial reduction in the deficit, passed tomorrow to take effect in 1984, it would do just what you said.

The President's proposals are to enact measures now which will bring down the deficit in future years. This will reduce the demand that comes from Government spending, but that will be replaced because we will have lower interest rates. There will be more investment demand. We will have a dollar that is more competitive, and that will mean our exports will be higher and our imports will be lower.

Senator PROXMIRE. Well, that is all a happy scenario.

Mr. FELDSTEIN. Well, it is not at all an unrealistic scenario.

Senator PROXMIRE. It is not at all realistic when you have got $196 billion deficit and you have got to come down from that and you have a $1.4 trillion national debt you have got to pay interest on.

If we do have the kind of resurgency you are hoping for and we also have the kind of anti-inflation monetary policy that you are arguing, it is going to be very, very hard for us to have anything like the 4-percent goals that you are projecting.

After all, as you point out in your report here, the growth of 1974–81 was 2.7 percent, far, far, far less.

Mr. FELDSTEIN. But the 4 percent we are projecting—4.3 percent for the 7 years, beginning with the recovery out to the end of the 1989 period, is three-tenths of a percent more per year than the average of the first 7 years of postwar recoveries.

I do not think that what we are projecting is going to happen unless we make the kinds of changes in the budget deficits that are important, but if that happens we can have a period of reasonably strong economic growth up to the end of this decade.

Senator PROXMIRE. Well, my time is up, but you have got to be a real magician if you want to come up with a program utterly reversing any kind of Keynesian logic and any other kind of program to cut spending and increase revenues and then have a better growth than we have in the past. It does not make any sense.

Mr. FELDSTEIN. If you think about what is current——

Senator PROXMIRE. I am for it, but it does not make any sense as far as the kind of growth you are expecting.

Mr. FELDSTEIN. I think you are not optimistic enough about the American economy. I think the lower level of the dollar that results will give us a stronger export performance.

We may have $100 billion this year of trade deficits. We should not have $100 billion of trade deficits. That is reducing demand by almost 3 percent.

We have interest rates that are higher than they should be. We think that investment this year is going to be far below what it has been historically. If we did not have the deficits, if we did not have Government spending and the private consumer spending crowding out these other activities, they could come in and take its place.

Senator PROXMIRE. My time is up.

Representative WYLIE. We will give you a chance to expand on that a little more later on. I want to get into that a little, too.

Congresswoman Snowe.

Representative SNOWE. Thank you, Congressman.

Mr. Feldstein, I certainly appreciate the contributions that you have made thus far, and I think that everybody understands it is going to require a mutual effort between the administration and the Congress to reduce these deficits over the next few years, and we would be kidding ourselves if we thought otherwise.

And so I think the situation is right on target as for a commission between the administration and the Congress to come up and suggest a deficit reduction. That is the only way it is going to happen, and I think everybody understands that.

Can you tell me, in your opinion, if this collective group between the administration and Congress were to come up with $100 billion over the next several years, would that be sufficient to stave off any threat to the present recovery?

Mr. FELDSTEIN. If it is seen clearly as a down payment, if it is part of an understanding that we are going to come back in 1985 and do more, yes, I think that would do well.

Representative SNOWE. But clearly we need to do more than just take the bottom line——

Mr. FELDSTEIN. Yes. If we finish with that and we say we are all done, I think that will do more damage.

Representative SNOWE. So in your opinion, it is sort of a bottom line, the $100 billion?

Mr. FELDSTEIN. I am not sure what "bottom line" means. It is a starting point.

Representative SNOWE. A starting point?

Mr. FELDSTEIN. A starting point and not a bottom line.

Representative SNOWE. Well, let us say at the very least.

Mr. FELDSTEIN. At the very least.

Representative SNOWE. I know there was some disagreement in the administration recently when you were developing your report about the effect of the deficit on high interest rates and trade deficits.

Did you accommodate the difference of opinion in your report?

Mr. FELDSTEIN. I think you will find that the statements in the report this year are very similar to the statements in the report last year.

Representative SNOWE. So no major changes?

Mr. FELDSTEIN. We always discuss the report with all the agencies as we go along, but basically the report represents our views.

Representative SNOWE. In your statement, you suggest that the administration's economic assumptions for 1985 and beyond must be interpreted with care because they are conceptually different from the type the private economists use.

Is this an unusual departure for this administration or from any other previous administration?

Mr. FELDSTEIN. No. I think it has always been true that administrations make projections based upon the kinds of policies that they expect to be adopted in the future.

The difference this year—the thing that may make our forecast this year a little more unusual is that those future policies are not the ones that are specified in this year's budget.

But what we are counting on to make this kind of low interest rate, low inflation, solid growth projections possible are actions that go beyond the budget and give us the results of current negotiations and further legislation in 1985.

Representative SNOWE. And, finally, there have been some substantial improvements in corporate cash flows as well as capital inflow from abroad.

Would this substantially reduce the danger of crowding out between private and Federal borrowing?

Mr. FELDSTEIN. Yes, it does, in the sense that in 1984 roughly half of all net investment in the United States is going to be financed by capital inflow. We will have a capital inflow that will be more than 2 percent of GNP, and we will have net investment which will probably be about 4 percent of GNP this year.

If we did not have that capital inflow, we would have even higher interest rates and more crowding out.

Representative SNOWE. How long can we continue to rely on that benefit?

Mr. FELDSTEIN. Not indefinitely. No question about it. Well, it could go on. We do not know. We really do not know how long the world is going to be prepared to continue to accept more U.S. securities as part of their government portfolios; 1984–85 seems very likely.

We think that the trade deficit in 1985, unless there is a very dramatic fall in the exchange rate, the foreign trade deficit will again be large and therefore there will be a significant capital inflow. That is why if we make progress now, if we start getting the deficit down and start following it up in 1985 so the Government's borrowing in 1986 and beyond is much smaller, then as the inflow of capital from the rest of the world shrinks we will not have the Government absorbing so much and therefore investing can go forward here.

Representative SNOWE. Thank you.

Representative WYLIE. Thank you. Congresswoman Snowe.

Representative Obey.

Representative OBEY. Thank you, Congressman.

Mr. Feldstein, I would like to express my personal admiration for you as well, but I must admit I am frankly flabbergasted by a number of statements that I have read in the papers the last 2 days, by some statements I read in the budget and by some statements that you have made. They are accurate, but I am nonetheless flabbergasted by them.

You just indicated in your response to one of the last questions that the future policies that are needed are not those reflected in the budget.

Now, I am relatively new to this committee. I look at the congressional world pretty much from the perspective of the Budget Committee, where I spent 6 years before I moved to this committee, and I just have to say that when I hear statements like that I almost have to assume that the budget was put together by Jimmy Breslin rather than a serious economist—a lot of blue smoke and mirrors.

What bothers me is that what you are apparently saying in your statement is that there is legislative action to reduce future budget deficits sharply, as we have assumed, then the administration's projected performance of the economy provides a plausible picture of our economic future.

What that really says—if you are going to invert it—is that, however we follow the recommendations, or at least a number of the policies in the budget, that we would face a plausible picture of the economic future.

You say, again in your statement, that your economic assumptions for 1985 through 1989 are based on the premise that legislative action will reduce budget deficits sharply in the years ahead. But the budget does not do that.

And I recognize that you now say that we are going to have this marvelous conference on the consideration of down payment efforts.

But I think it has been generally reported in this town that that was a last-minute addition to the administration proposal, and I just have to say if I were a member of the Budget Committee, I would be even more worried than I am now as a member of the Joint Economic Committee because the fact is—well, I should not say that, but it seems to me that if the administration were really serious in trying to elicit compromise from all sides, that offer and that suggestion would have been made not in a nationally televised state of the Union speech just before the beginning of February but in November, back when you were urging that it be done.

I know I am talking to the wrong guy, but the fact is that if that conference takes any amount of time at all, it very much assures that a budget—if a budget is adopted by Congress, it assures that budget's timetable is going to slip.

Even if you assume the normal timetable for the budget resolution, the Appropriations Committee, on which I also serve, would have under that timetable only 30 legislative days to pass the 13 appropriation bills implementing that recommendation.

So while I am willing to nominate you as permanent head of the "National Optimist Club" for some of the hopes you have expressed here today, I really think that if the administration is serious about this, it came to that seriousness very late in the game, and it creates a very tough question for us in actually meeting the deadlines that are needed, given the time that is taken out of the schedule this year for both national political conventions.

And I wish I had heard—and I do not blame you for it because I know you are not the only architect—but I wish I had heard from the administration that at least the budget document which is supposed to define the policy baselines of the administration for the country, I wish that document had reflected what it really wanted Congress to do rather than having Secretary of the Treasury Regan being interviewed by Daniel Schorr on Saturday and describing the budget submitted by the administration as essentially a baseline budget.

I mean, I have never seen a document that is being run away from by so many people who put it together in my life.

Mr. FELDSTEIN. Let me just say the budget calls for about $3,000 billion of spending over the next 3 fiscal years. The administration proposes about $60 billion of spending reductions and additional tax revenues over those same years, and we are saying, in addition to that, more has to be done.

We recognize that since the Democrats control the House, it has to be done in a way that is acceptable, not just to the Republicans but to the Democrats as well.

I do not think that it is irresponsible to put forward a budget that lays out most of what has to be done. It says a $100 billion decision still has to be made. We propose roughly how to deal with two-thirds of that and call upon key Members of both parties to sit down and talk about what can be agreed upon in this political climate.

I do not think that is an unreasonable thing, although, frankly, I think it would be better if, last year, the budget that the President had submitted had been enacted. But we got no progress on that.

Representative OBEY. Well, if I can respond, it seems to me it would have been much more responsible to call for that summit meeting at the end of the last session of Congress so that the recommendations of that summit meeting could have been included in your own budget.

Otherwise, we are playing a lot of games here and taking a lot of time that the economy may not have.

Representative WYLIE. Thank you very much, Congressman Obey.

Congressman Hawkins.

Representative HAWKINS. Just a brief comment. May I join in the commendations of Mr. Feldstein and his colleagues.

I will just make a brief statement as to the process that we seem to be using in order to achieve national objectives. I do not know what these new ideas are that we are going to negotiate the responsibilities around here and deal with a budget.

I would assume the President has submitted what he considers an honest budget. I would be amazed, however, that if we passed it in both Houses and sent it down to the President, would he sign it? He probably would disown it. That, to me, is a great abdication of responsibility.

If the President wishes to submit a spending program, a revenue program, why not include it in the budget? That is his budget, and it just seems to me that in saying we submit a budget and then we are going to rely on some extracurricular group to fix it up is really another indication of lack of responsibility.

In trying to read through the report—which I only received this morning—I was surprised that the actual law itself is not addressed till we get to the last full page of the report. There it says that it deals with the fundamental question, and I think the essential part of what we have got to do, if we intend to do something as a nation, to achieve our objectives, including the reduction of the deficit.

On page 202 of the report, it says the Balanced Growth Act—sets out the goals of reducing unemployment to 4 percent and inflation to 3 percent by 1983, a date which already has passed.

In other words, the administration already has had 3 years to try to at least move in the direction of those goals.

In contrast, it has moved to the worst and the longest recession since the Great Depression. So that has been in the opposite direction. So we will forgive you that. We will overlook that. We will give you another 4½ or 5 years to do it again.

And yet in the projections are assumptions, not stating them as goals, but merely guessing as to what is going to take place in the next 5 years.

You say, well, if we cannot move even to those goals within that 5-year period, then we are going to leave unemployment at abnormally, unbearably high rates as late as 1989, which is a direct violation of law. And it just seems to me that what we are doing, we are overlooking what the law compels and trying to serve what the law does not mandate, and that is dealing with our economic problems strictly in terms of reducing the deficit.

So the budget which is produced by the administration does not deal with what should be spent but what should be cut. So every emphasis is put on what can we cut.

Now, that is a violation of the budget process because the budget is a blueprint for what we must spend on what we consider to be national priorities and submit the basis on which we raise the money to meet that. But that is completely ignored.

The law is completely ignored, and now the President proposes to have a constitutional amendment to achieve what he wants to achieve anyway, and that is to reduce the budget regardless of anything else and to reduce it only by budget cuts.

Now, that again is a phony issue because he does not indicate what should be cut. If you are going to shift that responsibility to somebody else, who wants to negotiate that in a bipartisan manner?

So that again is a violation of law which has created the Council of Economic Advisers, created this committee to deal with these problems. And yet we are not doing it, we are shirking it.

Cut what? The President proposes to cut the little WIC program because it deals with pregnant mothers. So we are going to cut the medicaid because it deals with poor people. He is going to cut AFDC, cut off 500 new mothers off AFDC. That is what we are going to cut.

And then to offset that we are going to give a bonanza tax cut to a few wealthy people. And so that is contained in the budget.

Mr. FELDSTEIN. I think you must be reading a different budget, sir.

Representative HAWKINS. Well, you must be misinformed on the very report which you have given to us this morning.

Mr. FELDSTEIN. There is no proposal to cut anyone's taxes in this budget.

Representative HAWKINS. We have in 1981 based the cuts on bonanza gifts to a few people.

Mr. FELDSTEIN. That is not true. You know that. It has been an across-the-board cut. The tax rate cuts were proportional for everyone.

Representative HAWKINS. Yes, about $6,000 to the average individual who makes in excess of $80,000 and less than $1,000 to those who make less than $15,000. That is what it does, and you know it does.

I am a little surprised, after all the commendations we have been giving to you, Mr. Feldstein, that you would refute the very tax cuts which were made in 1981 and which were deliberately advertised as cuts that were going to give the money to those at the higher level and the corporate entities on the basis they were going to produce the jobs.

Mr. FELDSTEIN. The cuts——

Representative HAWKINS. May I just complete my statement?

So I think what we have here is a blueprint of priorities which are turned upside down. The main emphasis is on the growing Federal deficit, without any thought of what you cut, that we have turned them upside down, and therefore what we are doing in this report, if we follow this report—and Heavens knows, we will not do it—but if we were to do it, it would simply mean that we would be taking away from this country the productive capacity, putting plants and our numerous resources busy again to produce the very revenues that could reach the budget deficit that all of us say should be reduced.

What are we going to do? Are we going to turn it upside down and say we are going to have recessions, we are going to have tax giveaways, and we are going to have accelerating defense expenditures, and then turn around and say we have got to reduce the deficit?

Representative WYLIE. The time of the gentleman has expired.

Representative HAWKINS. Under this policy we just cannot do it.

Representative WYLIE. Thank you very much.

Mr. FELDSTEIN. I would add to that, but I think the gentleman has been reading a different budget, different press releases than I have.

But it does point up the problem that we have as Members of Congress, and I think I would like to address this question to Mr. Niskanen.

Everyone in Congress likes to talk about fiscal responsibility, but then we have trouble carrying out our own budget resolutions. Despite the common perception that Government spends too much, Congress is under intense pressure from special-interest groups at all times, and we are all trying to protect our turf, legitimately in most cases I would say, so it is extremely hard to bring the Federal budget under control.

Now, obviously there are going to be a lot of political posturings during this election year on the budget problem. If you could find a way—and I am not sure we can—to effect a quick fix on the budget policy, will that solve the problem or do we need some basic institutional reform?

And I think your answer is going to be the latter, and if so, what form would that take?

Mr. NISKANEN. The President, as you know, Congressman Wylie, has endorsed a proposed amendment that would require a planned balanced budget and would limit the rate of increase of tax revenues and spending. That is the measure that I have helped formulate and very long supported it.

The President has also recently revived the proposal for the line item veto. In that particular case, Congress itself has recognized the importance of the item veto, granting such authority to the Governors of Alaska and Hawaii before they became States, granting that same authority to the Governor of Puerto Rico, to the trust territories, and the Mayor of the District of Columbia.

Congress has recognized the importance of that for the whole budgeting process on every institution except the Federal Government. On the question of the item veto, I think we should be realistic about its consequences. It should be recognized as primarily a device to discipline the large number of rather special interest programs that are in the budget.

We should not expect that it will be a sufficient instrument to control the budget totally. All of us, I think, can probably operate better if we operate in the context of some shared rules about what kind of budget outcomes we want, and I think that Congress itself would find itself relieved—the individual Congressmen and Congresswomen would find themselves relieved—to have the excuse of saying, well, we are operating under a constitutional amendment that limits our authority to run indefinite deficits and to increase taxes relative to our national income.

I sincerely hope—and the President has endorsed—that Congress is prepared to readdress the balanced budget spending limit amendment this year and to address seriously the proposal for an item veto.

Representative WYLIE. So you are in favor of a balanced budget, a constitutional amendment then?

Mr. NISKANEN. Yes; very much so. But I think it is important to put that in the context of a general limit on spending and taxes as well.

Most States, as you know, have the requirement for a balanced budget in their operating budget. That by itself is not sufficient to discipline total spending, which may just increase taxes.

I think that the combined amendment—an amendment that combines both the requirement for a planned balanced budget and a limit on spending and revenue growth—can be very helpful to disciplining this process. I think both elements of that are important.

Representative WYLIE. Thank you.

Mr. Feldstein, we are all aware that high interest rates contribute to budget deficits by raising the cost of servicing the national debt. However, I am not aware that CEA, the Federal Reserve, or anyone else has provided conclusive evidence that budget deficits are the primary cause of real or nominal interest rates.

Would you say that most economic research supports the idea that huge budget deficits do have a dominant effect on interest rates?

Mr. FELDSTEIN. I would say so, although I would have to admit we are really dealing now with a set of projected budget deficits which are much larger than anything we have ever experienced before, so that it really is not possible to confirm—the way that you can confirm other things in economics—this impact.

Yet, I think it is very clear that with budget deficits absorbing such a large fraction of available net savings something has to be done to shrink the demand for funds by private borrowers for investment in housing and investment in plants and equipment, and that has to be the cost of funds that is bringing it down and also attracting funds from other parts of the world.

So I think it is clear that the only response that the system can have to a sharp reduction in available net savings can be a higher cost of capital relative to demand, higher real interest rates.

Representative WYLIE. You spoke of interest and budget deficits relative to the rest of the world. Each year our budget deficit adds to our national debt and each rise in the national debt increases the interest obligation of the U.S. Government.

In general terms, who owns the national debt of the United States? Is it the Americans? And how much of it goes to—or is obligated to foreign countries or foreign institutions? How much of it is owned by people abroad?

Mr. FELDSTEIN. The vast majority of it is owned by Americans.

Representative WYLIE. And I guess my concern here is that our future generations will be called upon to pay taxes to pay interest to international institutions abroad? Is that something to worry about?

Mr. FELDSTEIN. That is something that is of major concern. The size of this figure.

Foreign and international investors at the end of the year held about 16 percent of all of the privately held debt of the U.S. Government, or about $161 billion out of $983 billion in September 1983, which is the most recent figure we have.

But at the same time, because of these very large trade deficits and current account deficits, we are borrowing from abroad, not just publicly but also privately, and drawing down our assets, so that sometime in the next few years we will cease to be a net creditor nation. We will have foreigners having done more investing in the United States and lending to the United States as a whole, public and private, then we as a country have done to the rest of the world.

That means that future generations will—instead as now being able to draw future dividends from other countries, will be paying net interest and dividends to the rest of the world to make up for the borrowing they are doing now.

Representative WYLIE. That is another point I want to make. Would you explain in as succinct a way as you can:

On the one hand we have a budget deficit which is very large and which is of very much concern to this member, and I have introduced a resolution calling for a bipartisan commission like the Social Security Commission to try to come to grips with it, and that is really the only way we are going to do it.

And yet on the other hand, we have economic forecasts which are very rosy here this morning.

Is there an inconsistency there?

Mr. FELDSTEIN. Remember what we said about those forecasts. We only expect them to prevail if we get substantial cuts in the deficit and sound monetary policy. That is cuts as a result of these negotiations and cuts that go beyond.

If we do not get that, I certainly would not try to defend these forecasts. And these are forecasts of economic performance in terms of inflation and interest rates, very similar to the experience of the 1950's and 1960's in terms of real growth, and slightly better but not dramatically different from the real growth in the first 7 years of past recoveries from business cycle downturns.

Representative WYLIE. Would you care to comment on that, Mr. Poole?

Mr. POOLE. I think it might be helpful to start with a brief analogy. Suppose we were driving in a car down the highway at 55 miles an hour and we see a sign that says there is a reduced speed limit zone ahead.

Now, if the person that is next to me says you are not really going 55, you are going 52, we are not going to spend our time arguing about whether we are going 55 or 52 because the speedometer is wrong.

Economists naturally and always have different estimates of the magnitude of effects. Those different estimates very often mean little for their views on a policy recommendation they would favor.

So of course, I do not agree with Martin Feldstein or Bill Niskanen to the second decimal point on every estimate. We have different views about the magnitude of the effects, but we have common views on the appropriate policies to be followed.

Representative WYLIE. Thank you.

Representative Scheuer.

Representative SCHEUER. Still, I think we have a right to ask you some questions about the underlying intellectual underpinnings of some of these budgetary assumptions. They look glaringly unbelievable and not worthy of acceptance by people with commonsense, and we are unhappy about that because we believe all of you—the three of you—are people with eminent credibility and eminent common sense, and we are uncomfortable.

Maybe we have missed something in this budget, and what I would like to ask Mr. Feldstein is, is there anything in this budget that has escaped us that if we knew about it, if it were brought to our attention in very simple, understandable ways, would convince us that this budget was credible and that our fears about inflation galloping off the chart and budget deficits galloping up to $261 billion was something that we should not be concerned about?

Let me just question a couple of them and then see if you can assuage my fears.

You talk about a growth rate of 3.8 percent or higher for the foreseeable future, which is something we have achieved in less than half of the last four decades.

You have talked about 7 consecutive years of robust growth, about twice as long as the usual 39-month or 40-month postwar recovery period.

You have talked about a 50-percent decline in interest rates when the usual pattern is for interest rates to rise as the recovery matures or at least more or less stays stable.

We have never in our history, as I understand it, had a recovery rate accompanied by anything approaching the type of drop in interest rates that you have reflected on that chart that you projected from 8.6 percent last year to 5 percent in 1989.

In your 1982 budget, Mr. Feldstein, you projected a budget surplus of $28 billion for 1986, and in your new budget $177 billion deficit for 1986. Yet both the 1982 and the 1985 budgets say that interest rates will be 8.5 percent this year and 7.7 percent next year.

Now, is it not a little difficult for us to accept the theory that moving from a $28 billion surplus to a $177 billion deficit would influence interest rates at all? Are we to believe that a swing of $205 billion in the deficit rate simply will not affect interest rates?

Maybe I should just sum it up by asking: If you were an investor and you were looking at this year's budget, would you assume that inflation is under control for this country, and would you thereby accept a lesser interest rate for your investment, or would you feel, well, maybe Mr. Feldstein's hard-earned investments deserved a little higher return, considering all these nebulous prospects, and maybe would you demand a somewhat higher interest rate on your investment?

If there is something that has escaped us on this——

Mr. FELDSTEIN. I think there is. Let me tell you. The mystery is if all we get is what is in this budget we are not going to have that decline in interest rates. We are not going to have that growth, we are not likely to have the kind of inflation performance we would like.

And what we are saying is that we want to go beyond what is called for in this budget, that negotiations should supersede the figures in this budget and they should be followed by further legislative action in 1985 so that the deficit in 1987 will not be $170 billion but substantially less. If the deficits are not significantly below $100 billion in 1988 and if that is clearly within the law that is passed in 1985, then I do not think we can have the kind of interest rates that we talk about here.

But if, as I said in my statement and indicated before, if we get the kind of legislative action in 1984 and 1985 that puts those deficits on a sharply declining path, then I think that what we are projecting for real growth and for interest rates is quite in line with recent experience.

Representative SCHEUER. But where is the legislative program to achieve this?

Mr. FELDSTEIN. What we are counting on is that these negotiations provide at least $100 billion of reduction in deficits over the next 3 fiscal years. I would like to see it do more than that.

Representative SCHEUER. Mr. Feldstein, my time is up, and I admire you enormously, that is perfectly clear, but I wish you would carry the message to Garcia that in 1980 the American people did not elect a nonpartisan commission to run this country.

Mr. FELDSTEIN. This President proposed last year——

Representative SCHEUER. I do not recall a Republican candidate for President in 1980 telling us that when the tough decisions came down the pike that we were going to have a nonpartisan commission appointed to put together a program for the Congress.

Presidential leadership is a central core of Presidential Government, and it seems to me that has eluded this administration and you undoubtedly get a sense of great frustration from this side of the aisle. We are not trying to duck our responsibility, but it is difficult for Congress to put together a budget.

It is not a constitutional requirement that has been made upon us; that is an executive branch requirement, a Presidential burden.

Nobody forces the President to run for office because he had a pistol placed against his heart. He wanted to be President, and he wanted to exert Presidential leadership. We are waiting for it, and when we get that kind of a program, then is the time for the President to say to us, all right, now act like grownup men and women and do your job for the American people and do what this country urgently needs doing in 1984.

Nobody has said it better than you. Our country cannot afford to function—and parliamentary governments all over the world are wary as to whether our democracy can survive when 1 year out of 4 we simply put our decisionmaking capability into a deep freeze and just sort of muddle through for a year.

We cannot do that. We need Presidential leadership. Then it is up to Congress to make good, and then it is the obligation of the congressional leadership and each and every one of us 435 men to put the national good above partisan considerations, and I think we are ready to do that, and I think that the sense out there in the country is that we need that kind of Presidential leadership and we need that kind of courage on the part of every single Member of Congress.

But absent the leadership, we are not going to get it, and I do not think we should waste 1984, and I do not think you think we should waste 1984 either.

Mr. FELDSTEIN. I did not think we should waste 1983. I think the problem was that in 1983 we had Presidential leadership, we had a budget proposed that was very explicit. We had a budget that would have cut the deficit to 1.6 percent of GNP by 1988, and we got no action at all. We got a complete stalemate.

And so what we do is we go back and say, well, what has worked. In 1981, right after the election, it was possible to pull the Congress together. The President had a mandate, people felt they had to do the kinds of things he felt he had to do.

Maybe that is going to be possible again in 1985. But what has worked after 1981? The best example is the Social Security Commission. There was not a more explosive problem politically than social security, and yet by bringing the key people together we were able to get a proposal that the President, the Democratic leadership, Congress could sign on to and could get enacted and could do the job.

What we tried last year, an explicit budget, did not work. Our hope is that this will work this year.

Representative SCHEUER. Thank you, Congressman.

I would ask unanimous consent that individual members be able to ask questions in writing.

Representative WYLIE. Without objection, so ordered.

Well, I guess you have kind of summed it up there, and I agree with your statement, Mr. Feldstein. Maybe we will have to find out who this fellow Garcia is. [Laughter.]

Senator Abdnor.

Senator ABDNOR. Thank you.

I do want to come at this from a different direction. But I have just got to say you mentioned 1983 you mentioned social security, and you mentioned the pride we have all taken in that accomplishment.

How well I remember 1982 and that vicious ad that was run all over the country. It said "Sorry, Mrs. Olson, I have to tell you that we have got to cut your social security check because this administration apparently has either given a big writeoff to oil people or the big corporations." And then we came back after election and did exactly what the President said must be done. What if we could propose something for Medicare we would not be facing the same thing?

Going back to days of one of my campaigns for the State senate, I remember a little old lady that said to me at the door, "Senator Abdnor, is it true if Senator Goldwater gets elected President he is going to stop social security?"

In that campaign there was an ad with a check being ripped up. Such tactics had an effect on that election too. That is the kind of thing I think we all remember when we think about proposing the solutions to the deficit problem.

But let us get off of that. I want to ask you, what are forecasts for the economic condition of "Small Town USA" and "Main Street" in 1984 and beyond? Are rural areas going to join in the recovery this time around?

In my part of the country there has been a recession since 1980, not 1981, like the rest of the country. I am concerned about this because North Dakota, South Dakota, and Iowa were among just five States where personal income after inflation declined during the third quarter of 1983. Let us quit the politics and talk about the future of small towns, and I happen to have a lot of them.

Mr. FELDSTEIN. This is a recovery that will help the economy generally. I think that agricultural prices are likely to be higher this year.

Senator ABDNOR. You really do? You are the first guy that told me that. I am delighted to hear that.

Mr. FELDSTEIN. I thought about you, in fact, when I saw the story in the paper yesterday that said that agricultural prices—prices that farmers get for raw products rose 2.1 percent in January from December and were 12 percent higher than in January of 1983.

Senator ABDNOR. But they took a big fall in the third quarter.

Mr. FELDSTEIN. They did.

Senator ABDNOR. I am glad they came up a little.

Mr. FELDSTEIN. Up 3.7 percent in December and 2.1 percent more in January. So nearly 6 percent in just those 2 months.

Senator ABDNOR. Well, considering the big boo-boo we made in the Department of Agriculture on the estimates of the carryover of grain, that is encouraging to hear.

I saw in your economic report that you put in a whole chapter on agriculture. In fact, I commend you for it.

But most of that was dealing more with Federal programs and the benefits to farmers. I do not think you touched on the benefits of the family farm to our Nation as a whole.

You know, you could have talked about agriculture from a social point of view. You can talk about agriculture from a labor point of view. And one point of view about agriculture you did not mention is the break it gives the consumers of this country. I do not think that was touched on, was it?

Mr. FELDSTEIN. We did point out how dramatically prices had fallen, and how with about 3.1 percent of the labor force in agriculture we are feeding the American public at relatively low cost and exporting almost a quarter of all of the agricultural output of the country.

Senator ABDNOR. We all agree, I hope, in this group that 230 million Americans enjoy the greatest variety and the best quality of food anywhere in the world for less money than anywhere in the world, and I just did not feel that came across strong enough.

I know no one is fed like the people in this country are fed for the price.

Let us talk about the marketplaces. In your report you say the farm programs and the price food costs should be more market-oriented. What are you speaking of there? Oriented to the domestic market or the foreign market?

Mr. FELDSTEIN. No. I think what we were talking about, as developed in the chapter, is the contrast between the way the United States treated agriculture and the way in which the European Community has.

I think the fact that to support farmers incomes, we use deficiency payments rather than artificially keeping prices high for certain products. This is a plus in our system relative to the European system because it gives the consumers the benefit of the lower agricultural prices.

Senator ABDNOR. Well, thank you. I am not going to pursue this. There are a lot of of other members that want to ask questions.

But I just want to commend you. At least we have come a long way when we have a chapter on agriculture, and I tell you, that is a big start.

Representative WYLIE. All right. I have a feeling you had something to do with that. Thank you very much, Senator Abdnor.

Senator Proxmire.

Senator PROXMIRE. Mr. Feldstein, one of the good things about your statement, which is an unusual statement, is that you point out that the consensus economists disagree with your estimates in the outyears of what is going to happen to unemployment, interest rates, and so forth.

You are very frank and honest about that, and you do seem to have a pretty rosy picture of 1989, 5.7 percent unemployment rate, inflation at 3.5 percent, 91-day Treasury bill 5 percent, mortgage interest 7 percent.

Those are the assumptions on which the budget is put together, and you say that the difference between your position and that of the consensus economists is that they do not believe we are going to take these steps to cut spending and so forth and bring the budget into control.

Now, the reason why they do not believe it I think is not because they do not like the President—they love him—financial economists, by and large, at least—but I think that they wonder where we can make the cuts.

Now not in the military apparently. We have a President that is very firm on that. And not in the big entitlement programs. You made one of the clearest and most persuasive statements—I have never seen anybody rebut it—that the entitlement program, the big entitlement programs, social security, is in balance, in fact in surplus, over the next several years.

It is true we can make some changes in medicare, and you agree to that, and so do I. But that is about the only area.

The nonentitlement programs have been cut and cut, and it is hard to find—you look at childhood nutrition, look at food stamps, and so forth, and I do not think any realistic person, even if they are opposed to the programs, expect we are going to reduce those.

So it seems to me that you can talk about how we can negotiate spending reductions. It is hard to see them, and the President seems to have ruled out any really significant increases in taxes.

I think that he and Secretary Regan suggested some increases that would be $10, $15, $20 maybe, $30 billion, but nothing like what we need.

Mr. FELDSTEIN. In the current negotiations they have ruled out any major tax increase, although made it every clear taxes would be a significant part of the package, I think more than the number you talk about.

In fact, the budget proposal is $33 billion in additional tax revenue over the next 3 years.

Senator PROXMIRE. Well, that is in the budget. But beyond that.

Mr. FELDSTEIN. The notion is we would go beyond the budget as far as these negotiations.

Senator PROXMIRE. Now, you have a very interesting statement—it is dynamite. Let me read it. You say, "As a result of the universal extension of eligibility for Individual Retirement Accounts and the increased limits on IRA and Keogh accounts, the income tax system has been virtually transformed into a consumption tax for the majority of Americans."

I think that is a remarkable observation. What you are saying, as I understand it, is the savings would not be taxed and therefore the income tax that they pay is paid on what they do not save, which is their expenditure for consumption; is that right?

Mr. FELDSTEIN. That is exactly right.

Senator PROXMIRE. So we have converted the productive Federal income tax into a sales tax, in effect?

Mr. FELDSTEIN. Well, no. I would say consumed income tax.

Senator PROXMIRE. All right, a consumed income tax.

Mr. FELDSTEIN. Not for everybody obviously, but more for the majority of Americans.

Senator PROXMIRE. Well, now, where to we go from here? A value-added tax?

Mr. FELDSTEIN. I do not know.

Senator PROXMIRE. See, we would like to know. Nobody can tell us as well as you can tell us.

Mr. FELDSTEIN. It is going to be a hard year of study for the Treasury. They have said in testimony in the past that they are looking at everything from flatter, broader based income taxes to consumed income taxes to value-added taxes to try to figure out how each of those work in practice and what the transition rules would be like, and they are indeed hard at work on that now.

Representative WYLIE. If the gentleman would yield, you mentioned a value-added tax. What is your feeling about that?

Senator PROXMIRE. My feeling?

Representative WYLIE. No; Mr. Feldstein's.

Senator PROXMIRE. I am against it. It is horrible. It is about as regressive as you can get.

Furthermore, the worst thing about the value-added tax—I do want you to answer it, but just let me tell you my view—the worst thing about the value-added tax is it is hidden, and therefore there is not basis for the taxpayer protesting what happens to their taxes. They do not really know they pay it.

Mr. FELDSTEIN. I do not know whether that is really true. In my experience, living in England where they have a value-added tax, the public was very conscious when the budget brought out a 1-cent-on-the-pound increase in the value-added tax. I think people are conscious.

Senator PROXMIRE. The individual person does not see it when he is paying it.

Mr. FELDSTEIN. He does not see it every day when he pays it. He sees it when the Government changes the tax rate.

Senator PROXMIRE. Now, if your estimates are not right and if the consensus is correct and if in 1989 we have not the 5-percent Treasury bill rate or the 7-percent mortgage rate but about 4 percent above that, say 9 percent, that makes a difference of $72 billion a year in interest on the national debt.

Mr. FELDSTEIN. That is correct.

Senator PROXMIRE. So a lot hinges on what I think is an extraordinarily rosy estimate of interest rates coming down at a time when we have recovery, unemployment is falling. It is sort of like rain going up instead of coming down.

Mr. FELDSTEIN. No. It is hard to look ahead; it is easy to look back. If you look back into the 1950's and the 1960's, you see an economy operating with roughly the kinds of numbers we are talking about, an economy of what you are doing the first 7 years of recovery. Real GNP rose at an annual rate of 4 percent, an economy in which the average inflation rate is 2.5 percent, an economy in which the real interest rate is 1.5 percent for Treasury bills.

What we are talking about in 1989 is not at all out of line with the kind of experience the United States had in the 1950's and 1960's. It is just that we are not going to get back there unless we continue to have a sound monetary policy and unless we also bring down the budget deficit.

Senator PROXMIRE. My time is up.

Representative WYLIE. Thank you very much.

Congressman Obey?

Representative OBEY. Thank you, Congressman.

Sir, let me just put it this way, do you believe that the Federal budget should be balanced in all the years under all circumstances with the exception, say, of a national security emergency?

Mr. FELDSTEIN. No, I do not.

Representative OBEY. In your statement, you say:

> If economic activity exceeds our projections in some future year, the resulting budget deficit in that year will be smaller than we forecast; conversely, if the economy is weaker than we project in some future year, that year's deficit will be larger. Such cyclical fluctuations in the deficit along the path toward budget balance are not inappropriate.

How can you say that and yet support the suggestion that future Presidents ought to be bound in almost all circumstances?

Mr. FELDSTEIN. My colleague may be able to clarify it, but my understanding of the balanced budget amendment is that if there were cyclical fluctuations in the economic activity that cause a rise or shortfall in revenue, they would not be in violation of the rules of the balanced budget amendment.

Representative OBEY. So you would say, then, what you ought to do is require a budget which is in balance at full employment?

Mr. FELDSTEIN. We do not spend all of our time equally divided above and below full employment. If I had my choice, I would like to be balanced on average.

If we spend most of our time either at full employment or below, that means when you actually get up to full employment you ought to be running a surplus.

Representative OBEY. That does not respond precisely—that does not correspond to the answer you gave just a moment ago.

Are you saying you want a constitutional amendment that allows the Keynesian ebb and flow of the economy to continue to occur?

Mr. FELDSTEIN. What I would like to see is a balanced budget amendment in which cyclical fluctuations cause ups and downs in tax revenue, which move us sometimes into surplus and sometimes into deficits. On balance over the years I would like to see the deficit not grow—the debt not grow.

34-871 O - 84 - 11

Representative OBEY. The problem in past policy is we have always been able to prime the pump, but when we have full employment we do not pump it back in the bank.

Mr. FELDSTEIN. There is nothing in the balanced budget amendment that would prevent running a surplus at full employment.

Representative OBEY. Would it require that it be in balance in all the years when it was at full employment—in balance or better? Would it allow you—let me put it another way—would it allow you to be out the balance as you are moving in that cycle to full employment?

Mr. FELDSTEIN. When we are below full employment—is that what you are saying? I believe it would.

Representative OBEY. Well, then let me ask you this: if that is the case, then why could you not resubmit your budget for this year indicating what budget levels you would like to see, assuming the economy were at full employment?

Mr. FELDSTEIN. I do not think it would do any good. We submitted that budget last year.

Representative OBEY. No; you did not submit a balanced budget with full employment last year.

Mr. FELDSTEIN. We submitted a budget that would have got the deficits down.

Representative OBEY. You did not submit a budget that was in a balance with full employment last year.

Mr. FELDSTEIN. That is correct.

Representative OBEY. The reason I ask is that a number of us on both sides of the Hill are introducing a resolution today. We have two senses of the Congress resolutions, one on Lebanon and the second on the balanced budget.

We will be asking the administration to resubmit its budget in a form which would be in balance, at least with the economy at full employment.

I would like to ask you another thing. You mentioned the budget process. This has nothing to do at all with what we are talking about. You indicated you felt the budget process has some fundamental problems. I do, too. I think it is virtually a dead letter.

What I would ask you to do is to have the administration take a look at the budget process reform proposals that people as diverse as myself and Congressman Gingrich from Georgia have introduced which would in essence eliminate the promissory note budget resolution which we provide and simply require that the Congress deal with the entire budget in one bill, all spending, all revenues in the same package, just as most legislatures do.

It seems to me, on a procedural note, that might be a whole lot better than this folderol that we call the budget process.

I thank you, Congressman.

Representative WYLIE. Thank you very much, Congressman Obey.

Congressman Hawkins.

Representative HAWKINS. Just one question.

If I may return, Mr. Feldstein, to the unemployment problem.

In your projection of long-range economic assumptions for 1986, you project the unemployment rate for the fourth quarter to be 7.2 percent, which obviously means much larger for the total year.

Since that is all the rest of 1984 and includes all of 1985 and virtually all of 1986, that is 3 years yet to go.

That adds up roughly to—and I hope you will agree with this—over 8 million unemployed persons, not counting the discouraged, not counting those who may work part time. So we are really talking about in excess of 10 million Americans who would be unemployed during a 3-year period between now and the fourth quarter of 1986.

May I ask you, what in the budget itself or the economic report addresses this problem?

Some of us have areas and districts that are now much above the average—national average in unemployment—and if you were to try to explain that to those individuals, let us say, in an area such as mine where the unemployment rate is almost 20 percent—to those individuals that they must wait until 1986 before something is done for them, if the unemployment rate is projected as this report does, just how would you explain it?

What specific programs are included in this budget that addressed that problem?

Mr. FELDSTEIN. Remember when I came here last year we discussed all this. It was a time when our most recent unemployment rate was 10.7 percent.

Clearly, then, as I think now, bringing down the unemployment has to be very high on the list of economic responsibilities. I think we are all gratified to have seen the unemployment rate drop by 2½ percent since then.

I said this then. The most important thing in terms of bringing down unemployment is solid economic growth. More Government programs aimed at unemployment is not the answer. The best program for dealing with unemployment is strong economic performance.

We can have the kind of growth we are projecting if we can follow the kinds of sound, monetary, fiscal policies that give us noninflationary expansion over these next few years. Then we can continue to make progress in bringing down inflation.

Of course, none of those who are unemployed now are likely to remain unemployed despite the high levels of unemployment. There is a continuing turnover, as you know, and as we discussed at great length in the chapter on unemployment in last year's report.

Representative HAWKINS. You think that answer will satisfy an individual who has been unemployed 15 or 20 weeks already and who has family obligations to meet?

The reduction in the unemployment training programs, the funding of those programs, by almost 60 percent the last 2 years is in the direct opposite direction of trying to explain to the individual that that individual must wait another 2 years, let us say.

We are pleased we have reduced it as much as we have. We commend you on that reduction, but it is a reduction from a very high level. But that does not reach this individual. This is at 7.2 percent, which I selected. It is much higher than what it was at the beginning of this administration.

So can we say we have had recovery or we have anything to offer to that individual that we will not get back to where the rate was in the beginning of this administration?

Mr. FELDSTEIN. Of course, there are things that the Government continues to do for those who are unemployed: The job training partnership program. Although it spends less dollars, I think it spends the dollars more effectively.

That is what all the labor market experts that I have talked to say.

The unemployment insurance benefits still provide up to 55 weeks of unemployment insurance. We have made proposals for improving the operation of the unemployment benefits, and the President proposed last year that individuals might be allowed to use their extended unemployment benefits, FSC benefits, as a voucher to support on-the-job training, a voucher to allow them to compete more effectively for employment. Congress did not seem to want to deal with that.

The administration proposed a small reduction in the minimum wage for students during the summer months so they might get some useful experience, and a track record, and a recommendation that would hold them in good stead later on. Congress did not seem to want to deal with that.

I think there are things that we can do to strengthen employment in addition to the recovery, but most important is not to risk this recovery by an excessive runup of inflation of the sort that got us into so much trouble at the end of the 1970's and we are still suffering from.

Representative HAWKINS. Do you think the inflation is due to the large number of unemployed people—that unemployment is the cause of inflation?

Mr. FELDSTEIN. No; I think that policies—particularly the monetary policies that are well-intended but badly designed to bring down unemployment—often have been the cause of it.

I think people trying to do their best to bring down unemployment have advocated excessive monetary growth, and that in turn produced inflation and created the kind of aftermath from which we are still suffering.

Representative HAWKINS. Do you not think we should fight inflation directly and not by use of trading jobs off?

Mr. FELDSTEIN. I think, fortunately, we are beyond that now. We have got to a point where the inflation rate has been brought down and can stay down.

Representative HAWKINS. Are we going to help inflation by asking those individuals I referred to to wait 3 years in order to help inflation? That seems to be the essence of what you are saying.

Mr. FELDSTEIN. No, not at all.

Representative HAWKINS. I hope not.

Mr. FELDSTEIN. I am saying we can continue to have low inflation and shrinking unemployment, but if we try too hard, if we try to force unemployment down by rapid expansion of money we would end up with more unemployment after a short period of time.

Representative HAWKINS. That is a good argument why we should reduce the defense expenditures, is it not?

Mr. FELDSTEIN. You will have to explain that one to me.

Representative HAWKINS. Thank you very much.

Representative WYLIE. We will let you explain it for the record. Go ahead.

Representative HAWKINS. I thought the witness was in the process of answering the question.

Mr. FELDSTEIN. I have nothing further to say.

Representative HAWKINS. I am through, also. Thank you.

Representative WYLIE. What is your opinion, Mr. Feldstein, about the value-added tax?

Mr. FELDSTEIN. I think there are pluses and minuses. I am frankly afraid if I start expounding on it, it will be interpreted more as administration position than my own personal views.

Since at this point the administration has not made any specific recommendation on the tax implications area, I should probably keep my views to myself.

Representative WYLIE. All right, thank you. I will respect that.

I have one final question which I would like each member of the panel to comment on, if you please.

The last year has seen a strong rebound in productivity; that is, output per man-hours worked. Also, productivity declined less during the recession than past experience would lead us to expect.

Aside from the cyclical components, the apparent improvement in trend productivity growth seems to be closely correlated with the income-tax-rate cuts.

To what extent are improved productivity prospects a result of the tax-rate cuts, and would you not agree that higher taxes might jeopardize the improving productivity trend and hence the prospect for a complete recovery.

Mr. Feldstein.

Mr. FELDSTEIN. I do not think we know the answer to that.

One of the areas in which the economists have done rather badly is understanding the changes in productivity. It will be some period of time before we see whether there is improvement in the productivity trend, whether it is really a permanent change or just something temporary.

The 1970's were a period of very low productivity growth relative to earlier years. That was held down by a combination of things: low capital accumulation that has continued, and regulations. We have not seen the imposition of new regulations the way we had in the previous years, and I am sure that has helped productivity.

There has been a changing composition of the labor force, more mature, more experienced workers. All of that has helped.

But I do not think we can weigh the different factors and give relative importance to the different factors at this point.

Representative WYLIE. Thank you.

Mr. Niskanen.

Mr. NISKANEN. Thank you.

There is every reason to believe the reduction in taxes and increase in business investment by channeling a higher proportion of our Nation's savings into business investment will ultimately add to productivity. I do not believe we have begun to realize much of those effects to date.

Over the same period of time we should have increasing productivity by changing composition of the labor force, much lower proportion being new to the labor force or intermittently in the labor force. That will help.

I think, as my colleagues, the disciplining of regulations can be important. At the same time, I think we as economists should all acknowledge the precise complication of the contribution to productivity growth, and even in retrospect it is not possible, in that I think that people's inherent convictions about what contributes to productivity growth is likely to be almost as good a judgment as any knowledge we can put on it.

I have also been encouraged by what seems to be a much more prevalent willingness, both by management and labor, in the last few years to address work rules which have significantly impeded productivity growth in selected industries.

That may be triggered in part by the threat of their jobs and plant closings in particular communities, but I would hope that it reflects a more mature relationship between management and labor, in which they both recognize their interests in working out changes in work rules.

Representative WYLIE. Thank you.

Mr. Poole.

Mr. POOLE. It is difficult to add anything to that. I would point out, echoing what they said, the productivity slowdown in the 1970's is very incompletely understood.

I pulled out a table from the Economic Indicators and knocked out updated productivity numbers, and I am struck by the revisions in the recent numbers.

For example, here is a number in the third quarter. It used to be 3.1, and that is crossed out, and it says 2.3 percent.

And so you get revisions when you are dealing with early data in an incompletely understood area.

We know that we can destroy productivity if we destroy incentives for work and for productive investment. We know that.

The converse, of course, is that by creating those incentives we ought to improve productivity. But quantifying it is very difficult.

Representative WYLIE. Thank you very much.

Thank you, Mr. Feldstein, for your patience and another outstanding performance, and I thank Mr. Niskanen and Mr. Poole.

This has been an excellent panel, and your contributions were most significant.

The committee stands in recess.

[Whereupon, at 12:45 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 7, 1984.]

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 7, 1984

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

The committee met, pursuant to recess, at 10:12 a.m., in room SR-485, Russell Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen and Representative Scheuer.

Also present: Ruth Kurtz and Sandra Masur, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Mr. Wallis, I am pleased that you are able to join us today to take part in this committee's annual report hearings.

Our disastrous trade performance is costing American jobs and increasing frictions between nations. It could lead to trade war or serious political confrontation with our allies. We hope that you can suggest policies that would enable us to avoid either of these calamitous outcomes.

Good international economic relations are critical to broadening our domestic economic recovery to include our exporting industries. As you know, despite the overall domestic economic resurgence last year, our trade deficit rose to an unprecedented level of $65 billion. This year, it is now projected to reach over $100 billion.

Most analysts cite three factors as principally responsible for our poor trade performance: the international debt problem; the lagging recovery abroad; and exchange rates. Key U.S. industries lost sales this past year as less developed countries, facing enormous debt burdens, cut back on the imports.

At the same time, slow growth in other countries further limited foreign demand for our goods, while the domestic recovery here stimulated imports. The skyrocketing dollar exacerbated these problems, often simply pricing U.S. goods out of the international market.

We look forward to hearing your recommendations for effective bilateral policies, as well as your views on the appropriate U.S. role in the multilateral trade and monetary institutions that govern our international relations.

Again, the three factors that most analysts cite as principally responsible for our poor trade performance are: the international debt problem; the lagging recovery abroad; and the exchange rates.

I hope that you will be able to comment on those areas. I would advise you that your prepared statement will be entered into the record as if read and I would now ask if Congressman Scheuer has any opening remarks?

Representative SCHEUER. No remarks, Mr. Chairman.

Senator JEPSEN. OK, Mr. Wallis, you may proceed, then, in any manner you so desire. Thank you, and welcome.

STATEMENT OF ALLEN WALLIS, UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS

Mr. WALLIS. Thank you and thank you for the opening remarks which give the setting in which we are working very admirably for such a concise statement.

This series of hearings on international economic policy provides a service not only to the Congress and the public, but also to the administration, by requiring us to focus from time to time on the broad picture and take our eyes off the day-to-day activities.

My task today is made easier by the testimony you have already received from Ambassador Brock, Secretary Regan, and others in senior economic positions in the administration. Rather than review the ground that they have covered, I will restrict my comments to the international aspects of the economic scene.

So with your indulgence, Mr. Chairman, I would like to preface my remarks with a few words on the relationship between domestic and international economic policy. My position as Under Secretary of State for Economic Affairs gives me a unique vantage point from which to comment on this issue.

One often hears the question—what is the administration's international economic policy?—or from less friendly people it will be, "The administration does not have an international economic policy."

That last comment, though it is intended to be derogatory, actually embodies some good economics. What the administration has is an economic policy, the same abroad as at home.

As I have traveled around the world, I have been struck by the validity of old-fashioned market economics, by the importance of keeping inflation under control, and by the stifling effects of governments. Good economic policy is good economic policy, whether the application is domestic or international.

What is different about "international" economic policy is not the economics, but the politics, and the politics are more domestic than international. Trade policy, for example, seems to be a quintessential example of international economic policy. But I see trade policy more as did the 19th century humorist, Ambrose Bierce. Bierce defined tariffs as devices "to protect the domestic producer against the greed of consumers."

Trade policy involves decisions about diverting the income of some groups in a country—for example, consumers of automobiles—for the benefit of other groups in the same country—for example, producers of automobiles. The policy may be carried out at the border by limiting access to the U.S. market, but both its beneficiaries and its victims are primarily domestic and only secondarily foreign.

During the 3 years of this administration, understanding has spread internationally that economic health is, first and foremost, the result of the economic policies followed at home. But I can testify from experience in numerous meetings at the OECD, with officials of scores of countries and at the economic summit, that there is still a long way to go. The idea dies slowly that a new international institution or a coordinated action program or massive transfer of resources will solve the problems of growth, employment, development or debts.

I can illustrate my point by referring to the economic summit meetings, which bring together the leaders of the seven major industrialized countries of the free world. As the President's personal representative for the summit, I directed preparations for last year's meeting in Williamsburg, and I will represent the President again in preparing for this year's summit at London, which will be the 10th such meeting.

The economic summit meetings are evolving in a more productive direction, providing more flexible and informal opportunities for consultation and collaboration and deemphasizing formal, negotiated, specific commitments. Earlier meetings focused on detailed coordination of macroeconomic policies, reflecting a view that the route to sustained growth lay in internationally concerted manipulation of demand—so-called fine tuning. These efforts were disappointing and may even have been counterproductive.

Although I will not take the time to do so now, it is instructive to compare the policy prescriptions in the Bonn Declaration of 1978 with the annex to the Williamsburg Declaration entitled "Strengthening Economic Cooperation for Growth and Stability."

At Williamsburg, the leaders rejected calls for quick fixes and reconfirmed a medium-term approach to economic policies first laid out in the annex to the Versailles communique. They recognized trade as the mechanism transmitting growth among countries, enlarging markets, increasing efficiency, and spurring more growth.

Understanding that pressures for protectionism represented a serious threat to a sustained and vigorous recovery, they pledged themselves to halt protectionism and as recovery proceeds, to reverse it by dismantling trade barriers.

A further danger dealt with at Williamsburg was the heavy burden of debt that hung over more than a score of developing countries. While achieving a lasting, vigorous recovery in the industrialized world was the key to a lasting solution to this problem, the immediate serious financial problems of certain countries, notably Mexico, Brazil, and Argentina, had to be managed if the recovery was to be sustained.

Finally, and most important, the major message from Williamsburg was that the steady application of anti-inflationary policies was promoting economic recovery, and that there would be continuation of policies favorable to sustained growth.

It is now clear that the confidence projected at Williamsburg 8 months ago was not just wishful thinking. Noninflationary recovery in the United States is now well established. Performance and prospects in other countries vary, of course, in large measure reflecting different degrees of success in reducing inflation. Strong linkages to the U.S. economy have also helped. The recovery in Canada closely mirrors that in the United States. Among other summit countries, growth in 1983 appears to have improved substantially in Japan, Germany, and the United Kingdom. Growth in France was weak or negative in 1983, but adjustment measures taken in France last year ought to bear fruit in 1984.

In many ways, 1983 was a watershed for the international economy. The prophets of gloom and doom were easy to find as the recession hit bottom in late 1982. In fact, a quick review of the forecasting record is revealing.

In July 1982, when full-year forecasts for 1983 were beginning to be presented, the consensus was that the United States would experience a very modest recovery—2 percent full year to full year. At that time, the outlook was generally thought to be weaker in the United States than in Europe or Japan.

Now as the year 1983 progressed, these consensus forecasts proved to be well removed from reality. By spring, the United States recovery was well underway. The Japanese economy was still weak and France was entering a recession. Germany was faced with weak domestic demand and the U.K. recovery seemed to be losing strength.

That shift in relative growth prospects and performance added to the attractiveness of dollar assets.

As we now know, even the midyear forecasts failed to grasp the full strength of the U.S. recovery. Output rose over 6 percent while inflation barely exceeded 3 percent, though forecasts of inflation in July 1982 had been 5½ percent.

Now despite the strong recovery, U.S. economic policies have been, and they continue to be, subject to considerable foreign criticism. This is natural, given our large weight in the world economy, our traditional leadership in international economic policy, and the natural inclination of human beings to look for scapegoats.

Opinion abroad has moved from doubts that a genuine recovery was occurring, to concern that it would be short lived or weak, to worry that it might be so rapid as to reignite inflation.

Recent foreign criticisms have focused on assertions that high U.S. budget deficits are causing high real interest rates, which, in turn, are causing the dollar to be too high and, thus, it is alleged, hindering recovery abroad.

Secretary Regan has addressed those fallacies in detail, so I will not repeat what he said, except to note that I agree with him.

The U.S. recovery has had far-reaching effects. As the recovery proceeded, the strong growth in U.S. imports has provided the major impetus to world trade. The strong dollar has substantially improved the competitive position of our trading partners, allowing them to take full advantage of the growth in our market, and compete effectively in third country markets.

The French trade deficit, for example, was cut in half last year primarily because of the increased competitiveness of French goods.

The deterioration in the U.S. trade and current account balances between 1982 and 1983 is estimated to be about $30 billion—that is, the deterioration was about $30 billion. That is a measure of the powerful trade stimulus provided to other countries. The vigor of our recovery has boosted confidence and eased concern about the fragility of the world financial system.

Now while I am on the subject of record trade deficits—the 1984 deficit is projected to exceed substantially the record $65 billion of 1983—I want to comment on the popular notion that restricting imports will help to reduce that deficit. If we lump goods and services together and look at the current account balance rather than the trade balance, we find that we are examining once again an international manifestation of a domestic phenomenon. The current account balance is always exactly equal to the difference between domestic savings and domestic investment. An excess of savings, as in Japan, goes with a surplus on current account. A deficit of savings, as in the United States, goes with a deficit on current account. Trade barriers alter the pattern of consumer spending, but not directly the level of spending. Similarly, commercial policy can affect the pattern of investment, but has no necessary impact on its level since trade restrictions favor some domestic industries at the expense of others.

Trade policy cannot, therefore, have more than a transitory influence on the size of the current account deficit.

Last week, Ambassador Brock ably reemphasized to you our dedication to the aim agreed to in Williamsburg to halt and reverse protectionism. As he explained, we are pursuing this objective through a number of avenues. On the bilateral front, we are working with the Japanese Government to gain better market access for U.S. products, and, in particular, for products of high technology and of agriculture. We have achieved some success already, notably on trade and semiconductors and access for telecommunications equipment. We expect progress in other areas as well.

With the European Economic Community, our efforts to deal with the increased use of export subsidies and market restrictions have, as Ambassador Brock pointed out, been less successful. As the recovery in Europe gains strength, however, we can hope for a reduction in protectionist pressures in Europe.

Work by the Trade Ministers of the United States, Canada, Japan, and the European Community is leading to specific steps in the short run to reduce trade barriers. These are small steps—acceleration of the tariff cuts agreed to in the Tokyo Round, for example, and granting duty-free entry to exports from the very poorest countries—but they are steps in the right direction and they are evidence that multilateral agreements to roll back protection can become reality.

In the longer term, we are putting a good deal of emphasis on a new round of trade negotiations as a comprehensive means to dismantle trade barriers and to improve the international trading climate.

Since the inception of the GATT—the General Agreement on Tariffs and Trade—repeated rounds of multilateral trade negotiations have provided the basis for the expanded liberalization of international trade. They have provided a framework for generating the political will to reduce barriers and they have provided also a liberalizing direction for the management of trade policy during difficult economic periods, making it easier for governments to resist protectionist pressures. It is time to consider the preparation of new multilateral negotiations.

Let me single out one area of trade policy which the Department of State considers of key importance in our foreign economic policy—the defense and promotion of U.S. interests in agriculture. Agricultural exports totaled $36 billion in 1982 and supported well over 1 million jobs.

Many countries have trade barriers that shut out agricultural products in order to protect less efficient domestic producers. In some cases, high price supports for domestic producers result in huge surpluses, which are then disposed of through the use of export subsidies. We have also been engaged in intensive discussions with the EC concerning the use of export subsidies and the proposed changes in the common agricultural policy which would result in further restricting access to the EC market.

Currently, we are in discussions with the Japanese to expand access to their market for products such as beef and citrus. The expansion of imports into Japan would benefit not only the U.S. exporters, but also Japanese consumers.

We are also participating in discussions in the GATT on ways to improve the effectiveness of international rules governing the conduct of agricultural trade. The major thrust of these efforts has been to restrict the use of export subsidies. We believe that improved international discipline is needed so that U.S. farmers can benefit from their great efficiency and spread those benefits to consumers everywhere.

The State Department works closely with the U.S. trade representative and with the U.S. Department of Agriculture in efforts to reduce barriers to agricultural trade.

Now, Mr. Chairman, I would like to examine with you an exception that proves the rule. I said earlier that good economic policy was not a question of international or domestic application. But there are cases which require us to pursue "bad" economic policy because of overriding foreign policy and security concerns. Trade with the Soviet Union and its allies is such an exception.

In looking at East-West trade and how it relates to our security, there are a number of distinctive features that we have to recognize. First, this is an area of economic activity where some Government intervention is necessary. The asymmetry of our societies, with many self-interested firms and individuals on our side and a security-conscious monolith on the other, dictates a role for government.

Second, we recognize that in many areas of East-West economic relations, it is difficult to decide where to draw the line between allowable and unallowable transactions and the decision often hinges on information that is not available to the public.

The third and most important feature of our East-West economic policy is our strong belief that the best approach to East-West economic relations is one that we can implement in conjunction with our allies and partners. After all, if we deny a sale to the Soviets and the Soviets can easily purchase an equivalent item somewhere else, not much is gained, and something may even be lost by our action. That was illustrated by the 1980 grain embargo in which the Soviets were able with only a very little inconvenience and a little additional expense, to replace the grain that we denied them.

Because we believe strongly that a collective approach is most effective in enhancing western security, we have worked very hard during the last 2 years with our allies and partners to enhance our common understanding of the interrelationship between economics and security and to develop a basic framework for the conduct of East-West economic relations.

The results achieved thus far are encouraging. The hopes of President Reagan and Secretary Shultz in undertaking a little over a year ago a series of studies on East-West economic relations have been borne out amply by the positive and constructive spirit in which they were conducted and by the results that have been achieved.

In fact, the policy conclusion based on those studies made it unnecessary for the summit leaders to spend much time at Williamsburg on that subject, though at Ottawa, in 1981, and at Versailles in 1982, it had generated a good deal of controversy.

The Williamsburg Declaration said:

> East-West economic relations should be compatible with our security interests. We take note with approval of the work of the multilateral organizations which have in recent months analyzed and drawn conclusions regarding the key aspects of East-West economic relations. We encourage continuing work by these organizations, as appropriate.

Let me just remind you of some of the major points on which the leaders based that statement.

First, they recognized that the Soviets use some forms of trade to enhance their military capabilities and that, as a result, we must be vigilant to ensure that economic relations are consistent with our common security interests. While some forms of trade conducted on commercially sound terms can benefit both sides, we must insist on a balance of advantages and avoid preferential treatment of the Soviets.

Second, in regard to energy, the United States and its partners recognize that natural gas, with its relatively inflexible supply system, poses particular security problems. We have agreed that in meeting future gas needs, we will take concrete steps to insure that no one producer is in a position to exercise monopoly power over industrial countries.

Further, we are also acting to encourage the production of natural gas from Norwegian and North American sources, and each nation is improving its safety net measure in order to be able to deal with any interruptions of supply.

The United States and its partners have agreed also to conduct regular review of each country's energy policy, giving special attention to dependencies and alternative sources of supply. We believe that these concrete accomplishments will enhance Western energy security and make it more difficult for the Soviets to use their abundant energy resources to extract political gains.

Third, we reached agreement that it is not sensible to continue to give the Soviets the same reduction on interest rates given to newly industrialized countries to finance their imports. Our agreed minimum interest rates for official lending to industrial countries, including the Soviets, is now 12.4 percent, which is above the current U.S. prime rate.

Also in the area of credits, we are working to improve our ability to monitor credit flows, so that our data on foreign indebtedness will be accurate and up to date.

Finally, in coordinating controls over the export of strategic technology, we are united with our allies in declaring that economic relations should not be permitted to contribute to Soviet military capabilities. At an April high-level meeting with our Cocom partners, we explored ways in which the multilateral system of controls could be strengthened. The proceedings of that meeting are confidential, but I can say that the United States is well pleased with the work on improving coordination and export licensing and in the enforcement of controls. We are confident that the results of the Cocom work will reduce the flow of high technology to the East.

In conclusion, Mr. Chairman, a few general observations on the role of the State Department in international economic issues.

As our world economy has become increasingly interdependent, two things have happened. First, the relative share of the United States in total world production and trade has shrunk. And second, the importance of trade to the U.S. economy has grown. This latter phenomenon has been translated into greater attention by the domestic agencies to international issues.

In this arena, the principal concerns of the State Department are for our foreign relations, concerns which are hard to measure in dollars and cents are not always understood. I must confess that my colleagues at the State Department do not always understand my concerns about actions that they believe are valuable from a foreign policy point of view.

So I find myself the nexus of misunderstanding. In carrying out this role, I attend a never-ending stream of meetings. On the domestic side, I represent the Secretary at the various Cabinet councils and other Cabinet-level groups, such as the Senior Interagency Group on International Economic Policy, that formulate policy options and recommendations for the President.

On the international side, I head the delegation to a series of bilateral economic consultations with the European Community, with Japan, with New Zealand, with Korea, with India, with Pakistan, with the Asian countries. And then there are the international organizations, most notably, the Organization for Economic Cooperation and Development and the Economic Summit, in which we propound and defend our view of successful economic policy.

My colleagues in the administration could extend that list to the IMF, the GATT, the World Bank, and other institutions which are more directly involved in negotiating the rules and resources of the international economic system.

There is a lot of institutional knowledge, folklore, and even mythology about all of this. But the basic principle that I follow, sitting where international and domestic forces merge, is the one that I stated at the beginning of my statement—good economic policy is good economic policy, whether it is applied domestically or internationally.

Thank you very much.

[The prepared statement of Mr. Wallis follows:]

Prepared Statement of Allen Wallis

MR. CHAIRMAN, IT IS A PLEASURE FOR ME TO PARTICIPATE IN THIS SERIES OF HEARINGS ON INTERNATIONAL ECONOMIC POLICY. YOUR COMMITTEE PROVIDES A SERVICE NOT ONLY TO THE CONGRESS AND THE PUBLIC, BUT ALSO TO THE ADMINISTRATION, BY REQUIRING US TO FOCUS FROM TIME TO TIME ON THE BROADER PICTURE. MY TASK TODAY IS MADE EASIER BY THE TESTIMONY YOU HAVE ALREADY RECEIVED FROM AMBASSADOR BROCK, SECRETARY REGAN AND OTHERS IN SENIOR ECONOMIC POLICY POSITIONS IN THE ADMINISTRATION. RATHER THAN REVIEW GROUND THAT THEY HAVE COVERED, I WILL RESTRICT MY OPENING COMMENTS TO THE MORE PURELY INTERNATIONAL ASPECTS OF THE ECONOMIC SCENE.

WITH YOUR INDULGENCE, MR. CHAIRMAN, MAY I PREFACE MY REMARKS WITH A FEW WORDS ON THE RELATIONSHIP BETWEEN DOMESTIC AND INTERNATIONAL ECONOMIC POLICY. MY POSITION AS UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS GIVES ME A UNIQUE VANTAGE POINT FROM WHICH TO COMMENT ON THIS ISSUE. ONE OFTEN HEARS THE QUESTION "WHAT IS THE ADMINISTRATION'S INTERNATIONAL ECONOMIC POLICY?" OR FROM PERHAPS LESS FRIENDLY FOLKS: "THE ADMINISTRATION HAS NO INTERNATIONAL ECONOMIC POLICY!" THIS SEEMING DEROGATORY COMMENT HAS A LOT OF GOOD ECONOMICS EMBODIED IN IT.

AS I TRAVEL AROUND THE WORLD (FAR MORE THAN I CARE TO), I AM STRUCK BY THE VALIDITY OF OLD-FASHIONED MARKET ECONOMICS, BY THE IMPORTANCE OF KEEPING INFLATION UNDER CONTROL, BY THE STIFLING INFLUENCE OF GOVERNMENT RULES, REGULATIONS, AND RED TAPE. GOOD ECONOMIC POLICY IS GOOD ECONOMIC POLICY WHETHER THE APPLICATION IS DOMESTIC OR INTERNATIONAL. IF THE PROPOSED BUDGET DEFICITS FOR FY 84 AND BEYOND ARE TOO LARGE (AND I AGREE WITH THE PRESIDENT THEY ARE), THEN THEY ARE MORE HARMFUL TO US AT HOME THAN TO OTHERS. IF SO-CALLED "LOCAL CONTENT" REQUIREMENTS HURT JAPANESE PRODUCERS BY RESTRICTING THEIR ABILITY TO SELL IN OUR MARKETS, THEY HURT US MORE BY LIMITING CONSUMER CHOICE, MAKING AUTOS MORE EXPENSIVE AND, MOST BROADLY, ARTIFICIALLY DIVERTING LABOR AND CAPITAL INTO LESS PRODUCTIVE USES.

IN SHORT, WHAT IS DIFFERENT ABOUT "INTERNATIONAL" ECONOMIC POLICY IS NOT THE ECONOMICS, BUT THE INTRODUCTION OF DOMESTIC AND INTERNATIONAL POLITICAL CONCERNS INTO THE MAKING OF ECONOMIC POLICY. FOR EXAMPLE, TRADE POLICY SEEMS TO BE A QUINTESSENTIAL EXAMPLE OF INTERNATIONAL ECONOMIC POLICY. BUT I SEE TRADE POLICY MORE IN THE TERMS USED BY THE 19th CENTURY HUMORIST AMBROSE BIERCE WHO DEFINES TARIFFS AS DEVICES "TO PROTECT THE DOMESTIC PRODUCER AGAINST THE GREED OF HIS CONSUMERS." TRADE POLICY INVOLVES DECISIONS ABOUT REDUCING THE

INCOME OF SOME GROUPS IN A COUNTRY (FOR EXAMPLE, CONSUMERS OF AUTOMOBILES) IN ORDER TO RETAIN OR INCREASE THE PURCHASING POWER OF OTHER GROUPS IN THE SAME COUNTRY (FOR EXAMPLE, PRODUCERS OF AUTOMOBILES). THE POLICY MAY BE CARRIED OUT AT THE BORDER BY LIMITING ACCESS TO THE U.S. MARKET, CREATING ECONOMIC PROBLEMS FOR FOREIGN PRODUCERS AND POLITICAL PROBLEMS FOR BOTH THE U.S. AND THE COUNTRIES OF ORIGIN OF THE INPUTS, BUT ITS MOTIVATION IS DOMESTIC.

DURING THE THREE YEARS OF THIS ADMINISTRATION, WE HAVE COME A LONG WAY IN INSTILLING THE NOTION IN THE INTERNATIONAL COMMUNITY THAT ECONOMIC HEALTH IS FIRST AND FOREMOST THE RESULT OF THE ECONOMIC POLICIES FOLLOWED AT HOME. BUT I CAN TESTIFY FROM EXPERIENCE IN NUMEROUS MEETINGS AT THE OECD, WITH OFFICIALS OF SCORES OF COUNTRIES AND AT THE ECONOMIC SUMMIT - WE HAVE A LONG WAY TO GO. THE IDEA DIES SLOWLY THAT A NEW INTERNATIONAL INSTITUTION, OR A COORDINATED ACTION PROGRAM, OR MASSIVE TRANSFER OF RESOURCES WILL SOLVE THE PROBLEMS OF GROWTH, EMPLOYMENT, DEVELOPMENT, OR DEBTS.

I MIGHT USEFULLY ILLUSTRATE MY REMARKS FROM THE PERSPECTIVE OF THE ECONOMIC SUMMIT MEETINGS, WHICH BRING TOGETHER THE LEADERS OF THE SEVEN MAJOR INDUSTRIALIZED COUNTRIES OF THE FREE WORLD. AS THE PRESIDENT'S PERSONAL REPRESENTATIVE FOR THE SUMMIT, I DIRECTED PREPARATIONS FOR LAST

YEAR'S MEETING IN WILLIAMSBURG. I WILL BE DOING THE SAME FOR THIS YEAR'S SUMMIT IN THE UNITED KINGDOM, WHICH WILL MARK THE TENTH YEAR OF SUCH MEETINGS.

I BELIEVE THESE ECONOMIC SUMMIT MEETINGS HAVE RECENTLY BEEN EVOLVING IN A MORE PRODUCTIVE DIRECTION, PROVIDING A MORE FLEXIBLE AND INFORMAL OPPORTUNITY FOR CONSULTATION AND COLLABORATION, AND DE-EMPHASIZING THE NEED FOR FORMAL, NEGOTIATED, SPECIFIC COMMITMENTS AS AN INDEX OF SUCCESS. EARLIER MEETINGS HAD FOCUSED ON DETAILED COORDINATION OF MACROECONOMIC POLICIES, REFLECTING THE VIEW THAT THE ROUTE TO SUSTAINED GROWTH LAY IN INTERNATIONALLY CONCERTED MANIPULATION OF DEMAND -- SO-CALLED "FINE-TUNING." THESE EFFORTS WERE NOT ONLY DISAPPOINTING, THEY MAY HAVE CONTRIBUTED TO THE INSTABILITY WHICH WE ONLY NOW HAVE BEGUN TO CONTROL. ALTHOUGH I WILL NOT TAKE THE TIME TO DO SO NOW, IT IS INSTRUCTIVE TO COMPARE THE POLICY PRESCRIPTIONS IN THE BONN DECLARATION OF 1978 WITH THE ANNEX TO THE WILLIAMSBURG DECLARATION, ENTITLED "STRENGTHENING ECONOMIC COOPERATION FOR GROWTH AND STABILITY".

AT WILLIAMSBURG THE LEADERS REJECTED CALLS FOR QUICK-FIX POLICIES INSTEAD AND RECONFIRMED A MEDIUM-TERM APPROACH TO ECONOMIC POLICIES FIRST LAID OUT IN THE ANNEX TO THE VERSAILLES COMMUNIQUE. THEY RECOGNIZED TRADE AS THE MECHANISM TRANSMITTING GROWTH AMONG COUNTRIES, ENLARGING MARKETS,

INCREASING EFFICIENCY, AND SPURRING MORE GROWTH. UNDERSTANDING THAT PRESSURES FOR PROTECTIONISM REPRESENTED A SERIOUS THREAT TO A SUSTAINED AND VIGOROUS RECOVERY, THEY PLEDGED THEMSELVES "TO HALT PROTECTIONISM AND AS RECOVERY PROCEEDS, TO REVERSE IT BY DISMANTLING TRADE BARRIERS." A FURTHER DANGER DEALT WITH AT WILLIAMSBURG WAS THE HEAVY BURDEN OF DEBT THAT HUNG OVER MORE THAN A SCORE OF DEVELOPING COUNTRIES. WHILE ACHIEVING A LASTING, VIGOROUS RECOVERY IN THE INDUSTRIALIZED WORLD WAS THE KEY TO A LASTING SOLUTION TO THIS PROBLEM, THE IMMEDIATE SERIOUS FINANCIAL PROBLEMS OF CERTAIN COUNTRIES, NOTABLY MEXICO, BRAZIL, AND ARGENTINA, HAD TO BE MANAGED IF THE RECOVERY WAS TO BE SUSTAINED. FINALLY, AND MOST IMPORTANT, THE MAJOR MESSAGE FROM WILLIAMSBURG WAS CONFIDENCE THAT THE STEADY APPLICATION OF ANTI-INFLATIONARY POLICIES WAS BEARING FRUIT IN ECONOMIC RECOVERY, AND ASSURANCE THAT POLICIES WOULD CONTINUE TO PROVIDE A FAVORABLE ENVIRONMENT FOR SUSTAINED GROWTH.

IT IS NOW CLEAR THAT THE CONFIDENCE PROJECTED AT WILLIAMSBURG, NEARLY EIGHT MONTHS AGO, WAS NOT JUST WISHFUL THINKING. NON-INFLATIONARY RECOVERY IN THE UNITED STATES IS NOW WELL ESTABLISHED. PERFORMANCE AND PROSPECTS IN OTHER COUNTRIES VARY OF COURSE, IN LARGE MEASURE REFLECTING DIFFERENT DEGREES OF SUCCESS IN REDUCING INFLATION. STRONG LINKAGES TO THE U.S. ECONOMY HAVE ALSO HELPED. AS THE STRENGTH OF THE RECOVERY IN CANADA CLOSELY MIRRORS THAT IN THE UNITED STATES.

AMONG OTHER SUMMIT COUNTRIES, GROWTH OVER THE FOUR QUARTERS OF 1983 APPEARS TO HAVE ALSO IMPROVED SUBSTANTIALLY FROM THE PREVIOUS YEAR IN JAPAN, GERMANY, AND THE UNITED KINGDOM. GROWTH IN FRANCE WAS WEAK OR NEGATIVE IN 1983, BUT THEIR DELAYED ADJUSTMENT MEASURES SHOULD BEAR FRUIT IN A PICKUP IN 1984.

IN MANY WAYS, 1983 WAS A WATERSHED FOR THE INTERNATIONAL ECONOMY. THE PROPHETS OF GLOOM AND DOOM WERE EASY TO FIND AS THE RECESSION HIT BOTTOM IN LATE 1982. A QUICK REVIEW OF THE FORECASTING RECORD IS, I BELIEVE, REVEALING.

IN JULY, 1982, WHEN FULL YEAR FORECASTS FOR 1983 WERE BEGINNING TO BE PRESENTED, THE CONSENSUS WAS THAT THE U.S. WOULD EXPERIENCE A VERY MODEST RECOVERY -- TWO PERCENT (YR/YR). AT THAT TIME, THE U.S. OUTLOOK WAS GENERALLY THOUGHT TO BE A LITTLE WEAKER THAN THE EXPECTED REAL GROWTH RATES IN EUROPE OR JAPAN.

AS THE YEAR 1983 PROGRESSED, THESE CONSENSUS FORECASTS PROVED TO BE WELL REMOVED FROM REALITY. BY EARLY SUMMER, THE U.S. RECOVERY WAS WELL UNDERWAY. U.S. INFLATION PERFORMANCE CONTINUED TO IMPRESS THE MARKETS AS FORECASTS FOR THE YEAR HAD SHIFTED DOWNWARD FROM 5-1/2 PERCENT IN JULY 1982 to 4 PERCENT IN JULY 1983. THE JAPANESE ECONOMY WAS WEAK, FRANCE WAS

ENTERING A RECESSION, GERMANY WAS FACED WITH WEAK DOMESTIC DEMAND, AND THE U.K. RECOVERY SEEMED TO BE LOSING STRENGTH. THIS SHIFT IN RELATIVE GROWTH PROSPECTS AND PERFORMANCE ADDED TO THE ATTRACTIVENESS OF DOLLAR ASSETS.

AS WE NOW KNOW, EVEN THE MID-YEAR FORECASTS FAILED TO GRASP THE STRENGTH OF THE U.S. RECOVERY. OUTPUT ROSE OVER SIX PERCENT WHILE INFLATION BARELY EXCEEDED 3 PERCENT.

DESPITE THE STRONG RECOVERY, U.S. ECONOMIC POLICIES, AS SO OFTEN IN THE PAST, HAVE BEEN SUBJECT TO CONSIDERABLE FOREIGN CRITICISM. THIS IS NATURAL, GIVEN OUR LARGE WEIGHT IN THE WORLD ECONOMY AND OUR TRADITIONAL LEADERSHIP ROLE IN INTERNATIONAL ECONOMIC POLICY. OPINION ABROAD HAS MOVED FROM DOUBTS THAT A GENUINE RECOVERY WAS OCCURRING, TO CONCERN THAT IT WOULD BE SHORT-LIVED OR WEAK, TO WORRY THAT IT MIGHT BE SO RAPID AS TO RE-IGNITE INFLATION AND BOOST INTEREST RATES. RECENTLY FOREIGN CRITICISMS HAVE FOCUSED ON THE PERCEPTION THAT HIGH U.S. REAL INTEREST RATES RESULTING FROM BUDGET DEFICITS AND THE RESULTING STRONG DOLLAR ARE HINDERING RECOVERY ABROAD. SECRETARY REGAN HAS ADDRESSED THE FALLACIES OF THIS LINE OF ARGUMENT IN DETAIL - AND I WILL NOT REPEAT WHAT HE HAS SAID, EXCEPT TO SAY THAT I AGREE WITH HIM.

THE U.S. RECOVERY HAS HAD FAR REACHING EFFECTS. AS THE RECOVERY PROCEEDED, THE STRONG GROWTH IN U.S. IMPORTS HAS PROVIDED THE MAJOR IMPETUS TO WORLD TRADE. THE STRONG DOLLAR HAS SUBSTANTIALLY IMPROVED THE COMPETITIVE POSITION OF OUR TRADING PARTNERS, ALLOWING THEM TO TAKE FULL ADVANTAGE OF THE GROWTH IN OUR MARKET, AND COMPETE EFFECTIVELY IN THIRD COUNTRY MARKETS. (I MIGHT NOTE FOR EXAMPLE THAT THE FRENCH TRADE DEFICIT WAS CUT IN HALF LAST YEAR DUE PRIMARILY TO THE INCREASED COMPETITIVENESS OF FRENCH GOODS.) THE ESTIMATED $30 BILLION DETERIORATION IN THE U.S. TRADE AND CURRENT ACCOUNT BALANCES BETWEEN 1982 AND 1983 IS A MEASURE OF THE POWERFUL TRADE STIMULUS PROVIDED TO OTHER INDUSTRIALIZED COUNTRIES AND TO LDCs. JUST AS IMPORTANT PERHAPS MAY HAVE BEEN THE PSYCHOLOGICAL IMPACT OF SEEING THE U.S. RECOVERY ACHIEVE THE STRENGTH TYPICAL OF THE EARLY STAGES OF POST-WAR U.S. UPTURNS, DESPITE RECESSION AND FINANCIAL PROBLEMS ABROAD, AND HIGH DEFICITS AND INTEREST RATES AT HOME. THE DEMONSTRATION EFFECT OF OUR RECOVERY BOOSTED CONFIDENCE AND EASED CONCERN ABOUT THE FRAGILITY OF THE WORLD FINANCIAL SYSTEM.

WHILE ON THE SUBJECT OF THE RECORD TRADE DEFICITS - WITH THE '84 DEFICIT PROJECTED TO EXCEED SUBSTANTIALLY THE RECORD $65 BILLION OF 1983 - I WANT TO COMMENT ON THE POPULAR NOTION THAT RESTRICTING IMPORTS WILL HELP REDUCE THAT DEFICIT. IF WE LUMP GOODS AND SERVICES TOGETHER AND LOOK AT THE CURRENT

ACCOUNT BALANCE RATHER THAN THE TRADE BALANCE, WE FIND THAT WE ARE EXAMINING, ONCE AGAIN, AN INTERNATIONAL MANIFESTATION OF A DOMESTIC PHENOMENON. THE CURRENT ACCOUNT BALANCE IS ALWAYS EXACTLY EQUAL TO THE DIFFERENCE BETWEEN DOMESTIC SAVINGS AND DOMESTIC INVESTMENT. AN EXCESS OF SAVINGS (AS IN JAPAN) GOES WITH A SURPLUS ON CURRENT ACCOUNT; A SHORTAGE OF SAVINGS (AS IN THE U.S.) GOES WITH A DEFICIT." TRADE BARRIERS WILL ALTER THE PATTERN OF CONSUMER SPENDING BUT NOT, DIRECTLY, THE LEVEL OF SPENDING. SIMILARLY, COMMERCIAL POLICY CAN AFFECT THE PATTERN OF INVESTMENT BUT HAS NO NECESSARY IMPACT ON ITS LEVEL SINCE TRADE RESTRICTIONS FAVOR SOME DOMESTIC INDUSTRIES AT THE EXPENSE OF OTHERS. TRADE POLICY CANNOT, THEREFORE, HAVE MORE THAN A TRANSITORY INFLUENCE ON THE SIZE OF THE CURRENT ACCOUNT DEFICIT.

LAST WEEK AMBASSADOR BROCK ABLY REEMPHASIZED TO YOU OUR DEDICATION TO THE AGREED AIM IN WILLIAMSBURG TO HALT AND REVERSE PROTECTIONISM. AS HE OUTLINED, WE ARE PURSUING THIS OBJECTIVE THROUGH A NUMBER OF AVENUES. ON THE BILATERAL SIDE WE ARE WORKING WITH THE JAPANESE GOVERNMENT TO GAIN BETTER MARKET ACCESS FOR U.S. PRODUCTS, IN PARTICULAR IN HIGH TECH AREAS AND AGRICULTURE. WE HAVE ACHIEVED SOME SUCCESS, NOTABLY ON TRADE IN SEMI-CONDUCTORS AND ACCESS FOR TELECOMMUNICATIONS EQUIPMENT. WE HOPE FOR AND EXPECT PROGRESS IN OTHER AREAS AS WELL. OUR EFFORTS TO DEAL WITH THE INCREASED USE OF EXPORT

SUBSIDIES AND MARKET RESTRICTION IN THE EUROPEAN COMMUNITY HAVE, AS AMBASSADOR BROCK HAS POINTED OUT, BEEN LESS SUCCESSFUL. HOWEVER, AS THE RECOVERY IN EUROPE GAINS STRENGTH, WE CAN HOPE FOR A DIMINUTION OF DOMESTIC PROTECTIONIST PRESSURES IN EUROPE AND GREATER RECEPTIVITY ON THEIR PART TO REACHING AGREEMENT ON OUR OUTSTANDING PROBLEMS WITH THEIR POLICIES.

WORK IN A SMALL GROUP OF TRADE MINISTERS FROM THE U.S., CANADA, JAPAN AND THE EUROPEAN COMMUNITY IS LEADING TO SPECIFIC STEPS IN THE SHORT-TERM TO REDUCE TRADE BARRIERS. THESE ARE SMALL STEPS -- ACCELERATION OF TARIFF CUTS AGREED IN THE TOKYO-ROUND; GRANTING DUTY-FREE ENTRY TO EXPORTS FROM THE VERY POOREST COUNTRIES; -- BUT ARE STEPS IN THE RIGHT DIRECTION. MORE IMPORTANTLY, THEY ARE EVIDENCE THAT MULTILATERAL AGREEMENTS TO ROLL BACK PROTECTION CAN BECOME REALITY.

IN THE LONGER-TERM, WE ARE PUTTING A GOOD DEAL OF EMPHASIS ON A NEW ROUND OF TRADE NEGOTIATIONS AS A COMPREHENSIVE MEANS TO DISMANTLE TRADE BARRIERS AND TO IMPROVE THE INTERNATIONAL TRADING CLIMATE. SINCE THE INCEPTION OF THE GATT, REPEATED ROUNDS OF MULTILATERAL TRADE NEGOTIATIONS HAVE PROVIDED THE BASIS FOR THE EXPANDED LIBERALIZATION OF INTERNATIONAL TRADE. THEY HAVE PROVIDED A FRAMEWORK FOR ORGANIZING THE POLITICAL WILL TO REDUCE BARRIERS; THEY HAVE ALSO PROVIDED A LIBERALIZING

DIRECTION FOR THE ONGOING MANAGEMENT OF TRADE POLICY DURING DIFFICULT ECONOMIC PERIODS, MAKING IT EASIER FOR GOVERNMENTS TO RESIST PROTECTIONIST PRESSURES. IT IS TIMELY TO CONSIDER THE PREPARATION OF NEW MULTILATERAL NEGOTIATIONS.

LET ME ZERO IN ON ONE AREA OF TRADE POLICY WHICH THE DEPARTMENT OF STATE CONSIDERS AS A KEY OBJECTIVE OF OUR FOREIGN ECONOMIC POLICY: THE DEFENSE AND PROMOTION OF U.S. INTERESTS IN AGRICULTURE, WITH AGRICULTURAL EXPORTS TOTALING $36 BILLION IN 1982 AND WELL OVER A MILLION JOBS.

MANY COUNTRIES HAVE TRADE BARRIERS THAT SHUT OUT IMPORTED AGRICULTURAL PRODUCTS TO PROTECT RELATIVELY LESS EFFICIENT DOMESTIC PRODUCERS. IN SOME CASES HIGH PRICE SUPPORTS FOR PROTECTED DOMESTIC PRODUCERS RESULT IN HUGE SURPLUSES WHICH ARE THEN DISPOSED OF THROUGH THE USE OF EXPORT SUBSIDIES. WE ARE ACTIVELY ENGAGED IN DISCUSSIONS WITH THE JAPANESE TO EXPAND ACCESS TO THEIR MARKET IN PRODUCTS SUCH AS BEEF AND CITRUS. THE EXPANSION OF IMPORTS WOULD BENEFIT NOT ONLY U.S. EXPORTERS BUT ALSO JAPANESE CONSUMERS WHO BEAR THE COST OF THE PROTECTION FOR FARMERS. WE HAVE ALSO BEEN ENGAGED IN INTENSIVE DISCUSSIONS WITH THE EC CONCERNING THE USE OF EXPORT SUBSIDIES AND PROPOSED CHANGES IN THE COMMON AGRICULTURAL POLICY WHICH WOULD RESULT IN FURTHER RESTRICTING ACCESS TO THE EC MARKET.

WE ARE ALSO PARTICIPATING IN DISCUSSIONS IN THE GATT ON WAYS TO IMPROVE THE EFFECTIVENESS OF INTERNATIONAL RULES GOVERNING THE CONDUCT OF AGRICULTURAL TRADE. THE MAJOR FORCE OF THESE EFFORTS HAS BEEN IN RESTRICTING THE USE OF EXPORT SUBSIDIES. WE BELIEVE THAT IMPROVED INTERNATIONAL DISCIPLINE IS NEEDED SO THAT U.S. FARMERS CAN BENEFIT FROM THEIR COMPARATIVE ADVANTAGE. AT THE STATE DEPARTMENT WE WORK CLOSELY WITH USTR AND USDA TO STRENGTHEN THESE RULES AS PART OF OUR EFFORTS TO REDUCE BARRIERS TO AGRICULTURAL TRADE.

NOW, MR. CHAIRMAN, I WOULD LIKE TO EXAMINE WITH YOU THE EXCEPTION THAT PROVES THE RULE. I SAID EARLIER THAT GOOD ECONOMIC POLICY WAS NOT A QUESTION OF INTERNATIONAL OR DOMESTIC APPLICATION. BUT THERE ARE CASES WHICH REQUIRE US TO PURSUE "BAD" ECONOMIC POLICY BECAUSE OF OVERRIDING FOREIGN POLICY AND SECURITY CONCERNS. (I MIGHT NOTE THAT THIS KIND OF EXCEPTION IS NOT UNIQUE TO INTERNATIONAL AFFAIRS - WITNESS THE LITERATURE ON THE COSTS AND BENEFITS OF STRIKES TO SETTLE LABOR RELATIONS DISPUTES. THE MEASURABLE LOSS FROM A PROLONGED STRIKE IS SELDOM MADE UP IN THE SUBSEQUENT CONTRACT.) TRADE WITH THE SOVIET UNION AND ITS ALLIES IS SUCH AN EXCEPTION.

IN LOOKING AT EAST-WEST TRADE AND HOW IT RELATES TO OUR SECURITY, THERE ARE A NUMBER OF DISTINCTIVE FEATURES THAT WE

MUST RECOGNIZE. FIRST, UNCHARACTERISTICALLY FOR THIS ADMINISTRATION AND FOR ME PERSONALLY, THIS IS AN AREA OF ECONOMIC ACTIVITY WHERE SOME GOVERNMENT INTERVENTION IS NECESSARY AND, INDEED, CRUCIAL. THE ASYMMETRY OF OUR TWO SOCIETIES, WITH MANY SELF-INTERESTED FIRMS AND INDIVIDUALS ON OUR SIDE AND A SECURITY-CONSCIOUS MONOLITH ON THE OTHER, DICTATES A ROLE FOR GOVERNMENT.

SECOND, WE RECOGNIZE THAT IN MANY AREAS OF EAST-WEST ECONOMIC RELATIONS, IT IS DIFFICULT TO DECIDE WHERE TO DRAW THE LINE BETWEEN ALLOWABLE AND IMPERMISSIBLE TRANSACTIONS.

THE THIRD AND MOST IMPORTANT FEATURE OF OUR EAST-WEST ECONOMIC POLICY IS OUR STRONG BELIEF THAT THE BEST APPROACH TO EAST-WEST ECONOMIC RELATIONS IS ONE THAT WE CAN IMPLEMENT IN CONJUNCTION WITH OUR ALLIES AND PARTNERS. AFTER ALL, IF WE DENY A SALE AND THE SOVIETS CAN EASILY PURCHASE AN EQUIVALENT ITEM ELSEWHERE, NOT MUCH IS GAINED -- AND SOMETHING MAY BE LOST -- BY OUR ACTION. THIS PRINCIPLE WAS MOST VIVIDLY ILLUSTRATED BY THE 1980 GRAIN EMBARGO, IN WHICH THE SOVIETS WERE ABLE, WITH SOME INCONVENIENCE AND ADDITIONAL EXPENSE, TO REPLACE MOST OF THE GRAIN THAT WE DENIED THEM.

BECAUSE WE BELIEVE SO STRONGLY THAT A COLLECTIVE APPROACH WOULD BE MOST EFFECTIVE IN ENHANCING WESTERN SECURITY, THE U.S.

HAS WORKED VERY HARD OVER THE LAST TWO YEARS WITH ITS ALLIES AND PARTNERS TO ENHANCE OUR COMMON UNDERSTANDING OF THE INTERRELATIONSHIP BETWEEN ECONOMICS AND SECURITY AND TO DEVELOP A BASIC FRAMEWORK FOR THE CONDUCT OF EAST-WEST ECONOMIC RELATIONS.

THE RESULTS ACHIEVED THUS FAR ARE ENCOURAGING. THE HOPES OF PRESIDENT REAGAN AND SECRETARY SHULTZ IN UNDERTAKING A SERIES OF STUDIES ON EAST/WEST ECONOMIC RELATIONS HAVE BEEN BORNE OUT AMPLY BY THE POSITIVE AND CONSTRUCTIVE SPIRIT IN WHICH THEY WERE CONDUCTED AND BY THE RESULTS THAT HAVE BEEN ACHIEVED. IN FACT, THE POLICY CONCLUSIONS BASED ON THOSE STUDIES MADE IT UNNECESSARY FOR THE SUMMIT LEADERS TO SPEND MUCH TIME AT WILLIAMSBURG ON THIS SUBJECT. IN THE WILLIAMSBURG DECLARATION, THEY SAID:

"EAST-WEST ECONOMIC RELATIONS SHOULD BE COMPATIBLE WITH OUR SECURITY INTERESTS. WE TAKE NOTE WITH APPROVAL OF THE WORK OF THE MULTILATERAL ORGANIZATIONS WHICH HAVE IN RECENT MONTHS ANALYZED AND DRAWN CONCLUSIONS REGARDING THE KEY ASPECTS OF EAST-WEST ECONOMIC RELATIONS. WE ENCOURAGE CONTINUING WORK BY THESE ORGANIZATIONS, AS APPROPRIATE."

LET ME REVIEW FOR YOU SOME OF THE MAJOR POINTS ON WHICH THE LEADERS BASED THIS STATEMENT.

FIRST, THEY RECOGNIZE THAT THE SOVIETS USE SOME FORMS OF TRADE TO ENHANCE THEIR MILITARY CAPABILITIES AND THAT, AS A RESULT, WE MUST BE VIGILANT TO ENSURE THAT ECONOMIC RELATIONS ARE CONSISTENT WITH OUR COMMON SECURITY INTERESTS. WHILE SOME FORMS OF TRADE THAT ARE CONDUCTED ON COMMERCIALLY SOUND TERMS CAN BENEFIT BOTH SIDES, WE MUST INSIST ON A BALANCE OF ADVANTAGES AND AVOID PREFERENTIAL TREATMENT OF THE SOVIETS.

SECOND, IN REGARD TO ENERGY, THE UNITED STATES AND ITS PARTNERS RECOGNIZE THAT NATURAL GAS, WITH ITS RELATIVELY INFLEXIBLE SUPPLY SYSTEM, POSES PARTICULAR SECURITY PROBLEMS. WE HAVE AGREED THAT, IN MEETING FUTURE GAS NEEDS, WE WILL TAKE CONCRETE STEPS TO ENSURE THAT NO ONE PRODUCER IS IN A POSITION TO EXERCISE MONOPOLY POWER OVER INDUSTRIAL COUNTRIES. FURTHER, WE ARE ALSO ACTING TO ENCOURAGE THE PRODUCTION OF NATURAL GAS FROM NORWEGIAN AND NORTH AMERICAN SOURCES, AND EACH NATION IS IMPROVING ITS SAFETY-NET MEASURES IN ORDER TO BE ABLE TO DEAL WITH ANY INTERRUPTIONS OF SUPPLY. THE UNITED STATES AND ITS PARTNERS HAVE AGREED ALSO TO CONDUCT REGULAR REVIEWS OF EACH COUNTRY'S ENERGY POLICY, GIVING SPECIAL ATTENTION TO

DEPENDENCIES AND ALTERNATIVE SOURCES OF SUPPLY. WE BELIEVE THAT THESE CONCRETE ACCOMPLISHMENTS WILL ENHANCE WESTERN ENERGY SECURITY AND MAKE IT MORE DIFFICULT FOR THE SOVIETS TO USE ITS ABUNDANT ENERGY RESOURCES TO EXTRACT POLITICAL GAINS.

THIRD, WE REACHED AGREEMENT THAT IT IS NOT SENSIBLE TO CONTINUE TO GIVE THE SOVIETS THE SAME REDUCTIONS ON INTEREST RATES GIVEN TO NEWLY INDUSTRIALIZED COUNTRIES TO FINANCE THEIR IMPORTS. OUR AGREED MINIMUM INTEREST RATE FOR OFFICIAL LENDING TO RICH COUNTRIES, INCLUDING THE SOVIETS IS NOW 12.4% - ABOVE THE CURRENT U.S. PRIME RATE. ALSO IN THE AREA OF CREDITS, WE ARE WORKING TO IMPROVE OUR ABILITY TO MONITOR CREDIT FLOWS, SO THAT OUR DATA ON FOREIGN INDEBTEDNESS WILL BE ACCURATE AND UP TO DATE.

FINALLY, IN COORDINATING CONTROLS OVER THE EXPORT OF STRATEGIC TECHNOLOGY, WE ARE UNITED WITH OUR ALLIES IN DECLARING THAT ECONOMIC RELATIONS SHOULD NOT BE PERMITTED TO CONTRIBUTE TO SOVIET MILITARY CAPABILITIES. AT AN APRIL HIGH LEVEL MEETING WITH OUR COCOM PARTNERS WE EXPLORED WAYS IN WHICH THE MULTILATERAL SYSTEM OF CONTROLS COULD BE STRENGTHENED. THE PROCEEDINGS OF THE MEETING ARE CONFIDENTIAL, BUT I CAN SAY THAT THE UNITED STATES IS WELL PLEASED WITH THE WORK ON IMPROVING COORDINATION IN EXPORT LICENSING AND IN THE ENFORCEMENT OF

CONTROLS. WE ARE CONFIDENT THAT THE RESULTS OF THE COCOM WORK WILL REDUCE THE FLOW OF HIGH TECHNOLOGY TO THE EAST.

IN CONCLUSION, MR. CHAIRMAN, A FEW WORDS ON THE ROLE OF THE STATE DEPARTMENT IN INTERNATIONAL ECONOMIC ISSUES. I OFTEN FEEL LIKE THE UGLY DUCKLING OF THE FEDERAL BUREAUCRACY - BUT WITHOUT A GOOD PROSPECT OF BECOMING A SWAN. AS OUR WORLD ECONOMY HAS BECOME INCREASINGLY INTERDEPENDENT, TWO THINGS HAVE HAPPENED - FIRST, THE RELATIVE SHARE OF THE UNITED STATES IN TOTAL WORLD PRODUCTION AND TRADE HAS SHRUNK, WHILE SECOND, THE IMPORTANCE OF TRADE TO THE U.S. ECONOMY HAS GROWN. THIS LATTER PHENOMENON HAS BEEN TRANSLATED INTO GREATER ATTENTION BY THE "DOMESTIC" AGENCIES TO INTERNATIONAL ISSUES. IN THIS ARENA, THE PRINCIPAL CONCERNS OF THE STATE DEPARTMENT FOR OUR FOREIGN RELATIONS - CONCERNS WHICH ARE HARD TO MEASURE IN DOLLARS AND CENTS - ARE NOT ALWAYS FULLY UNDERSTOOD. AND I MUST CONFESS THAT MY COLLEAGUES AT STATE DO NOT ALWAYS UNDERSTAND MY CONCERNS ABOUT ACTIONS THEY BELIEVE ARE VALUABLE IN THE FOREIGN POLICY ARENA.

SO I FIND MYSELF THE NEXUS OF MISUNDERSTANDING - PERHAPS AN APPROPRIATE PLACE FOR AN EDUCATOR TO HELP ENLIGHTEN BOTH SIDES WITH THE VIEWS OF THE OTHER. IN CARRYING OUT THIS ROLE, I ATTEND A NEVER-ENDING STREAM OF MEETINGS. ON THE DOMESTIC

SIDE, I REPRESENT THE SECRETARY AT THE VARIOUS CABINET COUNCILS AND OTHER CABINET-LEVEL GROUPS (SUCH AS THE SENIOR INTERAGENCY GROUP ON INTERNATIONAL ECONOMIC POLICY) THAT FORMULATE POLICY OPTIONS AND RECOMMENDATIONS FOR THE PRESIDENT. ON THE INTERNATIONAL SIDE, I HEAD THE U.S. DELEGATION TO A SERIES OF BILATERAL ECONOMIC CONSULTATIONS WITH THE EC, JAPAN, NEW ZEALAND, KOREA, INDIA, PAKISTAN, ASEAN - JUST TO MENTION THE MEETINGS HELD OVER THE PAST SEVERAL MONTHS. THEN THERE ARE THE INTERNATIONAL ORGANIZATIONS - MOST NOTABLY THE OECD - IN WHICH WE PROPOUND AND DEFEND OUR VIEW OF SUCCESSFUL ECONOMIC POLICY AND THE ECONOMIC SUMMIT WHICH HAS BECOME THE CAPSTONE OF INTERNATIONAL COLLABORATION ON ECONOMIC POLICY. MY COLLEAGUES IN THE ADMINISTRATION COULD EXTEND THIS LIST TO THE IMF, THE GATT, THE WORLD BANK AND OTHER INSTITUTIONS WHICH ARE MORE DIRECTLY INVOLVED IN NEGOTIATIONS ON THE RULES AND RESOURCES OF THE INTERNATIONAL ECONOMIC SYSTEM.

THERE IS A LOT OF INSTITUTIONAL KNOWLEDGE, FOLKLORE AND MYTHOLOGY ABOUT ALL OF THIS. BUT THE BASIC PRINCIPLE THAT I FOLLOW, SITTING ASTRIDE THE INTERNATIONAL AND DOMESTIC FORCES AS I DO, IS THE ONE I SHARED WITH YOU AT THE BEGINNING OF MY STATEMENT: GOOD DOMESTIC POLICY IS GOOD INTERNATIONAL POLICY, OR TO RISK MISQUOTATION - "WHAT's GOOD FOR THE U.S. IS GOOD FOR THE WORLD <u>AND</u> VICE VERSA."

34-871 O - 84 - 13

Senator JEPSEN. Thank you, Mr. Wallis. If I may, I would like to start with where you ended, your last statement.

Recent press reports have dealt with the effects of U.S.-supported loans by international lending agencies directed at the establishment of production facilities in less developed countries that will compete with U.S. producers in our market. These are instances in which our national goals in terms of decreasing the unemployment rate and helping LDC's lessen their debt burden, appear to be in conflict.

As a matter of principle, do you believe that we should support loans, for example, that create competition for weak U.S. industries, such as steel or copper, which, in fact, we have, and I am just wondering why?

Mr. WALLIS. Well, the loans, at least the loans that I am familiar with in that category, cannot really be said to have created competition for the United States. There is competition in the areas where the loans are made. But the amount of the competition has not been affected by our loans.

Let me mention specifically the recent Eximbank loan to Korea for part of the equipment of a steel plant. There, the Eximbank did not make that loan until it ascertained first that other suppliers would be able to get credit, subsidized credit, from their governments. And second, until it was ascertained that whether U.S. equipment was used or not, it would have no effect whatsoever on whether the plant was built and went into competition with us.

The only effect of the Eximbank loan, and, actually, it was a guarantee rather than a loan, the only effect of the Eximbank participation was to help get the business for an American producer of the equipment. Otherwise, it had no effect on the competition with us for steel.

I am not as familiar with what has happened in other instances as that one because we in State looked particularly into that one, as did some other departments. But I believe that that is the general principle, that we certainly would not make a loan if it created competition for our industry that would not otherwise be created.

Senator JEPSEN. Are you familiar with the Inter-American Development Bank loan that recently was approved for $268 million development loan to the CODELCO, the Chile state-owned copper company?

Mr. WALLIS. No, I do not recall that one in detail, but I have heard of it.

Senator JEPSEN. Our agricultural trade relations continue to deteriorate. Japan has not yet made any concessions on beef and citrus and we know that the European Community is considering new restrictions on corn gluten, and vegetable oils and fats.

The United States tried to draw these countries into multilateral trade negotiations in agriculture in the Tokyo Round, but to no avail. Now we have engaged in a limited number of subsidized sales ourselves in order to spark reforms.

Where do we go from here on these developments?

Mr. WALLIS. That is certainly what we are trying to find out. We have to draw a distinction, I think, between Japan and the EC, the European Community. I would make a minor correction, not a sufficient correction, to your statement that the Japanese have not made any concessions on the citrus and beef quotas. They have increased those quotas a little bit from time to time and recently, we have been having intensive negotiations on that and they have offered increases that are not negligible, but which, however, we consider inadequate and we have rejected them and are pushing them to go further.

We had recent visits from the foreign minister and from the minister of international trade and industry. They, especially the foreign minister's visit, left us quite optimistic that there will be perhaps not sufficient, but, at any rate, greater progress than previously on both citrus and beef, as well as on many other issues of trade.

I would hope that by the end of April, at the latest we will see some progress. We were led by the Japanese to expect that by the end of April, they would have taken some action.

Senator JEPSEN. Secretary Brock——

Mr. WALLIS. Excuse me a second. The European Community is very different. They are not budging. If anything, they are getting worse, from our point of view. You mentioned the corn gluten threat, which, apparently, they intend to carry out. The one on vegetable oils and fats they seem to be backing off of. But more because of internal disputes among themselves then because of any recognition of sound principles on international trade.

On their subsidies, which, in some ways, are our worst problem because they affect us in third countries, not just in Europe, they have been saying, as long as I have been around here—now that is not very long, a little over a year and a half—but they have been saying for years that they are going to bring their prices into line with world prices, and if they did that, many of the problems would disappear. But, in fact, they have been getting further out of line with world prices and they have had to put in bigger and bigger subsidies, bigger and bigger support programs and they subsidize the exports.

That is one difference with our subsidized programs. We do not dump it on the world market at the expense of other countries.

So there, I do not see many signs of optimism at the moment. But Bill Brock keeps working on it. And we have some negotiations going on in the GATT which may be, given a couple of years, may be a more promising way to deal with it, by getting some multilateral agreements that they will then sign onto.

I am sorry. I interrupted when you started another question.

Senator JEPSEN. No, not at all. Ambassador Brock, in his appearance before this committee just recently, did not seem quite as optimistic about what might happen with Japan as you do. I hope you are right.

Mr. WALLIS. I am afraid he has had more experience. It worries me if he is not as optimistic.

Senator JEPSEN. Well, you know, this growing wave of demand for protectionism is very worrisome. In spite of the administration's preference for open trading policies, protectionist, pressures were difficult to contain last year, whether it be in textiles or in other areas. In 1984, these pressures will be even more intense.

We understand that certain industries have carefully timed petitions for import relief to coincide with the election calendar. Do you have any recommendations on how the administration should plan to handle these pressures this year?

Mr. WALLIS. Well, I would recommend that they resist them to the maximum extent feasible. But you pointed out I mentioned in my statement the political implications of international trade policy, the pressures of one group in the country to profit at the expense of other groups. That is politics, I guess, in general.

I think that you can count on the administration resisting them stoutly, but I would hesitate to predict that nothing of a protectionist character will be done. In fact, I flatly would not predict that, even though I have not any idea what it might be because I see how these pressures operate.

Senator JEPSEN. Well, now, at the Williamsburg summit, were you involved in that?

Mr. WALLIS. Yes. I was in charge of the preparations for the Summit.

Senator JEPSEN. At the Williamsburg summit, the United States made a commitment to consult with other trading nations on ways to dismantle existing trade barriers. Since that time, however, there has been a growing proportion of U.S. trade that has come under increasing control with regard to autos from Japan, specialty steel from the European Community, textiles from numerous countries.

How do we reconcile all of these things with this commitment made at Williamsburg?

Mr. WALLIS. On the steel action—you are referring to the specialty steel action that was taken almost immediately after Williamsburg—the die had been cast the preceding November when the matter was referred to the International Trade Commission.

Let us see—what was the other one that you mentioned?

Senator JEPSEN. Well, talking about specialty steel, textiles, autos.

Mr. WALLIS. Textiles. Textiles goes back a long, long way. That sector has been highly protected since the 1950's with the predecessors of the multifiber agreement. And, it seems to be the case in all countries with textiles—they are a problem because that is the area in which a developing country first develops industrial capacity. It happened in Great Britain during the Industrial Revolution in the 18th century. They developed an efficiency in textiles. Then what they have to sell we decline to buy, or at least not in the quantities that they would like to sell.

So textiles are a special problem and not a new one at all.

Senator JEPSEN. We have a domestic content bill. It has passed the House, I believe.

Representative SCHEUER. Overwhelmingly.

Senator JEPSEN. Overwhelmingly. Sent to the Senate. A domestic content bill which, in my home State of Iowa, makes most people who understand my home State of Iowa, as I do, shiver. They are very nervous with everything that we export, and we are rather large in the area of soybeans and corn, feedgrains, all those products that provide for the balance of trade payments to be less severe than they are. I mean, they are on the plus side. And yet, a domestic content bill, it is felt, would just absolutely shatter, or could be very devastating, certainly, to agriculture.

Would you comment on that? Is that an accurate observation?

Mr. WALLIS. Yes, I think it is definitely an accurate observation. Let me say that up in my hometown, which is Rochester, N.Y., where approximately half of the industrial production is exported, it gives them the shivers, too. And a couple of years ago I saw a bumper sticker up there which said, "Buy a foreign car. Protect your export job."

I think that shows how some of the people up there are thinking.

I do not know whether this was a practical joker or whether he is an economist. I just happened to see it on the road one day.

There is no question that that kind of legislation would have a devastating effect. Incidentally, of course, it would have a devastating effect on a very large number of consumers buying these Japanese cars and German cars that are coming in.

We do have major problems with the automobile industry. There are a lot of signs that it is going to recover, that it is not permanently going to go down the drain, as some other industries have, appropriately. That is an area in which I think we will retain a strong comparative advantage. We may import a lot of parts. But I certainly agree with you. And, as you know, the farming community, historically, has been the backbone of the free trade movement. They are the largest exporters, by far, and they are very well aware of the fact that you cannot export if you do not import anything. And, indeed, who would want to?

You do not want to give away everything you have and get nothing in return.

Senator JEPSEN. Well, I think it is difficult to understand some of the activities in the leadership and support of some of these bills. The domestic content bill, I believe, was supported rather strongly by United Auto Workers. The United Auto Workers have a great deal at stake in the farm implement manufacturing business, which is one of the largest in my home State, the Middle West, with John Deere and Caterpillar and International Harvester, and so on. Recent contracts have been made by these companies, I believe a substantial contract between John Deere and China.

But there seems to be quite a paradox in that if the rank and file of workers understood what domestic content would do by way of jeopardizing their own jobs, I am wondering whether they would stand still for the support that is being pushed and promoted with their own dollars.

Mr. WALLIS. Well, in some ways, I think you can understand the position of somebody who is working in a farm machinery plant or an automobile plant and now he is unemployed, and he sees these floods of foreign cars on the streets, and he thinks if they were shut out, that people would be buying the same number of cars there and he would get a job making some of them. And, certainly, some individuals are correct—they are better off with protection, as I said in my statement. Protectionism is simply a device by which one group in the country benefits at the expense of other groups. The total welfare is reduced by protectionism measures.

And so, it is simply a case of the people who make automobiles trying to make those who buy automobiles give them more than they would voluntarily give them for their product, in view of alternatives available to them.

And when you look at it with a microscopic view of a man who lost his job on an assembly line, I think it is fairly easy to understand. After all, he is not an economist and he is not looking at the whole world picture. And besides, he has a family to feed this week, not next year. And yet, from the point of view of government, it is very important to take the long-run view. If you look at the history of the United States, well, in the first place, why are we by far the most prosperous country in the world? I think, clearly, the dominant reason is that we are the largest free trade area in the world. And the Constitution has some things in it to keep it that way, unlike the European Community, which has tried to get to be a free trade area. Second, we have generally had a fairly open trading system. For all the protectionist measures you pointed to, and which distress me a great deal, when I go abroad and see what they are doing, I do not feel quite so bad about us. I mean, we do have the freest markets of almost any country, any large country, in the world. And I think our propserity and the world's prosperity since the Second World War has been unprecedented and has been largely attributable to the free world trading system.

Senator JEPSEN. Thank you. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman. I have a few questions to ask you, Mr. Wallis. I appreciate your very interesting testimony.

I was intrigued by your remark a moment ago that we are by far the most prosperous country in the world. As I understand it, our per capita GNP puts us fifth or sixth behind Japan and West Germany and Belgium and Holland and several other countries.

I do not ask this question in a hostile sense because I would like to feel that we were the most prosperous nation in the world. We have been for generations and generations. But it looks as if we have come upon hard times in terms of productivity and in terms of structural unemployment that keeps a large and growing number of people in our society off the job rolls.

How do you justify it? How do you document your statement that we are by far the most prosperous country in the world?

Mr. WALLIS. I do not have the figures right at hand. But let me say as a reformed, or only partially reformed statistician, I certainly do not take international comparisons of GNP at all seriously, if you look at how it is measured in this country and the difficulties of measuring it accurately.

You have real problems here tracing it through time. Things that were not in the market are in the market now, or were in the market and are out of the market. That affects the value of the GNP.

But what I would say is go to some of these countries and wander around there and look at what they are doing. Look at the people. I am impressed with people that are nowhere near the top of the economic ladder in this country——

Representative SCHEUER. People nowhere near what?

Mr. WALLIS [continuing]. That are nowhere near the top or even the middle of the economic ladder. Look at the things they do. I do not want to single out any occupation as being, say, low on the economic ladder and sort of a middle-class type of job, but take a truckdriver. I mean, truckdrivers now dress up like the rest of us and they eat in the same kind of restaurants we do and they do the same things that everybody does. Surely not as much as some and they probably do not take the winter off and go to Florida or something. But, nevertheless, when you look around and see what the population here does and how it lives and get around to the slums, and then go to the slums in some of the rest of the world, it surpasses credibility.

I was over in India for the first time in December and you see these people that literally have not a house.

Representative SCHEUER. Where is this?

Mr. WALLIS. India.

Representative SCHEUER. Oh, yes. My goodness, I am headed for India in 48 hours for a conference—a parliamentary conference on population and development there—and I am going to ask you a couple of questions about population.

But I am not talking about comparing us with India, but comparing us with the advanced developing countries. And it seems to me that not only are they above us in terms of GNP, mostly because of the effects of structural employment and a large poverty class here which most of these advanced developed countries do not have.

But also, if you travel in those countries, their public transportation systems are far more satisfactory than ours are. Their public education systems are far more satisfactory than ours are. Their law enforcement and crime control systems are far more effective than ours are. And you can rationalize and explain each of these, but in terms of prosperity—I suppose that includes the quality of life, too—it seems to me that we have a lot to learn from these countries.

I wish I could join with you wholeheartedly, as a matter of national pride——

Mr. WALLIS. I will agree with you that we have a lot to learn from some of these countries. Some of them are ahead of us in some things. If you take mass transit, the Japanese railroad system, which everybody marvels at and which is absolutely marvelous——

Representative SCHEUER. Well, in Europe, too.

Mr. WALLIS [continuing]. Bankrupts the Japanese. The amount of money per capita that they spend on that and what it could have done for people who are in poverty is appalling. I would hope that the United States would not do anything like that in terms of wasting resources.

Representative SCHEUER. Well, I sympathize with you and I would like to believe that——

Mr. WALLIS. Could I mention one other point about the GNP figures? One of the ways that we have taken the benefits of economic growth in this country is by cutting down the amount of time we work. We work shorter days and we work fewer days in a month and we take longer holidays and people retire earlier and they go to work later and spend more time in education.

This, of course, tends to hold down the GNP, which is only measured in dollars. It is a real welfare benefit and it adds to the quality of life. In some countries—well, the statistics differ so greatly that you really cannot make valid comparisons here. I would point out that even time comparisons for our country are misleading because of things like that.

You have some offsetting factors, too.

Representative SCHEUER. Those things that you mentioned would reduce productivity, perhaps. I would also think that you would want to add into that mix that it takes twice as many man-hours to produce a car in this country than it does in Japan.

That is also a reason for their high productivity and high prosperity, which is all part of the challenge ahead and I think we are all looking for the same thing.

Mr. WALLIS. Could I pick up that last point, though, on the cars. You know, you hear it said that we get all this—this may sound like it is off the track—but you hear it said that we get all this marvelous agricultural output from only 4 million farmers. And, in fact, people point out that practically all of it comes from about 1 million of them.

Well, now, that is not exactly a fair statement because they did not count those people working at John Deere and Caterpillar and International Harvester that the Senator mentioned earlier. Basically, they are also doing farm work. That is why the farmer can turn out so much. And then they do not count the people working in those fertilizer factories and the people working in, I guess it was Iowa that developed the genetic seed business. They do not count that.

And if you count those people, then you have a great many more people involved in agriculture than just the 1 million. I think that is relevant to your point about the automobilies, that before you draw any conclusions from those figures, you want to get in there and find out if they have got a robot in there.

I went to visit a Kodak camera factory and was surprised to see that there was not anybody there making cameras. They were moving around on belts and up and down and pieces were being put in. There were just a few people, almost nobody. But then it turned out that there were 160 engineers upstairs with elaborate computer scheduling that they were doing for the next week and there were several hundred people backing them up.

Now you could say that they make cameras with no labor, but they do not. The figures are terribly hard to interpret.

And I would also like to pick up your reference to structural unemployment. That is a phrase that does not have any really sharp meaning. Very often what we mean is people who are in an industry like steel, say, which is declining and therefore, there is simply going to be less employment.

Steel is declining independent of imports for a variety of reasons that you are probably familiar with. And there is the problem of readjustment. When the economy is going full steam, that is not much of a problem. A person that is thrown out of work gets a job across the street or, indeed, the way it usually works is that his son does not go into that business. He goes into a different one because he sees the handwriting on the wall.

What is called structural unemployment looks bad when you have a recession and you cannot make the normal adjustments. In this country, we have done an excellent job of structural readjustment. And it is striking to sit in Europe and listen to those people talk about their problem with steel capacity and see what they have not done with it, how little they have done with it, because the government's moved in and undertaken to do it.

Over here, the Government has not done it and the industry has gotten on the ball and the unions and they are doing it. We have done far better than they have at making the structural readjustments.

The structural unemployment can mean a lot of different things.

Representative SCHEUER. Yes. I meant structural unemployment not in the sense of a particular declining industry. I meant structural unemployment in the sense that it has been traditionally used over the years to signify the phenomenon that in good times or in bad, there is a certain segment of the work force that is not included in, to put it in Mark Twain's phraseology, that cannot find employment when there is a tight market or when there is a loose market.

This has typically included minority group members where traditionally, the rate of unemployment, in good years and bad, is 2 or 2½ times that of white males.

It is perhaps due to absence of literacy skills and work skills and attitudinal skills and other things. But it means that black youth in our urban centers, even in times of booming economic conditions, have found it difficult to get into the job market and to find their place on the ladder. And that is a problem that we have not solved yet.

Undoubtedly, it is caused in part by the fact that we have a growing group of young people in our society who seem to be able to go through 10 or 12 years of education and graduate from high school and still really not be able to read, write, and count. And you can call them functional—this is called functional illiteracy and other things—but they do not have the job skills that they need to become employed in an economy that is increasingly demanding sophisticated literacy and numerical skills.

Now, computer skills, too. And that is a problem that we are going to address ourselves to.

Mr. WALLIS. Let me point out one thing about that. Minority and youth unemployment has been rising and that is a major problem. What happens is that the schools do a poor job, whether they actually do a bad job or they get bad materials in or whatever. I will not attempt to diagnose that.

The fact is they turn out people who are not prepared for jobs. But, historically, the bulk of occupational training has been obtained on the job, not in the schools, because they are too specialized and too detailed. And there have been studies of what part of economic education, economically valuable education, is done on the job. It is the bulk of it.

But the present minimum wage laws prevent youth from getting employed at all, just to get on to the ladder and start learning these things. And if you look over the record, you find that every time the minimum wage law has been jumped, and it has been going on now since the 1950's, every time there has been a jump in the ratio of black to white unemployment in the youth group. When it started, there was no difference. If anything, the unemployment rate was a little higher among the whites. And every time this jump has occurred, you had a jump in that ratio.

The President has several times made proposals—he made one recently about having some subminimal wage opportunities for training purposes for breaking people into the labor force.

So I think we do a bad job of training them in the schools and then we put a big handicap in their way when they get out.

Representative SCHEUER. I think there is a lot in what you say. The labor unions, of course, have bitterly fought this kind of a proposal as threatening to labor unions because they feel that employers will fire adult workers and hire kids to replace them at jobs that pay less than the minimum wage.

And I must say that the Democratic Party has rather uncritically adopted that position of the labor unions. It may be that they have failed really to consider what the best interest of young minority youth would be. And I think that perhaps the Democrats ought to get into a painful, an agonizing reappraisal of their position on that.

I have thought that for a long time. Maybe that is overdue.

Mr. Chairman, I have a few more questions. There are a wealth of questions to be asked from Mr. Wallis' most interesting testimony. I would ask unanimous consent that members be entitled to submit questions in writing for the next week or 10 days, that we would hold the record open for that period of time.

Senator JEPSEN. Let the record show that today's hearing will be held open for written questions for a period of 7 days.

Representative SCHEUER. Fine. I appreciate that very much.

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

RESPONSE OF ALLEN WALLIS TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE SCHEUER

Q: The trade deficit for 1983 was almost $70 billion. It is estimated to exceed $100 billion this year.

-- What have been the employment costs of running trade deficits of this magnitude? (1 million jobs)

-- What have been the costs in terms of lost GNP growth? (1 percentage point or about $35 billion dollars)

A: The amount of lost output or employment (if any) associated with weak exports or a larger trade deficit depends on what one assumes about the other demand sectors of the economy. Wrong assumptions are often applied to obtain inflated estimates of the output and growth consequences of trade deficits. To the extent that trade deficits reflect strong import expansion, they reflect strong, not weak, economic growth. On the other hand, if export demand is depressed, there is probably an offset through higher domestic demand.

During 1983 the rate of growth in overall output and employment was quite high, and probably as high as would have been prudent. If export demand had been stronger, and monetary policy unchanged, some domestic demand would probably have been crowded out. If lower capital inflows had produced a weaker dollar, and thereby a better trade performance, U.S. interest rates would probably also have been higher, and domestic demand for housing or autos or investment goods less. More capital goods may have been sold abroad, but less at home. In sum, a drop in exports may temporarily lead to a loss in output and employment, but over time larger trade deficits will tend to be reflected in a different composition of output and employment, rather than lower levels.

Q: In the late 1970's American exports were a vibrant source of growth for the domestic economy. Our exports were growing faster than other industrial nations'. Exports as a percentage of GNP was on the rise. Four out of five new manufacturing jobs created during the late 70's were created by exports. In the last two years, our exports have plummetted.

-- How long can we run these trade deficits without critically harming this key sector?

-- How long can the economic recovery be sustained with this kind of imbalance in our external sector?

-- Is there any end in sight to these deficits?

A: The shift in relative composition of U.S. output that accompanies widened trade deficits does involve significant adjustment costs for U.S. industry, but trade deficits do not necessarily involve "critical harm" to any key sector of the economy. U.S. industry can and must respond and adjust to competitive pressures at home and from abroad. Our responsibility is to provide a healthy, growing economic environment in which they can so respond. If we continue to do so, our recovery can be sustained.

Prospects for an "end" to trade deficits are difficult to assess. Our traditional surplus on other current account transactions will continue to cover some deficit in trade, unless other factors change it. Several factors will probably be working towards reducing these deficits in the future. First, as the international debt situation gradually improves, debtor countries which are important markets for U.S. goods will be able to allow their imports to resume growth. Second, the recovery in the other industrialized economies is likely to gain strength, and they will buy more of our exports. Meanwhile,the speed of the U.S. recovery will inevitably moderate to more sustainable growth rates, slowing down the growth of our imports. Finally, if cumulative U.S. current account deficits, or, in the longer term, a reversion to our traditional capital outflow, put downward pressure on the dollar in foreign exchange markets, the U.S. competitive position will improve.

OVERVALUATION OF THE DOLLAR

Q: Everyone recognizes that the dollar is overvalued by a significant amount, given our underlying competitive relationship with our major trading partners. The overvaluation primarily is due to our high real interest rates, fed by our budget deficits. There is no way our exporters can compete given this kind of currency overvaluation. Nor can domestic industries compete with cheap imports.

-- What actions are the Administration planning to bring down the value of the dollar so that American exports can be competitive once again?

-- Do you think that official exchange rate intervention has any role to play in influencing foreign exchange markets?

-- Given our trade and current account deficits, would official intervention at this time give useful "guidance" to exchange markets to start a movement out of dollars into other currencies?

A: I cannot say whether the dollar is overvalued or not, without knowledge of the "equilibrium exchange rate". The value of the dollar depends on a number of factors including the flow of goods and services and the supply of and demand for various countries' physical and financial assets. The long-term value of the exchange rate is determined by these factors in the marketplace.

A variety of forces including heightened confidence in the U.S. economic policy, lower inflation, the strength of the U.S. recovery, and high interest rates have combined to strengthen dollar vis-a-vis a number of currencies. There is no question that the strong dollar means stronger competitive pressure on U.S. manufacturers.

The degree of pressure will abate -- but it would be foolhardy for the Administration to try to manipulate the exchange rate by intervening in foreign exchange markets or otherwise. The Administration will, however, do everything it can to insure that the dollar is not manipulated by other governments through capital controls or other devices.

Removal of Trade Barriers

Q: The Administraton is doing a commendable job of trying to negotiate removal of trade barriers of some of our major trading partners, particularly Japan.

-- Aren't all your trade liberalizaion efforts of the last three years being negated by our over-valued dollar?

A: There is no doubt that exchange rates do affect trade patterns and flows. However, successful efforts to open foreign markets to competitive U.S. goods and services is a goal in itself and will stimulate trade independently of any particular rate of exchange. Also, exchange rates can fluctuate; once solid market access has been achieved, its positive effects are much more stable. With regard to Japan, while we are continuing our efforts in many fora to open further that country's markets, we are also at the same time working through bilateral discussions between the U.S. Department of the Treasury and the Japanese Ministry of Finance to promote the internationalization of the yen and to open further Japan's capital and financial markets. Such action would help the yen more fully to reflect the underlying strength of the Japanese economy, and would complement our market opening efforts.

Q: We're now running bi-lateral trade deficits with every single major trading partner. We're even running a deficit with the European Community, where we have traditionally run a surplus. Our deficit with Japan is at record levels.

-- If the dollar were to begin falling tomorrow, how long would it be before we began to see results in our trade balance?

-- Are we forfeiting our international competitiveness for years to come by maintaining the policies which have produced the high dollar values which plague us today?

A: Most econometric studies show that the effects of exchange rate movements on trade flows occur over an extended period of time. The impact on trade volumes should begin to appear in a relatively short time -- six months or less -- but the full effects would not be felt for perhaps two to three years. The immediate effect of a dollar depreciation on the U.S. trade deficit in value terms would be temporarily adverse because of an increase in dollar import prices relative to dollar export prices. This adverse effect would last until the delayed response in trade volumes overcomes the relative price effect.

To a large extent, the strength of the dollar is a measure of the success of our policies in restoring a healthy, non-inflationary economy. Such an economy serves as a magnet for capital inflows. The dollar's strength also reflects economic and political instability elsewhere. Successful U.S.

policies will not be abandoned, but it is likely that the dollar will eventually decline in the foreign exchange markets in response to a number of possible developments or as a corrective adjustment to large cumulating current account deficits. If so, U.S. industry, benefitting from a basically healthy economic environment, will be able to deploy its resources in order to take advantage of greater competitive opportunities.

Q: Three factors principally seem to be the cause of our trade deficit, and they're all interrelated: 1) the overvalued dollar; 2) the international debt crisis; and 3) the fact that recovery has not taken hold elsewhere in the world to any appreciable degree. All three of these problems can, at least in part, be attributed to the level of U.S. interest rates, which is in turn a function of current and projected budget deficits.

-- How can we break this vicious cycle if the Administration won't present an effective plan to reduce the budget deficit?

A: The supposed linkages between the budget deficit and the trade deficit are not there. First, econometric research has failed to find an effect of budget deficits on interest rates. At the least, other factors appear to be much more important. Second, there have been many factors other than U.S. interest rates that have influenced the net flow of international capital movements and the dollar's strength -- including foreign confidence in U.S. economic policies. Further, the origins of the international debt crisis go much further back in time than the recent widening of the budget deficit. Finally, how can the U.S. budget deficits and interest rates be held accountable for a sluggish recovery abroad when in the United States, where their effects must be most pronounced, there has been a vigorous recovery?

Indeed, the strong U.S. recovery, which largely reflects our success in dramatically reducing inflation, is recognized to have greatly improved the international debt situation over the past year and substantially boosted the recovery in other industralized countries.

It is important that we reduce the size of the budget deficit, but it is even more important how we accomplish this aim. If it is accomplished at the expense of our national security or the vital incentives provided by the President's tax reduction programs, the cure may be worse than the disease.

Q: Many competing interests come into play in an Administration in formulating an economic program and a budget plan. This Administration does not seem to be factoring in the needs of our exporters into its decisions. In fact, the President in his State of the Union Address last week made no mention of trade, as opposed to last year when trade was given a prominent role.

-- Is your voice, and that of America's trading sector, being heard in White House councils on macro-economic policy formulation?

A: Domestic economic management is primarily the responsibility of other U.S. government agencies, not the Department of State. These agencies are all fully aware of the importance of the international dimensions of their decisions, and the effects of their policies on the U.S. trading sector. The Department of State on appropriate occasions provides its views, with special emphasis on international trade. We do so in formal meetings of such bodies as the Cabinet Council on Economic Affairs as well as numerous informal meetings. We believe the interests of the trading sector are being fully represented.

The Administration's Trade Rhetoric vs. Actions

Q: Last year, in Ambassador Brock's testimony before this Committee, he talked at length about the dangers of a "fortress" mentality, of "pulling up the draw bridge to insulate our markets from world competition". This sentiment has been echoed in speeches by the President, and other cabinet officials. Since last year, we now have restrictions on motorcycle imports, specialty steel imports, carbon steel imports, another year of voluntary restraints on auto imports from Japan, and increased protection for the domestic textiles industry.

-- Have we pulled up the drawbridge?

-- How do you reconcile the general free trade philosophy of this Administration with its actions?

A: No, we have not pulled up the drawbridge, although, like other countries, we do have restrictions in some sectors. This is not surprising, given the severe economic recession which we have just been through. Indeed, given the severity of that crisis, we can take some satisfaction in the fact that so few actions were taken.

TEXTILES

Q: You are known to have opposed last December's new textile policy. No doubt you opposed some of the other import restrictions as well.

-- Have the trade restrictions imposed by the Administration undercut the Administration's ability to negotiate reductions in other nations' barriers?

-- Can we still take the high road given the record of the past couple of years?

A: The White House Press Statement of December 16 announced additional criteria to be considered by U.S. officials responsible for implementing our textile import control program. These additional criteria will not automatically result in any action to restrain trade. These criteria simply require our responsible officials to take a closer look at those textile categories which meet the additional criteria. Administration spokesmen have taken care to emphasize that the U.S. will continue to faithfully honor our commitment to the Multifiber Arrangement and our bilateral textile agreements.

I do not think that U.S. actions consistent with the Multifiber Arrangement and our bilateral agreements should be seen as undercutting our ability to negotiate reductions in other nations' trade barriers where sound reasons exist for reducing these barriers.

The high road is not without its bumps and pot holes. Vice President Bush, in a recent (January 19) speech pledging that the Administration will continue to resist domestic pressure for more trade protection, nevertheless acknowledged that textiles was an exception. "We have some areas where we are something less than pure." Textiles has long been recognized as a special case in the world of international trade. That is the reason for the existence of the Multifiber Arrangement which is recognized universally as a derogation of the General Agreement on Tariffs and Trade (GATT). Textile trade policy has a long track record as one of our most difficult areas to deal with.

IMPORT RELIEF CASES

Q: The shoe industry has filed for import relief as has the steel industry. Spokesmen for these two industries are blunt in saying that they have timed their petitions for the election year.

-- Can the Administration resist these pressures in this election year, particularly given its recent decision on textiles?

-- Should the Administration grant relief to the steel industry, and the European Community retaliates as it has threatened, will we face an all out trade war with the Community?

-- What would be the impact on our agricultural exports to the EC if we accede to Bethlehem Steel's petition?

A: The political situation to which you refer is indeed a thorny one. Not only the shoe and steel industries, but also the stainless steel flatware, copper and tuna industries have filed Section 201 petitions which will be processed prior to the election. However, I think it would be premature to speculate on Administration reactions. Under the law, the International Trade Commission must investigate each case to determine if imports are a significant cause of serious injury before the President enters into the process. If the ITC finds that imports have not injured an industry, the Administration will not face the question of protection of that industry. While there is a possibility that this Administration will face difficult challenges in this area prior to the election, I think we should avoid trying to predict exactly what they will be and what the Administration will do about them.

It would also be premature to speculate on the reaction of the European Communities to possible import protection for the steel industry, before we know what, if anything, might be decided in terms of relief. We are, of course, concerned to maintain a good trading relationship with the EC, and that means we have to be very careful about actions which affect EC exports, just as we want the EC to be careful about actions which could affect our exports, including our agricultural exports.

I certainly do not foresee a "trade war". In the recent past, serious disputes on issues such as steel and the Soviet gas pipeline posed problems in our relations with the Europeans and many predicted a "trade war," but there was none.

NEW IMPORT RESTRICTIONS

Q: It has been estimated that a full 35 percent of U.S. consumption of manufactured goods is in product areas which now receive import protection. They are all areas where new import restraints have been adopted or previous restraints tightened since the Administration took office.

-- What do you estimate the cost to be to the American consumer as a result of the import restraints?

-- Were the interests of the American consumer factored into the decision-making process?

-- Were the costs of imposing these restraints available to policy-makers before making their decision?

A: I am unaware of the estimate to which this question refers. During President Reagan's time in office, the only new import restrictions imposed by the Administration have been on motorcycles and specialty steel. Some have argued that the new procedures adopted in the context of our textile program constitute tightened restrictions, and they may be correct, but all industrialized countries protect their textile sectors. On the other hand, we terminated import controls on shoes in 1981 and denied a request for protection in the machine tool sector. We continue to work against protectionist legislation with regard to automobiles, steel, and wine. So, in my view, the Administration's performance is not as negative as the question suggests.

The costs of import restrictions to consumers are indeed taken into account in the Administration's deliberations on import relief cases; in fact, they are a major concern. In the machine tool, specialty steel, and motorcycle cases, policy-makers had available to them various estimates of the costs to consumers of the proposals under consideration.

PROTECTIONISM

Q: At last year's Williamsburg Summit, the seven major industrial countries pledged to reduce protectionist barriers as their economies recovered. At the GATT Ministerial in November, 1982, the participants decided to review the situation two years hence to determine whether a new round of multilateral trade negotiations might be useful. We are recovering and there are signs of recovery in Europe.

-- Why are we embroiled in more trade disputes than ever?

A: Since 1960, the combined annual export-import trade of the U.S. has expanded from $35 billion to $467 billion. In addition, the U.S. trades a far larger share of its GNP than was the case in the past. In 1982, total U.S. trade in goods and services accounted for 20 percent of our gross national product, compared to 11 percent in 1970 and 9 percent in 1960. With this increasing importance of trade to the U.S. economy goes a natural increase in complexity of both the types of goods traded and international commercial interrelationships. It is thus not surprising that the attention given trade issues has increased and some have become contentious. Generally, however, the U.S. commercial relations with our trading partners are on a firm footing, with the large bulk of trade taking place relatively smoothly. This is the impressive reverse side of the coin.

PROTECTIONISM: AT HOME AND ABROAD

Q: In discussing the solution to the international debt crisis, Administration officials always stress the importance of providing developing countries with open markets so they can export and earn the foreign exchange necessary to pay their debts. Yet, we have restrictions on specialty steel imports, which affect Brazil; new restrictions on textiles which affects a host of developing countries; and we're taking Brazil to the GATT for unfair trading practices in third markets.

-- How would you reconcile this seeming contradiction?

-- What would you describe as the proper balance between the overriding need to keep Brazil, and other countries in similar situations, afloat, and the needs of individual American companies which are being harmed by these developing countries' less than pristine trading practices?

-- How do you reconcile IMF adjustment programs which require import curtailment with our companies need to export to these markets?

A: The Administration is committed to keep our markets as open as possible to exports of debtor nations. This policy not only benefits the debtor nations, but also benefits the American consumer and is consistent with our long-held belief in the value of free trade. From time-to-time, however, these objectives must be balanced with our need to limit the damage done by a rapid increase in specific imports. These actions, however, should be viewed rather as exceptions to our overall policy of open markets and free trade. Although the United States has placed temporary quotas and tariffs on certain specialty steel products in response to the serious crisis facing our domestic specialty steel industry, it is important to note that specialty steel represent only a small fraction of that country's exports. The great majority of Brazilian exports enter the U.S. without restrictions.

In the case of textiles our restrictions are in accordance with the Multifiber Arrangement, which is sanctioned by the GATT. They are intended to allow for the orderly growth of trade -- a growth that will allow the LDC's to continue to increase their exports to the U.S.

We have not initiated any GATT proceedings against Brazil. We have however held consultations with Brazil on some of their trade practices. Our objections to unfair trading practices by any nation are designed to ensure fair competition. This allows for better resource allocation in both nations and eventually a higher standard of living in both nations as well.

The IMF purpose is to help nations achieve a sustainable balance not to require countries to reduce their imports, although lack of sufficient foreign exchange in the early part an IMF program may have that effect. By providing financial support to countries in trouble, the IMF may in fact allow the borrowing nation to import more in the short-term than it would otherwise be capable of doing. This allows for less disruption of its economy while the country increases its capacity to export and, hence, also its long-term capacity to import. By allowing these changes to come more gradually, the IMF not only assists the borrowing nation, but also its trading partners.

JAPAN

Q: The current agricultural agreement with Japan affecting beef and citrus imports expires on March 31 of this year. At present, the U.S. and Japan are far apart in terms of negotiating a new agreement. Do you expect an agreement by the March 31 expiration date? If there is no agreement, is the Administration going to take the Japanese to the GATT as promised? How much do Japanese promises to increase defense expenditures affect our decisions on bilateral trade disputes such as beef and citrus?

A: The Administration has been engaged in intensive negotiations with the Japanese concerning a new agreement on beef and citrus. In January, Deputy USTR Ambassador Smith led a U.S. team to Tokyo to discuss the overall Japanese import regime for beef and citrus after March 31. The issue was also raised repeatedly at high levels during Foreign Minister Abe's late January visit to Washington. In late February, we discussed with the Japanese certain U.S. concerns relating to the administration of expanded Japanese quotas under a new agreement. We hope to negotiate a mutually acceptable agreement by March 31. However, it is difficult to predict the outcome of the negotiation at this point. If we do not achieve an acceptable agreement by March 31, we will, of course, evaluate our options.

It would be inappropriate to link or trade off various aspects of our relationship with Japan, such as trade and defense matters. We approach each issue on its own merits.

NTT PROCUREMENT AGREEMENT

Q: A new NTT procurement agreement has been signed with the Japanese.

--What are the major components of this agreement?

A: The Agreement between the United States and Japan to extend the NTT Agreement for three years incorporates a number of improvements designed to facilitate U.S. sales to the Nippon Telegraph and Telephone Corporation (NTT). Key improvements include commitments by NTT to:

-- afford equal treatment for U.S. and Japanese firms in all NTT's R & D activities;
-- use standard contract terms and conditions consistent with common international practice;
-- protect proprietary information provided by firms to NTT;
-- translate key procurement documentation into English;
-- accept bids in English at NTT's New York office;
-- aggregate purchases to provide commercially attractive opportunities for foreign suppliers.

Both sides reserved their respective positions on the issue of Japanese satellite procurement. However, Japan has committed itself not to restrict NTT from buying any other U.S. products.

34-871 O - 84 - 15

Operation of the agreement will be reviewed annually. Should either country become dissatisfied with the operation of the agreement, it may call for consultations. If these consultations do not produce a mutually satisfactory solution, either party may terminate the agreement. At the end of three years the agreement can be extended for a further three years if both countries agree.

Q:-- What will be the impact on the domestic communications industry?

A: The improvements in the renewed NTT Procurement Agreement should facilitate U.S. sales of telecommunications equipment to Japan. U.S. telecommunications firms which are active in the Japanese market have been virtually unanimous in their support for extending the Agreement. We worked closely with these firms prior to and during the renegotiations and believe that means of resolving the problem areas which our firms identified have been included in the new agreement.

Since the United States was already committed to maintaining an open telecommunications market, extending the NTT Agreement required no changes for the United States in our domestic communications market.

Q:-- Do we have sufficient government support at our Embassy in Japan to assist American companies wishing to bid in the Japanese market?

A: Our Embassy in Tokyo has actively supported the efforts of American firms to sell telecommunications equipment to NTT. There has been rapid growth in volume and importance of U.S. - Japanese trade in high technology products, including telecommunications products. Partly in response to this development, two new positions have recently been added to the Embassy's economic section. We are confident that the Embassy will continue to have the flexibility to provide full assistance to American companies wishing to bid in the Japanese market.

High Technology

Q: Japanese officials have just promised Vice President Bush that all lingering trade disputes, including differences over high technology, will be resolved.

-- Haven't we heard all this before from the Japanese?

-- What indication is there that true progress can be made this time around?

A: Prime Minister Nakasone has indicated his personal commitment to obtain significant, concrete results on trade issues during the coming months. Foreign Minister Abe recently reiterated this top-level commitment during his visit to Washington. One significant step forward was the renewal of the NTT Agreement, signed during Abe's visit. Officials at a variety of levels are working strenuously on the gamut of trade issues; discussions are, for the most part, proceeding at an appropriate pace. We believe real progress is being made, even though results are not yet concrete. The basic problem remains of translating this top-level political will into results and for Japan to achieve the political and bureaucratic consensus that is required before it can act. The next few weeks are a critical period for determining the outcome of these efforts.

Japanese Trade Barriers

Q: If every Japanese trade barrier which we complain about was removed, what would be the impact on U.S. trade? If both countries removed every barrier, which of our countries would be the net beneficiary?

A: This is a difficult question to answer quantitatively. Experts disagree. One figure which has been cited is that annual U.S. exports to Japan would be three to five billion dollars higher at the end of three years, were Japan to eliminate all trade barriers and even more beyond that as U.S. companies developed their markets in Japan. As for which country would be the net beneficiary of completely unencumbered trade, the pervasive perception is that Japan's markets are much less open than the U.S.' and we would expect, therefore, that U.S. exporters would be replaced. However, it is important to realize that trade cannot be considered as a series of bilateral balances. Bilaterally balanced trade is not our objective. It is the openness of the international system and expansion of trade opportunities for competitive suppliers that is important.

THE EUROPEAN COMMUNITY

Q: We seem to be at a complete impasse with the European Community over agriculture. Short of the EC reforming or abandoning its Common Agricultural Program, is there any way we are going to be able to resolve agricultural disputes? Is the EC going ahead with import limitations on non-grain feeds, such as corn gluten feed? If so, what are we going to do about it?

A: The EC is both the largest market for U.S. agricultural exports importing $7.4 billion in 1983, and our principal competition for agricultural markets. Because of the magnitude and complexity of the trade interests involved, agricultural disputes would probably continue, albeit at lesser level, even if the EC were to institute a serious reform of the CAP.

The EC's agricultural policies are, however, a serious concern for this Administration and U.S. farmers. Of particular concern is the EC Commission proposal to restrain imports of non-grain feeds such as corn gluten. The EC Commission has suggested that it raise with us in the GATT the issue of renegotiating the binding but it has not yet obtained approval from the member states to do so. We have, on many occassions, made strong representations to both the Commission and EC member states indicating our opposition to any move which would further restrict U.S. access to the EC market. If the EC requests GATT consultations concerning renegotiation of the duty, we will abide by our GATT obligations to discuss the issue, but we have, on several occassions, informed the EC that the likely consequence of a unilateral move to restrict access for corn gluten feed would be U.S. actions to protect its trade interests.

In addition to our concerns about preserving U.S. access to the EC market, we also believe that the EC's practice of using export subsidies to sell its surplus production in world markets has eroded U.S. exports. To a limited degree we have responded in kind. We subsidized the sale of a million tons of wheat flour to Egypt in 1982, and subsequently butter and cheese. We have also used USDA's export credit subsidy program -- "blended credits" -- to bolster our agricultural sales. We have not excluded the use of export subsidies when necessary to teach a lesson, but would be foolish and expensive to use them as a regular and routine component of our agricultural export programs.

TRADE IN STEEL

Q: The EC has threatened to lift its quota restraints on carbon steel exports, if the Administration grants import relief to the steel industry. The EC is going ahead with retaliatory measures for our specialty steel restrictions.

-- Where do you think the steel industry is headed?

-- Do you envisage a managed trade arrangement such as we have with textiles, for steel? Aren't we already headed in that direction?

A: It seems to me that what the future holds is a somewhat smaller, more efficient, more technologically-based domestic steel industry than we have at present. However, I am not one who believes that it is particularly useful for government officials such as myself to project the future of industries; the marketplace and the industries themselves do a much better job of that.

I will say, however, that I fervently hope that the steel industries of the world do not slip into the sort of managed trade system which prevails in the textile sector. If it does, we will see a proliferation of trade restrictions, with their inevitable costs and inefficiencies, for years on end -- perhaps even forever.

DEVELOPING COUNTRIES - TRADE AND FINANCE

Q: You have been trying to get Trade and Finance Ministers from the developed countries to sit down together at regular intervals to discuss coordination of trade policies and finance with respect to developing countries. Are you satisfied with the level of coordination both within the government and with our allies on this matter?

A: Yes I am. We are making progress both domestically and internationally. Within the government an interagency committee has for some time been considering the linkages between trade and finance, and arriving at common understandings.

Internationally, the U.S. has made significant progress in focusing attention on the link between trade and finance issues. These issues have been addressed in international organizations such as the OECD, the GATT, the IMF, and the World Bank, and in private sector meetings. Last May, Secretary Regan and USTR Brock hosted a meeting of Trade and Finance Ministers in Paris to improve understanding of the close link between trade and financial policies, especially in the debt context, and to encourage discussion of ways to assure better coordination of those policies.

The OECD is also looking at the adequacy of official export finance and at the potential for increased investment flows to help ease the debt situation.

Finally, the link between trade and finance was also discussed at the OECD during February's mini-Ministerial. Participants agreed that the OECD should look at trade and finance issues as joint rather than as separate issues. In the GATT, the linkage has been discussed in the Consultative Group of 18.

IMF ADJUSTMENT PROGRAMS

Q: IMF adjustment programs have generated a lot of controversy. A principle accusation is that the programs force countries to stop importing while flooding the market with exports.

-- Are you satisfied with efforts being made by the IMF to encourage trade rationalization?

-- What is your sense when developing countries will be able to begin importing at reasonable levels?

A: We believe the IMF is doing valuable work in encouraging trade rationalization. By encouraging nations to adopt sensible exchange rate policies and by discouraging non-market import barriers and export subsidies, it is helping many nations adopt rational trading systems.

The adjustment process for the heavily indebted LDCs has been difficult. Their shortage of foreign exchange has led to a reduction in their imports both in 1982 and 1983. However, the OECD predicts a 5 percent growth in the volume of non-oil developing country imports in 1984. We are hopeful that their recovery will accelerate in 1985.

GSP Renewal Legislation

Q: Why did you wait until last summer to submit new legislation? Wouldn't it have been easier to get this through last year?

A: Discussion of GSP renewal began in the interagency Trade Policy Staff Committee's GSP Subcommittee in the fall of 1982. In April 1983 the Administration solicited public comment on renewal through public hearings in Washington, D.C., New York, and San Francisco. Comments were requested on all the aspects of the program, including graduation, from business, labor, agricultural interests, and foreign government representatives across the country. After obtaining public comment the Administration's proposal was introduced by request in the Senate by Senator Danforth on August 1, 1983, and hearings were held on August 3 and 4 by both Houses of Congress. The Administration tried its best to rekindle interest in GSP renewal when Congress reconvened in September. The Administration also thought GSP renewal would have been easier last year, but was unsuccessful in its efforts to convince Congress to move quickly on the proposed legislation.

GSP Renewal Legislation

Q: What is the level of commitment of the Administration to passage of the legislation? Will the President get involved?

A: The Administration is committed to GSP renewal. The President pledged as far back as October 1981 in Cancun to the continuation of GSP to give beneficiary developing countries the incentive to diversify their economies, to trade and to promote economic development. The Generalized System of Preferences is a sound way we can work with other developed countries to help the developing countries progress. Our renewal proposal also addresses the recipients' basic interests in greater economic efficiency by calling on the beneficiaries to free up their trade regimes. We also recognize that the markets in beneficiary developing countries are vital to our own long-term economic growth. Therefore, our commitment to GSP renewal is strong; it is a key trade issue for 1984, and the Administration, led by Ambassador Brock, is determined the program must continue.

GSP Renewal Legislation

Q: Your proposal will curtail benefits to some advanced developing countries, such as Brazil and Mexico. Is this sound policy, given their debt predicament?

A: The debt situations of Mexico and Brazil were specifically considered when the Administration drafted its GSP renewal proposal. If the President is given the discretionary authority of implementation as requested, he will be able to take into account the problems facing individual beneficiaries as decisions on levels as well as on the timing of the implementation of new competitive need limits are made. It is not the intention of the Administration to exacerbate developing country debt problems when GSP is renewed.

Representative SCHEUER. In the President's Economic Report, whether it is in the first 7 or 8 pages, which some officials in the administration would not throw away, or after the first 7 or 8 pages, which they would throw away——

Mr. WALLIS. The last 140 are pretty good.

Representative SCHEUER. Pardon.

Mr. WALLIS. The last 140 are very good.

Representative SCHEUER. Yes. I happen to think very, very highly——

Mr. WALLIS. The last 140 are all statistical tables. [Laughter.]

Representative SCHEUER. I think very highly of the chairman. And I think that you, as an economist, would agree with me, as a sort of a horseback economist, that he has protected the integrity of the profession and stood up for what he believes and has not swayed to political pressures and has told it as a true professional, as he sees it. So I commend him for that and I told him that when he was sitting right where you are sitting a few days ago.

Mr. WALLIS. He is an old friend of mine. But even if he were not, I would agree with you about his integrity and his abilities. He is one of the top—I would predict that some day, he will win a Nobel Prize in economics, be the president of the American Economic Association, and so on.

I would base that on the things that he had already done before he came here.

Representative SCHEUER. He deserves, if not the Nobel Prize right now, he certainly deserves the Purple Heart with oak leaf clusters for the punishment that he has taken in battle, in the trenches. [Laughter.]

Mr. WALLIS. I would have to say that I am not in agreement with his position there at all. The economics of it, that is another matter.

Representative SCHEUER. Well, I am not sure that I am, either. I am not sure that he and I come from really the same point on the political spectrum. But I am simply saying that I admire his courage and integrity in reporting the economics of our present national situation as he sees it in terms of his position, which, of course, is that the deficits play a major role in producing high interest rates and deficits and high interest rates are attracting money to this country, raising the value of the dollar, and making it extraordinarily difficult for American manufacturers and purveyors of goods and services to sell their product around the world and making it very difficult for us to compete in global commerce.

Do you reject that theorum that he presents us?

Mr. WALLIS. Yes, I really do. I think there is absolutely no trace of evidence that high deficits cause high interest rates. And I have had people scouring the literature, the professional literature, and they have come up with a list of 8 or 10 articles; maybe it is more than that now, that they have come up with. And not a single one of them finds even a trace of evidence that high deficits are associated with high interest rates. In fact, most of them say, if anything, it might even be a little bit the other way around.

I really do not know anybody, any economist, professional economist who specializes in that area, other than Martin Feldstein, who does hold to that view.

The empirical evidence simply is not there. And if you take that position, you start behind the eight ball because in the last couple of years, the deficit has doubled and the interest rate has been cut in half. I would not say that that proves that higher deficits cause lower interest rates. I am just saying if you look through the historical record, you do not find anything of that sort.

There is a recent study by a professor at Stanford where he took the only three periods in American history where the deficits have exceeded 10 percent of GNP and looked to see what happened to interest rates. They did not go up at all. Again, he says, if anything, maybe they went down a little. Now those three periods are all war periods and so you can say, well, that is something about the war, atypical. But I just do not think that that argument is valid at all.

Representative SCHEUER. What I was beginning to get into was in the CEA report, they estimate that it could take as much as 10 years, as long as 10 years, for the dollar to return to its long-run value, whatever that may be.

Do you agree with this assessment? And if you do, what are its implications for the export sector of our economy, which has been such a major contributor to the growth of our economy in the late 1970's? And what are the implications of an overvalued dollar, if we are going to have to live with this overvalued dollar for the next decade, for adequate investment at home if companies opt for investment abroad, where their dollars will buy them far more?

Mr. WALLIS. Well, in the first place, investment is recovering strongly in this recovery, domestic investment. Funds are coming into the United States from abroad for investment purposes. So I do not see that hazard.

As to the prediction that it would take *x* years—10, I think you said—for exchange rates to get normal, of course there are two things there. Nobody knows what's normal and nobody's ever made a prediction like that that had any validity one way or the other. It was not so long ago, what, 3 years, 4 years, since the Chairman of the Council of Economic Advisers said that it would take a minimum of—I have forgotten what—10 years, maybe, I do not think it was quite that long, to get inflation down to 3 or 4 percent.

Well, it is down there. Last year it was between 3 and 4 percent. Economist simply cannot make that kind of forecast because they depend so much on things outside the sphere of economics, political forecasts.

So, I think you can be sure that we will not continue to run as large a negative trade balance-of-payments deficit as we have been running, for one reason or another, for a variety of reasons.

Representative SCHEUER. It has been estimated that about 35 percent of U.S. consumption of manufactured goods takes place in product areas which now receive import protection. Most notably, in steel, all kinds of specialty steel, autos, motorcycles, shoes, the rest of it, areas where new import restrictions and restraints have been adopted or previous restraints tightened since this administration took office.

Do you have any estimate of what the cost is to consumers as a result of these import restraints?

Mr. WALLIS. I do not have them. There is certainly a high cost. Most of the ones that you mentioned, the costs are probably lagged.

There have been some studies currently, people are making studies trying to estimate things like that, at least the direct costs. Of course, the indirect costs you cannot possibly get hold of. There is no question that they are substantial. Most of the ones that you mentioned have not been in effect long enough. I would be surprised if the 35-percent figure is correct, but it might become correct if those things stay in place.

Representative SCHEUER. Does the administration have any cost estimates that you or the CEA or anybody else has dished up to them to be cranked into the computer when they make these decisions?

Mr. WALLIS. Yes; when a specific measure is proposed, estimates are made. A lot of these protectionist measures that occur are really outside the control of the administration. The law gives the individuals and the companies involved the right to go direct to independent agencies, in effect, and claim that they are losing business because of imports. And if they are, the law says that something has to be done about it.

So that, repeatedly, the administration finds itself with its hands tied by the laws. There are some laws, you know, that say the State Department cannot have anything to do with certain issues of imports. No foreign policy considerations can be taken into account. And I understand that in the past, there have actually been decisions overturned on the grounds that the Commerce Department had listened to the State Department when it reached a certain decision.

Representative SCHEUER. Now the shoe industry has filed for import relief, as has the steel industry. Spokesmen for these industries have been very blunt in saying, quite frankly, that these petitions have been timed to take place in an election year, where the jobs are at stake. Where jobs are at stake, there is no question about it, in the industries affected, but where this whole vast group that is also negatively affected by these restrictions—namely, consumers—somehow or other, do not realize what is happening. And we have never really quantified for consumers what the effect of these import quotas and restrictions really are.

Can the administration resist these pressures in an election year, particularly, in its recent decision on textiles?

Mr. WALLIS. Some of these, the law just says that if they are able to demonstrate that their industry is being disrupted by imports, then such and such must be done to give them protection. And, as you say, they do time them astutely.

I am told by one of the people at STR that they were told by an industry that came in that they come in every fourth year, in November and again in April, and again in September. They come in three times in a period of a little under a year just preceding a Presidential election. Then you do not hear any more from them for 3 years.

Representative SCHEUER. Maybe what we ought to do is appoint some kind of a bipartisan commission to handle these problems. [Laughter.]

At least to talk about them long enough to last until the year beyond the Presidential election, where they could be settled in a less politically charged environment. I do not know where I got that idea from.

Mr. WALLIS. It is a novel idea. [Laughter.]

Representative SCHEUER. Let me ask you a question or two about the impact of demographic change around the world on our society.

If you recall, before you represented our country at the Williamsburg Conference and you were down there, I asked you a few questions then.

Has the State Department calculated the impact of demographic change, let us say, in Mexico and Central America, and the impact that it is likely to have on our country in terms of illegal immigration and loss of jobs here to Americans, the increase in costs of our redistributive services, such as welfare, unemployment insurance, health education, law enforcement, juvenile crime control, and the like?

Have you studied what is happening to, for example, increases in the labor force in Mexico and Central America?

Mr. WALLIS. I am generally familiar with that. That is one of the highest growth rates in the world.

Representative SCHEUER. Yes; in Central America, they have a 3-percent population growth rate. Their population from 1960 to 1981 went from 12 to 23 million. And it is going to double again in the next 20 years. In Mexico, they have about 800,000 new entrants into the job market every year and they have, at the most, 200,000 new jobs. So that leaves a deficit of 600,000 jobs.

It has been calculated that from now until the end of the decade, to the end of the century, Mexico has to create an average of a million jobs a year to cope with its growing labor force. The people are already born who will be entering that labor force by the year 2000. According to the Inter-American Development Bank, Robert Fox, an economist and demographer there, we are going to have to create a million jobs a year.

If you figure that it costs maybe $10,000 to produce a job in Mexico, and that is probably a low estimate, you are talking about $10 billion a year. A million jobs would be $10 billion a year. You would be talking about $200 billion in that period of time, which is a bizarre figure. It is so far out of the realm of possibility, that it is mind blowing.

We are not going to achieve that, nor have we in the past. And the reason that we have had a flood of illegal immigration from Mexico and Central America, and you know that only 60 percent of the illegal immigrants across the border are Mexicans. The rest are transiting Mexico from Central American countries, primarily.

The reason that we have had this terrific push factor is the fact that the growing labor force is far greater than the number of new jobs that they are creating.

Has there been any estimate of how this push factor, which is growing at an exponential rate, not an arithmetic rate, is likely to affect the flow of illegal immigrants into this country, in the absence of any clear policy of firming up our borders and making them real, in an era where, in effect, we have open borders between us and Mexico?

34-871 O - 84 - 16

Mr. WALLIS. Well, let me say first on that, I really do not know the answer to your question. You started with a question about is the State Department studying those things and doing anything about them?

Representative SCHEUER. I did not get that.

Mr. WALLIS. You started with the question about whether the State Department is studying those things and is trying to do anything about them.

Two comments on that. First, there is another under secretary under whom issues of population come, Secretary Schneider. But second, I would be willing to bet anything that I could get the kind of information that you are asking about within our building pretty quickly, if I needed it in a hurry. And if I had a little bit more time, I would get more and better information.

Now they would not necessarily have generated it there. They might have received it from the Census Bureau or from the Bureau of Immigration and Naturalization. Is that what it is called? Or they might have received it from outside demographers who study this.

Representative SCHEUER. Yes.

Mr. WALLIS. I would doubt very much that we have a big pool of demographers doing that work ourselves in the Department. In fact, if we did, I would have heard of it because of my previous professional connections.

Representative SCHEUER. You say that you could put together a study on this?

Mr. WALLIS. If I needed to get information on the questions you asked, I am sure that I could get some out of our building, that there would be people——

Representative SCHEUER. Well, I would ask unanimous consent, Mr. Chairman, that we invite Mr. Wallis or request Mr. Wallis to do such a study. I am not talking about a vast monolog, but a study that would tell this committee some of the realities that face us.

If the question of our open borders is not changed and if the employment pool factor, that magnet, is not turned off, what kind of increasing illegal immigration can we expect from the increasing push factors, the vastly increasing labor market, entrants into the labor market annually for the foreseeable future?

That would be very interesting and very helpful to us. And I can tell you a source that you might go to. The CIA is just printing now a report that it has done on demographic change around the world and how it is effecting the United States. They are going to brief me later this week, even though their report is still at the printer's. But I am sure that they have done a very workmanlike and thoughtful job and that would be of great interest to you.

I would appreciate that and I think that the members would find it very, very interesting.

Senator JEPSEN. If I may, may I suggest that we ask for advice from Mr. Wallis on how this committee might make arrangements to get that done rather than directing Mr. Wallis to do it.

Representative SCHEUER. He said he could do it.

Mr. WALLIS. No, I did not say that we could do it. I said I thought I could find such information in the building. It would have to be other people's studies that follow Latin America, follow population, follow the people that study population. I would guess that within half a day, I could get a bibliography and probably summaries of the main studies.

Representative SCHEUER. Could somebody over there sort of put it all together and sort of take a holistic look at the materials available and summarize them?

Mr. WALLIS. Senator Jepsen says that that would be a large enterprise and it sounds to me as if the CIA has done—what you describe CIA as having done sounds to me like exactly that.

Senator JEPSEN. I would assure the Congressman, I am very much interested in what you are asking for. The staff director of the committee is present and we will make those arrangements. We would ask for your counsel, Mr. Wallis, in helping us make those arrangements to get the information.

You do not care how we get it, as long as we get it.

Representative SCHEUER. No, not at all.

Senator JEPSEN. I just think——

Mr. WALLIS. I will tell Secretary Schneider about this, too, since it is his bailiwick in State, and not mine.

Senator JEPSEN. If we might counsel with you as to how we would make those arrangements, we will do that, rather than directing you to do it.

Mr. WALLIS. Fine.

Representative SCHEUER. That is excellent, Mr. Chairman. I thank the chairman and I thank the witness. I have enjoyed your testimony very much.

Senator JEPSEN. Just two quick questions, Mr. Wallis. If the deficits do not cause high interest rates and the high value of the U.S. dollars, then to what do you attribute the high value of the dollar? And can and should we do anything about it?

Mr. WALLIS. I appreciate your bringing that question up because it gives me a chance to make a point that I should have made when I mentioned about the deficits earlier.

I consider the deficit the greatest and most serious problem facing the United States; I do not think it is an economic problem. I think it is a political problem and that it has potential—the only thing on the horizon that has any potential for disrupting the political and social stability of the United States in the next generation is the deficit.

So I do not want to leave any misunderstanding about that.

As to the high value of the dollar, a variety of factors enter there. You mentioned most of them yourself. Each of you has mentioned them, as a matter of fact, in your opening statement and later on. That is, there is, first, the fact that our recovery is well ahead of that of the rest of the world and, consequently, I think it is estimated that about half of the high value of the dollar is attributable to that source.

I say it is estimated. I never take much stock in estimates like that unless I see personally how they are done. But, at any rate, a lot of it is due to that.

Another factor is that capital is flowing into the United States. The Japanese, for example, are investing heavily here. When the Secretary and I met Monday, last Monday or the Monday before, with Foreign Minister Abe, he had spent the weekend in Atlanta and he mentioned that they had visited with 100 Japanese firms that have establishments in Atlanta, which astonished the Secretary almost as much as it astonished me, that there are that many of them.

Now, of course, they are not all big, but some of them are.

Senator JEPSEN. Established what, again?

Mr. WALLIS. One hundred Japanese business establishments, manufacturing establishments, in the Atlanta area.

Senator JEPSEN. Just 100 alone within that area.

Mr. WALLIS. In that area. That is what Mr. Abe said. It does seem astonishing. Some of them must be pretty tiny, I think. But, nevertheless, that is what he asserted. And he had visited with them over the weekend.

In addition to that, though, you know, if I had any money anywhere in the world, I would want it here. The prospects for earnings are better here if you invest, if you want to go into business. The prospects for being treated fairly in the courts, for getting your money back when you want it, for being able to sell your property, for finding a buyer when you want it. And the propsects in terms of the political stability are just greater here. As I said earlier, there is really no cloud on the horizon unless you think, like I do, that it could be the deficit if it is not dealt with in the next few years.

So there would be lots of reasons if you have property elsewhere to want it in this country. And this is what we refer to usually as the safe haven effect, in addition to the one of simply the economic effect, that the earnings are good here.

One reason that interest rates have to be as high as they are here is because with equities available with good return, people will not lend money unless they get an interest that gives them a comparable rate of return after adjusting for the lower risk on loans, on equity.

So I think that there are a variety of factors that contribute to the high value of the dollar. And I think it is likely that it will not be so high a year from now.

Senator JEPSEN. One last question. It was indicated to me that you did say that we will not continue to run a sizable trade deficit; is that correct?

Mr. WALLIS. I think it will decline, yes.

Senator JEPSEN. Why do you say that?

Mr. WALLIS. Well, partly because of simply the facts that account for it now, being that we are ahead of the rest of the world in the recovery. As they recover, they catch up with us, they will begin to buy more from us. But beyond that, look at it another way. We buy these Japanese automobiles. They are not going to send us those automobiles if all they get are little green slips of paper. They will not eat them and they will not burn them. And they cannot wear them. And they simply are not going to go to all the trouble of making those things and shipping them over here if they do not get something.

Now they do not have to get it from us. They can take the little green slips of paper, which, of course, are not even that. They are just bookkeeping entries. And they can go to Brazil and buy coffee or whatever it is that they want, or what they mostly do is go to Saudi Arabia or elswhere and buy oil.

But, at any rate, if we issue those green slips of paper to get those automobiles, you can be sure that some day, you are going to have to give something real in return for that slip of paper. Somebody will show up here that wants to buy something. They simply are not going to settle for the entries, bookkeeping entries.

So I have sort of two reasons—one, the short-range, empirical one, and the second one is the basic theoretical one.

Senator JEPSEN. Do you have anything else?

Representative SCHEUER. No.

Senator JEPSEN. I thank you very much. This has been one of the most informative hour and a halfs that I have spent recently. I appreciate it.

Thank you.

Mr. WALLIS. Well, thank you very much. Frankly, I have enjoyed it, too. The questions you ask are the ones that I am interested in.

Senator JEPSEN. Thank you.

The committee is recessed.

[Whereupon, at 11:40 a.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 9, 1984.]

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 9, 1984

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

The committee met, pursuant to recess, at 10 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Abdnor, Symms, and Bentsen; and Representatives Hamilton, Obey, Holt, and Lungren.

Also present: James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and Robert R. Davis, William R. Buechner, and George R. Tyler, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. We wish to welcome you, Chairman Volcker. We are happy to have you participate in the Joint Economic Committee's annual report hearings.

I know that this is your third day in a row of testimony before congressional committees, so I first want to commend you on your stamina and your patience and cooperation in participating in these various oversight functions.

Second, I want to assure you that there is an unbounded and constructive congressional interest in the conduct of the monetary policies.

The last year has seen a remarkable economic improvement, especially given the general sentiments of a year or two ago. We can all share in the glory of success, but the victory will be hollow if continuing economic troublespots are not recognized and remedied.

The burden of dealing responsibly with fiscal policy now lies principally with Congress, while you and your colleagues must deal with the independent problem of monetary policy.

Chairman Volcker, your testimony to the Banking Committee earlier this week indicated two heartening changes in assumptions that I believe should improve the soundness of monetary policy.

First, Federal Reserve is increasing the emphasis on targeting M1. Second, the Federal Reserve has reached the conclusion that velocity is likely to be a more stable factor in the future. Each of these changes imply a more stable monetary policy.

The biggest problem of monetary policy, however, is the continued volatility of M1 growth rates. Although M1 has been in or near its growth range for the last 6 months, the dramatic reduction of money growth between the first and second halves of 1983 is likely to lead to a much slower economy in the near future.

More and more analysts are suggesting that real growth will not reach the Federal Reserve and the administration's 4.5 percent forecast range unless money supply growth is increased by spring.

Perhaps the Federal Reserve has painted itself into a corner where we face the unsavory monetary choice of an interruption of the recovery or the risk of somewhat higher inflation.

In sum, I feel that 1984 is likely to see more volatile economic growth than the Federal Reserve is forecasting. In addition, I worry that the economy faces more downside risks than your projected ranges imply, especially if the Fed decides to stay near the bottom of its M1 growth target of 4 to 8 percent.

Mr. Chairman, again I welcome you and hope that you can put my mind more at ease about the appropriate stance of monetary policy.

At this time, I would ask the distinguished Senator from Texas, Senator Bentsen, if he has any opening remarks.

Senator BENTSEN. Thank you very much, Mr. Chairman. I would like to submit my opening statement for the record at this point.

[The written opening statement of Senator Bentsen follows:]

WRITTEN OPENING STATEMENT OF HON. LLOYD BENTSEN

We have seen vivid evidence in recent days, Mr. Chairman, that the thread of confidence which sustains the economic recovery is slender, indeed.

I recall that last month, when the stock market dipped, analysts advised us investors were concerned that President Reagan might not run for reelection.

Their concern seems to have reversed direction. Since the President announced as a candidate for reelection the market has really taken a nose dive. What happened in January pales by comparison. The Dow Jones Industrial Average fell 70 points during the entire month of January. Yet in one three day period since the President's announcement it fell 40 points.

We all know, of course, that the President's announcement isn't the problem. The President's budget is the problem. The series of $200 billion deficits stretching on into the future is the problem. The announced intention of the President and his administration to simply try to ignore the deficits through the election is the problem.

We have a President who is budgeting higher spending for defense. We have a President who is budgeting hundreds of millions of dollars for a manned space station.

That may all be well and good, but his budget makes no provision for paying for any of this.

No wonder there is a loss of confidence.

As are you, Mr. Chairman, I am aware that one of the most vital strands in our thread of economic confidence is that of foreign investors. Their money is needed to prop up our financial markets, compensate for heavy government borrowing and keep interest rates down—although real interest rates today remain at historic highs.

I was interested in your concerns expressed yesterday about a possible loss of confidence by these foreign investors and what it might mean to our economy if they begin pulling their money out of our country.

I watch what's happening to our stock market and I wonder, if we have millions of American investors who have lost faith in their government's will to deal with huge deficits and who are taking their money out of their investments, if we have this loss of confidence by domestic investors, how long can we realistically expect foreign investors to keep the faith?

I certainly wouldn't put any stock in it.

Senator JEPSEN. Senator Symms.

Senator SYMMS. Mr. Chairman, I will defer until the questioning period.

I just want to welcome Chairman Volcker here this morning and I think I echo some of the concerns that you have expressed in your opening statement about the targets and the comment on what the projected targets are, which I think could cause a lot of disappointment out there in the recovery, so I look forward to hearing from the chairman and then I have some questions.

Senator JEPSEN. Mr. Chairman, you may proceed. Your prepared statement will be entered into the record as if read and therefore you may proceed in any manner you so desire. Welcome.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I have a short prepared statement, Senator, which I will dispense with reading, if you prefer, and get into some of the more specific questions you have.

Let me read a part of my prepared statement, anyway, because I think it refers in a very general way to some of the points you raise. You have, of course, all the detailed material before you in the Humphrey-Hawkins report and in my longer testimony before the Banking Committee.

Let me say, in general terms, that the basic policy objective of the Federal Reserve continues to be the achievement of long-lasting economic expansion in the context of the ongoing controls of inflationary pressures.

In setting the target ranges for the various monetary and credit aggregates, the Federal Open Market Committee at its meeting last week had to remain alert to the danger of renewed inflation as well as to the need for economic growth.

Consistent with these objectives and the current economic situation, the FOMC essentially reaffirmed the tentative ranges for the monetary and credit aggregates for 1984 established last July. The ranges call for growth rates that are one-half to one percentage point below those set for 1983.

As you indicated, Mr. Chairman, the ranges for 1984 envisage the relationship between monetary and credit growth and economic activity and inflation—the velocity of money—will broadly follow past trends and cyclical developments after the unusual behavior of 1982 and early 1983.

Most of the special influences that depressed velocity in late 1982 and early 1983 are behind us, and as of the past year it is more in line with longer run experience.

This judgment about the fundamental relationship between money and economic performance will, of course, be reviewed constantly in the weeks and months ahead and our evaluation will reflect all of the available evidence about production, employment, prices, and domestic and international financial markets.

Consistent with the monetary ranges established for this year, the members of the FOMC generally felt that the economy would grow at a more moderate and potentially more sustainable pace of 4 to 4.75 percent during 1984 and into 1985. The gains in output are expected to generate a further expansion of new job opportunities and the unemployment rate is expected to decline.

After remarkably good progress in 1982 and 1983, price increases are expected to be a little larger on average, essentially as a result of cyclical factors and special circumstances.

All of this, just to summarize the rest of my prepared statement, comes on top of much better performance in 1983 than had been anticipated. I think that statement is true both as to the expansion of the economy and the progress against inflation, and what is particularly heartening about what has happened to date is that we have had both. We have had a good economic expansion and that has been combined with considerably more price ability than we have been used to in earlier years.

I also believe—we can get into more of this if you wish—that there are signs of more fundamental developments in the economy in the area of productivity, in the area of efficiency, restraint on costs, that potentially bode well both for inflation and sustained advances in the future but, of course, I do see some hazards and risks out there in terms of our budgetary deficit, the potential pressures that it puts on financial markets in increasing the critical concerns that arise precisely because the economy is now growing and it is nearer—not at capacity—to a range when you would hope that investment in housing would be sustained at high levels but you have the potential for considerable pressures from the budgetary side.

So far, those pressures have been ameliorated to a considerable degree by an inflow of capital from abroad, but I think that is another vulnerability that we have; do we want to and can we count on this growing capital inflow from abroad and count on that to relieve pressures on domestic markets? That does not seem to me to be an entirely sustainable situation.

So I think we have a great opportunity for really looking toward a decade that, in a sense, reverses what we saw in the 1970's when performance deteriorated and inflation accelerated. We have more confidence now. I think we can build on that, but I think there are certainly problems for monetary policy and problems in the fiscal area that have to be dealt with.

I will conclude there, Mr. Chairman.

[The prepared statement of Mr. Volcker follows:]

PREPARED STATEMENT OF HON. PAUL A. VOLCKER

I appreciate the opportunity to appear before this Committee today. As you know, the Federal Reserve submitted its semi-annual monetary policy report to the Congress earlier this week, copies of which have been distributed to you. That report describes in detail our plans for monetary policy, including the Federal Reserve's objectives for the growth of money and credit. I have also testified before the House and Senate Banking Committees the last two days and have distributed copies of my formal statement to you. My prepared remarks this morning, therefore, will be brief and confined to more general considerations of monetary policy within the context of recent and prospective economic and financial developments.

The basic policy objective of the Federal Reserve continues to be to contribute to sustained economic expansion in a context of greater price stability. In setting the target ranges for the various monetary and credit aggregates, the Federal Open Market Committee at its meeting last week had to be alert both to the need for economic growth and to the danger of renewed inflationary pressures. Consistent with these objectives and the current economic situation, the FOMC essentially reaffirmed the tentative ranges for the monetary and credit aggregates for 1984 established last July. The ranges call for growth rates that are 1/2 to 1 percentage point below those set for 1983.*

The ranges for 1984 envisage that relationships between monetary and credit growth and economic activity and inflation --

---

*The new target ranges are set out in Table I attached, against the background of last year's targets.

the "velocity" of money -- will broadly follow past trends and cyclical developments after the unusual behavior of 1982 and early 1983. Most of the special influences that depressed velocity in late 1982 and early 1983 appear to be behind us, and the evidence over the past half year has become more (but not entirely) in line with longer-run experience. This judgment about the fundamental relationship between money and economic performance will, of course, be reviewed constantly in the months ahead, and our evaluation will reflect all of the available evidence about production, employment, prices, and domestic and international financial markets.

Consistent with the monetary ranges established for this year, the members of the FOMC generally felt that the economy would grow at a more moderate -- and potentially more sustainable -- pace of 4 to 4-3/4 percent during 1984 and into 1985. The gains in output are expected to generate a further expansion of new job opportunities and the unemployment rate is expected to decline to the area of 7-1/2 to 7-3/4 percent by year's end. After remarkably good progress in 1982 and 1983, price increases are expected to be a little larger on average, essentially as a result of cyclical factors and special circumstances -- including the effects of bad weather and the large hike in payroll taxes earlier this year.

The prospect of further good economic gains in 1984 comes on the heels of a far better than anticipated performance in 1983. Real gross national product rose 6 percent over the four quarters of the year, well above earlier projections, and the unemployment rate was cut by 2-1/2 percentage points. At the same time, most broad measures of prices and wages recorded further progress toward lower inflation. With employment expanding, productivity improving, and inflation moderating, the real income of the average worker rose.

As we move into 1984, there are strong reasons for believing the economic gains of the past year can be extended. The latest reports on employment, income, and production, showing further gains around the turn of the year, are consistent with that view, as are indices of consumer and business confidence at high levels. Much more fundamentally, the progress against inflation, the evidence of increased productivity, the sense of greater discipline and restraint, and a recovery in profits all, in my opinion, go a long way toward setting the stage for a long period of greater prosperity.

We all realize a year of strong recovery -- hard on the heels of a severe recession -- has left unemployment still far too high, with some 9 million still out of work. To some degree, the rapid progress toward price stabilization has reflected "one time" or cyclical influences. More time must pass before we can claim success or take satisfaction that we have restored prosperity or assured stability. And, we need to recognize, and deal effectively, with some obvious hazards and risks that jeopardize the good prospects for 1984 and beyond.

Those prospects rest in good part on whether interest rates, and conditions in credit markets more generally, can support the housing and investment we need, whether we can restore better balance in our international accounts, and whether, in the meantime, we can count on the inflows of capital from abroad upon which we have become dependent.

Over time, success in those areas is dependent upon the expectation and the reality that we can build on the progress toward price stability. Monetary policy must contribute to that goal -- disciplined growth in the money supply is a critical ingredient. But there are also factors outside the control of monetary policy that bear importantly on the question.

As you know, we are faced with two deficits: the structural deficit in our Federal budget and the deficit in our external accounts -- both at unprecedented levels and getting worse. Those twin deficits have multiple causes, but they are not unrelated. Left unattended, each, rather than improving, will tend to cumulate on itself. Sooner or later, the financing of those deficits will expose us to financial risks that could undercut all that has been achieved in recent years with so much effort and so much pain.

Large budget deficits, currently and prospectively, are a burden on credit markets and absorb historically unprecedented fractions of our domestic savings. That is one reason interest rates today are far higher than is healthy from the standpoint of balanced growth domestically. Those interest rates have been moderated as a result of a growing capital flow from abroad, stimulated by a variety of causes; in effect, net capital inflows have been used, directly or indirectly, to help meet the government's financing requirements. But those growing capital inflows, which have tended to appreciate the dollar relative to other currencies, are also inextricably related to a large and growing deficit in our trade accounts. In both our financial and our trading interests, we simply can't afford to become addicted to drawing on increasing amounts of foreign savings to supplement our limited domestic savings simply because the Federal Government is drawing so heavily on that savings pool. The longer they last, the more difficult it is to cope with these internal and external deficits because interest costs compound on themselves.

I believe we now have a rare opportunity to set in train a long period of growth and stability. A decade that began with accelerating inflation and prolonged recession can end with renewed confidence and strength. But that happy vision will not be achieved by resting on our oars -- by sitting back and drifting with the tide. It will require a continuing sense of discipline by business and labor, and emphasis on competition and productivity. It will require the demonstration by those of us responsible for public policy that our twin deficits can be brought under control and that inflation will not again get the upper hand.

We can and should be gratified by the progress that has been made, and by the many positive signs in the outlook. We have time -- time to influence markets constructively, time to demonstrate that we are in control of our own financial and economic destiny. But to wait would be to multiply the risks, to increase the hazards to full recovery, to jeopardize what has been achieved.

That is why I hope that you in the Congress, together with the Administration, can find the consensus required to begin reducing the budget deficit, and to restore confidence that, over time, the structural deficit can be closed. Right now, no other action appears so promising and so important in terms of seizing, and capitalizing upon, the immense opportunities before us. Certainly, that would make it easier for monetary policy to play its own essential role.

* * * * * * *

Table I

Federal Reserve
Objectives for Money and Credit Growth in 1984[1]

	New ranges for 1984 (%)	Tentative ranges for 1984 set in July 1983 (%)	Ranges for 1983 established in July 1983 (%)
M2	6 to 9	6-1/2 to 9-1/2	7 to 10[2]
M3	6 to 9	6 to 9	6-1/2 to 9-1/2
M1	4 to 8	4 to 8	5 to 9[3]
Domestic Nonfincial Sector Debt	8 to 11	8 to 11	8-1/2 to 11-1/2

1. Ranges apply to periods from fourth quarter to fourth quarter, except as specified.
2. Range applies to period from February-March 1983 to fourth quarter of 1983.
3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

34-871 O - 84 - 17

Senator JEPSEN. I thank you, Chairman Volcker.

The chart on the far right, that first one, illustrates the relationship between money growth and after a short lag the nominal gross national product growth. The evidence is clear that the monetary volatility has been a major cause of volatile economic performance for the past 5 years.

Now it appears that the latest contraction in money as we see the M1 grow, as we head into the 1984 year, plummeting at a rather sharp angle.

We are concerned that this may interrupt the economic expansion that we want to foster. Your target proposal has come out with, I believe, a 4 to 8 percent range for M1 versus 5 to 9 percent in 1983, and your ranges for 1984 indicate a tightening of the targets.

As you can see, there is certainly a direct relationship. There is some lag between the M1 rate and gross national product, but certainly the chart is in direct correlation.

How will the Fed cope with the risk of an accident that we as a nation cannot afford if we go down and hold to the bottom side of this 4 to 8 percent range? Are we in danger of triggering another recession?

Mr. VOLCKER. Let me just raise a technical question first and then address your general question.

I do not know what the numbers on these charts mean in terms of whether they are revised or unrevised figures for M1, and I am also not clear precisely how they were calculated.

On the figures we have issued in connection——

Senator JEPSEN. The figures are revised.

Mr. VOLCKER. They are revised? That is what—December over June?

Senator JEPSEN. December over June on money supply, yes, sir.

Mr. VOLCKER. Plotted once every quarter on a 6-month period?

Senator JEPSEN. Every month.

Mr. VOLCKER. Let me make a general observation about that chart. There is a broad relationship between money growth and nominal GNP that I suppose is a common foundation for approaching these monetary targets.

That is a nominal GNP; it is a combination of price and real GNP. Of course, we are interested in prices and real GNP separately.

You have GNP running above the monetary growth pattern there for M1 through mid-1981, by a considerable amount. A lot of that was prices at that time, but if you put it in other terms you have velocity rising quite rapidly.

You can look at the period 1982 through 1983 and you have GNP below the monetary numbers. Velocity was falling and that was rather an abnormal development; that is one way of looking at it in reaction to that fall in velocity, along with some other evaluations that encouraged us—if that is the right way to put it—to permit the M1 money supply to rise rapidly in the second half of 1982 and through the first part of 1983. The increase in the GNP in that case was increasingly real, and less in prices, which of course is what you like to see.

When we talk about velocity returning more to normal patterns—and that is still a tentative judgment—but in line explicitly with the M1 target this year, we would expect that blue line on your chart to again move above the red line. That is what a return to more normal velocity would mean and that is allowed for in this 4- to 8-percent target range.

In other words, if we were in the middle of that range, let us say around 6 percent, you would expect the blue line on that chart to move above the 6 percent M1 growth; we have projected something in the neighborhood of 9 percent or a little more in the nominal GNP, and that would be broadly consistent with past cyclical patterns at this point.

Of course, we like to see as much of that 9 percent in real growth and as little of it in prices as possible. We are taking off from a point where, as I said, more has been real and less in prices, so the calculation is that that is consistent with the kind of growth that we foresee and we have a fairly wide range which, among other things, reflects some uncertainty as to precisely what the growth in velocity will be during this period.

We think the evidence is that it is returning to more normal patterns, but that has to be a tentative judgment.

Senator JEPSEN. Is your assumption, as I understand it, the present assumption that velocity growth will rebound to its postwar trend, at or about 3½ percent to the effective money growth and spending?

Mr. VOLCKER. It is not just a long-term trend. It depends on what series of years you take. Four and a half percent is the average over a period of years. In cyclical expansions you often get a higher rate of growth of velocity than that.

We are not counting on velocity growth as high as you would get during some cyclical expansion, but, yes, we are counting on—maybe "counting" is too strong a word—expecting some return to more of a normal cyclical pattern, which would be above the long-term trend. Because it has been lower, it might be less than that, and we have allowed for that in the target range.

Senator JEPSEN. Many economists now feel that the interest payments on checking accounts increase the public holding of cash balances and permanently reduces velocity by more than 2 percent.

Now if this holds true, then the money growth is effectively 2 percent slower than you think in terms of its impact on spending and inflation, and I think we get right back to what I said in my initial question: Do we not get closer to the danger of accidentally generating a recession?

What would be required for the Fed to alter its views on velocity?

Mr. VOLCKER. Let me say two things in that connection. First of all, we had the decline in velocity in 1982 and 1983 in reaction to the phenomenon that you referred to—this institutional change of paying interest on checking accounts and increasingly paying market rates of interest. I think there were other influences involved, but that was an influence, and partly for that reason, partly because the inflation rate is down and expected to remain down, we have, in effect, said we will forgive the decline in velocity; we are not operating on the expectation that that decline in velocity is going to reverse itself.

If you just look at the long-term trend of velocity and assume we are going to stay on trend, what you might say is the decline in velocity will be reversed and we will get a much quicker increase in velocity, looking a year or two ahead.

If that happened, these targets might be too high, in fact, or at least you will go toward the lower end of the range. We are not necessarily assuming that. We are assuming some cyclical growth in velocity.

The underlying trend, which only can be measured over a long period of time, may indeed be less than it was before. I rather share the view that that is something that is quite possible—we cannot prove it now—but we believe that within that 4- to 8-percent range you can allow for that, and then you would appropriately be toward the top of the range.

Senator JEPSEN. Well, velocity being the speed at which money turns over in the economy, when everything we are doing in Congress is to encourage savings and we have the added factor, as you indicated, of interest on checking accounts and IRA's and the proposal now to expand those, can you project and predict these things and have it both ways?

Mr. VOLCKER. if I may just respond: we feel, frankly, a bit tentative about this, which is why we are not giving full weight, in a sense, to M1. As I said yesterday, M1 is kind of "on probation" because of the very uncertainties that you suggest.

We have made certain assumptions and we have a fairly wide range reflecting precisely the kinds of concerns you are expressing, but we will evaluate this as time passes. We will evaluate the evidence of what's happening in the economy, what the growth is, how inflation is behaving, and if the evidence accumulates that velocity is not rising at all, let us say, just taking that hypothetically the target would be too low.

We do not expect that to happen. It is a matter of degree, and it is just going to need continuing evaluation. That is not our only target. We are putting substantial weight on the broader aggregates—and the credit aggregate—where the targets, as you know, are higher and we would not expect the same trend in velocity.

Senator JEPSEN. OK. My time is up. I advise the members of the committee we are having 10 minutes apiece today.

Senator Bentsen, you may proceed.

Senator BENTSEN. Thank you very much, Mr. Chairman.

Mr. Chairman, in the last 30 days we have had approximately a $150 billion loss in the stock market. The Dow Jones industrial index has gone down in that period about 130 points. We have had a drop of about 10 percent.

I am looking at a news story that says, "The fall in the stock market reflects the new economic worries." There is a feeling, this story reports, that nothing meaningful is going to be done by the administration or the Congress to make substantial cuts in expenditures or cut the deficit with taxes.

Would you comment on that?

Mr. VOLCKER. I understand that feeling, and I presume that is a factor in this market performance and uncertainty. I think there is a very real problem in these budget deficits and the need to deal with it becomes more urgent, as I said, as the economy grows.

You can stand a bigger deficit in the middle of recession, when inventories are falling, and the investment is low, and housing is just beginning a recovery, and when, indeed, the budget deficit is a result of providing a lot of purchasing power and stimulating consumption. That has a positive side when you are in recession, but the negative effects on financial markets and investment begin becoming predominant as the economy grows, and I think we are now in this critical period where action is necessary.

I understand the pessimism or discouragement about the possibility of action that you refer to. It is ironic to me, in a way, that I feel a little bit better about the prospects. I see some consensus developing now that I might not have felt a few months ago, but we are obviously not there yet and there are many problems, as you know so much better than I, in arriving at an effective consensus for action.

Senator BENTSEN. I was reading Mr. Feldstein's comments, that in 1983 and 1984, we had an estimated $100 billion in net foreign investment inflow to this country. In effect, hot money coming here helped and will help hold interest rates down.

I was just in Davos, Switzerland, at a meeting with about 30 public figures from around the world, including the finance minister of Germany, the trade minister of England.

They were speaking of their deep concern for these mounting deficits, the fact that they have almost doubled each year for the last 3 years, and that they do not see any appreciable curtailment in the size of those deficits. They were talking about the amount of——

Mr. VOLCKER. You are speaking of the trade deficit—the current account deficit?

Senator BENTSEN. They were talking about the total deficit in the budget and seeing their European currencies flow out and bolstering the dollar. One of the reasons is, of course, high interest rates here, but another very major reason, and a more intangible one is the feeling that we have stability in our economy. Yet, all of a sudden that particular presumption is being challenged as we see these deficits piling one on top of another. There is a feeling abroad that we could see some of that hot money turn around and start out from here, go back to Zurich or to Tokyo or to London. If that happens, what do you see happening to interest rates in this country?

It seems to me if you had a 20-percent drop in the value of the dollar and an exodus of that kind of capital, it could have just a more serious effect than a drop in the stock market.

Mr. VOLCKER. You would see, in that case, more pressure, potentially, on financial markets and an improved trade position, which over time would be good.

Senator BENTSEN. Yes, but that takes quite a while.

Mr. VOLCKER. That is exactly right; over time you would see more pressure on domestic financial markets which would squeeze investment and housing and so forth here.

Senator BENTSEN. Does that mean an increase in interest rates as that happened?

Mr. VOLCKER. It depends on what else is happening at the same time, but that danger exists.

Just to leap to the answer, so to speak, when you look at those kinds of risks, you ask yourself what can we do to deal with it, and it seems to me the answer is fairly obvious and unambiguous.

The way we can deal with those risks is to take the actions that we can take to reduce our dependence on that inflow of foreign money by reducing the financing burdens on the U.S. market, and the way we can do that, obviously, is by moving as promptly and effectively as we can on the budgetary side.

That is going to take a while in the best of circumstances, but I think it is also true that the action to move in that direction significantly and forcefully will deal with precisely the problem mentioned at the start—the uncertainty and the confidence factors that bear upon this inflow of foreign money. We are going to need it for a while. There is no way we can escape it because of the big current account deficit, so we want to take actions that underscore and reinforce the feeling—the intangible feeling—of confidence that you referred to.

Senator BENTSEN. Are you hearing more and more increased concern about that from foreign sources, about the stability of that dollar, because of the mounting deficit?

Mr. VOLCKER. Yes, I think there is increasing concern, basically growing out of the circumstance that I referred to.

It is one thing to have deficits when you are in the middle of a recession, but it is quite another thing when the economy is doing so much better.

To complete her argument, you might say, well, let us deal with this problem insofar as we can through monetary policies. I cannot object to that in general terms.

Senator BENTSEN. But you cannot handle it by yourself.

Mr. VOLCKER. No, you cannot handle the interest problem or the budgetary problem if you try to handle it through great big increases in the money supply. That way you undercut confidence.

Senator BENTSEN. It seems to me if you get into our present situation where on the fiscal side it is very expansionary while you are trying to hold it down on the monetary side, it is a little bit like driving a car with one foot on the brake and the other foot on the accelerator.

Mr. VOLCKER. I agree with that.

Senator BENTSEN. You may be able to control the speed but it sure raises "Cain' with the machinery.

Mr. VOLCKER. Right. That is a good analogy.

Senator BENTSEN. And that is my concern. Thank you very much, Mr. Chairman.

Senator JEPSEN. Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman.

Chairman Volcker, if I read the paper correctly yesterday, you I think warned the Banking Committee that you are worried about a recession. Is that correct?

Mr. VOLCKER. I think that's a little blown up. I think I mentioned the words "recession" once in the midst of a colloquy and said that eventually, down the road, this obviously complicates our problems and you could even have a recession way down the road.

I think basically the outlook is bright, as reflected in our projections here. The only way I can state this is I think the basic outlook is encouraging. A lot of good things have happened in recent years, but this budgetary situation and the remaining international dimensions of it pose increasing risks that get greater and greater as time passes, because in part the economy is performing well otherwise.

Senator SYMMS. Well, I appreciate that and I appreciate Senator Bentsen's question and the analogy about the automobile with one foot on the gas pedal and one foot on the brake.

So what you are saying is the fiscal policy is stimulative as to the recovery.

Mr. VOLCKER. No question about that.

Senator SYMMS. But the monetary policy right now, and as Senator Jepsen pointed out, do you not think we should be worried about the restriction in money growth and restriction in bank reserves right now with respect to what is going to happen?

Mr. VOLCKER. You would expect me to say, and I will say, we think it is broadly appropriate given all the circumstances. I think you should worry about precisely the kind of concern that Senator Bentsen was describing that makes life for the financial markets more difficult. It increases the pressures policy and the difficulties of maintaining a monetary policy.

Specifically, it keeps interest rates higher than they would otherwise be, which is not good for investment, which is not good for housing, is not good for the trade balance, so, yes, I think there are problems out there—plenty of problems to worry about.

We have gauged the monetary pressures as best we can, given those other circumstances that exist.

Senator SYMMS. Well, if the dollar is extremely strong relative to other currencies, as it now is, does this suggest that there is a substantial dollar shortage in the world?

Mr. VOLCKER. Not in the sense of general liquidity of the world economy; it certainly suggests we are sucking in a lot of funds to finance our deficit. We indeed are.

Senator SYMMS. Well, is that primarily because of high interest rates, a strong dollar or is it a safe haven that people view?

Mr. VOLCKER. It is a combination of things. I think it is some sense—and all of these things are relative—of relative confidence in the stability and progress of the American economy, the kind of broadly favorable conditions we have for conducting business in the United States; and, related to that—a somewhat different aspect—is the relative political stability at a time of concern in some other countries. Certainly the interest rates themselves are a factor; no doubt about it.

Senator SYMMS. Well, I am on the Budget Committee, also, Mr. Chairman, and we have had witnesses there all last week testifying and we hear a lot from OMB now and they focus on the alleged deficit, that that is the problem, and we have to increase taxes to eliminate the deficit, but sometimes I wonder if that is not just some kind of a ploy to cover up the fact that OMB never advocated the spending cuts that should have been advocated in the first place.

Do you really believe we can solve this problem by raising taxes?

Mr. VOLCKER. I have said on many occasions that from an economic point of view you have to deal with many other priorities. The best way to deal with this problem would be to reduce expenditures, but I think the problem is serious enough so that if you cannot for whatever reason—if other priorities conflict—reach a consensus on doing enough on the expenditure side, then I think you are forced to look at the revenue side. But from a strictly economic point of view I would rather see you do it on the expenditure side.

Senator SYMMS. Yesterday before the Finance Committee, Peter Grace testified and they advocated we could cut 10 to 12 to 15 percent out of every department of the Government, and I happen to agree with him, by simply giving the senior executive corps the authority to go out and do it and pay him $20,000 reward per person if they actually make a 15-percent cut in their agency without losing any of the services available that the Government puts on, yet somehow Congress never seems to be able to come up with that dramatic of a proposal.

Would a 10-percent cut across the board in the Federal budget make an enormous difference?

Mr. VOLCKER. There is no question that a 10-percent cut in the budget that is running $800 and some billion would pretty well deal with the problem.

Senator SYMMS. In other words, your job would become easier.

Mr. VOLCKER. Yes. We would have lower interest rates. It would be much easier for us to keep the monetary side on track. It would be healthy for economic activity. That is not saying it is possible.

Senator SYMMS. So if we raise taxes, that has to be financed out of the private sector so that we would not solve the problem.

Mr. VOLCKER. It comes out of the private sector anyway; even the Government spending puts the money in the hands of the private sector. But raising taxes changes the dimensions of the problem, the structure of the problem quite considerably, and it depends on what taxes you raise.

What we have now is a great stimulus to domestic consumption, but that deficit has to be financed and the way it is financed inevitably hits at the investment side of the economy and hits at the foreign trade side of the economy; that is not a healthy mix, in my opinion. What you would have, potentially, is a much healthier and more sustainable mix of economic growth.

Senator SYMMS. Well, let me just put it this way. If the Congress chooses, and the administration, to solve the deficit problem by raising taxes as opposed to cutting the spending, do you believe that interest rates would have a substantial—that there really would be any major change in your ability to keep from having the dollar fly, as Senator Bentsen was talking about, or what else could keep things stable?

Mr. VOLCKER. I think it would have a favorable effect on interest rates. I am extracting from what kind of taxes you choose, but it would not have as favorable an effect on the growth and strength and balance of the economy over a period of time. But it certainly would remove one source of pressure on financial markets.

If the tax all came out of the cash flow of businesses, it would be the most nearly equivalent thing to a deficit, but to the extent that taxes are more broadly conceived and go to this purchasing power question, I think it would have a favorable effect—although not as favorable as reducing spending.

Senator SYMMS. Mr. Chairman, one other question I wanted to ask, if I may have another minute here.

In your decisionmaking process of trying to pick out all things that happen, how much do you pay attention to the general commodity range of prices?

Mr. VOLCKER. I personally observe commodity prices fairly closely because of several implications. It is one measure of speculative tendencies and concern about future prices. Those prices are sensitive. They may be affected by inflationary expectations. They also, in some cases, depending upon the commodity price, are an important element in costs and therefore in the underlying inflation trend.

They give you some idea of whether you are running into capacity limitations and that kind of thing, so I think they are a useful economic indicator and psychological indicator.

Senator SYMMS. Are not commodity prices, in general, on a decline or have been in the last 6 months?

Mr. VOLCKER. No; as I read it, the prices are generally increasing. They have had a general cyclical increase from very low levels. I do not think it is disturbing at this point, in terms of the basic trend of inflation in the future, because they are coming up from such low levels, and in many cases they are still below earlier peaks 3 or 4 years ago; but the general trend has been upward.

Senator SYMMS. Is that true for industrial raw materials?

Mr. VOLCKER. Yes; it is true of industrial materials. Grains reached a peak in the autumn following the drought and the PIC program and so forth, and grain prices in general in important commodities have been drifting off for some months but from a sharp peak late in the summer and the early fall; in general the broadest indexes you look at have been rising.

Figures compiled by the BLS, the Commodity Research Bureau I guess it is called, generally show an up trend, but of course that disguises a lot of ups and downs among commodities.

Senator SYMMS. Thank you Mr. Chairman.

Senator JEPSEN. Congressman Obey.

Representative OBEY. Thank you.

Mr. Chairman, as I read the statements made in the last several months, I get the impression that you still have at least residual concerns about reinflation, the reignition of inflation in the long term.

Mr. VOLCKER. I think that is fair.

Representative OBEY. You indicated that it is going to take a while to get deficits down, even if we begin to move on it now. Let me ask a couple of questions first, following up on Senator Symms' statement about it being preferable to start the budget reduction on the spending side, and I guess everybody would agree to that as long as the discussion is in the generic, but when you look at the budget and you see that 82 percent of it is in either military expenditures, retirement-related expenditures or interest, you are not going to affect interest directly.

Mr. VOLCKER. Now if I may just interject Congressman Obey, I think that one of the opportunities, potentially, is if we can get the budget on the downhill path; that is reflected in the lower interest, and you have a lot of leverage there.

Representative OBEY. I understand that, but that is not a direct attack on interest; it is an indirect attack.

Mr. VOLCKER. Exactly.

Representative OBEY. I see the negotiations at the White House yesterday have apparently taken social security related items off the table for discussion for the time being. That is one big ticket item that is off the table.

If the administration were to continue to suggest that it is simply not possible to get large savings in the military area and if Congress were to agree with that, that would take the other second big ticket item off the table and it would mean that in terms of reduction on the spending side that we would be left with relatively minor actions on the military side and retirement side and it would mean there simply is not enough portion of the budget remaining to get to that $80 billion figure that you just talked about in terms of the 10-percent reduction across the budget.

At that point, would it not be better for us, even though none of us wanted to politically, would it not be better for the Congress and more responsible for the Congress and the administration to include in its package a significant action on the revenue side rather than simply settling for minor actions on spending side because of our inability to reach agreement on reducing military and retirement?

Mr. VOLCKER. I think then you are stuck, and as I indicated earlier, I would have to turn to the revenue side of the budget, yes.

Representative OBEY. Thank you, and I hope that my colleagues in the Congress and our other partners down at the other end of the street face up to that fact.

Mr. VOLCKER. You are making some assumptions that may not be related.

Representative OBEY. Yes. By me, I would like to be president of an optimist club but I am not, and I do not see much movement on the military side.

Let me ask you, getting back to the inflation issue, discussing your apparent concern about the possibility for a reignition of inflation in the long term, is it your view that we really now do have inflation licked or is it still a potential problem for us?

Mr. VOLCKER. I think inflation is an animal that you never lick without continuing attention. I think we have made a great deal of progress but that has, as one assesses the situation now, something of a one-time component, or at least a portion of it is one-time or cyclical.

Representative OBEY. So you are saying it could be Lazarus-like unless we take further actions on the fiscal side than have been taken?

Mr. VOLCKER. I think it is important that the action is on the fiscal side. I do not think the inflation outlook turns on that alone. I think we have signs of increasing productivity. They are not yet absolutely conclusive, but I think it is terribly important in terms of long-term outlook for inflation that we convert these tentative signs of increasing productivity to a more permanent increase.

Representative OBEY. So that in the short run we ought to keep in mind that while inflation may be down for the moment, it may not necessarily be licked without further action.

Mr. VOLCKER. Right. I think we can lick it but it will take continuing efforts and we cannot just sit back. It is not going to take care of itself.

Representative OBEY. All right. Having established that, let me lead you to the question of the value of the dollar on the international market.

As you know, there is a great deal of concern about what some people describe as the overpricing or overvaluing of the dollar by about 20 percent or so, and Federal Open Market Committee meeting in December 19–20 indicated their concerns about what a rapid drop in the price of the dollar would do to interest rates.

What does that mean to you in terms of policy that should be followed on the monetary side? Does that mean that it is preferable to maintain a level of money growth and a level of short drop in the dollar in order to prevent a reignition of inflation that might cause the whole situation to unravel?

Mr. VOLCKER. Yes.

Representative OBEY. Is it your feeling that is the price we have to be prepared to pay short term?

Mr. VOLCKER. If the dollar is too high in some sense relative to our trade and trade outlook, sooner or later you would expect that to be moderated; that in itself—a decline of the dollar—is an inflationary factor, but it is going to happen sooner or later. You have to absorb it. A lot would depend on how it happened.

Let me say I do view that as a concern or a risk that makes it all the more important that we deal with other sources of inflationary pressure, for two reasons.

Representative OBEY. Because my time is almost up, let me interrupt you and ask a last question.

You indicated earlier that it was going to take a while to do all these other things, even if we were able to attack the deficit immediately.

Does that mean in your judgment that until that occurs that our monetary policy ought to follow a path which would avoid a precipitous drop in the value of the dollar until you have those other actions taking place in order to avoid that reignition of inflation?

Mr. VOLCKER. I would not focus quite as exclusively on that as your question implies, I am sure. Generally you would not focus on that exclusively.

I think it does increase the sensitivity in the conduct of monetary policy to doing what we can to avoid a reignition of these inflationary pressures, which would only aggravate a falling dollar.

Representative OBEY. That is my concern because I recognize your reluctance to do anything which would reignite the impression that inflation was moving, but I am concerned that because of your concern on that point that there might in fact be such attention to the short-term problem that we would have on the inflation side if the dollar were to drop, that in your monetary policy you might in fact be making it more difficult than we ought to be making it to get to the long-term benefits that would come from changing those rates.

Mr. VOLCKER. I think I would focus on monetary policy on the longer term and the continuing need to deal with the probability of a resurgence of inflation in the United States, rather than focus it narrowly on trying to maintain any particular value of the dollar.

We do not want to create a situation in which whatever other risks may develop on that side are aggravated by an inflationary policy. It is not a policy designed to maintain particular value of the dollar.

Representative OBEY. My last question, Mr. Chairman. Do you think it would be good or bad for the country if we had within the next 2 or 3 months a drop in the value of the dollar of, say, 10 percent?

Mr. VOLCKER. We have had a very sharp increase in the dollar. I would not take the position that some decline in the value of the dollar is in itself a problem. It would help on the trade side and it would hurt on some other side. But, again, I would not base policy on trying to maintain a particular value of the dollar. I would aim policy at maintaining an overall climate toward price stability which in itself will contribute, I expect, to the confidence needed to maintain some capital inflows upon which we are now dependent and which will avoid a rout in the foreign exchange market, so to speak.

To put it the other way around, if we embark on what was interpreted as an inflationary policy, it would increase the risks on the exchange rate side, but I do not think we want to sanctify any particular level that the dollar has reached.

Representative OBEY. Thank you, Mr. Chairman.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. Thank you, Mr. Chairman.

Chairman Volcker, you have touched on a point that I want to get at, but I want to clarify it in my own mind.

Economists that have appeared before this committee have seemed to say over the past year that timing in increasing revenues through tax increases is the key to the whole thing, that we have to establish some stability in the economic growth, that we have to make certain that we do not really put a drag on the economic growth that we are seeing taking place now.

You also said that we should not place a burden on industries, so I am assuming that you mean that our revenues should come from tax rate increases.

Mr. VOLCKER. Not necessarily. The administration, as you know, is apparently prepared to put forward a series of measures that would raise revenues and that do not involve an increase in tax rates.

Representative HOLT. Do I understand you correctly in saying the time is now if we cannot reduce the deficit through spending cuts, you feel that it would not slow the economic growth?

Mr. VOLCKER. No; I think it would be better to do it by spending reductions; let me just repeat that again. But given the other implications of the deficit and the other problems that are created, you obviously want to construct any revenue-increasing measures as carefully as possible. You want to take measures that are as consistent as possible with a good tax structure over time.

This is the time to do it if you cannot do it on the spending side.

Let me point, if I may, in a longer term perspective, that you cannot do this this year, and I am not suggesting that.

Representative HOLT. That is the point I want to make.

Mr. VOLCKER. If you really arrive at the conclusion—the hard conclusion—that you are kind of forced to take revenue measures and that between national security and retirement and other priorities we are going to continue to spend 24 or 25 percent of the GNP—which is where we are now—then I think you have to look at how to get the revenue generating capacity up in proportion.

That, I think, involves a very great problem of devising a more basic change in the tax system that is the least damaging for economic growth; that is going to require a lot of thinking and a lot of study and that is what you cannot do this year. That is a basic change which I think you have to face up to if you cannot get the spending down.

What you can do this year is to take some more limited and immediate measures if you have to, if you cannot get spending down in the short run.

Representative HOLT. I think that the most important thing we have seen beginning to happen is an improvement in productivity.

Mr. VOLCKER. I agree with that.

Representative HOLT. It seems this is the place where we have destroyed ourselves in this country. What would be the effect of increased taxes, aside from the cyclical component that it seems that this productive improvement is related to?

Now if we go for revenue enhancement through increasing it, what are we going to do to productivity?

Mr. VOLCKER. I think that depends on what kind of tax you think of. Again, from the standpoint of productivity it is better to do it on the spending side rather than any tax side, but I think there are big differences between types of taxes and the effect they have on incentives and growth.

The key point is that by reducing the pressures on the financial market you presumably get lower interest rates and more investment, which is very helpful from the productivity side.

Representative HOLT. Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Mr. Volcker, we are pleased to have you with us this morning. I would like to pursue a few questions along the line that Congressman Obey suggested on inflation.

In looking at the most recent published directives of the Federal Open Market Committee for the meetings in mid-December, it seems to me that those minutes reflect a very deep concern on the part of that committee about the possibility of resurging inflation. In those minutes, they cited five separate reasons why inflation might come back soon or surge forward again.

One was an indication of strengthening in inflationary expectations. The second was underlying wage pressure. The third was a large increase in M1 during the latter part of 1982. Another was a significant decline in the foreign exchange value of the dollar, and I think the last was a projected decline in productivity growth.

Now would you then say as a result of that meeting that the desire to forestall rising inflation was a principal motive behind the current course of money policy and the targets that you have given us for 1984?

Mr. VOLCKER. That is certainly a factor, but you have to look at the other side of the equation. As you recited those five separate factors, they are all concerns about what potentially might happen against a particular economic background. What you did not mention is the background of good momentum in the economy itself.

We would obviously adopt a different policy posture if we did not think the economy was growing with considerable momentum; that is the basic judgment, I think, that was reached, and against that background these various concerns that you mentioned were certainly mentioned as potential dangers we want to avoid.

How shall I characterize this? I suppose on the average wages are rising faster than is consistent with stability, but they have been coming down. Recent experience has been favorable. Expections are maybe a little unsettled, but they are certainly lower than they were some years ago. The foreign exchange value has had a repressing effect on prices recently, so that is only a concern about the future. The productivity growth has been pretty good during this recovery, but there is a concern that it be maintained. These are all potential concerns out there in the future and they certainly are an influence on policy, but against the background of declining unemployment, rising employment at a rather good clip, rising demand in the domestic economy.

Representative HAMILTON. I get the sense from those minutes that your number one concern—your number one priority—is inflation, and that really is the driving factor behind the decisions of the Open Market Committee.

Mr. VOLCKER. I think our number one concern is seeing sustained growth, and integral to that, as I see it, is a sense of stability in prices and so forth.

Representative HAMILTON. Now is the corollary of that that we can expect a permanently high rate of unemployment for a while?

Mr. VOLCKER. No; I would hope not. The natural rate of unemployment, whatever an economist may call it, has been much debated and there is a feeling it may be higher now than it was 10 years ago, or 15 years ago.

There is also some feeling that potentially it may be declining, because we have a more experienced work force, and the labor force is rising less rapidly and we get more productivity from the greater efficiency; thus, the tendency for the natural rates to rise may be in the process of reversing.

We cannot judge that yet, but I think there are a lot of things we can do. I am not just talking about monetary policy now, although monetary policy is important in setting the overall environment in which to increase the competitiveness and increase the productivity of industry.

To the extent we do that, then I think that is the only way we can have our cake and eat it, too, so to speak—having the stability with a low rate of unemployment, which that is obviously what we would like to get.

Representative HAMILTON. In the past it seems to me that the monetary policy has reacted to rising inflation after it has occurred for the most part, but that very seldom has monetary policy acted in advance of inflation to prevent inflation from occurring.

Now you have a lot of considerations to balance here, I appreciate that, but I am wondering if a policy is now moving to try to prevent a resurgency of inflation before it occurs.

Mr. VOLCKER. I suppose, to the extent your observation is valid and there may be some tendency of the sort you describe, it arises out of our history; in fact, inflation got ahead of us in the last 1960's and 1970's and we found ourselves reacting after the fact.

That made it more difficult to deal with, made the economy less stable and resulted in higher interest rates, and it fundamentally undercut the productivity growth that we need. In a sense, yes, there was too little too late, not just in monetary policy but perhaps in other policies.

The lesson we learned was that that environment of accelerated inflation in the end was good neither for employment or unemployment nor for productivity, either. They all went bad and that is, in my judgment anyway, a lesson of the late 1960's and 1970's. We want to try to avoid that.

Representative HAMILTON. This week we have seen a very worried Wall Street as reflected in the stock market, at least, that might suggest that there is a great deal of unease if not alarm.

Is there a cause in your judgment for that kind of alarm?

Mr. VOLCKER. It may be overdone. Let me just state my position again positively.

I think we have made enormous progress in dealing with some of these problems that arose during the 1970's, certainly inflation, productivity, and competition. We have a launching pad for a much more satisfactory period, and in that sense I am very optimistic.

You have to recognize the bad news or the risks, and I think a lot of that is tied around the budgetary deficit. The good part of that is that it is something that obviously is within our control. I am not saying it is easy, but it is a matter of public policy that can be corrected. It is by all odds the major hazard that I see. If that could be corrected, my optimism would be unbounded, because there is so much in the picture that is favorable relative to what we have gone through in the past.

I do not want to put it all on the deficit. We have problems in monetary policy. Let me just mention one other aspect in terms of the inflationary outlook.

I think we have come a long way in getting more interest in efficiency, moving away from the kind of speculative activities toward productive concerns.

Nominal wage settlements are much lower. What is so happy about that is that it has been accompanied by an increase in real income. But there is still a lot of skepticism out there that this may all be temporary and we will go back to what is normal, and unfortunately what is normal in many people's minds are 9 or 10 percent wage increases, with prices going up.

If people act on that presumption, then we are in trouble, because then all the restraint has to come from the monetary side.

Public policy can affect that in ways other than monetary policy or fiscal policy. One of the dangers I see in the present situation is that under the very real pressure in our position—which is again partly related to the budget—we may retreat to protectionism. We are then going to feed, I think a reversal of that attitude of restraint, because people will say, "Well, we will run to Washington and get protection when we get in trouble." I do not think we want to feed that kind of psychology.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Senator JEPSEN. Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Chairman, and welcome, Chairman Volcker. You are a very busy man and you are a very important man to the whole economic recovery and I know we take a lot of your time. If you are not before the Joint Economic Committee, you are in Finance, Ways and Means, Appropriations, or some other committee. I guess we all try to get ourselves schooled on where we are going and what the situation is. I am sure you leave the same message to almost every meeting—that we have an upbeat economic situation and if we are going to continue it, it is going to take some action on the part of this Congress. This word deficit has become a major topic here and well it should be. Too bad it was not several years ago. We would not find ourselves in the situation we are in today. But we are and the final outcome of the deficits are high interest rates, an unfavorable balance of trade, and an overvalued dollar.

We often talk about wanting to cut the spending in Government. If we could take action on the deficit that would get interest rates to drop 1 or 2 percent, the biggest benificiary would be the taxpayers since we have a trillion and a half dollar debt.

My constituents have their backs against the wall. The other members of this Committee hear this a lot because I am always crying about agriculture and the farmer.

Did I not read in the paper yesterday where you said if we could just show a $50 billion cut this would have a tremendous effect on the overall situation?

Mr. VOLCKER. I said something like that, yes.

Senator ABDNOR. I mean is that a realistic figure?

Mr. VOLCKER. I do not know whether that is a realistic figure. I was pressed to throw out a number that I thought would have a rather dramatic effect. I think that would have a rather dramatic effect.

Senator ABDNOR. If, instead of showing a deficit of $183 billion, we had it in black and white that we were going to cut the deficit down to $133 or $135 billion, what kind of effect would that have on the market?

Mr. VOLCKER. I think it would have a very constructive effect on attitudes in the market assuming it was done with assurance and not done too far down the road.

Senator ABDNOR. Yes.

Mr. VOLCKER. I think you would see the effect of that in the market rather promptly in the lower interest rates.

Senator ABDNOR. I know you have to be careful when you talk about interest rates because it goes all over the world, but could you assume that a $50 billion cut in the deficits might affect the interest rates a point or two?

Mr. VOLCKER. Yes.

Senator ABDNOR. And interest itself is a big, big item. But I know this is an election year and we are playing games on both sides of the aisle.

Mr. VOLCKER. If I may just take a minute to put the problem in perspective, I think we would all like to see lower interest rates. These interest rates are damaging.

If we assume prices are going to remain more stable, the interest rates are too high and there is that one focus for analyzing all these problems; nobody is going to disagree with that. The question is how to get them lower, and I do not think we can get them lower by conducting an inflationary monetary policy.

You have suggested an avenue that seems to me to be constructive from every direction.

Senator ABDNOR. Well, from every piece of testimony that I have read from the Finance Committee hearings back in November or December, most people agree it is going to take a blend of both spending cuts and tax increases.

Neither one would do it by itself. So you are going to have to have a combination.

I do not suppose you could make a guess. Should it be a 50-50 mix of spending cuts and tax increases. This seems to be what we hear from most testimony.

We just got the Grace Commission reports. That is just great, but it requires a change in a lot of policy that I do not think this Congress has the guts to change—Senator Symms, pardon me for saying so. The waste and abuse——

Senator SYMMS. We will get a chance to vote on it, I guarantee you that.

Senator ABDNOR. That is going to be interesting, but I do not think this Congress will do it, and that is why the President has taken the position he has.

I sat here in meetings for 3 days in a row a year or so ago when the President and my side of the aisle got burned pretty badly because we brought up social security as an issue prior to the previous election. On election day we paid the price. Yet, 2 months after the election was over, we passed a reform package that we are all bragging about.

If this group really wanted to do something, by golly, they could find $50 billion worth of cuts if both sides of the aisle were together on it. We could bring this country around instead of talking about it. But we will not do it.

Mr. VOLCKER. Up until then I was all with you.

Senator ABDNOR. Let me talk about taxes. We really need tax reform in this country, do we not?

Mr. VOLCKER. I think you need some kind of what I would call tax reform, some reshaping of the tax structure, if we are going to spend as much money relative to the GNP as we are currently spending.

Senator ABDNOR. We probably have too many exemptions in our tax laws, and yet we keep talking about more tax exemptions. Of course, we are all cutting spending, and closing loopholes, but every group I have ever met with wants to make darn sure you are not going to affect their end of the exemption. This is the kind of thing this Congress is going to have to face up to.

They can talk, and they can campaign all they want to, but in the House of Representatives and the Senate lies the power to do something. To find $50 billion in spending cuts out of a budget of $931 billion should not be difficult to find. Do you think $50 billion would show the money markets and the people who control it that we mean business resulting in a drop of 1, 2, or 3 points in interest?

Mr. VOLCKER. I did not say 3——

Senator ABDNOR. All right, 2. I'll settle for 2.

Let me ask you something. My time is up, but I want to say that one group that is seeing the economy in a difficult way is agriculture.

I wrote you a letter, Mr. Volcker, and I know you have not had time to get to it.

Mr. VOLCKER. I looked at it a bit.

Senator ABDNOR. When you go back, I hope you will take a look because I do not know where farmers are going to find the money to borrow. I do not think the banks have money to loan to farmers.

Mr. VOLCKER. I can give you a very general answer, particularly for your area of the country. The banks are, I think it is fair to say, in pretty good shape in that area in terms of the amount of money available; while their losses have gone up some, they are not extraordinary compared to nonagricultural loans.

There are problems, delays in payments and so forth, but less today than 1 year ago. Very clearly they are on a declining trend. The demand for agricultural loans is rather limited.

I think what you see here is that interest rates are high enough so that that in itself discourages the loan application, but you get a picture of a diminishing distress in your area of the country at least, and certainly the problem is not that the banks do not have money to lend.

The great majority of agricultural banks say they have money to lend. They would rather have more loans if they had the borrowers, the ones who can pay that rate of interest.

Senator ABDNOR. That is where we are. I know that when banks loan money to businesses they expect that business to make 12, 13, to 14 percent. If the farmer made the kind of income to afford that interest rate, we would not have half the problems we are having. It is a real dilemma. It is something I would like to have you give me your views on.

Mr. VOLCKER. The best news is that while there are obviously pressures out there they seem to be diminishing since the low point winter.

Senator ABDNOR. Well, I look forward to getting your comments on my letter. I appreciate it very much. Thank you.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman.

Mr. Volcker, I guess I am confused as any constituent is as to how we take all these different parts of the economy and economic policy and put together how one impacts on the other, but you have suggested if we were to close the deficit by $50 billion perhaps we could see a 1- or 2-point decrease in interest rates.

My question is this: Along that same line of thinking, in the last year or so the Congress passed a major tax increase bill of $96 billion, I think, some estimated $228 billion over a number of years.

In addition to that, we have unemployment today far less than I guess virtually anybody would project. We have heard a figure bandied about here that for every 1 percent increase or decrease in unemployment it affects the budget in the neighborhood of about $20 to $25 billion.

If that is the case, are you suggesting if unemployment were running higher and we had an increase of $25 billion in the deficit this year just because of that fact, that the interest rate would be perhaps a percentage point higher than it is today?

I mean have any of the things we have done in the past affected the interest rates today?

Mr. VOLCKER. They have. I think the fact that those things you have done in the past left us with this kind of deficit just illustrates how big the problem was; you took a bite at it. It was a limited bite and still left us with a very big problem.

Representative LUNGREN. I understand the deficit is still a big problem. The problem I have is everybody talks about it and the gentleman who just left talked about all the experts that come to us and tell us we have to have a mix of this spending cuts and tax increases and the only thing I ever see that it results in is an increase in taxes and we do very little about spending cuts.

I am not as sanguine as some of them about the fact that we are going to reach an accommodation since this is a Presidential election year and there is sniping going on everywhere. We have a lot of born-again balanced budgeteers around this joint, but I think realistically we might overlook the fact that we are not going to deal with it this year. I am not too sure that is bad, if that creates a situation where the American people demand the Members of Congress and the Presidential candidates to take a position on the deficit such that we would come in with momentum to do something about it next January.

I happen to think that is part of what the political process is. You present it to the people and hopefully they make some judgments based on positions people take rather than hide from them.

My question in that regard is this: Is the problem so acute that if in fact my scenario went along that the deficit would not be successfully addressed this year but the political climate would be such that we would be in a position to deal with it honestly and forthrightly next year, with a new Congress and after the Presidential elections, can we wait?

Mr. VOLCKER. It seems to me you are making a big assumption when you pose that somehow the political climate is such that it is impossible to do something this year but that somehow the political climate is going to improve magically in the next year.

Representative LUNGREN. That is because the people might change here.

Mr. VOLCKER. The people might change but if they are changing in response to some kind of crisis, that does not seem to me to be very constructive.

I would hate to think we can only act after a crisis instead of before. Of course you can wait; mechanically you wait. Maybe you will wait.

All I can say is that you take increasing chances with the American economy when you wait.

Representative LUNGREN. I guess my question is then would you wait.

Mr. VOLCKER. No; I absolutely would not.

Representative LUNGREN. So you would clamp down on the money supply that——

Mr. VOLCKER. Oh, no. I thought you meant if I were a Congressman.

Representative LUNGREN. No; I am asking what you would do.

Mr. VOLCKER. All I can do is wait if you wait. It does not mean we crank down on the money supply. What it means is that we would stick to the money supply that is appropriate. There are more potential problems for the American economy.

Representative LUNGREN. Let us try to get on what is appropriate, because I am still—and I know you give excellent testimony, I have gone through it.

I still am confused as to what the money supply is that is appropriate. In your testimony today, and your prepared statement, you mentioned that some of the assumptions you make with respect to the economy are that it would grow with a more moderate rate and then you say a potentially more sustainable pace of 4 to 4¾ percent during 1984 and 1985.

Now that to me is as difficult to pinpoint as is what is the natural unemployment rate. Do you think that there is a rate of economic growth which is inherently inflationary and therefore unsustainable and, if so, what is that and what would you do in reaction to make sure that rate did not go forward?

Mr. VOLCKER. You have to look at this over a period of time. I cannot estimate exactly what that rate is. But we grew more than 6 percent last year, and I think it is apparent that if we continue to grow at 6 percent for a couple of years we would be jamming up against every capacity limitation we have.

We have labor shortages in many areas. We would have the kind of market situation where there was every invitation to raise prices. Investment could not catch up by an amount necessary to satisfy demand, and we would have a problem.

You may tell me that is going to happen next June, or a year from now, or 6 months later; but I am not making that kind of a judgment. I am just saying, yes, you cannot maintain a rate of growth of more than 6 percent without expecting to run into a wall that would not be good in terms of sustainability of the recovery.

We cannot grow over a long period of time faster than the basic labor force and productivity growth permit; and that involves a certain amount of investment, too.

Representative LUNGREN. I understand that, but also with respect to the labor force we are starting at a higher rate of unemployment than we have ever had before. Would that not really shortchange the mix as to what would be sustainable and what would not be sustainable as we come out of it?

Mr. VOLCKER. It certainly could change the rate of speed at which we would potentially grow. In the past, 6 percent was fine; it has been accompanied by subsidence in price structure. How long you can persist in the high rate of growth depends on when you start; that is certainly true.

Representative LUNGREN. The concerns I have is we are starting to talk about that very loudly here in Washington and I am just talking to small business people who are saying we are just feeling this recovery.

How can we talk about not being able to sustain something that barely reached us and we have still got 8 percent unemployment?

Mr. VOLCKER. It depends on the industry. We have an industry, just to take one—there are several like this—the paper industry is running at full capacity.

Representative LUNGREN. In my area we have an aerospace industry, McDonald Douglas, which used to have a 60,000 capacity jet plant and is now down to 50,000 and a lot of growth is still left there.

Mr. VOLCKER. That is right. If I could just interject here, with this kind of a situation where you have some sectors at or close to capacity and others way below, what you really need is flexibility in new investment and speedy new investments or else you cannot take care of those potential problems. You come back then to conditions in finanical markets and interest rates and all those.

Representative LUNGREN. And tax policies.

Mr. VOLCKER. Tax policies and all these other factors, exactly.

Representative LUNGREN. Let me just ask one question. This is my last one but we have a time limit here.

Is there any concept that you folks have in mind with respect to a floor or ceiling on any commodities price index? Some people even talk about the pricing call, and I am not talking about that, but any commodity index that you feel should not be violated with respect to money supply, or is that something that we do not worry about any more and is considered oldschool and not for us?

Mr. VOLCKER. I myself worry about evaluating the general trend of commodity prices. I do not have any fixed limits in mind, but that is certainly one thing I would look at in judging the inflationary outlook and the sustainability of an economic event.

As the question came up earlier, we have had an increase in commodity prices on the average in the past year and continuing in proportions that do not appear to be cyclical. They started from a very low level.

If those increases in prices, let us say, had been twice as fast as in fact they were, I would read them as an ominous sign of a mounting inflationary psychology and pressures. They do add to costs.

If they had not risen at all from those recession lows, I would certainly raise questions about whether things were not too depressed in that area.

I am taking extremes, but it is a matter of judgment as to how you evaluate those. They are still, as I indicated earlier, below, on the average, from earlier peaks, which is one indication to me that the economy is not subject to strong speculative pressures at the moment nor strong pressures on capacity in that general commodities area. That is a favorable sign.

Representative LUNGREN. Thank you.

Senator JEPSEN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman, and thank you, Mr. Volcker, for your patience this morning.

I have sat here through the entire hearing and listened to this and several times a comment comes up that if Congress would cut the deficit that interest rates would come down and the implication is that if Congress does not have guts enough to cut the spending they are going to have to raise taxes today.

Mr. VOLCKER. That is not my implication.

Senator SYMMS. I hope that is true; that it is not. You do not, in any way, mean to be holding Congress hostage to this?

Mr. VOLCKER. I certainly do not. As I indicated, I think we have to set our policy on the basis of our evaluation of all the circumstances. We set forth monetary growth rates that we think are appropriate to the situation economically.

Senator SYMMS. Do you favor a constitutional amendment to the Constitution which would both limit spending and taxes to balance the budget, that would limit the percentage of the gross national product that we could spend but requires Congress to balance the budget?

Mr. VOLCKER. I have expressed some doubts about the practicality of a balanced budget amendment and I would, I suppose, have some doubts of trying to put in the Constitution some numerical ratio for spending as a percentage of the GNP.

Having said that, experience has seemed to suggest that our system is biased toward spending more than we want to tax, and if there are even constitutional arrangements that could be made to correct that bias I would be sympathetic to them.

The item veto is one approach toward that. Another approach, very broadly, would be, if there is such a bias, to require a supermajority to pass a spending bill.

Senator SYMMS. Well, Mr. Chairman, I would have to say that I think it is bad politics personally for what is going on in Washington right here. I think at some point in time the American people are going to wake up and demand better performance by the politicians in Washington, because I believe the most pragmatic position a person can take is one of practical common sense and one of principle which commonsense would dictate that if we are spending 25 percent of the gross national product and we are taxing the people where revenues are coming in at 90 percent of gross national product, all this fluff that we hear about the deficit is really a lot of hogwash because we are balancing the budget by either borrowing, inflating the currency, foreign borrowing, or taxing. Is that correct?

Mr. VOLCKER. Yes; I do not think the deficit is a lot of hogwash, but I think you are left with those alternatives.

Senator SYMMS. You would tend to agree, though, if we spent 90 percent of the gross national product in Federal outlays that Chairman Volcker's position would be much less controversial and you would not be a watchword in all the financial markets—what is Volcker going to do tomorrow or today or yesterday.

Mr. VOLCKER. If you tax 90 percent and spend 90 percent, life would be easier and we would get a little less attention.

Senator SYMMS. And you could play golf 4 days a week.

Mr. VOLCKER. That is right.

Senator SYMMS. Well, that is what I would like to see happen, but I would just like to pin this down.

Since we have this situation here where even a conservative republican President does not even submit a balanced budget, to put the burden back on the spenders in the Congress—and went ahead and just sent a budget over here through OMB that in my opinion is a disastrous budget as far as how much spending it calls for.

But if we agree, as you just said, that we have to pay for the budget and balance it by way of domestic borrowing, foreign borrowing, taxes, and inflation, how would you like to put a percentage on each one of those areas?

Mr. VOLCKER. I would certainly want to move toward financing it with taxes. That does not mean you have to balance the budget in 1985 or 1986. I would be quite content with decided progress in that direction. You would not want to do it too suddenly anyway, because that in itself would be a wrench, but I certainly want to see substantial progress in that direction—looking toward the possibility of a balanced budget under prosperous economic conditions.

Senator SYMMS. Well, let me go back again. You say you would favor a higher percentage in taxes?

Mr. VOLCKER. I would want to see the budget balanced, expenditures and revenues balanced, over a period of time.

Senator SYMMS. Well, I think we might agree we do balance the budget as a matter of accounting. We either borrow the money, print the money, or we tax the people for it.

Mr. VOLCKER. We are talking semantics now. I do not see what is balanced about borrowing.

Senator SYMMS. Do you not agree the big problem is spending 25 percent of the gross national product?

Mr. VOLCKER. I think they are both a problem, frankly, Senator. I say if there are other reasons, justified reasons, for spending that much you have to increase taxes, but from an economic standpoint the economy would run better with less spending.

Senator SYMMS. I see my time is up. I wanted to ask you one other question.

Senator JEPSEN. Go ahead.

Senator SYMMS. The chairman says I can ask one more.

I was one of the members of the Finance Committee that opposed the social security so-called compromise because I felt that it came down on the side of solutions that was 80 percent tax increases; and there are taxes that cut right at the heart of the young workers' savings ability and really destory the incentive for them to save and yet rewards those people who are in many cases upper middle income class; people who are in their retirement years. There was just such a discrepancy here that we were possibly going to drive a wedge between the workers and retirees in this country and it could cause a social problem on down the road.

I offered an amendment which would remove the necessity for future tax increases, which would raise the retirement age 1 month every year for the next 36 years.

That would remove the necessity for the regressive tax in the future on those increases. Would you look favorably on those kinds of gradual suggestions?

Mr. VOLCKER. I think there is something to be said for it in this whole area of changing fixed spending or revenue patterns. We cannot be too gradual right now in the overall picture because we have to make an impact, but I do not really want to make an evaluation of the best way to approach the Social Security problem.

Senator SYMMS. I am looking for support for my amendment.

Mr. VOLCKER. I know you are—I get into a lot of controversial areas, and I do not think this is one where I have any particular wisdom to impart.

I recognize, I think, the general validity of what you say, that the last social security package put a lot of emphasis on the revenue-raising side rather than on expenditure containment, but that involves a great many political and social issues that you have referred to, and I have not any particular wisdom to cast on those.

Senator SYMMS. Well, Mr. Chairman, I appreciate your indulgence, and other members of the committee.

I might just say in closing that I have a personal experience with this, Mr. Chairman. My dad is a small businessman and my son now works for my dad's company. My son is a college graduate and just gone into the business with his grandfather. His grandfather will barely pay him more than he receives from the Social Security Administration, but the grandfather owns the company and he has all the money and the grandson does not and this is true all across our society and I think it is one of the most misunderstood political issues in the country and I think the President and the Commission here in Washington—and I hope we have a spending commission this year, a bipartisan spending commission, that Congress has the wisdom to mandate that they cannot meet in Washington, DC, because I think anywhere west of the Mississippi they could come up with a better recommendation.

Mr. VOLCKER. Get out on the Snake River.

Senator SYMMS. Or east of the Rockies.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman.

I know we have gone into this somewhat based on this chart up here, but I would again like to go back to it, if you do not mind, because it relates to, I am sure you know, among other things a column not long ago by Milton Friedman in Newsweek and a lot of people read that and a lot of people believe that and a lot of people are concerned about that.

His basic contention is perhaps expressed—and he has a chart somewhat similar to this except it is followed with a quarter lag instead of a 4-month lag—and he said some months ago:

> I expressed a fear that a drastic reversal of how the monetary growth would abort the economic expansion and lead to a renewal of recession by early 1984.
>
> That fear now seems all too likely to be realized. Also, we shall be lucky indeed if the economic slowdown now in progress does not degenerate into a full-fledged recession.

From the perspective of the Fed and monetary policy, how do you respond to that? That seems to suggest that with eyes open the Fed is following a monetary policy which will lead us into a recession, suggesting either that is a necessary component of getting rid of inflation or that it will be an accidental happening, not intended, even though the policy will continue to remain the same.

Mr. VOLCKER. We obviously do not intend it. We are constantly in the position of balancing the need to see some continuing expansion, progress of the sort we would like to see, which requires some increase in the money supply, against the possibility of having too big an increase in the money supply that would regenerate the inflationary forces and, in my judgment, bring an end to the economic expansion.

Representative LUNGREN. We are not running that risk right now, are we? We are certainly not expanding at a fast rate now.

Mr. VOLCKER. As Congressman Hamilton quoted from our last directive and the discussion leading up to it, yes, that concern exists in terms of a potential.

We have to be careful to conduct a policy that does not restimulate the inflationary forces in the economy. That balance is the whole trick of monetary policy, in a sense.

Part of what we are saying is that that choice and that decision becomes easier if there are other forces, other public policies, other private policies, that are working both to contain the inflationary threat and to help the productivity of the economy, the efficiency of the economy, and the growth of the economy.

That, I think, is the relevance of the budgetary situation, but it is not just the budget that I am concerned about. We have a responsibility to try to strike that balance and that is what we try to do.

Representative LUNGREN. And as I understand it you are still saying that M1 is a very important component in following or in helping make your determination as to what your overall monetary policy is. Is that correct?

Mr. VOLCKER. Yes, but we still are looking at it in a somewhat tentative way because we do not feel fully confident of its technical characteristics, specifically in terms of velocity.

We are feeling better about it in the sense that it has moved toward more normal patterns of behavior for the last 6 months or so, but we are not putting full weight on it.

Representative LUNGREN. I understand what you are saying and I certainly accept that. It is just that the market goes up and down and you hear people say, well, the market went up because M1 was this today.

Mr. VOLCKER. That is right.

Representative LUNGREN. And next week, the market went down because M1 was this today.

Mr. VOLCKER. That is right.

Representative LUNGREN. And you are quoted as saying we are following a stable monetary policy—you know, I am not an economist but I went to school and learned graphs and that just does not look very stable to me and the average person out there is trying to figure out what in God's name do I do—do I invest, do I not invest, do I lay people off, do I hire more people. It is just tremendously confusing.

Mr. VOLCKER. Our end product would be to have a stable economy and less inflationary economy. M1 or any of the Ms are means to an end. You can look at that chart—it is printed with some lags, I guess—and say that M1 did in fact go up from mid-1982 to mid-1983 at an extraordinary rate of speed in terms of historical experience.

You say that's an unstable monetary policy, but I would have to tell you given what we know now, if it had not gone up fairly rapidly you would not have had a recovery and you would not have had interest rates where they are now.

What we are interested in—in the end—is what the economy does and what prices do, not what M1 does. It is a means to an end.

There is a great controversy in economics as to how direct the influence is, how mechanical the influence is between some of these monetary numbers and the economy itself, but that is what we have to make a judgment on.

Representative LUNGREN. Let me ask it this way. This is my last question.

Can you give us some insight into your balancing it out? You say balance these things off. What economic conditions do you look to to make a decision that would result in an increase in the money supply? What would be those things that we would look down the road at the next couple of months that would indicate that? Yes, the Fed feels that conditions are such that we ought to loosen up on what appears to be a contraction.

Mr. VOLCKER. Some of those are expressed in the targets themselves. In setting the targets, we have already made a judgment that we think growth in the various money and credit figures within that target range broadly balances those concerns. If things were running much higher or much lower we would want to change the implementation of policy, so that is one factor that can almost be measured mechanically. But then we would also judge whether, indeed, those targets were appropriate, whether something was going on, whether it would be appropriate to be at the upper part or the lower part of the range.

Basically, we look at all the evidence we have as to what the present and the future costs of real economic activity are and in this case, particularly, the potential pressures on prices. There are a variety of indicators that can be brought to bear. But if money appeared to be running, let us say, in the upper portion of the target ranges and the economy analysis suggested weakening, the balanced judgment would be not to squeeze down on the money supply under those conditions.

You begin with targets. We have expressed policy in those terms. But how you modify policy in that general framework as time passes depends on an evaluation of the course of the economy, the course of inflation, and how actual financial market conditions are bearing as time passes.

Representative LUNGREN. Is unemployment taken into consideration?

Mr. VOLCKER. It is taken into consideration obviously in a general way, but the first item I mentioned is the real growth of the economy, which obviously affects the trend of unemployment.

Representative LUNGREN. I understand that, but is the unemployment rate one of the indices you look at in terms of making your determination?

Mr. VOLCKER. Yes.

Representative LUNGREN. Thank you.

Senator JEPSEN. Mr. Chairman, we will conclude this meeting very shortly.

The last year has seen a strong rebound in productivity, and productivity declined less during the recent recession than past experience would have led us to expect.

Aside from the cyclical components, the apparent improvement in trend productivity growth seems to be closely correlated with the income tax rate cuts.

In your opinion, to what extent are improved productivity prospects a result of tax rate cuts?

Mr. VOLCKER. I would be inclined to put the primary emphasis in the short run on the fact that economic adversity itself forces more attention on efficiency to reduce the break-even points, to find more effective ways of getting output.

It is a great stimulus to restraint, productivity, and all the rest. You do not want to rely, obviously, on recessions to produce increases in productivity, so the large policy problem is how to maintain and amplify that growth in productivity over time.

I think lower taxes in general can help in two directions. First, to the extent they help incentives to work and to work harder, that helps; that's very hard to identify I think in the economic literature, but it certainly must run in that direction.

Second, to the extent that lower taxes assist investment, that is very important in terms of maintaining productivity growth. And, to the extent it changes the tax structure—and we certainly had some tax measures that favored investment in these recent years—you get more cash flow, you get more incentive to invest, and all other things being equal, it certainly moves in the direction of sustaining productivity growth.

Senator JEPSEN. Mr. Chairman, bank reserves are directly under the control of the Federal Reserve. Money supply is indirectly under Fed control, and ultimately money supply growth determines to a great measure inflation.

I know these connections are not exactly precise, but they are a rationale behind money supply targeting, are they not?

Mr. VOLCKER. Yes, sir.

Senator JEPSEN. By controlling money supply growth, we ultimately control inflation, is that correct?

Mr. VOLCKER. Yes. I think a lot of other factors enter into the pattern that inflation takes but ultimately, yes.

Senator JEPSEN. Do you feel that if interest rates should drop and growth remains high, if that should happen, that the Congress would lose any desire it might have to cut deficits this year?

Mr. VOLCKER. As a practical matter that may be the case. I do not have much doubt that the satisfactory nature of our economic performance recently has taken the edge of urgency off the desire to do something about the budget. All I can do is plead that, while the economic performance has been good and the outlook is basically good, we run into more and more problems and risks if this situation is allowed to fester.

The best reflection of that, I think, is the fact that interest rates are so high given the rate of inflation.

Senator JEPSEN. Could we examine that a minute? The double-digit difference between inflation rate and the interest rate, is it unprecedented?

Mr. VOLCKER. I do not think it is a double-digit difference.

Senator JEPSEN. Well, it is where people are borrowing money. It is when people have to bite the bullet and borrow the money, whether it be in agriculture, a small business or wherever it is across this country.

This 11- or 12-percent prime, bankers are not paying any attention to at all, and the people are borrowing money at 15, 16, or 17 percent and that is considerably higher than the 3.9 percent rate of inflation and that is killing us.

Mr. VOLCKER. I would have thought most people were borrowing money at less than that. It is high.

Senator JEPSEN. They are not.

Mr. VOLCKER. But let us not dispute the fact that indeed the spread between the current inflation rate and the interest rate is historically high.

You asked whether it is unprecedented. I do not think it is unprecedented, but it has typically been higher during the periods of economic disturbance.

We also have an unprecedented budget deficit for peacetime. We have an unprecedented foreign trade deficit. I think there is some relationship between all these unprecedented characteristics of the economy, and I would like to see all those uncharacteristic things become more typical of past behavior.

Senator JEPSEN. Would it be more accurate just in the area of semantics—and it is very important that we, especially in this year, that we are going to have a lot of dialog, which is a charitable way to describe some of it—that we will be hearing about the deficits and one thing or another, the deficits are the result of budget not being under control, that is, under control as a prudent businessman rule would dictate, is that correct?

Mr. VOLCKER. I think the deficit reflects two things, just to be clear. It reflects, partly, fundamental imbalance. We say the budget is out of control and spending has been rising particularly rampantly.

At the moment, it also reflects the effects and the after-effects of recession. It is not that part that bothers me; that is not the part you have to eliminate. It is this more underlying, structural part of the deficit.

Senator JEPSEN. Well, you said earlier Congress has a tendency to spend all the revenues it takes in and then all the additional money it can get away with. You said something to that effect.

Mr. VOLCKER. I did not quite put it that way, but I have observed some bias toward spending more money than we take in tax revenue.

Senator JEPSEN. Now if the people felt the budget was—in other words, this is old hat and you have heard it said many times before, but for clarity and to put perspective and a frame around what the problem is, the budget is not out of control here, it is the people that make the budget that have been out of control, and the people that make the budget by all authorities—constitutional and otherwise—the only ones are the Congress. Is that correct?

In other words, there is no use pointing the finger——

Mr. VOLCKER. I think Congress can control the budget. I had better limit myself to that.

Senator JEPSEN. Pointing the finger of blame at the executive, pointing the finger at Federal Reserve Board or anywhere else, the facts are when the rubber hits the road the authorities who are letting taxes and appropriating funds rest with Congress, and you do not need any more power than that to take care of the budget.

Unfortunately, all of these programs they talk about—and I have heard some rather loose figures given today. I let it go by, but the figure was slipped in here saying 83 percent of the budget is spent in the military and then very quickly someone said our retirement programs, too.

These are the type of things—the next thing you know you will be hearing talk about 83 percent of the budget is spent for the military because it kind of gets cut off and dropped off somewhere along the road and people across the countryside, they really again have gotten distorted information as to what percentage of the budget goes where.

The fact that we have, in the so-called uncontrollable areas, things that have either been put in by statute or put in by a rulemaking, where Congress, just as it has for many years, ignored its responsibility for any programs they put in. Once they got them on the books, they went off to find some other program they could put on the books, and in the bowels of the bureaucracy there are plenty of folks here who are ready to make all kinds of rules to give them more money to justify their existence and they spend and continue to grow in the administration of their program, and when you get automatic increases and you have an attitude, a posture, that exists around here where if you have $500 million left in your budget 2 days before the end of the fiscal year, you have to run right out and spend it so that you make sure it does not get taken away from you next year.

This type of inane practice really does not make for a lot of faith by people in this country and the discipline or the possibility that Congress will indeed get control and manage the budget. But a budget under control, if it were, and if it was perceived to be, would that not lower the interest rates rather dramatically?

At the risk of being misunderstood, forget the deficits for this conversation for a moment.

If the budget were under control and it was perceived to be under control in all the financial measurements and judgments, would that not do more to lower the interest rates than any other single thing we could do right now?

Mr. VOLCKER. I believe that is true. Now you did not put any quantities in your statement, and I cannot answer your question without considering what the deficit is and what impact you are making on the deficit, but I interpret your question to include that.

Senator JEPSEN. I think that is part of it. If the deficit is 160 billion or the deficit was $30 billion, if the people in the financial community did not believe the budget was under control——

Mr. VOLCKER. By "under control," you are just thinking of the spending side?

Senator JEPSEN. That is correct.

Mr. VOLCKER. I am just repeating myself, but I believe that our control of the spending side is important to the long-term economic health of the country. I cannot answer your question about interest rates without considering what you do to the revenue side. If you have equal reduction in spending and revenue, it is going to have a less pronounced effect on the markets than otherwise.

Senator JEPSEN. In closing, let me examine a couple of for instances with you. If, for instance, the deficit was $30 billion—that is a lot different than it is now?

Mr. VOLCKER. Yes.

Senator JEPSEN. And if the deficit were $30 billion and interest rates were 17½ percent and going up, and inflation was 12½ percent and going up, do you think that people would say everything is okay now that deficits are down?

Mr. VOLCKER. No.

Senator JEPSEN. If the deficits are up $170 billion and inflation at 3.8 percent and interest rates are heading downward, it is difficult to get anybody to spend much time focusing their attention on the problem, is it not?

Mr. VOLCKER. That is correct. That is part of our problem.

Senator JEPSEN. Anything further?

Congressman Lungren.

Representative LUNGREN. Just one question.

Senator JEPSEN. Yes.

Representative LUNGREN. You talk about the high interest rates and you did not believe that it was just a coincidence that we had an unprecedented deficit, and I have always though we ought to get rid of deficits, but according to figures I have here, last year's deficit was 6.1 percent of GNP and this year's projected deficit is only 5.2 percent.

Mr. VOLCKER. Right. If it is as low as projected——

Representative LUNGREN. If it stays low, which brings the question why have not interest rates dropped then if we had dropped a full percentage point of GNP? We are still at high levels but it is much better than last year.

Mr. VOLCKER. That is right. It would be somewhat lower than last year.

Representative LUNGREN. Well, it is 6.1 to 5.2, and that is almost a whole percentage point.

Mr. VOLCKER. That is right, but let me answer your question specifically.

Obviously deficits are not the only influence on interest rates and the decline in the deficit—the projected decline, I might say—that you observed, is entirely a reflex to the fact that the economy is growing.

During this period we have not done anything about the underlying, continuing deficit which is in the neighborhood of $100 billion plus. That is really the portion of the deficit that I am worried about, to the extent you can separate the two parts analytically.

By definition almost, when the budget deficit is declining simply because the economy is rising, you have other credit demands arising out of that growth of the economy. You are not going to cure this budgetary deficit—the unprecedent structural deficit—simply by riding on the wings of an economic expansion. That will cut down the cyclical portion and eventually eliminate it if the economy keeps growing. But, unfortunately what all these projections show—unambiguously and there is a wide range of difference among them—is the basic disparity between the revenues and expenditures, with expenditures tending to grow rather than the reverse. So, you pick up some on the cyclical side and you lose it on the structural side.

Representative LUNGREN. So the growth part, we can take care of the deficit, although comforting, does not deal with the essential deficit problem which you view as structural?

Mr. VOLCKER. Precisely.

Representative LUNGREN. And which I would define as Congress caused.

Mr. VOLCKER. All right, that is fine. That is exactly what I am trying to say.

Representative LUNGREN. I understand what you are saying. It is just that the message has not gotten out clearly enough what we are talking about is the continuing pressure on the deficit caused by spending on programs that either have been specifically appointed or annointed by this Congress, or acquiesced in, and I think that sort of puts the finger where the blame ought to be.

Thank you. Thank you, Mr. Chairman.

Senator JEPSEN. Thank you. Do you have any closing statement?

Mr. VOLCKER. I do not. Thank you for your courtesy, Mr. Chairman.

Senator JEPSEN. Mr. Chairman, thank you for your answers. The committee will recess until this afternoon at 2:45 p.m.

[Whereupon, at 11:55 a.m., the committee recessed, to reconvene at 2:45 p.m., the same day.]

AFTERNOON SESSION

The committee reconvened, at 2:45 p.m., in room SD-562, Dirksen Senate Office building, Hon. Roger W. Jepsen, (chairman of the committee) presiding.

Present: Senators Jepsen and Abdnor.

Also present: Charles H. Bradford, assistant director; and Christopher J. Frenze, Deborah Clay-Mendez, Dale Jahr, and William R. Buechner, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. The committee will come to order. It gives me a great deal of pleasure to welcome you today. Mr. Penner. I just indicated to you, and again I will repeat it, congratulations on your recent appointment as CBO director. I think—congratulations.

[Laughter.] I understand this is your first appearance before the committee in your new capacity.

Our budget problems have been many years in the making, and the establishment of our expansion of various entitlement and other domestic programs in the last two decades has resulted in rapid growth in Federal spending. Since the mid-1960's, both the amount and the budget share of domestic spending have mushroomed dramatically.

In 1965, nondefense spending amounted to 57 percent of the Federal budget or about 10.8 percent of the gross national product, and by 1980, nondefense spending absorbed 77 percent of budget outlays or 17 percent of GNP. These figures reflect the shift in the composition of budget outlays away from defense and toward nondefense spending between 1965 and 1980.

Under the leadership of President Reagan, this trend was reversed to meet the growing Soviet threat and to restrain runaway domestic spending. In fiscal year 1985, the President recommends a level of nondefense spending which amounts to 71 percent of Federal outlays or 16.8 percent of the gross national product.

In real terms, nondefense spending in the proposed fiscal 1985 budget is still about three times its 1965 level.

To listen to some of the rhetoric that we are hearing today, you would not realize that this was the proportion or that this amount of the budget was spent on nondefense spending. Although much progress has been made in getting Federal spending under control, much remains to be done. Federal outlays in fiscal year 1984 are projected at $854 billion or 24 percent of gross national product. Except for the previous fiscal years, this is the largest share of gross national product absorbed by the Federal Government in over two decades. This mounting burden on saving, investment and consumption is one major factor limiting our economic growth.

We must do more to bring Federal spending under control. Open-ended commitments by the Federal Government must be contained. About three-quarters of the budget now is exempt from annual review and adjustment by Congress. Fundamental constitutional reform, such as the adoption of the balanced budget/tax limitation amendment, would provide a better inistitutional framework for resolving our budget problems.

Reducing the large projected budget deficits will involve difficult choices, as well as compromise. I believe that our fiscal problems, however large they may be, can be dealt with effectively, if we address them in an analytical, factual, and cooperative manner.

Above all, we must avoid emotionalism and partisanship, if we are to improve the situation, instead of making it worse. the President's call for a bipartisan budget consultation is a welcome step.

Whatever we do, we must not renege on tax indexing, as some have suggested. This tax reform, which primarily benefits low and middle income taxpayers, is one of the most important components of the 1981 Economic Recovery Tax Act. The Congress must not surrender tax indexing in a misguided effort to tax our way into prosperity.

As has been said many times, Mr. Penner, it is not the budget that is out of control in Washington; it is the people that make the budget that have been out of control. And that is probably most accurate. Congress has the authority to levy taxes and appropriate funds, and they have that authority and responsibility by the Constitution, and no other branch of Government has it. And when it comes to getting in control of the Federal budget, there is only one branch of our Government that can do that, and that is Congress.

The President proposes; the Congress disposes.

And regardless of what some may say, or as we are witnessing a lot of finger pointing to try to fix blame, at this particular time, the facts are that over the years, we have had a Congress whose attitude on spending is commensurate to the kind of parallel for putting Dracula in charge of the blood bank. And they continue to spend now as much as the revenues have brought in, but as much, in addition to the revenues that are there that they can get away with politically.

The age of spend yourself rich is now over, and that philosophy is about as outdated and shopworn and useless as a drunk trying to drink himself sober. We have changed direction, and we need all the advice and help that we can get and all the support.

So your appointment as a congressional—CBO Director—is a very key one and also might well prove to be a very exciting one, challenging and testing.

I wish you good luck.

Mr. PENNER. Thank you.

Senator JEPSEN. And welcome here today. Your remarks will be entered into the record. You may proceed in any way you desire.

STATEMENT OF HON. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. PENNER. I shall give you a very brief summary of them, Mr. Chairman.

First, I am delighted to be here. As you say, it is my first appearance before this committee in my current position.

This week the Congressional Budget Office has released three parts of our annual report:

Part 1 on the economy; part 2 on the budget; and part 3 on options for reducing the deficit.

As you know, the condition of the U.S. economy has improved markedly since the recession. Output grew vigorously during the first year of recovery, and the unemployment rate declined at a near record pace from a level that was a post-World War II high. At the same time, the dramatically lower inflation rates that were achieved during the recession held firm in 1983, despite the pace of the recovery. At the end of 1983, economic growth appeared to be slowing, as is normal during the second year of a recovery.

In one respect, however, the recovery was unusual: Interest rates remained at very high levels, apparently because of huge current and prospective deficits and the anti-inflationary policies of the Federal Reserve. As a result, some sectors—particularly the export- and import-competing industries—did not fully participate in the recovery.

Despite the high interest rates and signs of unbalanced growth, most forecasters, including the CBO, believe that the near-term outlook remains favorable. The consensus forecast calls for econom-

34-871 O - 84 - 19

ic growth in the 4- to 5-percent range during 1984, with inflation only slightly above the previous rate. But the horizon is clouded by uncertainty concerning Federal economic policy.

Some have questioned whether continued recovery is possible, given the huge deficits implied by current fiscal policy. Our own forecast implies that the economy can continue to expand robustly in the short run, despite the level of Federal borrowing. The real harm done by deficits involves the negative impacts on long-run growth and, therefore, on our future living standards. In other words, the process is gradual, and there is no easily identifiable traumatic event that clearly illustrates the effects of deficits. There is an intense conflict between public and private borrowing needs, but the word collision, which is often used to describe this clash, may not be exactly appropriate. A collision is a readily observable, violent event. The gradual erosion of our future prospects is much harder to detect.

However, more than the usual degree of uncertainty must be attached to the short-run forecast and the foregoing analysis. CBO projects Federal deficits rising from $190 billion in the current fiscal year to $326 billion in 1989, if budget policies are not changed. The projections imply that deficits will average 4.7 percent of the gross national product during the 1980's. The comparable levels in the previous decades were: 0.4 percent in the 1950's. 0.4 percent in the 1960's, and 1.9 percent in the 1970's. We are operating so far outside of the range of recent historical experience that any analysis must be put forward tentatively, and the risks are enormous, even in the short run.

Much of the rest of my testimony, Mr. Chairman, reviews recent economic developments. We talk about our forecasts in some detail. We compare our assumptions to those of the administration.

Let me, however, turn and discuss, only briefly, the effects of that forecast on the composition of Federal spending. If you look at the revenue side of the budget implied by current law in our forecast, the overall tax burden, relative to GNP, remains about the same as it is this year, and the composition of revenues does not change very much. However, the changes on the outlay side are much more substantial. After falling a little bit from the record level that you referred to in your opening remarks, because of this recession, spending then begins to grow again relative to GNP, and the changes in the composition of Federal spending are quite substantial. Disturbingly, the most rapidly growing category of spending in our baseline projection is net interest, with large and growing deficits and no reduction in inflation-adjusted interest rates, after 1985.

Federal borrowing costs are projected to double over the next 5 years. The portion of gross spending—excluding offsetting receipts—devoted to interest rises from 12 percent in 1984 to 16 percent by 1989. Defense spending grows by 79 percent between 1984 and 1989, assuming real increases of 5 percent per year. The share of defense spending in the budget grows from 26 to 30 percent.

In our projections, domestic spending—the combination of entitlements and discretionary programs—grows by 38 percent between now and 1989. Because this is well below the rate of growth of total outlays, their share of the budget declines from 62 percent in 1984 to 55 percent in 1989. The dollar increase is still substantial, however, from $556 billion in 1984 to $769 billion in 1989. Of this $213 billion, $124 billion—or 58 percent—is in just two programs: namely, social security and medicare.

I think perhaps the most startling figure in my testimony is that, as we trace out the course of spending over the next several years, the budget becomes more and more dominated by very few programs. Indeed, our projections suggest that by 1989, defense, social security, medicare, and net interest will be equivalent to about 99 percent of the receipts that we project.

Let me just stop at that point, Mr. Chairman.

[The prepared statement of Mr. Penner follows:]

PREPARED STATEMENT OF HON. RUDOLPH G. PENNER

Mr. Chairman, I am pleased to have this opportunity to testify on the economy and on the federal budget. This week the Congressional Budget Office (CBO) has released the three parts of our annual report: Part I on the economy, Part II on the budget, and Part III on options for reducing the deficit. 1/

As you know, the condition of the U.S. economy has improved markedly since the recession. Output grew vigorously during the first year of recovery, and the unemployment rate declined at a near record pace from a level that was a post-World War II high. At the same time, the dramatically lower inflation rates that were achieved during the recession held firm in 1983 despite the pace of the recovery. At the end of 1983, economic growth appeared to be slowing, as is normal during the second year of a recovery.

In one respect, however, the recovery was unusual: interest rates remained at very high levels, apparently because of huge current and prospective federal deficits and the anti-inflationary policies of the Federal Reserve. As a result, some sectors--particularly the export and import-competing industries--did not fully participate in the recovery.

Despite the high interest rates and signs of unbalanced growth, most forecasters, including the CBO, believe that the near-term outlook

---

1/ Congressional Budget Office, A Report to the Senate and House Committees on the Budget, Part I: The Economic Outook, Part II: Baseline Budget Projections for Fiscal Years 1985-1989, Part III: Reducing the Deficit: Spending and Revenue Options (February 1984).

remains favorable. The consensus forecast calls for economic growth in the 4 to 5 percent range during 1984, with inflation only slightly above the previous year's rate. But the horizon is clouded by uncertainty concerning federal economic policy.

Some have questioned whether continued recovery is possible given the huge deficits implied by current fiscal policy. Our own forecast implies that the economy can continue to expand robustly in the short run despite the level of federal borrowing. The real harm done by deficits involves their negative impacts on long-run growth and, therefore, on future living standards. In other words, the process is gradual and there is no easily identifiable, traumatic event that clearly illustrates the effects of deficits. There is an intense conflict between public and private borrowing needs, but the word "collision," which is often used to describe this clash may not be exactly appropriate. A collision is a readily observable, violent event. The gradual erosion of our future prospects is much harder to detect.

However, more than the usual degree of uncertainty must be attached to the short-run forecast and the foregoing analysis. CBO projects federal deficits rising from $190 billion in the current fiscal year to $326 billion in 1989 if budget policies are not changed. The projections imply that deficits will average 4.7 percent of the gross national product (GNP) during the 1980s. The comparable levels in the previous decades were: 0.4 percent in the 1950s, 0.8 percent in the 1960s, and 1.9 percent in the 1970s. We are operating so far outside of the range of recent historical experience that any analysis must be put forward tentatively and the risks are enormous, even in the short run.

RECENT ECONOMIC DEVELOPMENTS

Output rose 6.1 percent during 1983, close to the average of previous postwar recoveries. The cyclical upturn in output began in the first quarter of last year, following a rebound in residential construction and consumer spending and an abrupt decline in inventories in the fall of 1982 (see Table 1). The impetus for this improvement in household demands was the easing of monetary policy beginning in the summer of 1982 and the cuts in income taxes. Defense spending also grew rapidly in 1982. Higher demands caused industrial production to increase sharply (16.1 percent) during 1983, and by year-end capacity utilization in manufacturing had risen from a post-World War II low of 68.8 percent to 79.4 percent. Business investment spending turned up in the second quarter of 1983 and grew rapidly in the second half of the year in response to rising capacity utilization and to the net stimulative effects of the business tax legislation of 1981 and 1982.

Unemployment and Inflation

The unemployment rate declined dramatically last year, from the postwar record of 10.7 percent of the civilian labor force to 8.0 percent at the beginning of this year. The decline was much sharper than warranted by the increase in output, given past experience. In the first year of recovery, the labor force grew less than expected and growth in employment was

TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

	1981	1982	1983	1982 Q3	1982 Q4	1983 Q1	1983 Q2	1983 Q3	1983 Q4
Real GNP	2.6	-1.9	3.3	-1.0	-1.3	2.6	9.7	7.6	4.5
Final sales	1.8	-0.7	2.8	-1.5	4.5	0.6	6.8	5.1	3.5
Consumption	2.7	1.4	4.2	0.9	3.6	2.9	10.0	2.2	6.5
Business fixed investment	5.2	-4.7	1.1	-8.8	-6.6	-1.5	7.9	18.7	22.3
Residential investment	-5.2	-15.4	39.6	-13.0	53.2	57.3	79.5	35.9	-5.2
Government purchases	0.8	1.8	0.5	9.4	10.6	-8.8	-1.1	4.4	-2.7
Inventory Change (billions of 1972 dollars)	8.5	-9.4	-2.4	-1.3	-22.7	-15.4	-5.4	3.8	7.5
Net Exports (billions of 1972 dollars)	43.0	28.9	11.7	24.0	23.0	20.5	12.3	11.4	2.5
Industrial Production	2.7	-8.2	6.6	-3.4	-8.4	10.1	18.4	21.8	11.6
Capacity Utilization (percent)	80.2	72.1	75.4	71.7	69.8	71.2	73.9	77.3	79.1
Payroll Employment (millions)	91.2	89.6	90.0	89.3	88.8	88.8	89.5	90.3	91.4
Civilian Unemployment Rate (percent)	7.6	9.7	9.6	10.0	10.6	10.4	10.1	9.4	8.5
Inflation Rate									
CPI-U	10.4	6.1	3.2	7.7	1.9	-0.4	4.3	4.7	4.9
GNP deflator (fixed weight)	9.5	6.4	4.3	5.9	4.7	3.4	4.3	4.7	4.5
Productivity a/	1.9	-0.1	3.1	2.3	1.3	3.7	7.1	2.3	1.0
Interest Rates (percent)									
Treasury bill rate	14.0	10.6	8.6	9.3	7.9	8.1	8.4	9.1	8.8
Corporate AAA bond rate	14.2	13.8	12.0	13.8	11.9	11.8	11.6	12.3	12.4

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Moody's Investors' Service.

a/ Output per worker hour, nonfarm business sector.

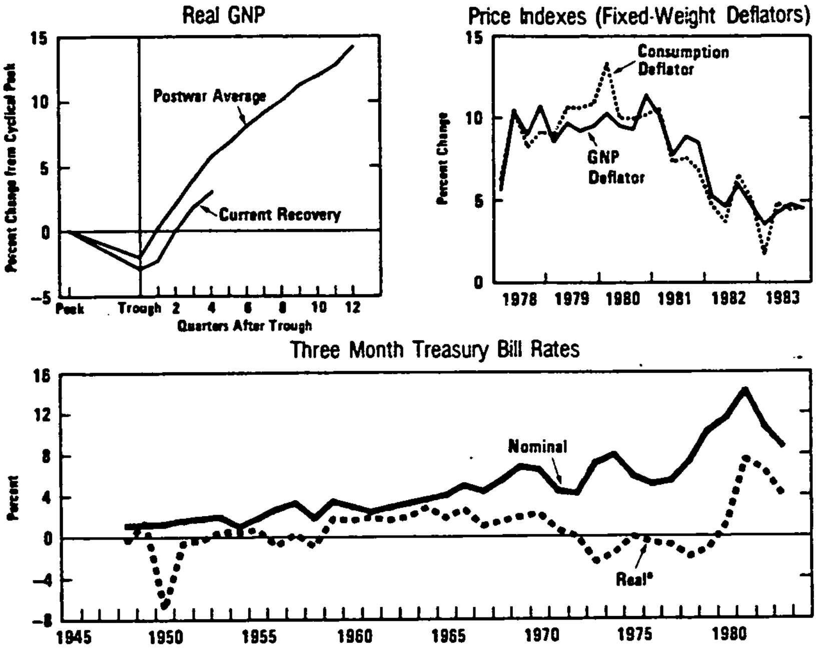
exceptionally rapid. In consequence, the rebound in productivity was somewhat less than in the normal cyclical rebound.

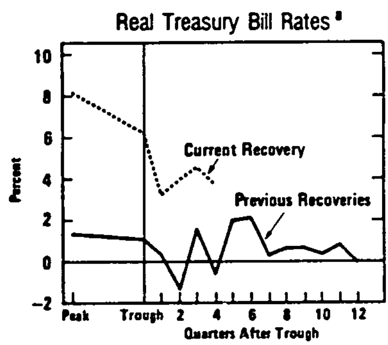
Inflation declined in 1983, though the rate of decline appeared to be slowing. The increase in the fixed-weight deflator, a broad measure of inflation, fell from a record 9.8 percent in calendar year 1980 to 6.4 percent in 1982 and to 4.3 percent in 1983. Although some of the decline in 1983 reflected temporary factors, present indications are that inflation will be quite moderate again this year.

The Distribution of Growth

High interest rates, the most unusual feature of this recovery, have not had as large an effect on overall economic growth as many expected (see Figure 1). They have, however, affected the composition of growth. Net exports have been particularly hard hit. The U.S. merchandise trade balance ran a record $69 billion deficit in 1983, and some forecasters expect it to exceed $100 billion this year. At the same time, capital inflows were very strong because relatively high interest rates in the United States attracted foreign investors. Of course, the capital inflows benefited domestic investments and prevented interest rates from rising further. But, at the same time, foreign demand for dollars to invest in the United States pushed up the international exchange rate of the dollar to record levels. This in turn reduced foreign demand for the products of U.S. exporters, while cheaper imports reduced demand in many domestic industries. Thus,

Figure 1.
Recent Economic Developments





SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Congressional Budget Office.

* Unless otherwise specified real interest rates in this report are calculated by subtracting from the nominal interest rate the rate of inflation in the succeeding quarter. This value, the "ex post real rate," is a proxy for the unobserved real rate, which is the nominal rate less *expected* inflation over the life of the instrument. The inflation rate used for these two figures is that of the consumption deflator (fixed weight since 1958).

in 1983, net exports were effectively crowded out by tight credit conditions that arose, at least in part, from large budget deficits.

Interest rates also appear to be having an adverse effect on the recovery in residential construction, which at first was rapid. Between May and August of 1983, interest rates rose significantly, apparently because of strong economic growth and a tightening of monetary policy, and have since remained in a higher range than before. As a result, the growth in housing starts stalled in the fall and residential construction activity declined in the final quarter of 1983. The outlook for further growth in this sector now depends critically on the future course of interest rates and the resolution of the budget deficit problem.

THE CBO ECONOMIC PROJECTIONS

The CBO baseline economic projections, which are used to generate baseline budget estimates, consist of two parts: (1) a short-run forecast for the 1984-1985 period conditional upon specific policy assumptions; and (2) longer-run projections based upon historical growth trends and the assumption that inflation will gradually decline.

The Short-Run Forecast

The short-run baseline forecast incorporates the following policy assumptions:

- The federal budget policies are those currently in place. Defense authority, in real terms, increases at roughly a 5 percent rate. Budget outlays are $853 billion in fiscal year 1984 and $928 billion in fiscal year 1985.

TABLE 2. THE CBO FORECAST FOR 1984 AND 1985

Economic Variable	Actual 1982	Actual 1983	Forecast 1984	Forecast 1985
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	2.6	10.4	10.3	9.0
Real GNP	-1.7	6.1	4.7	3.7
GNP Implicit Price Deflator	4.4	4.1	5.3	5.1
Consumer Price Index for Urban Consumers	4.5	3.3	5.1	4.9
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.7	9.6	7.8	7.3
3-Month Treasury Bill Rate	10.6	8.6	8.9	8.6

- o Federal government revenues are those associated with current law: $663 billion in fiscal year 1984 and $733 billion in 1985.
- o Growth in the M1 money aggregate is assumed to be 6.0 percent over the four quarters of 1984 and 5.5 percent during 1985.

The forecast also assumes that there will be no price shocks or credit crises. Retail food prices are assumed to increase at about 4 percent in 1984 and 5 percent in 1985--reflecting the delayed effects of last summer's drought. Crude oil prices are assumed to remain constant, at about $29 per barrel, throughout the forecast period.

With these assumptions, real GNP is projected to rise 4.7 percent over the four quarters of 1984 and 3.7 percent during 1985 (see Table 2).

Average growth over the two years is slightly above the average for the second and third years of previous postwar recoveries. The civilian unemployment rate is projected to decline from 8.5 percent in the last quarter of 1983 to 7.6 percent by the end of 1984 and to 7.1 percent by late 1985.

As measured by the GNP deflator, inflation is expected to accelerate slightly from 4.2 percent in 1983 to 5.3 percent over the four quarters of 1984 and to average 5.1 percent during 1985. This increase in inflation reflects temporary factors--for example, the decline in oil prices last year that is not expected to be repeated this year, and a temporary acceleration in food prices later in 1984 stemming from last year's drought. In addition, the relatively rapid reduction of slack in the economy will tend to keep inflation from falling rapidly. However, nothing in the CBO forecast is inconsistent with the hypothesis that inflation is on a long-term downward trend.

The three-month Treasury bill rate is projected to average 8.9 percent this calendar year and slightly lower next year. Interest rates remain very high in real terms because of the exceptionally large amount of Treasury borrowing combined with strengthened private credit demands.

The Longer-Run Economic Projections

The baseline economic projections for the 1986-1989 period assume moderate noncyclical growth in output averaging about 3.4 percent per year (see Table 3). The projections for the long run are based on historical trends and are not meant to be necessarily consistent with the policies now in

TABLE 3. LONG-RUN ECONOMIC PROJECTIONS, CALENDAR YEARS 1984-1989

Economic Variable	1983 Actual	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)	3,310	3,651	3,995	4,339	4,704	5,084	5,481
Nominal GNP Growth Rate (percent change, year over year)	7.7	10.3	9.4	8.6	8.4	8.1	7.8
Real GNP (percent change, year over year)	3.3	5.4	4.1	3.5	3.5	3.4	3.3
GNP Implicit Price Deflator (percent change, year over year)	4.2	4.7	5.1	4.9	4.7	4.5	4.3
Consumer Price Index, CPI-U (percent change, year over year)	3.2	4.8	5.1	4.9	4.7	4.5	4.3
Civilian Unemployment Rate (percent, annual average)	9.6	7.8	7.3	7.0	6.8	6.6	6.5
3-Month Treasury Bill Rate (percent, annual average)	8.6	8.9	8.6	8.4	8.2	8.0	7.8

place. Unemployment declines gradually to 6.5 percent by the last year of the projection. Inflation declines very gradually from 5.1 percent in calendar year 1985 to 4.3 percent in 1989, and interest rates decline with inflation. This may be somewhat optimistic since analysis based on past experience suggests that the inflation rate might cease its decline given the assumed reduction in the unemployment rate. However, the relationship between unemployment and inflation is highly unstable and it is our judgment that if unemployment falls smoothly and slowly--as is implied by our growth path--continued progress can be made against inflation.

Since the longer-term projection of real growth is based upon historical trends, it is not intended to be an implicit judgment about what would be appropriate growth. 3/ For the seven-year period beginning with the recession trough (1982:4 to 1989:4), growth in real GNP averages 4 percent in the CBO baseline projection, precisely the same as the average growth rate during the first seven years following previous postwar recessions.

Uncertainty in the Outlook

There is a great deal of uncertainty in the economic outlook, particularly with respect to inflation and interest rates.

3/ Although these longer-run projections for inflation and nominal GNP growth do not reflect specified goals for the economy, they appear to be broadly consistent with statements by both the Administration and monetary authorities. See Economic Report of the President (February 1983), p. 23, and Paul A. Volcker, "We Can Survive Prosperity," an address to the American Economic Association, December 18, 1983.

- Inflation is subject to unforeseeable events--a bad crop year, a cut in oil supplies, or a sharp change in the value of the dollar in international exchange markets. Some analysts claim the dollar is "overvalued" by 20 percent or more; a decline in the dollar by that amount would raise the cost of imported goods and raise domestic prices by, perhaps, 2 percent. Inflation is also affected to an uncertain degree by the relative effects of economic slack and rapid growth.

- Interest rates are very difficult to forecast accurately. In addition to economic policy, the interest rate outlook depends on: the course of expected inflation, the response of savings to recent tax law changes, foreign capital inflows, and the risk of credit market disruptions, perhaps resulting from payment problems in developing countries.

The major source of uncertainty lies in economic policy. Some analysts believe that monetary policy has been too tight since last summer, and fear that there will be a slowdown in economic growth during the first half of this year despite the fiscal stimulus. Others are concerned that the Federal Reserve will find it difficult to maintain moderate money growth in the face of large federal deficits and the developing-country debt crisis.

With regard to fiscal policy, the major question is whether deficits will be reduced soon and if so, how? It is difficult for businesses and individuals to make effective decisions about the future without knowing what deficit-reducing measures will be taken and the impact these measures are likely to have on their activities. Moreover, the competition between private and federal credit demands will be intense, if policies are not changed. Federal borrowing will decline relative to GNP only in the first years of the projection--and then only slightly--and will remain exceptionally high and increase relative to GNP in later years.

If action on the deficit is postponed, it is also possible that foreigners will lose confidence in U.S. policies and reduce their investments in this country. While the resulting decline in the exchange value of the dollar would benefit U.S. export and import-competing industries, it would also generate increased domestic inflation and--given a fixed rate of money growth--push up interest rates. It may even force the Federal Reserve to undertake a more restrictive policy in order to maintain stability in foreign exchange markets.

THE BUDGET OUTLOOK

Given baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the federal deficit will rise from about $190 billion this year to $326 billion in fiscal year 1989 (see Table 4). Despite rapid growth in GNP, the budget deficit rises from 5.3 percent of GNP in fiscal year 1984 to 6.1 percent in 1989, matching the record level established last year. Federal spending remains very strong in the baseline projection: relative to GNP, it declines from 24.7 percent in fiscal year 1983 (a postwar record) to 23.9 percent this year, but then rises to a new record high by 1989. Revenues are projected to be 18.6 percent of GNP in fiscal year 1984, rising gradually to 19.0 percent in 1988.

CBO's baseline budget projections are designed to show what would happen to the federal budget if current policies were continued into the future. For revenues and for mandatory spending items, current policies are largely defined by the laws now in effect. For discretionary spending,

TABLE 4. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1983 Actual	1984 Base	Projections 1985	1986	1987	1988	1989
			In Billions of Dollars				
Baseline with 5 Percent Real Growth in Defense Authority a/							
Revenues	601	663	733	795	863	945	1,016
Outlays	796	853	928	1,012	1,112	1,227	1,342
Deficit	195	190	195	217	248	282	326
Budget Authority	867	923	1,019	1,116	1,231	1,374	1,504
Baseline with No Real Growth in Defense Budget Authority							
Revenues	601	663	733	795	863	945	1,016
Outlays	796	853	923	998	1,083	1,177	1,265
Deficit	195	190	190	203	220	232	249
Budget Authority	867	923	1,005	1,090	1,183	1,299	1,395
			As a Percent of GNP				
Baseline with 5 Percent Real Growth in Defense Budget Authority a/							
Revenues	18.6	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	24.7	23.9	23.7	23.8	24.1	24.6	24.9
Deficit	6.1	5.3	5.0	5.1	5.4	5.6	6.1
Baseline with No Real Growth in Defense Budget Authority							
Revenues	18.6	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	24.7	23.9	23.6	23.5	23.5	23.6	23.5
Deficit	6.1	5.3	4.9	4.8	4.8	4.7	4.6
Reference:							
Gross National Product (In billions of dollars)	3,229	3,563	3,910	4,251	4,612	4,987	5,379

a/ Defense budget authority for 1985 and 1986 is assumed to be the amounts specified in the most recent Congressional budget resolution; defense budget authority for 1987-1989 is an estimate of the amounts required to achieve real increases of 5 percent per year.

however, the definition of current policy is not as clear, since appropriations are made for only one year at a time. The baseline projections for nondefense appropriations are generally based on fiscal year 1984 funding levels, with future increases to keep pace with inflation. The projections for defense are based on the fiscal year 1984 Congressional budget resolution, which not only allowed defense spending to keep pace with inflation but also provided for roughly 5 percent annual real growth in defense budget authority.

While our baseline projections assume 5 percent real growth in defense spending as the best approximation of current policy, CBO has also projected defense expenditures on the same basis as is used for nondefense discretionary programs. These alternative defense projections simply increase 1984 defense budget authority by the rate of inflation and thus allow for no real growth in defense spending. Even with no real defense growth, however, the deficit would still reach $249 billion by 1989 (see Table 4).

Changes in the Composition of Revenues and Spending

The composition of federal revenues is projected to change somewhat over the next five years. Individual income taxes and social insurance taxes rise faster than other taxes, growing from 80 percent of total revenues in 1984 to 85 percent by 1989. Corporate income taxes, excise taxes, and other receipts will continue to diminish in relative importance (see Table 5).

TABLE 5. BASELINE REVENUE AND OUTLAY PROJECTIONS BY SOURCE OR MAJOR CATEGORY (By fiscal year, in billions of dollars)

	1983 Actual	1984 Base	Projections 1985	1986	1987	1988	1989
Revenues							
Individual Income Taxes	289	294	329	362	396	438	478
Corporate Income Taxes	37	62	65	71	81	85	85
Social Insurance Taxes	209	237	269	296	320	354	382
Excise Taxes							
Windfall profit taxes	13	9	7	5	4	4	4
Other	22	29	31	27	28	28	29
Estate and Gift Taxes	6	6	6	5	5	4	5
Customs Duties	9	10	11	12	12	12	13
Miscellaneous Receipts	16	16	16	17	18	19	20
Total Baseline Revenues	601	663	733	795	863	945	1,016
Outlays							
National Defense	210	235	263	295	331	372	419
Entitlements and Other Mandatory Spending							
Social Security	165	173	184	197	211	227	243
Medicare	56	64	74	83	94	106	120
Other	179	162	167	177	186	197	208
Subtotal	400	400	425	456	490	530	570
Nondefense Discretionary Spending	144	156	161	168	178	189	198
Net Interest	90	108	127	145	168	194	219
Offsetting Receipts	-48	-46	-49	-52	-55	-59	-64
Total Baseline Outlays	796	853	928	1,012	1,112	1,227	1,342

Changes in the composition of federal spending are more substantial. The most rapidly growing category of spending in the baseline is net interest. With large and growing deficits and no reduction in inflation-adjusted interest rates after 1985, federal borrowing costs are projected to double over the next five years. .The portion of gross spending (excluding offsetting receipts) devoted to interest rises from 12 percent in 1984 to 16 percent by 1989. Defense spending grows by 79 percent between 1984 and 1989, assuming real increases of 5 percent per year. The share of defense spending in the budget grows from 26 percent to 30 percent.

In our projections, domestic spending--the combination of entitlements and discretionary programs--grows by 38 percent between now and 1989. Because this is well below the rate of increase in total outlays, their share of the budget declines from 62 percent in 1984 to 55 percent in 1989. The dollar increase is still substantial, however, from $556 billion in 1984 to $769 billion in 1989. Of this $213 billion increase, $124 billion--or 58 percent--is in just two programs, Social Security and Medicare.

Perhaps the most important point to make about the spending side of the budget is that very few programs are responsible for the bulk of federal outlays. Our projections suggest that, by 1989, spending on defense, Social Security, Medicare, and net interest will be equivalent to almost 100 percent of total tax revenues.

Comparison of CBO and Administration Economic Assumptions and Budget Projections

The CBO and Administration economic forecasts for 1984 and 1985 are very similar (see Table 6). Projected growth rates for real GNP are almost identical. The Administration's short-run forecast for inflation is only slightly more optimistic. Interest rates are lower in the Administration's forecast, but by less than one percentage point.

However, the Administration's longer-run projections for the 1986-1989 period are considerably more optimistic than CBO's. The Administration's projection shows growth rates averaging about one half of one percentage point higher than CBO's, and inflation lower by a similar amount. However, the largest difference between the CBO and Administration's projections is in the area of interest rates. The Administration's projections show substantially lower interest rates than CBO's, with the differential growing.

The Administration's budget estimates, presented in Table 7, show substantially lower outlays and somewhat higher revenues than CBO's baseline budget estimates. CBO is now examining the Administration's budget to determine how much of the differential is due to differences in policy assumptions and how much is due to differences in economic assumptions or technical estimating methods. While the analysis is not complete, it appears that economic assumptions account for a large part of the difference in budget estimates in the 1986-1989 period. Interest-rate

TABLE 6. COMPARISON OF CBO AND ADMINISTRATION'S ECONOMIC ASSUMPTIONS (By calendar year)

	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)						
CBO	3651.2	3994.8	4339.0	4703.7	5083.5	5480.5
Administration	3642.4	3973.8	4319.2	4681.2	5059.0	5444.9
Difference	8.8	21.0	19.8	22.5	24.5	35.6
Real GNP, (1972 dollars, percent change, year over year)						
CBO	5.4	4.1	3.5	3.5	3.4	3.3
Administration	5.3	4.1	4.0	4.0	4.0	3.9
Difference	0.1	0.0	-0.5	-0.5	-0.6	-0.6
GNP Deflators (percent change, year over year)						
CBO	4.7	5.1	4.9	4.7	4.5	4.3
Administration	4.5	4.8	4.5	4.2	3.9	3.6
Difference	0.2	0.3	0.4	0.5	0.6	0.7
Consumer Price Index (percent change, year over year) a/						
CBO	4.5	5.0	4.9	4.7	4.5	4.3
Administration	4.4	4.6	4.5	4.2	3.9	3.6
Difference	0.2	0.4	0.4	0.5	0.6	0.7
Civilian Unemployment Rate (percent, annual average)						
CBO	7.8	7.3	7.0	6.8	6.6	6.5
Administration b/	7.9	7.7	7.5	6.9	6.2	5.8
Difference	-0.1	-0.4	-0.5	-0.1	0.4	0.7
90-Day Treasury Bills (percent, annual average)						
CBO	8.9	8.6	8.4	8.2	8.0	7.8
Administration	8.5	7.7	7.1	6.2	5.5	5.0
Difference	0.4	0.9	1.3	2.0	2.5	2.8

a/ Consumer price index for urban wage earners and clerical workers.

b/ The Administration publishes only the overall unemployment rate. The adjustment to civilian is made by CBO.

TABLE 7. ADMINISTRATION UNIFIED BUDGET ESTIMATES (By fiscal year, in billions of dollars)

	1983 Actual	1984	1985	1986	1987	1988	1989
Revenues	601	670	745	815	888	978	1060
Outlays	796	854	925	992	1068	1130	1184
Deficit	195	184	180	177	180	152	123

projections appear to account for about half ($80 billion) of the differences between the CBO and Administration outlay estimates in fiscal year 1989. The Administration's current services revenue estimates are above those of CBO, though the Administration, for the most part, assumes lower incomes. We will have a report on the Administration's budget in a few weeks when our analysis is complete.

The analysis produced by both the Administration and CBO shows that it is unlikely that a vigorous economic expansion will cure the deficit problem. The Administration's current services budget shows persistent deficits of around $200 billion annually in the projection period. CBO's analysis indicates that, even if economic growth matches the strong expansion of the 1960s, which appears unlikely, federal deficits will probably remain at near-record levels unless policies are changed. 4/ The sheer magnitude of the projected budget deficits means that percentage errors in forecasting them are likely to be much smaller than in the past. 5/ It is noteworthy that CBO's projection of the deficit for fiscal year 1988 has changed very little from that of a year ago. 6/

CONSEQUENCES OF LARGE DEFICITS

Federal deficits of the magnitude shown in the baseline projection would have major consequences both for the economy and for future budgetary choices. Most economists agree that federal deficits of the size projected by CBO keep interest rates higher than they would be otherwise. The effect would be particularly strong as the economy approached full employment (or the limits to growth set by monetary policy), where public and private borrowing would compete for a relatively fixed level of saving.

4/ Congressional Budget Office, The Economic Outlook (February 1984). See CBO's high-growth path and associated budget estimates in Chapter I.

5/ Forecasts of deficits have shown large errors in the past because the deficits were a residual of two much larger numbers. Thus in the 1960s, when deficits averaged 4.6 percent of total outlays, a 5 percent error in the forecast of spending would have resulted in a 109 percent error in the projected deficit. But in 1983, when the deficit was 24.6 percent of outlays, a 5 percent error in the outlay estimate would have resulted in an error of only 20 percent in the deficit estimate, other things being equal.

6/ CBO currently projects a fiscal year 1988 baseline budget deficit of $282 billion, up from the $267 billion in CBO's February 1983 baseline budget projection for fiscal year 1988.

Even in the present situation of less than full employment, deficits are likely to raise interest rates. A few analysts contend that there is no historical evidence for a link between deficits and interest rates. But one should not expect to find in historical data a simple association between deficits and interest rates. Previous deficits experienced during peacetime have been much smaller than those now projected, and their impact on interest rates has often been overwhelmed by recessions, Federal Reserve policies, or international capital flows.

The current and prospective deficits are extremely large relative to past history. In fiscal year 1983, the federal deficit was about 107 percent of domestic net private saving and 34 percent of gross private saving. Our forecast implies that federal deficits would be 79 percent of net private savings and 29 percent of gross private savings during the fiscal year 1984-1985 period. Fortunately, very large capital inflows from abroad have so far limited the rise in interest rates. It should be emphasized that these capital inflows are not a costless remedy for deficits. If the capital inflow continued for a long time, foreign claims on U.S. output could rise to such a level that it would reduce our standard of living significantly below what it would be if we decreased government borrowing and relied less on capital inflows.

High interest rates, if they persist, are likely to reduce capital accumulation. Although the cyclical rise in demands and increased capacity utilization rates are now providing a strong stimulus to investment, this may eventually be offset by the retarding effect of high interest rates on structures investment. Over time a reduction in the capital-output ratio will retard growth in productivity, the major source of rising living standards.

The Interest Payment Bill

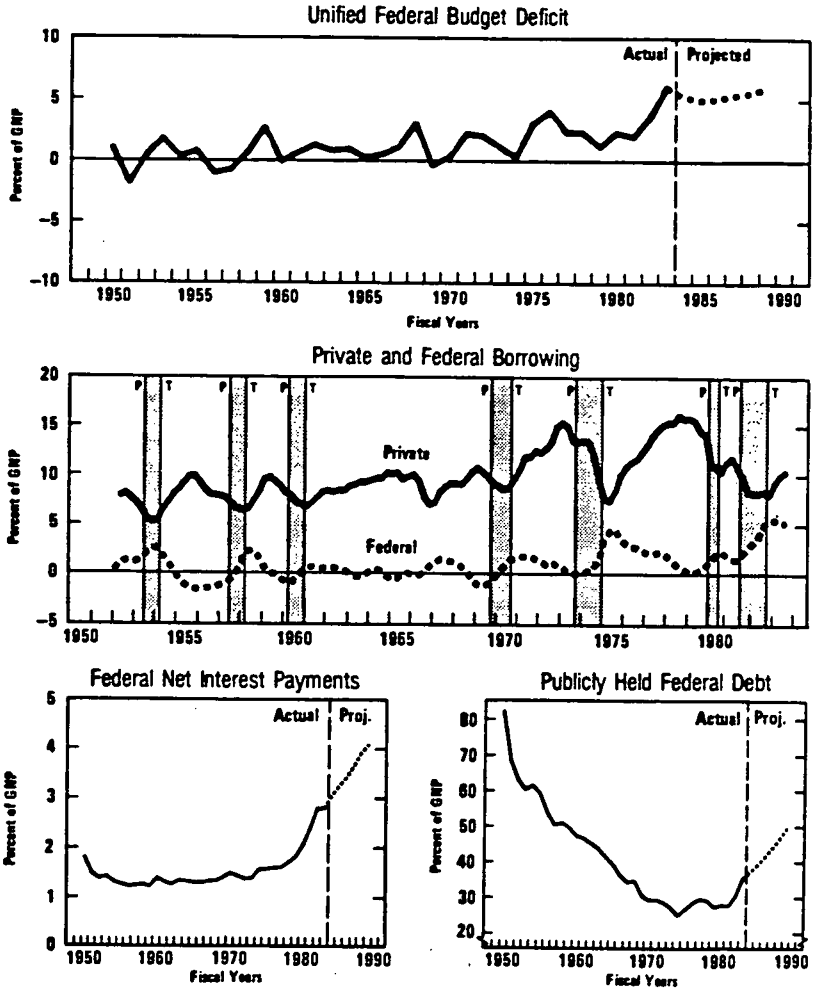
The most striking feature of the CBO budget baseline projections is the extremely rapid growth in outlays for interest on the debt (see Figure 2). Net interest costs, which were between 1 and 2 percent of GNP for decades, are projected to rise from 2.8 percent of GNP in fiscal year 1983 to 4.1 percent in 1989. In these circumstances, major spending cuts or tax increases are necessary just to avoid the possibility of explosive growth in interest outlays.

The rapid rise in the debt-to-GNP ratio also makes the future deficit outlook highly sensitive to interest rates, one of the hardest economic variables to forecast. A one-percentage-point error in the forecast, if continued through the projection period, implies a $30 billion error in the projection of the 1989 deficit.

BUDGET PROCESS

Mr. Chairman, your letter requesting this testimony asked me to comment on the effectiveness of the Congressional budget process in meeting the task before us. It is clear that a process, no matter how well designed, cannot provide easy answers to hard questions. The questions posed by our current budget dilemma are among the most intellectually

Figure 2.
Government Borrowing



SOURCES: Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic analysis; Congressional Budget Office.

NOTE: P and T lines indicate business cycle peak and trough dates.

profound and complex questions that can confront a nation: namely, what should the federal government be responsible for, and who should pay for it?

As we attack such issues, the process can make the debate more orderly and help to bring useful information to bear at crucial times during the discussion. It also forces the deliberations into a multiyear framework. This is important in assessing deficit reduction options because many proposals to reduce outlays and to increase revenues have very different effects in the short and long run.

Assuming that we will come to some agreements and embody them in a budget resolution, the remainder of the budget process seems pretty well-suited to the task. Since the resolutions cover several years and now contain limits on credit as well as spending and taxing, their scope seems about right. Moreover, implementation of the budget resolution through reconciliation allows the package nature of any likely deficit reduction plan to be preserved. Thus, although I would favor some strengthening and streamlining of the budget process procedures--perhaps along the lines now being studied by Congressman Beilenson's House Rules Committee Task Force. But it would be misleading to imply that reforms in the budget process will greatly ease the resolution of the difficult problems before us.

Yesterday, CBO released Part III of our annual report, Reducing the Deficit. In it, we analyze options for cutting spending and raising revenues. I hope this aids in clarifying the hard choices before the Congress.

In sum, it has to be admitted that the budget process has many problems and did not work well last year. But if we can build a consensus for deficit reduction--and that is the hard part--I feel confident that we have a vehicle that can get us where we want to go.

Senator JEPSEN. Ninety-nine percent of the receipts?

Mr. PENNER. Under current law, yes.

In other words, you could do away with the whole rest of the Government, other than those few programs—defense, social security, and medicare and net interest—and you would just barely balance the budget.

Senator JEPSEN. It is an interesting idea. Defend our country and deliver our mail on time, and leave us alone. That is kind of what your slogan was in 1980.

In your prepared statement, you note that relatively high interest rates have not had as large an effect on overall economic recovery as many expected. I also note in your opening statement, as your initial remarks, you alluded to the fact that the Federal deficit is possibly responsible for holding up interest rates. It is accurate, is it not, the Federal deficit has gone up rather dramatically in the last several years and interest rates have been going down?

Mr. PENNER. When we refer to a link between deficits and interest rates, we are referring to real interest rates. That is to say, the interest rate, as corrected for——

Senator JEPSEN. But you have to pay when you borrow money; is that what you are talking about?

Mr. PENNER. No. I am talking about what you have to pay after you adjust for the fact that the dollars you pay in the future are worth less because of inflation, and measured that way, in fact, interest rates have gone up. Indeed, in figure 1 of my prepared statement you can see this chart here [indicating] which shows that in the 1970's, interest rates were quite low. Interest rates, as adjusted for inflation. That is the dashed line. Then they soared to the early 1980's. Actually, the pattern follows the deficit pretty well. I would be the last to argue that deficits are the only thing that affects interest rates. Obviously, that is not true. There are all sorts of other things and, in particular, this rise, at first, in 1980, was due to a pretty severe tightening of monetary policy.

In the very short run, at least, monetary policy can have some effect on all of these things. But their continued high level, in my judgment, is due very largely to the deficit. You can see them coming down a little bit, and the worst situation was the deficit in the last quarter of 1982, when the deficit reached its peak, relative to savings and national product, and so on. It has been on a slight downward course ever since. Our projections suggest, however, that after 1985, if no spending or tax laws are changed, the deficit will again begin to soar relative to GNP, reaching record levels by 1989.

Senator JEPSEN. That is where your 30 percent figure comes in? Thirty percent of gross national product by 19——

Mr. PENNER. No, the 30——

Senator JEPSEN. That is the total spending?

Mr. PENNER. The 30 percent, no, sir. I believe that is debt relative to GNP. That is in figure—well, the 30 percent is closer to what is now—I am not sure what you are referring to.

Senator JEPSEN. We are spending 24 percent of our gross national product now, of this budget of $847 billion, projected to be 30 percent by 1989.

Mr. PENNER. No, sir. Not that high. The outlays go down from 24.7 percent to about 23.7, then they start rising. Our peak year is 25.9 percent in 1989.

Now I should add, Senator Jepsen, that very important to these paths is the fact that we assume—somewhat arbitrarily but not totally arbitrarily—that defense spending will rise 5 percent per year in real terms.

If you had chosen to assume that it would be less than that, then, of course, the spending level would be lower, relative to GNP. These numbers can be found in my prepared statement in table 4. You can see what would happen if defense rose by 5 percent in real terms and what would happen if it grew at zero percent in real terms.

Senator JEPSEN. The CBO report released this past Tuesday, in the economic outlook, includes the following observation, and I will quote:

> Now while large deficits may have adverse economic consequences, abrupt or poorly designed measures to reduce deficits could be a threat to economic efficiency and continued economic growth.

Would you elaborate on this for the committee, please?

Mr. PENNER. I think, as much as we dislike deficits—and no one really much likes them, and clearly they do a great deal of harm in the long run—one obviously has to be careful about how one goes about curing them. Every possible cure that one can think of also has some painful elements, or obviously, we would have cured the deficit long ago. So very radical, poorly designed tax increases, for example, could do a great deal of harm, and I suppose, in the extreme, could almost be as bad as deficit. At the same time, very poorly thought-through spending cuts might also negatively affect the economy and economic efficiency, and so on. So we have to show some care. Those remarks, however, were not meant to discourage us from trying.

Senator JEPSEN. If you had your choice, would you work on the deficits by controlling—by doing it with reductions, getting control of Federal spending, or would you do it with taxes?

Mr. PENNER. Well, that is a choice that the Congressional Budget Office does not feel it should make. We think that is entirely a political choice that has to be made by politicians. Indeed, that is what the major fight is about. What we have done in part 3 of our annual report, which is called "Reducing the Deficit: Spending and Revenue Options," is to lay out for you about 138 different options on both the spending and tax side of the budget. We try to state, as fairly as we can, the advantages and disadvantages of each, and give you some idea of the menu that is available. But actually choosing among them is not something we and the staff can do for you.

Senator JEPSEN. You have no recommendations?

Mr. PENNER. No; we do not make recommendations on policy issues of that type.

Senator JEPSEN. Well, since you have expertise and are the director of the Congressional Budget Office, do you feel that—what is your opinion, if you care to give it, with regard to working on deficits, with regard to control of Federal spending, or would you resort to recommending taxes?

Mr. PENNER. Well, again, as Director of CBO, I cannot have opinions on that sort of thing. As I say, we have laid out the options and tried to describe their characteristics and state their advantages and disadvantages. You know, it is hard to think of anything you could do that would be absolutely costless, either to the economy or to particular individuals. The various choices have very, very different distributional effects. They affect some people more than others, and so on.

Senator JEPSEN. Sure.

Mr. PENNER. And we can study that part and try to decribe the effect to you. But when it comes right down to choosing, it comes to choosing among things that have very difficult political trade-offs.

Senator JEPSEN. I understand and appreciate that. I thank you for your answer, and I appreciate your position.

One last question. You point out that projected defense expenditures rise rapidly between 1984 and 1989. I believe it was 79 percent; is that correct?

Mr. PENNER. Yes.

Senator JEPSEN. Can you tell me how the CBO's baseline projections for defense expenditures as a percent of gross national product, and as a percent of outlays, compare to levels prevailing in 1960 and 1970?

Mr. PENNER. I do not know if you can see this, sir. This is in our third part of our volume. It shows defense spending as a percent of GNP, starting way back in 1948, I guess it is. Can you see that, sir?

Senator JEPSEN. What was it in 1960? What is it, part 3?

Mr. PENNER. Part 3, page 17 of the CBO report. What you see there is a very rapid rise to a post-World War peak during the Korean war, over 13 percent of the GNP; a fairly steady fall in 1965; then a rise during the Vietnam war to something a little less than 10 percent of the GNP. Then you see a steady fall from Vietnam to a drop, I guess in the late 1970's, where it got to about 5 percent of the GNP, and then a steady buildup to the current level, a little over 6. And in this projection that we have made with 5 percent real growth, it would end up between 7 and 8, by 1989.

Senator JEPSEN. Well, according to your chart—that is figure 3?

Mr. PENNER. Yes.

Senator JEPSEN. National defense outlays, percentage of gross national product.

Mr. PENNER. Yes; on page 17, 2-3.

Senator JEPSEN. In 1960, you have roughly 8½—about 9 percent. You drew a line straight up from 1960.

Mr. PENNER. Yes.

Senator JEPSEN. In 1970, you drew that line straight up, and you are looking at about 7.5 percent, not quite 8; is that correct?

Mr. PENNER. That is correct.

Senator JEPSEN. And what did you say you projected it for in 1989?

Mr. PENNER. By the end of the period, it is a little bit below 8 percent.

Senator JEPSEN. And a percent of the Federal outlays, do you have that also?

Mr. PENNER. Yes; I believe that, by 1989, it rises to about 30 percent of Federal outlays.

Senator JEPSEN. That is for defense, about 30 percent of the budget?

Mr. PENNER. Yes.

Senator JEPSEN. And that, compared to 1960, would be what?

Mr. PENNER. 1960? Wait a minute. I do not have it in my head. No, I do not have 1960 handy here. I think it was——

Senator JEPSEN. We have it here.

Mr. PENNER. OK. It is almost half the budget.

Senator JEPSEN. Forty-nine percent?

Mr. PENNER. Yes; 49 percent.

Senator JEPSEN. For 1970, 40 percent.

I thank you for coming. I have no further questions. Senator Abdnor will take the Chair. Again, good luck, and we will be looking forward to working with you.

Mr. PENNER. Thank you very much. We look forward to it.

Senator ABDNOR [presiding]. Thank you.

Mr. Penner, I guess we all have other places to be; and you probably more than any of us.

Mr. PENNER. I do not think so.

Senator ABDNOR. With all the demands we make upon you to appear in front of this committee and that committee, I sometimes wonder how people like you are able to get your work done back in your office. But at least you have the relief of knowing we are going to be out of town for 10 days, and maybe that will give you a chance to get something done.

Mr. PENNER. It is these guys back here who do all the work. I am just the front man.

Senator ABDNOR. Well, you have to have somebody backing you up in your job. You have a great responsibility. I was very interested in the testimony you presented to the Finance Committee back—when? In December?

Mr. PENNER. December 12.

Senator ABDNOR. I was so interested that I took it with me on my Christmas vacation to read. That is when I became even more alarmed, and my fears became even greater, because there was the same theme throughout most of these hearings. We should be giving a lot of consideration to what is going on.

Earlier today I asked Mr. Volcker about a statement I saw in the paper yesterday where he said that if we made an all-out effort to cut the deficit—the projected deficit—by $50 billion, it would be a great stimulant to the economy.

How much of a cut would it take to really have an impact on the economy and maybe help bring the interest rates down?

Mr. PENNER. Well, I think different people might have different views on this question. My own view is that it is not so important exactly how many dollars you cut from the 1985 deficit. What is really important is to show the marketplace that we are firm in our desire to cut it in the longer run. So if you make structural changes in the spending or the tax side and start to bring these lines together a little bit, even if the major effects are 1986 or 1987, I think if you changed the laws or at least show a resolve to change them, that that would have a very beneficial effect on the deficit.

Or maybe putting it another way, Senator, I think it might cut quite a bit from the 1985 deficit, but if you did it in some temporary way—say, cutting a few capital expenditures or something like that—that would not do as much good as some smaller cut that really showed a more fundamental change in the structure of spending and receipts.

Senator ABDNOR. Give me an example. What would be a good faith effort?

Mr. PENNER. What our figures show very clearly—to the extent you want to do it on the spending side—you have got to go where the money is, and the money is in defense, social security, and medicare. Those are the really big programs. That does not mean you should not cut others, obviously, but you ask what kind of targets might we have. It is hard to think of any that are very easy to meet, but one target that we think makes some sense is a preliminary target, at least to reduce the deficit by enough to stop the debts out there from growing faster than the GNP.

Now that is not going to be an easy trick, because in our projections, that would require cutting the deficit by $110 billion by 1987.

I should point out that not all of that necessarily involves programmatic changes. My testimony shows very clearly, I think, that one of the most severe problems we face is just the growth of the net interest bill on the debts. That is what is really killing us right now, and it is going up in our projections by more than $20 billion a year.

Now, just as that is the sort of bad side effect of having big deficits, if you can cut a program and reduce some spending or raise some taxes by $1 a year and keep that going over 5 years, at the end of 5 years, you have got $5 less in bonds out there. You are paying interest on $5 less in bonds. And are paying less interest on the interest that you would accumulate over that time.

So any kind of program cut or tax increase you make has a multiplier effect on it in terms of saving you a lot of interest. If you think, as I would, that if you make this kind of effort, interest rates will come down as well, you have a double whammy. Not only do you have much less debt out there, but you also are paying less interest on the debt you have and the debt you are refinancing, which is now getting up to $400 billion a year. So, what I am saying is, you do get this extra reward.

Senator ABDNOR. It seems once we add debt, we never consider getting it reduced. It seems to be here to stay and so it is something we have just got to go ahead and make part of the program. This is what really disturbs me.

Although we are talking here about entitlements and defense, let us first talk about discretionary spending. I think you said one time that discretionary spending is only about 14 percent of all budget expenditures. Is that right?

Mr. PENNER. Of the total budget; yes. If you set the offsetting receipts against the debt, that is right. If you take out the offsetting receipts, it is a little more than that—I think about 25 percent. But you are right; basically, it is very small.

Senator ABDNOR. We have been hacking away for several years at that now. Do you think there is much more in reductions to be taken out of there?

Mr. PENNER. Well, certainly, that is a section of the budget that has been scrubbed over the most, and every time you have done it, you have taken the easiest ifs that you could.

I am just noticing I was a little high in my 25 percent. It is a little lower than that: In 1984, it would be about 17 percent. But in any case, you are right. I think we have done a lot of easy things. It does not mean you cannot scrub them again, but it gets harder and harder each time you go down the same road.

Senator ABDNOR. Well, maybe this is an unfair question to ask you, but you have been talking to all of us in Congress—the House, the Senate, the various committees—do you really think there is a sincere move on the part of Congress to reduce the deficit, or do you think it is mostly rhetoric?

Mr. PENNER. Well, I hear an awful lot of concern about the deficit.

Senator ABDNOR. Yes, but we have not converted that concern to action. You would agree, regardless of what the President or the administration would like to do, Congress could do what we darn well please up here, for starters, could we not?

Mr. PENNER. Well, you are the ones who pass every single spending law and every single tax law.

Senator ABDNOR. I was saying today—was it $928 billion we are talking about in spending next year? If we were to cut $25 billion out of it and increase taxes, maybe of $25 billion, we would make a great start, would we not?

Mr. PENNER. That is more of a start than most people are talking about. That is certainly true. In fact, at this point, it would be very hard to do that, actually to get that much out of the deficit in 1985. But you could pass laws now that might somewhat more easily get more than that in the longer run starting in 1986.

Senator ABDNOR. Well, something along that line. What would you project that might do to interest rates, if cuts were properly placed and the tax increase were in effect? Would you make a guess?

Mr. PENNER. That is an extraordinarily difficult question to answer. But if you adjust interest rates, they are running at about 4 percent these days, once you take the inflation out of them. The historical norm is a little less than 2 percent. Now, I do not want to say that whole difference is because of the deficit. I do not think that is true. I think there are other problems, other certainties, and so on, that are at work here. But I think you could, depending on how much progress you made, and depending how you do it, cut interest rates by a significant amount. Obviously, if you are just interested in the interest rates, you are very interested in the flows of savings—private savings and investment, too. They play a big role. So if you were to pass some tax increase that was extremely punitive to savings, for example, then you would not get that much. You might get something out of it, but not that much. If you were to pass one that was less detrimental to savings, then you would get more. But I think you would start moving the real Treasury bill rates down toward the historical norm, if you could get these deficits more into line.

Senator ABDNOR. We have been making some real efforts, have we not, to encourage new savings? Have we made any real progress?

Mr. PENNER. Frankly, sir, the numbers we have on that so far are disappointing. (As a private citizen, I was a proponent of a lot of the things we have done, like the IRA's, Keoghs, and so on.) We have to be somewhat disappointed in our preliminary numbers anyway. The first data we are getting seem to suggest a large part of those IRA's and Keogh accounts are not new savings, but rather just movements. You know, this time of year, I can sell some stock and put the money in my IRA. I do not save even an extra penny, but I get a lot of tax savings anyway by doing this kind of transfer. So a lot of people are doing that.

It has been argued that, maybe once you get the first transfers of assets out of the way, they will start adding to real savings. But I have to say that I have been disappointed in the results.

Senator ABDNOR. We tried numerous things. As I remember, we had an All Savers program here a couple of years ago that lasted 1 year, and I do not think that created that much savings.

Mr. PENNER. That was not one of my favorites.

Senator ABDNOR. I think a lot of people had second thoughts about it. But that brings up another question. I think you mention in your testimony to the Finance Committee, that our tax base is not as broad as it should be. Maybe we ought to be looking at the whole tax structure picture. Everybody has a great idea to increase saving by adding some kind of an exemption. I do not know how many more exemptions we can put on. We have come a long way in tax exemptions.

Do you not think the real answer down the road is some kind of a new tax reform program?

Mr. PENNER. Well, from a purely economic point of view, I do not think there is any doubt—and I think you would get enormous agreement within the economic profession—that it is absolutely crucial from the point of view of economic efficiency to start simplifying and getting rid of an enormous number of deductions, exemptions, the whole works, in our Tax Code; which have so distorted economic activity.

It has to be said on the other side, though, that every one of those deductions had somebody arguing successfully for it in the past, that somebody somewhere thinks it serves some economic or social purpose. And that is what has to be reexamined. We have in our volume an enormous number of suggestions as to what might be looked at and the revenue implications, and so on.

Senator ABDNOR. Which volume is that?

Mr. PENNER. Part 3 has all of these options on the spending and on the tax sides, with the amounts involved, for reducing the deficit. The way the volume is organized, we have an index at the back that gives you all the items and tells you what pages they are discussed on. It tells you how much money is involved in each.

Senator ABDNOR. I am happy to have that.

Let me ask you, in the long run, what kind of tax system should the United States have? Would you favor a reform in the direction of a consumption tax? I hear a lot of talk about that. Or would you personally prefer the type of a flat tax proposed by Mr. Hall and

Mr. Rabushka? I have heard a lot of versions of the flat tax. Which is the best one? I mean, you probably have to go one way or the other, would you not think?

Mr. PENNER. I think the term "flat tax" has been abused so much, it is not very meaningful. I heard someone the other day say they strongly favored a progressive flat tax. That tells you something about where our language has gone.

I think there are two different issues that have to be separated. One is the issue of simplification. And I think there is a great yearning both amongst the ordinary taxpayers and certainly among tax experts and economists for simplification, for getting rid of all of this complexity. And that can be done by getting rid of these deductions and credits and exemptions, and so on, to the extent possible.

The second issue is somewhat different. It is how progressive the tax system should be, how much taxes go up with income, and then there is even a different debate.

I guess this is a third issue that is hanging around: What really should be the basis of the tax system? Should it be income, or should it be consumption? All of these things tend to get mixed up a bit, but I think there is almost total agreement among the tax experts, as I have been suggesting, that simplification is a good thing. Once you get into the question of how progessive the system should be, then you get into value judgments and a lot of political squabbling. That is a somewhat different issue. Whether the tax base should be consumption or income, I think is also a different set of issues, but many, many economists I know—while they might favor a consumption base instead of an income base—say that the important thing is to broaden the base, whatever it is—let us tax more, so we can get the tax rates down. I have heard proponents of the income tax say:

> I would like a broad-based income tax—a Bradley-Gephardt variety—but if I cannot get that, I should prefer a broad consumption tax to our current mess.

Or similarly, I have heard people on the other side of the debate say:

> I would like a consumption tax but this mess we have now has nothing to recommend it; I will take a broad-based Bradley-Gephardt type tax in preference to what we have now.

So most people are rebelling and complaining about the horrible inefficiency of our present system, which is just terribly worrisome.

Senator ABDNOR. It just seems to me that whatever way we go, it is not going to be done quickly. There are going to be lots of hearings and testimony.

Mr. PENNER. I think there is a great yearning out there for more movement.

Senator ABDNOR. We think there is, until you start talking about the specifics. Like you said, everybody has their own version, and the people are not always willing to give that much in order to come to some kind of a basic conclusion. It looks to me like at this time, that when we pass a new tax package, it is with the thought in mind that it may be changed within a year or two. This almost makes you think that, maybe, a surtax may be the best way to go for a while until this Congress is ready to take those steps. But who knows?

Mr. PENNER. Again, we explored those kinds of issues in this volume, and what we say there is, certainly, a surtax is simple; it is readily understandable. Everybody knows what its implications are. The basic problem is that it is a surtax on this small portion of income that is still in the tax system. And we contrast that approach with, as you say, the much more complicated one of trying to broaden that tax base.

Senator ABDNOR. I just do not think, in a short time, you are going to get it done. That is all, and I think the sooner we make a start on our deficit—and that is what we are talking about—the better.

Now I am sure they told you, when I got up here, I would be talking agriculture, because I am from a farm State, and it is always, I think, something that is sadly neglected. I was on this committee for some time, and I hardly heard the word used. Now we do talk about agriculture once in a while, because it is an important part of the economy. We are just as interested and concerned about deficits in our rural area, as you are in the big cities, because I do not know who borrows more money than farmers and some of the small businesses, on a per capita basis out in the country like mine. I do not know what would be a bigger gift for farmers than cutting down the inflation and dropping interest rates a couple of points.

Mr. PENNER. Well, I think there is another aspect to it, sir, that is very important, and that is a lot more indirect. But as you are suggesting, I think the farmers are getting kicked around directly once by the high interest rates, because they tend to be big borrowers. But there is the other indirect effect. High interest rates attract a lot of capital from abroad, pushing up the value of our dollar. And that means, when you translate crop prices into world currency equivalents, it comes out to be much fewer dollars than if we had a lower-valued dollar. And that is a very important side-effect of this budget deficit.

Senator ABDNOR. It is terrible. The situation is too much in favor of the other countries. What would a 2-percent drop in interest rates do on the inflated dollar? Not the inflated dollar, the overvalued dollar, in relation to other currencies of the world? Would 2-percent make much of a difference in interest rates?

Mr. PENNER. That is very hard thing to say, in part, because it depends so crucially on what other countries do. If, in response to a 2-percent fall in interest rates here, they were to lower their own interest rates concomitantly, it probably would not have a huge effect. I doubt if they would make it all up, though, and it depends very much on whatever differential remained. It is very hard to predict that.

Senator ABDNOR. Is the best way to get the dollar back in line by lowering of interest rates? That has really been one of the bigger attractions for the demand for the dollar.

Mr. PENNER. I think that is absolutely right, sir, and that, in turn, is, in our view, so intimately related to the deficit. Again, we keep getting back to it.

Senator ABDNOR. There we are. You know, I sounded off today, but I just cannot imagine a bunch of strong people down here speaking for the people of this country—535 of us—knowing the importance of getting the deficit under control, but we cannot drop politics long enough to do the things that must be done.

Two years ago, the President dared to bring up the subject of social security. We Republicans got kicked around for the rest of the year. We went through a campaign with some vicious ads in how terrible it was to suggest making any changes in social security. Then 2 months after the election we came back in session and passed a Social Security reform bill that everyone wants to take credit for, claiming it is one of the great accomplishments of this Congress.

If we could cut out that sort of thing and really do what ought to be done—maybe I am naive—we could come together in a meeting of the minds. Maybe I am a dreamer, but it would be awfully nice if it could happen. And I think it could. But I guess I was talking to you about agriculture and how important I think it is.

We have a subcommittee now that I chair on this committee, dealing with agriculture. One of the things we are going to do is to investigate the economic conditions of rural areas, small towns, and, in short, the economic condition of nonurban America. I just do not think there is always that much attention given to that part of our country. Someday I am going to solicit your expertise in this effort.

Just last week, Janet Norwood, of the Bureau of Labor Statistics, presented a monthly unemployment finding for January, and we discussed a topic related to this. Labor data for rural areas is very unreliable and subject to seasonable changes. In fact, employment or unemployment data is not a good measure of labor utilization in the areas where underemployment is common or where a sizable portion of workers are self-employed. It really does not tell you the truth. Perhaps your office could help develop a measurement—an index which would reflect labor utilization from nonurban America? Is that a difficult challenge?

Mr. PENNER. I am afraid it is, sir. I think, frankly, the very best people that have all the expertise and are able to do that are in Ms. Norwood's office.

Senator ABDNOR. Because she agreed that all of our Federal programs are based on the unemployment areas, and that really does not tell the whole tale.

Mr. PENNER. That is absolutely right.

Senator ABDNOR. Just because we do not have the number of unemployed, we have some very difficult conditions. We have farmers that go to work and are not getting paid enough to pay for the fuel they are using out in the field, or people in business who are barely hanging on. They might be better off if they were unemployed, collecting unemployment insurance compensation, because it brings in greater income. And I think someday that this situation has to be related to the overall picture of the underemployment situation.

Mr. PENNER. You are absolutely right that our data on the quality of the labor-force situation, if I can call it that, are not that good. I would also warn you that it is very expensive to collect that sort of data.

Senator ABDNOR. Well, we are going to try.

I could ask you a lot of tough questions, like what all these deficits mean to rural America and tax increases, but I will not burden you with that.

I would like to feel free to submit questions in writing, if I should so desire.

But just for the record, what is the current and the projected condition of the medicare trust fund? Will policy changes be needed to assess medicare, or will the problem just go away?

Mr. PENNER. I think we can guarantee that the problem will not go away. We cannot forecast the exact date on which the trust fund goes broke under current law, but it is somewhere around 1990. It might be 1991 or 1992 or maybe even 1989, depending on how the economy does. But it will go broke, with virtual certainty.

Senator ABDNOR. Well, one thing is for sure, the longer we let it go, the more difficult it is to get it back into shape.

Mr. PENNER. Absolutely. It is very analogous to the Social Security situation, Senator. We knew, certainly, years ago, that that fund was going to go broke. It was not a last-minute thing that fixed it up. I hope we do not do the same thing on medicare.

Senator ABDNOR. Well, I know it needs attention, and yet I am afraid, because of the ramifications of an election coming up, and one side trying to make political hay over it I am afraid we may have to look at it another time. I hope not. We have to wait and see.

Well, I had a lot of other questions here, but I know you are busy, and you have been pretty well quizzed out during the day. This is your third appearance, on behalf of the Joint Economic Committee.

I certainly want to thank you for your appearance here today, and we are looking forward to a return on your part later on.

I am sure this deficit is not going to go away before you come back again.

So we thank you very, very much.

The committee is recessed.

[Whereupon, at 3:45 pm., the committee recessed, to reconvene at 10:20 a.m., Friday, February 10, 1984.]

THE 1984 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 10, 1984

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

The committee met, pursuant to recess, at 10:20 a.m., in room SD-124, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senator Jepsen and Representative Obey.

Also present: James K. Galbraith, deputy director; and Edward Abrahams, Dale Jahr, and Robert J. Tosterud, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. I wish to welcome you, Mr. Secretary.

There are so many issues I want to discuss with you that, quite frankly, I am not sure where to begin.

It is only logical that we begin at the origin—the origins of today's farm problems.

Today's depressed farm economy is readily and directly traceable to the economic policies of the late 1970's which yielded hyperinflation and interest rate levels.

Between 1977 and 1980 farm production costs increased 45 percent, from $89 billion to $129 billion. Those 3 years of hyperinflation have devastated farm net income and thereby the farm economy. Ten years ago farm cash sales totaled $87 billion and production expenses were $65 billion, yielding a net income from farm sales of $22 billion. Back in 1973, it took less than $4 of product sales to generate $1 of net income. But, while farm cash receipts have increased 66 percent since 1973, production costs skyrocketed 117 percent. As a result, today a farmer needs to sell over $32 of product to realize $1 of net income.

Had those inflation rates of 12 percent in 1978, 19 percent in 1979, and 9 percent in 1980 been kept down to just 8 percent each year by the previous administration, farm net income from sales would have been $22.5 billion in 1982 rather than $4.5 billion. Those 3 inflationary years have cost farmers over $70 billion of net income during the last 5 years.

In addition, when the previous administration took control of this country's economic policies in 1977 the interest rate on non-real estate farm loans was 8.8 percent. Four years later, this interest rate stood at 18 percent. The prime interest rate went from 6.25 percent to 21.5 percent. The prime is currently at 11 percent.

This doubling of interest rates more than doubled farmer's interest rate payments from $7 billion in 1976 to $16 billion in 1980. On January 1, 1977, total farm debt stood at $103 billion. Four years later, on January 1, 1981, total farm debt had climbed to 70 percent to $175 billion. Tragically, this phenomenal addition to debt incurred by farmers during the late 1970's will burden generations of farmers to come.

Add the grain embargo of January 1980, and one begins to understand the roots of the farmer's current financial plight.

Commensurate with these record cost increases came record crop production levels, a global recession and the buildup of price depressing carryout stocks. The Reagan administration implemented a $30 billion supply control effort, including the payment-in-kind program, and created and expanded its export blended credit program, to reduce stocks and improve farm prices and incomes.

Aided and abetted by the drought, supply control programs achieved their objectives. For the first time in several years, farmers looked to the market and away from the Government Treasury as the source of improved earnings and relief from financial stress. Between 1981 and 1983, farm net cash income went up 24 percent, from $34.7 billion to $43 billion.

It is with considerable displeasure, however, that I note that the Department of Agriculture is forecasting a decline in farm net cash income of 14 percent in 1984, a $6 billion drop from 1983. This $6 billion decline is the net result of a $4 billion increase in cash income and a $10 billion increase in cash expenses. I am sure you will agree, Mr. Secretary, that there is something terribly wrong with an industry which must spend $10 to make $4.

In addition, according to your own budget figures, the Reagan administration will have spent $55 billion between fiscal years 1982 and 1985 on just farm price support and income stabilization programs. Yet, given current forecasts, it appears that any improvement in the farm economy during this same period is certainly not in proportion to the magnitude of this public assistance. In fact, your Department's forecast of farm net income in 1984 is but 5 percent greater than that realized by farmers in 1981. The point I wish to make is that this administration, burdened by a 4-year farm program not of its own making, nonetheless has been generous virtually to a fault.

This $55 billion public expenditure, however, is not our greatest cost. Spending $55 billion or $100 billion for that matter, is no measure of a job well done. Our greatest cost is reflected in the dramatically changed national perception and attitude toward American farmers and their industry. Equally tragic is the farmer's loss of pride and independence. Farming has become a problem to be minimized, not an opportunity to be maximized. In my judgment, nowhere has our Government failed its citizenry more than in its ignorance and misuse of our agricultural resource.

As evidence I offer the conclusions of the agricultural chapter of the 1984 Economic Report of the President written by the Council of Economic Advisers. This report states that the solution to agriculture's apparent excess capacity is to "retire resources from production" by "allowing capital losses." I agree some agricultural resources should be retired, and economic logic suggests we start with the most inefficient—let us begin with the French. Our unilateral supply control programs have demonstrated again and again that retiring U.S. farm resources encourages the retention and expansion of less efficient non-U.S. farm resources. The net result is a global misallocation of resources, eventually higher food costs, a more vulnerable and tenuous food supply, and a lower world income. Our agricultural policy must assume this long-term global perspective.

The choice is whether we continue to implement futile, costly, and counterproductive unilateral supply control policies and programs or do we promote and secure our greatest and perhaps last international competitive advantage. I propose we ask the primary beneficiaries of today's farm programs—those 300,000 farms, or 12 percent of all farms, who traditionally have received about one-half of all direct Government payments. These are the farms with sales in excess of $100,000 per year, an average farm income of $93,000 per year and an average net worth of more than $1.3 million.

I cannot tell you how proud I am to inform you, Mr. Secretary, that there is presently the beginnings of a grassroots movement in Iowa—the State with the most $100,000 farms and therefore the State with the most to lose—to petition this Congress and this administration to reprogram the 1985 farm budget by shifting funds from direct Government payments to market development. For example, a maximum Government payment of $50,000 to an individual farmer could be used instead to pay the Department of Agriculture's interest outlays to support a $2.5 million blended credit program consisting of $2 million of guaranteed export credit and $500,000 of direct, interest-free credit. I might add that similar credit programs could be devised to promote domestic markets such as alcohol production and even low operating loans to less fortunate farm neighbors.

I note in the President's fiscal year 1985 budget that $3.1 billion is allocated to direct producer payments for feed grains, wheat, rice, and cotton. If only the largest farms—farms with sales of more than $500,000 per year—were to yield back their direct Government payments, $470 million would become available for market development and/or production credit programs. Assuming a 10 percent interest charge, $470 million could buy $4.7 billion of direct, interest-free credit. When combined with guaranteed loan authority on a 4-to-1 mix one begins to get an appreciation for the magnitude and potential of the program. I would appreciate your reaction to this proposal and how we may encourage and assist these farmers in their imaginative and bold initiative.

The growing dependency of the American farmer on public aid is tremendously disheartening. In 1981, 5.5 percent of net farm cash income came from direct Government payments; in 1982, 9.6 percent; in 1983, 20.9 percent; and according to your projections, 21.6 percent in 1984. Mr. Secretary, the next generation of farm policy will be developed by this generation of farmers, legislators, and Government officials. We must all ask ourselves the very difficult question, what legacy do we wish to leave the sons and daughters of American agriculture? One of renewed pride and spirit, or one of deepening Government dependency and bondage? One of responsibility and self-determination, or one of economic subordination and political manipulation? I contend that nothing short of the heritage of the American farmer is at stake. You know as well as I, Mr. Secretary, that there are those who desperately want to increase the dependence of the farmer on the State; to assume the role of benevolent caretaker of America's farmers and who view individual independence as a barrier to be torn down and replaced by a leash. After all, what finer political prize than to subjugate the American farmer?

I plead with you to take a message to the President, Mr. Secretary. It is true, there are things wrong with U.S. agriculture, specifically its Federal policies. But there are also many things right with America's agriculture. If this President is in search of this country's greatest contribution to mankind he need look no further than to the soil at his feet. Even if we win this frantic battle of international industrial competitiveness, if we lose our ability to feed ourselves, what have we gained?

The United States is the only country which has both the science and natural resource base to explore and commercialize the next agricultural frontier. There are more and more hungry in the world every day. Perhaps our greatest challenge as a society is to devise new methods to grow more, and perhaps new, foods without exploiting our unique agricultural resource base. We need to expand our public efforts to develop more uses for existing crops; more environmentally compatible production techniques and equipment; new crops capable of being grown on vast and presently unproductive lands in hostile environments; new crops which minimize negative environmental impacts; and more efficient food production is the key by which the standard of living as well as the hopes, expectations, and confidence of all nations can be raised.

I obviously cannot overstate the importance of the mission of today's farmer. The U.S. farmer has the natural resource base, the technology, the expertise and the willingness to fulfill this mission. Now is the time to design and implement Federal farm policies that will unequivocally endorse and support that mission.

The next generation of farm policy must unleash U.S. agriculture's present competitiveness and future potential; target public support; preserve its natural resource base and family structure; and confidently and aggressively pursue new opportunities.

At this point in the record, I would like to insert Senator Abdnor's written opening statement.

[The written opening statement of Senator Abdnor follows:]

Written Opening Statement of Hon. James Abdnor

IT IS ALWAYS WITH GREAT PLEASURE THAT I WELCOME YOU TO OUR JOINT ECONOMIC COMMITTEE, MR. SECRETARY. YOU DESERVE A PROMINENT ROLE IN THIS COMMITTEE'S ANNUAL HEARING SERIES WHICH STUDIES IN DEPTH THE CONDITION OF THE U.S. AND WORLD ECONOMIES.

WHILE YOU ARE THE OFFICIAL SPOKESPERSON FOR THE AGRICULTURAL SECTOR, I MUST TELL YOU WITH SOME PRIDE THAT YOU ARE NOT THE FIRST ONE TO DISCUSS AGRICULTURE. EVERY WITNESS THUS FAR HAS MENTIONED AGRICULTURE IN THEIR APPEARANCES -- REGAN, FELDSTEIN, BROCK, AND VOLCKER WERE AMONG THOSE MENTIONING THE IMPORTANCE OF AGRICULTURE. WHEN I JOINED THIS COMMITTEE SOME THREE YEARS AGO, MY NUMBER ONE OBJECTIVE WAS TO PUT THIS FARM SECTOR ON THE ECONOMIC MAP, AND I AM PLEASED TO NOTE THAT GOAL HAS BEEN ACCOMPLISHED.

OVER THE PAST 30 MONTHS, THIS COMMITTEE HAS CONDUCTED SOME PUBLIC HEARINGS ON AGRICULTURE INVOLVING OVER 100 WITNESSES. IN ADDITION, THE COMMITTEE HAS PRODUCED TWO PUBLICATIONS ON THE ECONOMIC CONDITION OF AGRICULTURE AND FARM POLICY, AND HAS BEEN INSTRUMENTAL IN PUBLICATIONS BY THE COUNCIL OF AGRICULTURAL SCIENCE AND TECHNOLOGY, THE NATIONAL AGRICULTURAL FORUM, THE CONGRESSIONAL BUDGET OFFICE AND THE OFFICE OF TECHNOLOGY ASSESSMENT. YES, MR. SECRETARY, THE WORD IS OUT THAT THE JOINT ECONOMIC COMMITTEE RECOGNIZES THE IMPORTANCE OF AGRICULTURE AND WE HAVE

DONE OUR PART TO SEE THAT AGRICULTURE GETS THE PROMINENCE IT RIGHTFULLY DESERVES.

AS YOU KNOW, SECRETARY BLOCK, I AM A MEMBER OF THE APPROPRIATIONS COMMITTEE AND I AM CONCERNED ABOUT SEEING THAT THE DEPARTMENT OF AGRICULTURE RECEIVES ADEQUATE FUNDING, GIVEN THE PRECARIOUS CONDITION OF THE FARM ECONOMY. YOU ARE AN ADVOCATE OF A MORE MARKET-ORIENTED AGRICULTURE AND THAT APPROACH HAS CONSIDERABLE MERIT. SINCE THE U.S. IS NOT COMPETING IN A FREE MARKET, HOWEVER, I WOULD CAUTION THAT RELYING MORE ON MARKET FORCES, BOTH DOMESTIC AND GLOBAL, MAY JEOPARDIZE THE WELL-BEING OF AMERICAN AGRICULTURE, AND THAT WE NEED TO KEEP THAT IN MIND WHEN WE SET OUR FUNDING PRIORITIES.

THE FISCAL YEAR 1985 AGRICULTURAL BUDGET IS A CRUCIAL ONE FOR THE FARM COMMUNITY. IT WILL ESTABLISH THE SETTING IN WHICH THE RENEWAL OF THE FARM BILL WILL TAKE PLACE. DOES THE 1985 BUDGET PUT AGRICULTURE'S BEST FOOT FORWARD, REALIZING THAT A FOUR YEAR AUTHORIZATION WILL BE MOLDED DURING THAT YEAR? FOR EXAMPLE, SHOULD NEXT YEAR'S FUNDING FOR EXPORT CREDIT LOAN GUARANTEES FALL 25 PERCENT OR $1 BILLION AT A TIME WHEN OUR AGRICULTURAL EXPORTS ARE SUFFERING FROM THE EFFECTS OF HIGH INTEREST RATES, A STRONG DOLLAR AND UNFAIR TRADING PRACTICES?

MR. SECRETARY, THE COMMERCE DEPARTMENT HAS RELEASED THIRD QUARTER 1983 DATA WHICH SHOWS THAT THE AGRICULTURE SECTOR AND MANY RURAL STATES ARE NOT PARTICIPATING IN THE ECONOMIC RECOVERY. AND YET, THE ADMINISTRATION IS RECOMMENDING THAT SMALL COMMUNITY AND RURAL DEVELOPMENT PROGRAMS BE CUT 28 PERCENT OR $5.1 BILLION. THAT CONCERNS ME GREATLY.

AS I MENTIONED EARLIER, I AM PROUD OF THE ACCOMPLISHMENTS OF THIS COMMITTEE IN REGARD TO ITS AGRICULTURAL AGENDA. BUT OUR WORK IS NOT GOING TO END WITH A YEAR OF ECONOMIC ANALYSIS AND A YEAR OF FEDERAL FARM PROGRAM ANALYSIS. IN ORDER TO DO THE AGRICULTURAL ECONOMY JUSTICE, OUR EFFORTS NOW WILL FAN OUT TO A BROADER DOMAIN. THE FARM IS AN INTEGRAL PART OF A LARGER RURAL COMMUNITY AND SMALL TOWN SETTING. THIS YEAR'S TENTATIVE JOINT ECONOMIC COMMITTEE AGRICULTURAL INITIATIVE WILL STUDY RURAL DEVELOPMENT AND THE ECONOMIC CONDITION OF NON-URBAN AMERICA.

OUR COMMITTEE HAS PROVEN AGRICULTURE'S IMPORTANCE TO AND INFLUENCE ON THE OVERALL ECONOMY. BUT THE OVERALL ECONOMY HAS IMPORTANT AND INFLUENTIAL EFFECTS ON AGRICULTURE AND RURAL AREAS AS WELL. FOR EXAMPLE, FISCAL PRIORITIES AND MONETARY POLICIES ARE CHANGING, DEMOGRAPHIC CHARACTERISTICS AND CONSUMER DEMANDS ARE CHANGING, TECHNOLOGICAL ADVANCES ARE CHANGING THE WAY AMERICANS LIVE AND WORK, AND THE GOVERNMENT IS CHANGING THE WAY IT OVERSEES AND REGULATES THE MARKETPLACE AND INDIVIDUALS. ALL OF THESE CHANGES AFFECT RURAL AREAS AND SMALL TOWNS TO SOME DEGREE, AND OFTEN QUITE DIFFERENT FROM HOW URBAN AREAS ARE AFFECTED. FOR THAT REASON, A COMPREHENSIVE ASSESSMENT FROM A RURAL PERSPECTIVE WOULD PROVIDE VALUABLE INFORMATION FOR POLICYMAKERS.

JOHN BLOCK IS A FRIEND OF AGRICULTURE AND I KNOW YOU WANT TO WORK WITH CONGRESS IN MAKING THE FUTURE BRIGHTER. I PLEDGE MY SUPPORT TO DEFEND AGRICULTURE'S RIGHTFUL AND DESERVED PUBLIC SUPPORT. MR. SECRETARY, WE'VE GOT A COUPLE OF TOUGH YEARS AHEAD OF US. THE FISCAL PRESSURES WILL BE UNBEARABLE AND AGRICULTURE NEEDS MORE ALLIES AMONG TAXPAYERS AND CONSUMERS. YOU'RE FIGHTING A GOOD FIGHT, AND YOU CAN BE ASSURED THAT I'M WITH YOU IN THAT FIGHT FOR A BETTER FUTURE FOR AMERICA'S FARM FAMILIES AND COMMUNITIES.

AGAIN, WELCOME TO OUR HEARING. YOUR PARTICIPATION WILL MAKE A VALUABLE CONTRIBUTION TO OUR ANNUAL REPORT.

Senator JEPSEN. Now with that short introduction, Mr. Secretary, I thank you for coming and I look forward to your testimony.

STATEMENT OF HON. JOHN R. BLOCK, SECRETARY OF AGRICULTURE, ACCOMPANIED BY WILLIAM LESHER, ASSISTANT SECRETARY FOR ECONOMICS; AND WILMER D. MIZELL, ASSISTANT SECRETARY FOR GOVERNMENTAL AND PUBLIC AFFAIRS

Secretary BLOCK. Thank you, Mr. Chairman, and may I tell you that I am delighted to be here to have an opportunity to talk on the important subject of agriculture and the current state of the economy and the considerations of where we are going from here in agriculture. I compliment you on your forceful, challenging opening statement and will be interested in reviewing it more carefully.

I would like to provide my prepared statement for the record, if that is acceptable.

Senator JEPSEN. Your prepared statement will be entered into the record and you may proceed any way you so desire.

Secretary BLOCK. Thank you very much. I have with me Assistant Secretary for Economics, Bill Lesher; Assistant Secretary Wilmer Mizell to my left, and if there is a need for some help and assistance, I will feel free to call upon them.

I would like to start out first of all by reviewing what took place in 1983 and then proceed to agriculture's outlook for 1984. Finally, I would like to discuss briefly some issues that I believe are critical for the future prosperity of American agriculture.

The year 1983 was a year of dramatic events, of renewed hope, and new concerns for us in agriculture. In past years I have appeared before this committee and given the outlook for agriculture that was based on normal weather, economic conditions, and farm policies as we saw them at the time. As we all know, very little was normal in 1983, and the events during the year dramatically changed the conditions facing American agriculture.

Starting off, first of all, was the implementation of a program that certainly was not normal—the payment-in-kind [PIK] program. The PIK program was developed as we reviewed the situation in the fall of 1982 and could see that traditional commodity programs would be insufficient to deal with the huge surpluses that were on hand. A paid diversion program of the magnitude needed would not be responsible, considering the impact that it would have on the budget. Despite some criticism and controversy over the payment-in-kind program, it has accomplished its objectives—taking almost 80 million acres out of production, reducing our surplus in almost every category, strengthened farm prices, reduced the cost of farm programs to the Federal Treasury, and in many cases provided some assistance to producers from the drought.

That leads us to the second unexpected event for 1983, and that was the devastating drought that primarily hit the midsection of the country. It was the worst that we have witnessed in nearly 50 years. Fortunately, we had the payment-in-kind program that made actual commodities available to farmers who participated in the program. This was a great help in the face of drought, where some farmers raised practically no crop at all, or maybe 50 percent or less of a normal crop.

It is very difficult to separate the effects of the drought from the impact of the PIK program: U.S. coarse (feed grain) production totaled 137 million tons in 1983, down nearly 50 percent from record 1982 levels. Wheat production fell 14 percent and soybean production was down 30 percent, cotton and rice declined by about one-third.

U.S. exports suffered in 1983, the second year running, primarily because of the high value of the dollar and the effects of the worldwide recession. Many countries experienced little or no economic growth in 1982 and 1983. Some countries actually experienced a net decline in their country's GNP.

The dollar continued strong and in fact strengthened over this period of time. That has made us less competitive in international trade. In fact, the value of the dollar has appreciated so much that for many countries our products cost 50 percent more than they would have cost back in 1980.

This has exacerbated the problem of price support levels which are too high—appreciating that the dollar is so strong and realizing we have to trade in the international market. Indeed, some of our price supports have actually ended up above market clearing levels. This has hindered our ability to trade abroad. The value of U.S. exports declined 20 percent between 1981 and 1983.

That provides some of the background. Let us now focus on the 1984 commodity outlook. Global grain production is falling more than 4 percent; the first decline in 4 years, and the largest year-to-year drop since 1961–62.

With output down and world usage up, the record large 1982–83 world grain carryover will be drawn down by more than one-fourth by the end of 1983–84 to the lowest level in 8 years.

The global grain picture has not been uniform because most of the reduction was in the United States. I think it is fairly significant that the United States was cutting back while the rest of the world, for the most part, was increasing production. We need to keep that in mind.

In the case of wheat, the PIK program cut production by 14 percent. But around the world, wheat producers increased their production by 4 percent, which meant that the global wheat production actually increased by 1 percent, primarily because of gains in China, India, and Australia.

Fortunately, in the United States, we have seen the feed use of wheat increase dramatically and that is because of the abundant supplies. We are going to feed 450 million bushels of wheat this year, which is almost double what we would normally feed.

The market prospects in the coming months are going to be a reflection of the participation in the 1984 program and, of course, continued appreciation that we have large world supply indications.

In the case of rice, the global picture is similar to wheat. The U.S. supply-demand situation is more balanced for rice than it is for wheat because we have reduced our surpluses more dramatically.

For coarse grains, despite a projected 4-percent increase in foreign coarse grain production, the 1983–84 global situation is tighter than for food grains. The feed grain production this past year in the United States was cut by 50 percent. U.S. stocks this fall in October are going to be down to a tight 550 million bushels, and that is down from the high level of 3.1 billion bushels last October, that is an almost unbelievable kind of adjustment in carryover stocks credited primarily to the PIK program and the drought which further reduced production of these crops. The world's stocks-to-use ratio for coarse grains is 8.7 percent, the lowest on record.

In the case of oilseeds, we are looking at nearly a 10-percent decline in world oilseed production. The U.S. producer prices for most oilseeds and products are expected to be up by a third from the depressed levels a year ago due to the large supplies and generally weak demand.

Let us turn to livestock now and look at beef first. Feedlot inventories are down 4 percent from the year earlier level. Placements are expected to be near the year earlier level in the first half of 1984. For the entire year, a decline in beef production of about 1 percent is anticipated. Beef cattle prices are reasonably strong right now and they should continue into the spring and summer.

Turning to pork, the inventory of hogs kept for breeding was down 1 percent from the previous year. The pork output this year probably will decline by about 2 percent. We should be looking at stable to stronger prices in pork.

Poultry has seen stronger prices because of two reasons, reduced egg sets last fall and more recently the avian influenza, which has cut back broiler production. The same situation holds true in the case of egg production.

Milk production was up 2.5 percent in January from a year ago. The January 1, 1984, inventory of milk cows is 1 percent greater than the year before. Heifer replacements are about the same as the year earlier level. The results of the signup for the dairy diversion program at this point in time indicate that we may be cutting the production by about 5 percent, which is about half of the desired reduction. While it will help, the prospects of a continuing reduction in the price support level as provided by the law will hopefully discourage further growth in dairy production.

In the case of cotton, the most dramatic occurrence had been in China. China had been a big customer of ours, buying as much as 2 million bales. Since 1979–80, they have doubled their production to 20 million bales a year and are now self-sufficient in cotton.

In the case of sugar, we are looking at continued heavy stocks, depressed prices, and substantial surplus buildup.

Because of the freeze last December, the orange crop is down by 18 percent this year from a year ago; prices of vegetables and fruits, especially vegetables, have gone up much higher than they would have been otherwise, but by March or April they should moderate back to last year's levels as new vegetable crops are being planted at this very moment.

Now I would like to discuss the 1984 farm economic indicators. The farm expense side of the ledger rose at an annual rate of more than 11 percent from 1976 through 1980. However, the rise in farmers, total production expenses slowed to 6 percent in 1981 and

2 percent in 1982 and actually declined by 3 percent in 1983, in response to the payment-in-kind program. That is a very dramatic decline in agriculture production expenses.

Another point I think is important is at the recent levels of production expenses, a 1 percentage point increase in inflation will lead to about $1.5 billion increase in farm production expenses. That tells us how important inflation is in terms of how it affects farm production expenses. A slight increase in inflation to about 5 percent is forecast this year and there will be more acres planted and thus more money spent in agriculture this year than last.

The receipt (income) side of the ledger is improving and it is going to continue to improve. The net farm income increased in 1983 to around $24 billion from the $22 billion in 1982. Net farm income this year is expected to rise into the range of $29 billion to $34 billion. Certainly it is headed in the right direction.

Farmland values are important because they provide the resources that many farmers borrow against for obtaining loans for operation and for growth and improvement in their businesses. We saw farmland values nationwide decline by 7 percent between 1981 and 1983. This, of course, led to reduced equity, reduced cash flow for many farmers, and made it very difficult for them. It appears that this decline has stabilized and, in some cases, turned back up. Farmland values may well be preparing to trend upward. I would hope that would be the case.

The growth in farm debt is forecast to rise only 3 percent during 1984 which is an indication of a more conservative attitude in agriculture, and reduced inflation. We are going to see less aggressive borrowing on the part of agriculture. Part of that probably will be encouraged by lenders, but a lot of it will be a conscious decision made by farmers because they want to be more conservative in managing their operations.

Farm equity will grow slightly. The farm sector equity will grow slowly in the 1980's, certainly more slowly than in the 1970's. By next January, it likely will reach $876 billion, up 2.7 percent.

The debt-asset ratio is expected to be about 20.2 percent on January 1, 1985; which is close to where it has been the last couple of years. Conditions I think are stabilizing in this area as the farm real estate market firms and grain stocks are down. There is optimism in agriculture in that we are anticipating an annual capital formation increase of about $3 billion this year.

Turning to the international side, the U.S. agricultural trade balance is expected to improve as the value of our exports is expected to rise 8 percent. Keep in mind that is an 8-percent increase this year. We saw a 20-percent decrease in the 2 preceding years. So that is one step in recouping those losses that we earlier experienced.

Imports of agricultural products are forecast to increase about 4 percent to $17 billion, allowing an additional $3 billion of trade surplus in agriculture, giving us a total surplus of about $21 billion. That is a very good sign, appreciating that the overall deficit in trade is going to be about $75 billion. You can imagine where we would be if agriculture was not making such a large contribution.

Food price increases are going to continue to be very modest in 1984. The food cost at retail rose about 2 percent in 1983 compared to 4 percent in 1982. This was the fifth consecutive year in which retail food prices rose less than the Consumer Price Index. It is very significant that food has been a leading fighter of inflation for this country. If food prices had gone up as much as the general rate of inflation in the last 5 years, consumers would have spent about $35 billion more for food. I think that the food and agricultural industry should be complimented for its efficiency.

We are looking this year at a probable increase in the cost of food of somewhere between 4 and 7 percent. Only about 1.5 percent of that increase could be attributed to a combination of drought, PIK, and the freeze in December.

Agriculture has made some important adjustments that will have it better poised for improved economic times in the years ahead. Some of the adjustments have been painful. I think that a review of 1983 and 1984 gives us a picture of change and of a turnaround in agriculture. Looking to 1985 and beyond, we are going to be a healthier, stronger industry in my judgment.

Many farmers, certainly not all, are on a better long-term financial footing now than they were in the past. I know that you can find some individuals and some regions where it is not true, but I do believe that with the retrenchment and adjustments farmers are making, on balance nationwide, their decisions are more conservative and they are positioning themselves to be stronger than they have been in the last 2 or 3 years.

I am urging all of the agricultural industry, indeed everyone who is interested in agriculture, to become involved in the preparation of the 1985 farm bill. President Reagan charged the Secretary of Agriculture as the chairman of the Cabinet Council on Food and Agriculture, to conduct a comprehensive review and assessment of current food and agricultural problems. I have established a Cabinet council working group whose mandate will be threefold: To review and assess current food and farm programs; to initiate a dialog on the future course on food and agricultural policy with interested parties outside of Government; and to prepare a set of food and agricultural policy options.

This working group will be chaired by the Deputy Secretary of Agriculture, Dick Lyng. It will be composed of other high-level Government Department representatives.

I look upon this as an opportunity to expand the understanding of the problems we face in agriculture within the public at large as well as be helpful to me within the administration.

We will be conducting several listening sessions across the country. We want to provide a forum for the public to express their views about the shape of future agricultural policy.

In closing, Mr. Chairman, 1983 has been a year of surprises and change. I personally believe it has been a year of a turnaround in the agricultural situation. We are certainly not out of the woods yet. We are looking at a number of problems, some of them new, but there are some signs on the horizon that there are better times ahead. We are looking at increases in crop and livestock prices from a year ago. The export picture turning around as some of the other economies of the world are starting to strengthen. Markets are our lifeblood in agriculture and I think we are looking to the future with some hope. Thank you.

[The prepared statement of Secretary Block follows:]

PREPARED STATEMENT OF HON. JOHN R. BLOCK

Mr. Chairman and members of the Committee, I appreciate this opportunity to appear before you and discuss the outlook for agriculture in 1984. I also appreciate the keen interest and deep concern this Committee has demonstrated over the economic health of the agricultural economy.

Before I go into a detailed discussion concerning the agricultural outlook, I would like to review some of the events that took place in 1983, for they set the stage for a recovery in 1984 for agriculture. And, following my discussion of agriculture's outlook for 1984, I will review some issues that I believe are critical for the future prosperity of American agriculture.

1983 -- A YEAR OF DRAMATIC EVENTS, RENEWED HOPE AND NEW CONCERNS

In years past, I have appeared before this Committee and given the outlook for agriculture that was based on normal weather, economic conditions, and farm policies. Well, as we all know, very little was normal in 1983, and events during that year dramatically changed the conditions facing American agriculture.

The Payment-In-Kind (PIK) Program

By the fall of 1982, it became obvious that the traditional commodity programs were insufficient to deal with the huge surpluses on hand. Record world production and sluggish demand had depressed farm prices and incomes to unacceptably low levels. A paid cash diversion program of the magnitude needed would have been irresponsible from a budget standpoint. A special program was needed to specifically address the immediate needs of agriculture. As a stopgap measure, PIK was the best alternative available to deal with the record surpluses overhanging the market without shorting the market.

Despite some controversy, PIK has been successful in getting agriculture on an even keel. The PIK program removed a record of around 80 million acres from crop production in 1983. In combination with the drought, PIK reduced our surpluses to reasonable levels with ample supplies to meet domestic and foreign demand. Farm prices have improved substantially. Expenses were lowered. The financial downturn in the farm economy was halted. Federal outlays for price support programs for FY 1984 may be cut by two-thirds. And, the stage was set for an improved setting in 1984.

Drought Devastates the Midwest

The worst drought in nearly 50 years hit the Nation's midsection this summer. National average yields for corn and soybeans were reduced by one-third and one-fourth, respectively. Many farmers had no crop at all, although those who participated in PIK were partially protected because they received commodities. While the main impact of the drought was in the crop sector, the drought set off a chain of events in the livestock sector that is likely to stretch over the next year or more. The large increase in feed costs sharply altered the profit outlook for livestock and poultry producers. Many farmers and ranchers began to liquidate animals that would have been held for breeding or placed on feed.

It is difficult to accurately separate out the effects of the drought from the impact of the PIK program. U.S. coarse grain (feed grain) production totaled 137 million tons in 1983, down nearly 50 percent from record 1982 levels. The drought-related loss was about as large as the impact of reduced plantings. In contrast, 1983 wheat production fell only 14 percent with all of the cutback coming from smaller plantings. The 1983 soybean crop declined about 30 percent with most of the reduction due to the severe drought. Plantings were also down because of the heavy sign-up of all cropland in the PIK program. U.S cotton output fell about one-third with most of the decline due to smaller plantings and low yields anticipated before the drought.

U.S. Exports Suffer from Worldwide Recession

Growth in the world economy, which is critical for export expansion, came to a halt in the early 1980's. In several countries--EC-10, Canada, South Africa, Mexico, and Argentina--real economic growth was zero or negative. In many more countries, per capita real incomes declined. Also, rising indebtedness, combined with a drop in export earnings, especially in OPEC countries, reduced the ability of many nations to purchase abroad. As a result, commercial credit became more difficult to obtain, and the number of countries forced to reschedule debts has risen. The financial problems of countries like Poland, Mexico, and Brazil were especially harmful to U.S. exports. Furthermore, the strengthening of the U.S. dollar dramatically reduced the international buying power of many countries. The appreciation of the dollar, which remains at near-record levels against several major currencies, has weakened the U.S. competitive position in a depressed world market. Moreover, with some U.S. price supports above market-clearing levels, our ability to compete has been further eroded. This lack of flexibility in current farm legislation has further encouraged other exporters to expand output and employ aggressive marketing tactics. These developments have placed a disproportionately large share of the dropoff in world trade on U.S. farm exports. By 1983, the value of U.S. exports had fallen 20 percent from 1981 levels.

1984 COMMODITY OUTLOOK

Grains

In 1983/84, we are witnessing an abrupt turnaround in grain prospects. Global grain production is falling more than 4 percent, the first decline in 4 years and the largest year-to-year drop since 1961/62. World consumption, after being flat from 1979/80 to 1981/82, has moved forward the past 2 years with most of the increase occurring in China. With output down and usage up, the record large 1982/83 world grain carryover will be drawn down by more than a fourth by the end of 1983/84 to the lowest level in 8 years.

This year's change in the global grain picture has not been uniform. The big drawdown in stocks has occurred in coarse grains, but not in wheat; and in the United States, but not abroad.

Food Grains

Wheat. In contrast to the United States, where the PIK program brought wheat production down 14 percent to a crop of 66 million tons (2.4 billion bushels) in 1983/84, foreign wheat producers have increased output by 4 percent. Thus, global wheat production actually has increased about 1 percent, with the big gains occurring in China, India, and Australia.

Foreign wheat consumption is projected to be up about 1 percent in 1983/84, and global wheat trade volume probably will be down a little from last year, so competition is quite stiff. The U.S. wheat traders appear to be losing out again--with a second straight decline in U.S. exports now projected following a period of good performance in the late 1970's.

One bright spot for U.S. wheat producers is domestic use, which is gaining by more than a fifth this year. Feed use of wheat has more than doubled to 12.2 million tons (450 million bushels) because of wheat's abundance relative to corn. U.S. wheat stocks may decline as much as a tenth from the record high 1982/83 carryover. Farm prices for wheat in 1983/84 should about match last year's $3.55 a bushel. Market prospects in coming months will reflect participation in the 1984 program and large world supply indications.

Rice. The global rice picture is similar to wheat, although the U.S. supply/demand situation is more balanced for rice than for wheat. Acreage reduction programs caused a decline of more than a third in U.S. rice output, while foreign production has increased by 4 percent. Foreign rice consumption is expected to gain by only 2 percent and world trade is no larger than last year. Again, U.S. traders appear to be losing out to foreign exporters--U.S. exports are projected to decline for the second straight year, with a 6-percent drop expected in 1983/84.

In contrast with the export outlook, U.S. domestic use of rice is recovering by about 11-percent from the previous year's depressed level. The increased use in the face of lower production will cause a sharp drawdown in record large U.S. rice stocks from 71.5 million cwt. (rough equivalent) to less than 40 million cwt.

Coarse Grains

Despite a projected 4-percent increase in foreign coarse grain production in 1983/84, the global situation is much tighter than that for food grains. The dominant reason is the small U.S. crop of 137 million tons, down nearly one-half from 1982 levels. The U.S. crop normally provides about a third of the world's coarse grains. In the United States, the most successful acreage reduction effort on record coincided with the worst drought in half a century and farmers harvested a corn crop of 107 million tons (4.2 billion bushels) that was barely half the size of 1982's record.

A substantial price run-up followed, but foreign demand has been relatively firm. Foreign consumption of coarse grains is projected to increase by 3 percent in 1983/84 and global trade by 2 percent. U.S. coarse grain exports may edge slightly ahead of last year's disappointing performance of 54 million tons, but will remain well below the 1979/80 record due to the strong dollar and poor global economic conditions.

Global coarse grain stocks will drop to less than half the 1982/83 carryover, as U.S. stocks fall to one-fourth of last year's burdensome record level of 98 million tons. U.S. corn stocks next October are estimated at around 550 million bushels, down from 3.1 billion last October. The projected global coarse grain stocks-to-use ratio, at 8.7 percent, is the lowest on record. Consequently, U.S. corn prices are running substantially above last year's season-average price of $2.68 per bushel. The supply situation for the other feed grains also has tightened significantly, and U.S. prices for sorghum, oats and barley are running well above year-ago levels. Developments in coming months will depend on the level of new crop plantings, Southern Hemisphere crops and demand conditions.

Oilseeds

A near-10 percent decline in world oilseed production, due principally to drought-reduced U.S. crops and below-trend gains in demand for protein meals and vegetable oils, dominate the 1983/84 outlook. Large carryover inventories for most oilseeds and vegetable oils moderated the impact of production shortfalls, although prices rose sharply at the beginning of this marketing year.

For all of 1983/84, U.S. producer prices for most oilseeds and products are expected to be up by a third or more over year-earlier levels that were depressed by large supplies and generally weak demand. Price rises for soybeans are expected to receive more help from soybean oil than soybean meal, with prices for soybean oil and other vegetable oils likely to be up about 40 percent while protein meal prices may rise about 20 percent. Prices for other oilseeds are also stronger this season due to generally tighter supplies. Prices for sunflower seeds are the highest since the mid-1970's.

High protein meal demand is being held in check in many countries because of very sluggish growth in livestock output and consumer incomes. Only the Soviet Union and a few Far East countries are expected to record good use gains while many traditional-consuming areas decline.

A strong dollar and weak economic growth is plaguing the EEC, and financial debt problems and high prices are cutting demand in many developing countries and Eastern Europe. In the United States, continued slow growth in livestock output and below-average feeding margins are contributing to about a 10 percent drop in protein meal feeding.

The cutback in meal use also is reflected in lower crush and small production of vegetable oil. This, combined with recent declines in Malaysian palm oils and smaller foreign crops of rapeseed and flaxseed, points to price strength for soybean and other vegetable oils that have been depressed for the past 3-4 years.

Livestock and Dairy

Beef

The number of U.S. cattle placed on feed decreased in 1983 as feed costs rose. Feedlot inventories were down 4 percent from the year-earlier level on January 1. Placements are expected to be near the year-earlier level in first-half 1984, keeping feedlot inventories and fed cattle marketings down for most of the year. Nonfed steer and heifer slaughter may continue at a relatively high level until spring as forage supplies are down in many areas. Total cow slaughter will be influenced by weather conditions and dairy cow slaughter this winter. Beef cow slaughter likely will remain relatively large through the winter, but decline in the spring and for the rest of the year.

Beef production is likely to remain above the year-earlier level through early spring. Beginning in the late spring, production is expected to be less than in the previous year, and for the entire year, a decline of about 1 percent is anticipated.

Fed cattle prices have strengthened in early 1984, but part of this strength resulted from adverse weather conditions. Prices may weaken in the coming weeks but strengthen again in the spring and into the summer. Feeder cattle prices also are expected to strengthen in the spring and summer. Retail beef prices in the first half of 1984 may remain near the year-earlier level but rise from the low low levels of late 1983.

Pork

Hog producers reacted to the rising feed costs and weaker hog prices by reducing breeding stock in 1983. By year end, the U.S. inventory of hogs kept for breeding was down 1 percent from the previous year. The reduced breeding inventory is expected to result in year-over-year declines in pork production in the last three quarters of 1984; first quarter production probably will remain above the year-earlier level. For the year, pork output may decline about 2 percent.

With declining pork production this year, hog prices and retail pork prices are expected to strengthen. Hog prices probably will weaken from the early 1984 level as adverse weather has given some support to higher prices. But spring prices should rise as production declines; further strength in prices is likely this summer. Retail pork prices will likely remain below the year-earlier level this winter, but rise from the late-1983 level.

Poultry

Broiler output for the first half of 1984 may be down about 2 percent from a year earlier due to reduced egg sets last fall and more recently the avian flu. Year-over-year gains are expected for the last half with a small rise likely for the entire year. Broiler prices have been stronger than expected in recent months, reflecting strong demand. Fourth-quarter 1983 wholesale broiler prices averaged more than 55 cents a pound; prices are expected to remain strong through most of 1984.

Turkey producers reduced output in late 1983 in response to poor returns early in the year. The reduced output helped boost prices. Turkey production is expected to remain lower for the first half of 1984 but rise in the second half. The lower output is helping to hold up turkey prices.

Egg production in 1983 was down from the previous year as egg producers reduced laying flocks in reaction to poor returns. Production was further cut in late 1983 as a result of the avian flu outbreak. The planned production cutbacks plus those resulting from the flu boosted egg prices sharply. Output probably will remain below year-earlier levels through the summer, but year-over-year declines will moderate. The lower production will help support egg prices.

Dairy

Milk production reached excessive levels in recent years as a result of an expanding milk cow herd and more output per cow. Cow numbers continued to rise in 1980/81 and each year thereafter. Production reached a record 138.1 billion pounds in 1982/83, up 12.8 percent from 1978/79. Gains in commercial use of dairy products did not keep pace with the increased output. Commercial use in 1982/83 was 121.0 billion pounds, down 0.8 percent from the year before and up only 1 percent from 1978/79. This sharp rise in production, combined with a weak commercial use, resulted in high levels of Government purchases under the price support program. CCC net purchases rose from 1.1 billion pounds milk equivalent in 1978/79 to 16.6 billion in 1982/83.

Milk production continues to increase in 1983/84. During the first quarter of the marketing year production was up 2-1/2 percent from a year earlier as a result of an increase in cow numbers and a higher output per cow. On January 1, 1984, the number of milk cows was up 1 percent from a year earlier and replacement heifers were equal to the year earlier level. Production is expected to continue to exceed commercial demand for the year due to the relatively low producer participation in the new dairy program. Commercial use should get some boost this year from the lower support price level for milk, the strengthening economy, and the new dairy promotion program.

Cotton

The most dramatic development in the cotton world centers on China. As late as 1979/80, China was a major importer, taking 4 million bales--more than 2 million from the United States--to help supply its growing textile industry. However, since 1979/80, China has doubled its production to 20 million bales in 1983/84 and now is self-sufficient. Chinese use this season is estimated at 17.5 million bales, which means China has a surplus of cotton. The implications for longer term U.S. cotton exports are not encouraging.

This season record world consumption of 69.6 million bales is exceeding production of 67.5 million, resulting in a 2-million bale decline in stocks from last season's high level of 28.7 million. Reduced production and stocks in the United States account for reduced world production and stocks.

Near term U.S. cotton export prospects have brightened in recent months. Weather problems and insect damage have reduced export availabilities in Pakistan and the Soviet Union. The Soviets have turned to the world market to supplement their needs, including recent purchases from the United States.

Sugar

The 1983/84 season will mark the fourth consecutive year in which world sugar production has matched or exceeded consumption, resulting in a substantial buildup in stocks and low prices. Production is estimated at 95 million tons, down in the United States and abroad, compared with last season's record 101 million. Still, sugar use may total only about 94 million tons in 1983/84, compared with 92 million last season. Thus, global stocks are estimated at around 46 million tons, equal to nearly 50 percent of consumption. U.S. stocks are estimated at about 1.1 million tons, down from 1.3 million a year earlier.

Although overall U.S. per capita sweetener consumption has remained about flat over the past decade, use of sugar has declined dramatically. Increased use of lower priced high fructose corn syrup (HFCS) is responsible. Since 1970, HFCS use jumped from virtually zero to about 30 pounds per person, while sugar use declined from more than 100 pounds to 71 pounds per person.

Fruits and Vegetables

As a result of the late December freezes that hit both Florida and Texas, the 1983/84 U.S. orange crop is estimated at 194 million boxes. This is 18 percent less than a year ago. Smaller harvests are expected for all citrus except lemons.

Prices for citrus and frozen concentrated orange juice (FCOJ), which have already risen, are likely to advance further since demand is expected to be strong in response to continued economic recovery. However, adequate beginning stocks of FCOJ and prospects for greater imports will moderate price increases.

The bitter cold weather that swept over Florida during the Christmas weekend seriously damaged winter vegetable plantings. Despite the severity of the freeze, its effect on total U.S. supplies of fresh winter vegetables will be mild. Mexico usually supplies a major portion of some winter vegetables to the United States, and this year the decreased value of the peso made exporting to the U.S. even more attractive. Thus, larger-than-usual Mexican supplies will probably be available to alleviate the shortages from Florida. In addition, replanting of damaged crops is progressing rapidly; supplies from freeze-damaged areas may be nearly normal by March.

Prices for vegetables are running sharply higher, but they will return to last year's levels during March or April. If market gluts develop in the spring when production from replanted acreage competes with the normal northward movement of crop harvest; prices may even decline from a year earlier.

1984 FARM ECONOMIC INDICATORS

Farm Expenses Slow

After rising at an average annual rate of more than 11 percent from 1976 through 1980, the rise in farmers' total production expenses slowed to 6-1/2 percent in 1981 and down to 2 percent in 1982, and actually declined 3 percent in 1983 in response to the PIK program.

As agriculture has grown more dependent on nonfarm origin inputs, production expenses have increasingly been influenced by the general level of prices and interest rates in the economy. Thus, high and accelerating inflation in the late 1970's led to high and escalating costs. Similarly, the lessening in inflation has helped to slow rises in prices paid by farmers for non-farm origin inputs to about 2 percent in 1983--the slowest increase in over 10 years.

At recent levels of production expenses, a 1-percentage point increase in inflation will lead to about a $1.5-billion increase in farm production expenses. Thus, with a slight increase in inflation to about the 5 percent that is forecast for 1984, farm costs are expected to increase somewhat. Slightly higher interest rates will also raise production expenses. Since the economic recovery in the United States has taken place at low levels of inflation, demand should improve commodity markets more than input price increases will raise costs. Even so, with more modest acreage reduction programs in place for 1984, new crop plantings are expected to return to more normal levels and pull production outlays back in line with the pattern in the early 1980's.

Farm Receipts and Income to Improve

In the 1970's, cash receipts in the farm sector rose an average of slightly more than 11 percent annually. The rapid increase reflected favorable growth in export and domestic demand. So far in the 1980's, farm receipts have not shown this high rate of growth due to sluggish world demand and excessive supplies. In 1984, we are expecting cash receipts to increase 3 to 5 percent from 1983 levels due to higher prices for crops and livestock. Despite lower dairy receipts, total livestock receipts will be up slightly as a result of higher prices and a recovering economy. Crop receipts are expected to increase by 4-7 percent.

Current projections show net farm income in the $29-34 billion range, up from $22-24 billion in 1983. The improvement is due to greater crop marketings, higher livestock prices, and a moderate rebuilding of crop stocks, which combined, more than offset a decline in government payments. But even with the probable increases, rising expenses could reduce net cash income somewhat from the much improved levels of last year.

Farmland Values Decline With Commodity Prices and Reduced Inflation

With reduced exports and lower expected returns to agriculture, farm real estate values declined about 7 percent between early 1981 and the middle of 1983. Since then values appear to have stabilized and even increased in some areas. The weak farmland market led to reduced equity and cash flow difficulties for some existing farmers. At the same time, lower farmland values or rental rates help those who want to get started in farming.

Growth in Farm Debt Slows

Total farm debt is forecast to rise only about 3 percent during 1984. Relatively high interest rates, the need to conserve cash flow, and lower inflation rates will dampen borrowing for the next few years. While rapidly rising land values and low real interest rates made financial leverage an effective strategy for farm growth in the inflationary 1970's, in contrast, the 1980's seem likely to be characterized by financial conservatism. Farmers and lenders will attempt to reduce their financial risk. This probably is a good sign for the long term health of agriculture.

Although it has become more diff... for farmers to qualify for credit, money is available. As in the past year or two, the major constraint will be the condition of the farmers' financial statements. Creditworthy operators should have no trouble obtaining loan funds.

Farm Equity Grows Only Slightly

Farm sector equity will grow slowly. By next January it likely will reach only about $876 billion, up 2.7 percent. The debt/asset ratio is expected to be about 20.2 percent on January 1, 1985, which is near a record. While higher than in recent years, still it is low compared with other industries. In spite of the difficult financial situation, conditions seem to be stabilizing because of a firming in the farm real estate market and lower grain stocks. After 3 consecutive years of declining net investment in the farm sector, annual capital formation is expected to increase about $3 billion in 1984 to $22 billion.

Agricultural Trade Balance to Improve

Despite fragile growth in the world economy and strong foreign competition, the value of U.S. farm exports is expected to rise 8 percent in FY 1984 to about $37.5 billion, after declining the two previous years. Higher prices for feedgrains and soybean products are the primary cause of improved earnings as total export volumes are projected to decline slightly. Foreign markets for U.S. food grains are not expected to improve. Imports of agricultural products are forecast to increase about 4 percent to $17 billion, allowing the agricultural trade surplus to reach nearly $21 billion, up about $3 billion from last year's level.

The increase in agriculture's contribution to the trade surplus occurs at a time when the Nation's overall trade deficit is projected to rise to a record $75 billion.

Food Prices Continue to Rise Moderately

Food costs at retail rose about 2 percent in 1983, compared to 4 percent in 1982. This was the fifth consecutive year in which retail food prices rose less than the Consumer Price Index (CPI). These small increases are a result of low farm prices and a general reduction in inflation which has held down labor, processing, and other food manufacturing and distribution costs. If food prices had gone up as much as the general rate of inflation in the last five years, consumers would have spent about $35 billion more for food. Moreover, the average consumer in most other countries in the world spends well over a 20 percent of his/her disposable income on food, while the average American consumer spends only about 16 percent.

The general economic and farm sector outlook suggests that food prices may increase about 4 to 7 percent in 1984. About 1 to 1-1/2 percent of the increase may be attributed to last season's drought, PIK and the December cold snap that will temporarily push up vegetable and citrus prices. The costs of food processing, distribution, and labor will increase, although at a moderate pace. In summary, it is unfortunate that lower cost food to consumers often comes at the expense of U.S. farmers.

1985 AND BEYOND

Over the past year or so, agriculture has made important adjustments that will have it better poised for better economic times in the years ahead. The supply and demand for most commodities have been brought into better balance as stocks have been reduced. Many farmers are now on a better longer term financial footing than they were a year ago. Resources in the agricultural sector should come more closely into line with long-term market conditions and the economic reality of more moderate demand growth is apparently beginning to take hold.

We are now approaching a critical period for agriculture and for the development of future agricultural policy. The past few years have demonstrated that in order to insure the long term viability of agriculture, we need to meet the competitive challenges of the export market and adjust to a new domestic and foreign economic environment. Failure to develop and implement agricultural policy that meets these changes could lead to irreparable harm to our farm and agribusiness economies and the total economic standing of the United States.

In preparing for the debate over the 1985 farm bill, it is important that those with a stake in agriculture become involved. The Department has encouraged the participation of a broad range of interests, beginning with the Agricultural Summit that I held last July and through a variety of forums since then.

Most recently, President Reagan charged the Cabinet Council on Food and Agriculture, which I chair, to conduct a comprehensive review and assessment of current food and agriculture problems. The President indicated that the purpose of this endeavor is to better prepare the Administration to participate in the debate on the future of Federal food and farm programs and policies. The President emphasized that this Administration will be seeking information and ideas from people inside and outside of government during this comprehensive review and assessment.

In response to the President's directive, I have established a Cabinet Council working group on Future Food and Agriculture Policy. The working group's mandate is three-fold: to review and assess current food and farm programs; to initiate a dialogue on the future course on food and agricultural policy with interested parties outside of government; and to prepare a set of food and agriculture policy options.

The working group will be chaired by the Deputy Secretary of Agriculture and will consist of high-level officials from the Departments of State, Treasury, and Commerce, the Office of the U.S. Trade Representative, the Office of Management and Budget, the Council of Economic Advisors, and the White House Office of Policy Development. We are now at work formulating a process through which interested parties will be given an opportunity to express their views on a wide range of agricultural policy issues. I will encourage broad participation in this endeavor.

Before we start holding formal meetings of the Cabinet Council on Food and Agriculture, the USDA plans to hold several listening sessions throughout the country. These sessions will provide a forum for the public to express their views about the shape of future agricultural policy.

Agriculture is vitally linked to the larger domestic and international economies. Agriculture's problems and the solutions to those problems require that we look beyond the farm gate. That is why I always look forward to meeting with this Committee. You bring a perspective that is essential to the well-being of the agricultural industry in this country.

Thank you. I will be happy to answer any questions you may have.

Senator Jepsen. Thank you, Mr. Secretary, for a very thoughtful statement.

As I mentioned in my opening statement, and in your testimony, the economic policies of the late 1970's which yielded this hyperinflation rate in the cost of production and high interest rates have put agriculture into a deep hole. The chart on my left [indicating] shows total production costs and farm debt. The bars indicate annual rates of change in costs and debt.

Would you agree, Mr. Secretary, that rational macroeconomic policies are equally or perhaps more important to agriculture than farm programs?

Secretary Block. Yes, I would. I am convinced that they are more important. The strength of the dollar, the interest rates, the inflation rate, and the impact that they have on the economy, all have a much larger impact than farm programs.

Senator Jepsen. I am pleased, Mr. Secretary, to hear about your Cabinet council working group that you have discussed at some length at the end of your statement, but I am sure you are aware of how a group like this tackles an issue depends on the group's attitude toward the issue.

We have over a period of years seen some consistent indifference on behalf of OMB, regardless of whether it has been a Republican or Democratic administration, to agriculture. We have seen where in the matter of trade and so on we have some concern for motorcycles and steel and other areas, yet it does seem now to appear the European Community is going ahead with its threat to tax corn gluten. Consistently the Japanese have held firm on the imports of red meat.

Agriculture provides the major part of the plus or the black side of the ledger in the balance-of-trade payments and yet as we look at policy and trade activities we see that agriculture somehow or other seems to get left, as we say in the Middle West, on kind of the short end of the stick.

Because perhaps of our farm programs, the public views agriculture as a problem to be minimized and we hear very little about the opportunity that we have in agriculture and the great thing that it does for our economy.

What assurances can you give that this group, given its composition with the State Department, the OMB, Commerce, the Council of Economic Advisers, that they will not begin their deliberations with the proposition that the solution is less American production and fewer American farmers? Many of them characteristically in the past throught their actions have sort of reflected that.

Now I am pleased to see Dick Lyng is going to chair it, but do you need any help in that Cabinet council working group? The deck looks kind of stacked.

Secretary Block. Well, let me point out the way I visualize it. First of all, keep in mind that when a farm program option is chosen, it is not chosen by the Secretary of Agriculture alone. It may have been at one time in history some years back, but it is really a Presidential decision, and agriculture policy has an impact in many different ways, just as macroeconomic policy impacts agriculture.

I usually am able to put forward my position when we talk about other issues in the various Cabinet councils and others are going to get a chance to state their positions when we talk about policy in the Cabinet council on food and agriculture. That is the way the system works and will work in the future.

So I think you need to plan a system that can give you the best chance of achieving appreciation and understanding of the problems that agriculture faces in order to arrive at the best possible answer. You cannot do that if the Secretary of Agriculture or whoever prepares a plan and then takes it in cold to all of the other advisers to the President and says, "This is it," because they are going to have a lot of questions. They will not completely understand it. I have been through this process before. The next time the Secretary takes it in, hopefully, there has been a lot of time spent on the issue. That way there is a much greater in-depth understanding and appreciation for the position. In addition, the public at large will also understand what we are doing because there will be much public discussion of farm policy, not just the listening groups that Mr. Lyng will be chairing. I know that Members of Congress and many interested parties in agriculture are doing the same type of thing.

In the end I think we are going to have a much better appreciation for the problems and needs of agriculture and will be able to come to a better solution than we would otherwise.

Senator JEPSEN. I agree with everything you said and certainly the next generation of farm policy which this committee has been turning its attention toward with some top priority for some time now must be forged on the basis of consensus, and that is what I think you are pointing out, rather than conflict. We need everybody involved and all their input.

My only comment on the council is that we have a track record with some of these departments and I know that you have personally really moved mountains in educating. I have seen the results of your work when just the other day we had a member of the State Department here, an economist, before this committee, and his knowledge and understanding of agricultural problems was quite refreshing compared to what conversations I have had with some members of the State Department when I first came to the Senate. So somebody is making some real headway.

We have a President, of course, that came out the day after the Korean airliner was shot down and when there was a great movement to immediately come up with a grain embargo. The President, without even having had a Cabinet meeting or advice from anybody, simply said no; we are not going to have any of those grain embargoes; they hurt us more than they hurt our adversaries.

I say that is great progress because we have had both Republicans and Democrats in the past who have not understood that type of logic.

So my only comment with regard to that group was meant to be very constructive. If you need any help visiting with any of these folks, there are those of us here who would volunteer to do so from our end by way of education because I have found personally and much to my dismay that some folks in a couple of Departments, OMB and the State Department to be specific, in the past have not always been very sympathetic or displayed very much perspective as to the role that agriculture plays in this country, let alone those of us who come from the firing line where they produce and process.

I will not ask you to comment on that. It is just that you have a standing offer and I will gather together some of my colleagues in case you need some assistance in working with some of those folks.

You know, the United States is the only country which practices agricultural supply control and you alluded to that in your prepared statement. After several years of unilateral supply control, where has this policy gotten the American farmer or taxpayer or consumer, in your opinion? We are going to do it again now in 1984 and probably in 1985. That is from the sound of things. Where is this path taking us and what are your feelings about supply control?

Secretary BLOCK. I do not want to prejudge all of the efforts of the group that are working on agricultural policy, but I do think that it is relevant to look at what has happened in the United States relative to other countries. It is true we are the only country that uses Government programs to take large amounts of our acreage out of production. As an example, after 50 years of rigid production controls and artificially high prices, U.S. cotton production has declined by almost 50 percent. Over all this period of time we have had control programs and I am not so sure it has served us very well.

Prices may have been stronger than they would have been otherwise, but the other countries in the world have increased their cotton production more than 7 times as much as the United States. Put all that together and you wonder whether we maybe missed an opportunity. On the other hand, look at soybeans. This is a crop where we have no production controls and minimal price supports and it has been a miracle crop for us in the United States. I am sure you could argue that soybeans are somewhat different, but nevertheless, these are examples that we should look at carefully as we work on the farm bill.

We should learn from experiences of the past and we should approach it with an open mind and not assume that anything is sacred because we can make mistakes over again.

Senator JEPSEN. Just two more questions and then I will defer to Congressman Obey.

Mr. Secretary, in another area now, I understand that spending for Federal food assistance programs has reached about $20 billion a year, yet reports of increasing hunger in America continue.

Would you explain for what food assistance the $20 billion is being used and why this does not seem to be enough?

Secretary BLOCK. It is true that the spending has reached $20 billion a year and it has been a frustration for me to see our spending go up as dramatically as it has, some 35 percent for food programs overall—that is food stamps, child nutrition, and WIC—they use 90 percent of our food money. Food stamps are up 45 percent in the last 3 years. The frustrating thing is this dramatic increase in resources provided for people in need. A phenomenal effort has been made by the private sector—charitable organizations are really a tribute to the people of this country. They have come together and worked hard with the States and the Federal Government to help solve this problem. No one is proud that there are some people that are hungry and that we have more people in need than we have had in the past.

But realizing we have gone through one of the most difficult recessions that this country has ever faced, certainly in the last 50 years, there are special problems of different kinds. I am not sure we know everything about them yet, but we are still trying to learn. This whole problem was thrust upon the Federal Government, the State governments, and the private sector, and probably we all have not done as good a job as we could have.

But I would point out that we are all learning how to do a better job and I think we are doing a better job every day. My frustration is that the message of the efforts that have been made and the human and governmental commitments to satisfying the needs is a story that somehow does not seem to get told.

Senator JEPSEN. Following this along, why are Government warehouses stockpiling surplus foods if indeed some people are going hungry in this Nation?

Secretary BLOCK. We do have surpluses of several commodities, but the ones that are in surplus, we are giving away at record levels. We have quadrupled the donation of dairy products, cornmeal, and rice, and I think perhaps flour and honey in the last year. There has been a dramatic increase and most of the outlets are able to get all they want.

There are cases that could be cited where States have turned back commodities to the Federal Government, and I do not bring this up to point the finger at States or local communities but only to show that this is a massive distribution system. Some States are still trying to make the next linkup down to the cities and to the communities and to get it all to work right. It takes a little bit of time, and a few bugs have to be worked out and I think they are being addressed.

I do not believe anybody is hoarding all this food in our warehouses. We are using a great amount of it today and I think we all realize you cannot just give all the food away to anyone. You have to concentrate on the people in need. Otherwise, the Government would be the sole provider of this food and we do not want that to happen either.

Senator JEPSEN. Congressman Obey.

Representative OBEY. Thank you, Mr. Chairman.

Mr. Secretary, let me ask you to respond to a statement made by Senator Huddleston a while ago. He indicated that the President's budget submission contained the statement that net farm cash income is expected to reach a record level of over $42 billion in 1984 and he then pointed out that the budget stated then that this higher income will enable farmers to repay more of their loans and result in lower target price deficiency payments in 1984; and then he goes on to say that that statement directly contradicts official Department of Agriculture estimates that were included in the December issue of Agriculture Outlook and that in that official forecast net farm cash income was estimated to be close to $35 billion, a drop of about 20 percent from 1983.

What is the right figure?

Secretary BLOCK. Well, I think that there may have been a typographical error. The figures are that 1982 net farm income is $22 billion and 1983 will be $22 to $24 billion. We are projecting 1984 net farm income to be in the range of $29 to $34 billion.

Representative OBEY. Well, if it is a typographical error, it is one hell of a typographical error, because what it says——

Secretary BLOCK. The $40 billion figure, Congressman.

Representative OBEY. Pardon.

Secretary BLOCK. I think you mentioned something about $40 billion net farm income.

Representative OBEY. Yes.

Secretary BLOCK. Is that the net cash income?

Representative OBEY. Net cash income.

Secretary BLOCK. I will let Mr. Lesher respond.

Mr. LESHER. Just briefly, Congressman, we do several calculations. One is net cash income, one is net farm income. Two major differences are inventory adjustments and depreciation. The net cash income is not reduced by the inventory adjustments and depreciation.

In the budget print on the cash income figure there was a typographical error. We sent over corrections but perhaps they were not received in time for that document to go to print. There was no intent to keep anyone from knowing the truth. We stand by our December estimates and they are available to anyone.

Representative OBEY. Well, what I am trying to figure out is this. There is no difference in the designation of the number. I mean, it is referred to as being the same thing. In the budget on page 5–55, it is referred to as net farm cash income and in the statement of the Agriculture Department it is referred to as net farm cash income. So it is not mixing apples and oranges, I do not believe, and I am trying to figure out—because I believe I have heard three sets of figures here—I am trying to figure out what it is.

You are saying, if I gage it correctly, that the $42 billion figure is not correct in the budget; is that right?

Mr. LESHER. The Secretary gave you the correct figures for net farm income.

Representative OBEY. I am asking for net farm cash income.

Mr. LESHER. OK. With net cash income, there is a difference.

Representative OBEY. Well, why do your own publications use the term "net farm income" then?

Mr. LESHER. U.S.P.A. does not use the term "net farm cash income." We use net cash income. You are reading from a document produced by the Office of Management and Budget. We sent some corrections over concerning the terminology and they were not included in that document. It is unfortunate. It is an oversight, but the published figures for both net farm income and net cash income are available. We have not changed them.

Representative OBEY. I have not suggested you are. I am just trying to figure out what the right figure is and I wish you would not be so defensive about it. I am just trying to get the number. I am not trying to question anybody's motives, intelligence, or anything else. I just want the right number and I want to know what that number actually reflects.

Mr. LESHER. The 1983 net cash income figure is $42 billion.

Representative OBEY. The cash farm income is $42 billion?

Mr. LESHER. Yes, $42 billion.

Representative OBEY. And what was it for the previous year?

Mr. LESHER. Let me see if I have it here.

Secretary BLOCK. We think it was $36 billion.

Representative OBEY. Now that is what you call net cash income?

Mr. LESHER. Yes.

Representative OBEY. How does that compare with net farm income?

Mr. LESHER. Well, the net cash income represents total cash receipts and income minus actual cash expenses.

Secretary BLOCK. Accounting on a cash basis.

Mr. LESHER. Farmers also have other expenses they have to pay out in a given year including depreciation of farm capital.

Representative OBEY. I understand that.

Mr. LESHER. The cash income excludes that depreciation and inventory adjustments.

Representative OBEY. What I am trying to get is how does net farm income compare in your projections for 1984 with 1983.

Mr. LESHER. Net farm income is projected to be $29 billion to $34 billion in calendar year 1984. It is estimated to be between $22 billion and $24 billion in calendar year 1983. And it was $22.1 billion in calendar year 1982.

Representative OBEY. Then explain the figures to me. What does the Agriculture Outlook mean when it indicates that in 1983 net cash income nominal will be between $42 billion and $44 billion and in 1984 it will be between $35 billion and $39 billion? What are they talking about there?

Mr. LESHER. In 1983, the payment-in-kind program cut farmers cash expenses dramatically. In 1984, one can expect larger acreages of corn and wheat and all the other commodities, and so the cash expenses are going to be much higher. Even though farm prices are higher on the receipt side—the expenses will increase in the absence of the PIK program. Thus, net cash income may be down in 1984, but not net farm income.

Secretary BLOCK. Let me add just one thing and correct me if I am wrong, but the net farm income figure is a better gage of what is going on in agriculture than the cash farm income because the net farm income takes into account the inventory.

Representative OBEY. Let me stop, because I do not want to go home to Wisconsin for a week, more confused than I was when I came in the room, and I expect I am going to. Let me simply ask that you provide me as quickly as possible a concise statement rationalizing the numbers in Agriculture Outlook and responding to Senator Huddleston's statement.

Let me ask you some questions on dairy. You indicated that signup is going to be, in your judgment, insufficient to meet the target that you hoped for on production reduction. Is that right?

Secretary BLOCK. Yes, sir, that is true.

Representative OBEY. 5.5 percent you indicated?

Secretary BLOCK. Yes, sir.

Representative OBEY. What do you think the major reasons are for that shortfall in the signup?

Secretary BLOCK. One reason is I think it is kind of a natural tendency for dairymen that have a business with a certain labor force and equipment designed to satisfy a certain volume of business that one does not like to make a dramatic change. While they might pencil it out in the very short run and find that it is a profitable decision to participate, they do not like to see this kind of interruption.

The second point and maybe the most important—feed grain farmers are used to coming in and signing up for programs to cut a certain amount of production acreage. Dairymen are not used to doing that. When they found that they were obligated to come into the ASCS office and agree to sell so many cows over a certain period of time, meet the requirements of the contracts over 15 months and that they would not be able to change their mind. I do not think most dairymen liked these restraints. I do not think you could get beef cattle or hog farmers to do it either.

Representative OBEY. What they are telling me—a lot of them are telling me that the reason they did not sign up for it is because they felt that over a short 15-month period they simply could not make it work and they thought they would have been much more inclined to risk going into the program if it were of longer duration, say another year or so. Any reaction to that?

Secretary BLOCK. Well, there is no reason why it would not work over 15 months if they had signed up and I cannot see any reason why a longer period of time would have made it a better program for them. Frankly, if I was a dairyman and wanted to go into it or felt I was going to try to participate, a shorter obligation would have been better.

Representative OBEY. All I can say is that I have been to about four farm meetings in the last month and that is what I hear 80 percent of the time, and I think we made a mistake in having a shorter program, but that is water over the dam.

Let me ask you, what do you expect to happen to the dairy farm picture in the United States in the next 3 or 4 years? How many dairy farmers do you expect are going to go out of business?

Secretary BLOCK. I do not know, but one way or another, we are going to have to cut about 10 percent out of production.

Representative OBEY. Somebody in your shop must have some guess of how many fewer dairy farmers we are going to have 3 or 4 year from now.

Secretary BLOCK. No, we do not have that. How many are we losing?

Mr. LESHER. We are not losing very many.

Secretary BLOCK. I think the dramatic change we are going to see, Congressman, is that there are not going to be new people going into the business.

Representative OBEY. That is not what I am asking. I am trying to get a picture of what is going to happen over the next 4 or 5 or 10 years, you name it. You mean your shop does not have any estimates or expectations of how agriculture's face will change the next 10 years?

Secretary BLOCK. We may have some figures.

Representative OBEY. How can you plan if you do not know or if you do not have some expectation as to what will be happening in terms of numbers out there?

Secretary BLOCK. Well, I am sure we have some kind of numbers, but I do not have any with me now, but would be happy to review what we have and make them available to you.

Representative OBEY. I would be very interested in knowing in 5- and 10-year slices what your expectations would be in the Department in terms of the number of dairy farmers we will have at each of those periods, in terms of the percentage of production which will be coming from farm operations which are, say, 500 head and over, and how you think the regional distribution of dairy farmers will be changed 5 and 10 years from now.

Secretary BLOCK. We will do what we can.

Representative OBEY. Can you give me that?

Secretary BLOCK. We will do what we can. One of the major problems is going to be the kind of dairy program we end up with in 1985. We have a recent USDA study and it focused on marketing orders.

Mr. LESHER. And other issues as well.

Secretary BLOCK. The study may have some good projections.

Representative OBEY. I would be interested in seeing what your projections are specifically on the point that I just raised.

Secretary BLOCK. We will make them available to you, sir.

Representative OBEY. What happens now in dairy if we are not going to meet those targets? Are you and is your Department content to just allow the scheduled price reductions to take place or do you have anything else in mind?

Secretary Block. No, I do not have any legislation in mind and I would assume that those scheduled price reductions would come about, assuming that the targets are not met. I doubt whether they will be met under current projections right now.

Representative OBEY. But you just want to let it ride for the time being then with the existing law?

Secretary BLOCK. Politically, I do not think anybody wants to deal with dairy in the Congress right now and we have tried to deal with it for 3 years now.

Representative OBEY. What are some of the options we should be looking at, if you want to get it out of politics, after the next election? What are the options you hear being bandied around the country and what do you think makes the most sense from the standpoint of future dairy policy after the next election?

Secretary BLOCK. I think we are uniquely positioned so that as we go forward with development of the 1985 farm bill, that farm policy including dairy will receive a full review. I think the options should be framed and the decision should be made as a result of that effort.

Representative OBEY. What are some of the options that people in the industry, and you in your own head, think we ought to consider? I am not asking you what you are going to choose, but what are the options that you think we will be faced with?

Secretary BLOCK. Well, one option would be to have more Government controls on how much an individual producer could produce.

Another option would be—after the price does adjust downward—to keep the support price at a level that provides a safety net for dairy but is not at a level that encourages excessive production. There are different variations on that theme.

There are other questions that need to be answered, such as regional problems. These are all difficult questions.

Representative OBEY. You indicated what had happened in terms of the increase in production over the last year in dairy. Would you prepare for me a State-by-State inventory indicating how much production has changed on a State-by-State basis each year for the last 3 years?

Secretary BLOCK. Certainly. We can do that.

Representative OBEY. One last question. I think that everybody has their own moral view. I think that in the end that the worst moral shortcoming that we, in the developed world, have had is our inability to find ways to use the incredible surpluses, which we have accumulated from time to time, in parts of the world where they are needed to save lives.

What are the major impediments to doing that to a greater degree right now, and what are some of the things that we could be doing to help overcome those impediments?

Secretary BLOCK. Congressman, I would be inclined to agree with you. It concerns all of us that there are countries having so much trouble providing food to their people and we have such an abundance. I think that without a doubt, we probably can do a better job of using this great asset of food in this country to help others and our technology in agriculture to provide a more stable, peaceful world.

Representative OBEY. Do you have any specific efforts going on now to review that situation?

Secretary BLOCK. What we have been trying to do and what we are trying to focus in on are twofold. First of all, we need to again be recognized as a reliable supplier to all these countries. That has been the policy of this administration and it will continue to be our policy.

These countries want to be able to buy what they need when they want it. Second, they want more agricultural technology. We are educating representatives from other countries in the United States each year. I have just returned from Algeria and Morocco and we signed a memorandum of understanding in Algeria where we would provide expanded trade and agricultural technology for that trade.

Representative OBEY. Mr. Secretary, with all due respect, those are very generalized answers and you are talking about something that I did not ask you about. What I asked you about was whether there were any specific efforts in your shop at this time, whether you are looking at Public Law 480 or greater use of PVO's or you name it? Do you have any specific efforts to look at methods by which we could use some of the surpluses in the various commodities—as the chairman was asking earlier—not just to deal with our domestic problems, but also to provide greater assistance to areas of the world where people are starving? I am not talking about long-term development. I am talking about specific short-term emergency actions now to help in these areas.

Secretary BLOCK. We are continuing to use every means possible to move our surplus dairy products.

Representative OBEY. I have asked these questions for about 5 years of the appropriate officials before my Foreign Operations Subcommittee, for instance, and I always get the same generalized responses but I never—what I get out in the countryside is people asking every day—farmers asking every day, why can that not be done; what are the impediments? We understand the problems in terms of different diets, the necessity not to crush developing agricultural institutions in those parts of the world. We understand that. But I have never seen in one place a lucid description on the part of any administration of either the problem or specifically what some of the specific efforts are that are being made to overcome the problem.

Secretary BLOCK. Well, I would be happy to get a detailed review of that prepared for you. We have expanded the section 416 donation of dairy products to some 16 countries. This is a new program which started a year ago. We are giving away our dairy surpluses to countries in need, which is very helpful for children in these countries. I think you are probably quite aware of the recent announcement of $90 million more aid for Africa. I announced $25 million of aid when I was at the Food and Agriculture Organization meeting in November, which is money for food from the United States. These are specific kinds of efforts.

Representative OBEY. I am aware of that, but it is a drop in the bucket and it does not—well, I stand on my previous statement. Why do you not just prepare for me the most specific response you can to the question that I raised?

Secretary BLOCK. We would be happy to.

Representative OBEY. Mr. Chairman, thank you for your time.

Senator Jepsen. Thank you, Mr. Congressman.

Mr. Secretary, I have several groupings of questions here that I will move along very quickly with on a variety of issues currently being discussed.

The first is farm credit. I am extremely concerned about the price of farm credit that is occurring in this country, certainly in the Midwest which I know most about, and more specifically in the southern tier counties of my own home State of Iowa. I understand that this is not atypical. Many farmers have told me that the burdensom paperwork trail on emergency loans is causing undue backup in the county Farmers Home Loan Mortgage offices. The number of forms sometimes required seems to be delaying forever the application process.

We are coming into a time when it will not be too long before people will be leaving for the fields and so decisions have to be made now concerning operating loans and many other needs.

What is being done to work on those areas of delay and is there any way we can simplify that process and move it forward?

Secretary BLOCK. Mr. Chairman, I talked to Under Secretary Naylor yesterday and I am quite aware of the problems in the southern tier of counties in Iowa and I asked them to see what could be done to expedite the applications and satisfy the need there. I have not yet had a report back, but that problem has reached my desk and I have asked that some action be taken.

Senator JEPSEN. I would hope that we could make some special effort. I will be in Iowa all of next week. In fact, we will be together 1 day, I believe a week from Friday, with the corn growers. But the question is going to be asked often, and I hope that I can call early in the week and get an answer. Iowa has lost some of their best Farmers Home Mortgage county supervisors to the lending institutions and banks, and I do not know if that is characteristic of all States but they are going out and have hired some of these more knowledgeable people away.

So this, combined with the understaffing problem and the miles of paperwork, seems to be magnifying their problems greatly. What is the reason, Mr. Secretary? Are there any answers or more long-term solutions to the staffing problem? I know we have hired extra people, but they say they are temporary employees for 90 or 120 days where some of our key people in these counties have been leaving this permanent employment for banking institutions.

Secretary BLOCK. I am aware of your special problems in Iowa. They have lost some of the better lending officers for different reasons. We are going to try to address that problem.

Senator JEPSEN. Is this unique in Iowa?

Secretary BLOCK. Yes.

Senator JEPSEN. Just in Iowa?

Secretary BLOCK. Well, it is one of the worst pockets of drought in the United States. There are other areas with problems, but this has to be one of the worst we have right now to deal with.

Senator JEPSEN. On another matter that I can assure you is being discussed often and I am asked about it often, is your Department's January 13 erroneous crop report. After that report, during the following 2 trading days, as you know, soybeans dropped 50 cents. Some have indicated prices never have recovered. And now it is my understanding—I do not know whether I have my dates exactly correct here—that you have February 24 for the deadline for the signup?

Secretary BLOCK. February 24.

Senator JEPSEN. Approximately a week prior to that you are planning to come out with a report on projections for planting, is that also correct?

Secretary BLOCK. Yes.

Senator JEPSEN. And a lot of farmers scratch their heads and say, "Why in heaven's name are you coming out with a planting projection when you have not finished the signup and you have no idea how many acres will be planted?" That is just another typical example of some of these reporting things that really dilute, to be charitable about it, the credibility of your reporting agency. Does that make any sense?

Secretary BLOCK. Mr. Chairman, the variations in the reports stem primarily from the different methodology that was used in the different reports. We have seen differences before but never of this magnitude. The administrator in charge made some personnel changes and a review in the methodology is being undertaken in order to improve the reporting process. I will ask Mr. Lesher to comment, if he would, on the reporting service under his jurisdiction.

Senator JEPSEN. Well, you can appreciate the concern that they have and what they are saying. I mean, they really do not know about all the formulas that go into the report. I might just add for further perspective. Mr. Lesher, we recently held a hearing in Chicago at which time the Commodities Futures Trading Commission admitted that price manipulation is possible and that they currently have ongoing investigations into alleged market abuses. Part of the reason for holding that hearing was the fact that we had all kinds of projections last fall in September of lower amounts of supply and that prices would attain such levels. Then later on they said, "Oops, the amounts aren't going to be that high; the amounts are going to be way down here," which would have led one to believe that prices would remain at least the same since the supply had gone down dramatically. But prices actually dropped.

You put all these things together, and I know you understand that, Mr. Secretary, because you are a farmer, and farmers start scratching their heads. Farmers do not know much about formulas and methodologies and who does what and where. All they see is the end result, and the end result after they did some planning and thinking and maybe a little hoping on the basis of what seemed to be very logical projections and then defying all precedents, prices went down when supplies turned out to be less. You then mix in a little bit of erroneous projections after Christmas that drive prices down another 50 cents, and then on top of that they come out later and say, "Oops, that wasn't what we meant," it is no wonder farmers are concerned. And frankly, there has not been really any statement or effort made to correct that situation. I know you have moved some personnel around, but people say, what good does it do?

I do not know if I have asked a question. I have kind of told you what I get. How do you respond to that now?

Mr. LESHER. I know Secretary Block, myself, and others, are alway concerned whenever there is a question about the validity of the numbers. Concerning the earlier crop report versus the stocks report, there were some apparent inconsistencies that we are deeply concerned about. Administrator Kibler recommended that the personnel rotation, which is a normal ongoing procedure, would provide a fresh look to assess the methodology and the analysis of the data. He has also ordered an internal review in SRS to make some recommendations to him about what we can do to improve the reporting process.

Concerning your hearing in Chicago, Deputy Assistant Secretary Ahalt testified before your committee and provided some background that the overall supply of grain was perhaps a little bit larger than some had previously anticipated. I sometimes hear farmers complain when a report is issued and prices go down. I appreciate those views, but you never hear from them when you issue a report and prices go up.

I think our job is to not necessarily say what prices should or should not be, but to make the best estimates of production and supply we possibly can. I accept your criticism of the quality numbers and suggest that we are going to do better.

Senator JEPSEN. I understand that only about 2 percent of the farmers use the futures markets as a financial planning tool. The financial assistance provided by proper use of the futures market is very key especially during these stressful, tough financial times that the farming community is going through. It is unfortunate that we have something that punctures any confidence level that they may have been building on, it seems to me, one thing is piled on top of another. That is why I was asking this question.

Mr. Ahalt did acknowledge the fact that your Department, as a practical matter, has not had, to the best of his knowledge, a lot of direct contact with the Commodities Futures Trading Commission. I would think that by way of educating farmers, by way of providing for maximum credibility and building confidence and hopefully assisting in other ways, a good relationship with the CFTC is needed. I have not talked to him since, but he was going to check on that.

Mr. Secretary, your fiscal year 1985 budget asks for $12.6 billion for farm price support and income stabilization programs, all of which was basically preprogrammed by the 1981 farm bill. What are you anticipating regarding participation in this year's farm program?

Secretary BLOCK. In feed grains I am rather optimistic that we are going to get a good signup. In wheat, we probably will get a reasonably good signup. I am not pessimistic about the signup prospects right now. I believe we are looking at a range of 50 to 70 percent feedgrain. A failure to get a good signup is an indication producers are willing to take a big risk and I do not think it is a wise thing for them to do. Most of our respected analysts and economists studying farm programs are recommending to producers that they participate because of the security that it provides and the income protection. So I hope when I say participation in the range of 50 to 70 percent that I am accurate.

Senator JEPSEN. If you had complete freedom, what would you do with the $12.6 billion that your fiscal year 1985 budget asks for?

Secretary BLOCK. I have never had that kind of freedom.

Senator JEPSEN. Is the administration going to push for a freeze in target prices this year?

Secretary BLOCK. Well, we are going to try to freeze the prices for 1985. I do not anticipate now any changes in 1984.

Senator JEPSEN. I hope not. Regardless of how it felt, it is too late.

Secretary BLOCK. It would be confusing to change the program at this point in time.

Senator JEPSEN. Getting to exports, our volume of agricultural exports declined for 3 consecutive years. So has your budget for export loan guarantees. Do you see any relationship here?

Secretary BLOCK. The budget for export loan guarantees was up in 1982 and 1983. In 1984, it is set at $4 billion, which is not an increase from 1983, but it is the second highest on record. I have said publicly that we can sell more products if we had more guarantees, but there is a lot of risk involved in doing this because we have been finding that some of the guaranteed loans are not being paid back on time which is causing rescheduling problems. You can always sell a product if you are willing to guarantee a loan for it and you do not care if you get paid back. It is a delicate balance of how much are we willing to provide guaranteed loans, and the President has set the level at $4 billion.

Senator JEPSEN. Well I am going to conclude this hearing very quickly. There are questions that I would have to submit for the record and ask for your reply. Time does not permit us to cover all of the areas I would like.

You did mention earlier, and you used soybeans as an example, about how we picked up in exports and so on. I did want to just touch on this area because it is related to your council that you have that is going to study agriculture. It is also related to probably one of the most serious problems, and that is our trading relationships with our neighbors around the world.

Whereas it is true that soybean exports of whole beans have picked up the last 7 years, the United States has lost 40 percent of the soybean oil and meal markets. If we are to continue to provide the leadership in the world in the production and processing of agricultural products, which we had better do, we are going to have to do everything we can to make sure that our agricultural products are given as much attention when we go to the negotiating tables for various limits and tariffs. I note that, for example, we have had some sunflower seed activity pick up. Years ago in Iowa the sunflower was a noxious weed. We used to get in an argument with Kansas about that. In fact, the legislatures were in session and they sent us a telegram telling us they were going to kill our State bird if we did not stop naming the sunflower a noxious weed. They have found now that sunflower seeds have had quite a market in recent years and there have been some industries and individuals that have invested considerable amounts of money in building plants.

Mexico has literally come in and bought up the sunflower seed business. They pay and guarantee an automatic profit for processed sunflower seeds and oil. They pay for that excess profit by money that we and other countries around the world loan them and a little bit of that goes a long way. GATT is one of the great things that has happened. It is a little cumbersome, but it is a great idea. It has not functioned as well for agriculture as it should, however, especially in the area of developed and processed foods.

We need a collective basis to educate and work together with all of our economy and in all segments of our economy to do what we know how to do best in this country, better than anyplace else in the world, and that is to produce food and fiber and find out new high tech ways to use it, process it, store it. You talk about providing $25 billion extra for foreign aid and so on. We need to tell the story about some problems we are encountering in some of these countries where we are indeed trying to help. In Ethiopia, for example, I know people see on television the same thing I do, starving youngsters with flies around their faces, and you see that and it tears at one's soul and one's heart. Then when you inquire, as I have, and find out that the Ethiopian Government gives our Government and our people who are trying to feed their people and help them out a very tough time. They will not even let us fly food in to these desolate areas or truck them or will not allow spare parts to go in when the trucks break down.

So it is inconceivable that we have governments that consist of people of the same color, race, blood, and creed of those people that are starving yet they refuse to help people help their starving people. These things are not very pleasant to talk about. But I think they are not realized by many who may criticize this great country of ours, who has always lent a helping hand and who has always had a record of compassion and assistance, not one of taking over as one of our adversaries has. That needs to be told, too.

Anyway, in the mix of things, we need greater emphasis on high tech and utilizing agricultural products and our relationships and trade agreements around the world.

Do you have closing statement, Mr. Secretary?

Secretary BLOCK. No, sir. I am pleased to have a chance to testify on this very important subject here today. Thank you, Mr. Chairman.

Senator JEPSEN. I thank you, Mr. Secretary. The committee will stand in recess.

[Whereupon, at 12:10 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 21, 1984.]

[The following information was subsequently supplied for the record:]

Response of Hon. John R. Block to Additional Written Questions Posed by Senator Jepsen

Senator Jepsen: Are you satisfied with the way the EPA handled the EDB issue? What input does USDA have to the EPA in these investigations? Does the EPA have an agricultural chemical "hit list"?

Secretary Block: The results of the EDB actions appear reasonable given the stated risk of exposure to EDB. The EPA established recommended action levels in grain products that allow for the orderly marketing of grain and grain products containing EDB residues except for small quantities of products with very high residues. The actions on quarantine uses on fruits and vegetables established tolerances consistent with those established for grain products and hopefully will allow time to develop and have in place by September 1984, alternatives for domestic products requiring treatment.

Historically, the Department has developed agricultural pesticide use information, estimated benefits of use and developed agricultural worker exposure information. These are important activities that benefit both the pesticide regulatory process and the agricultural community by helping ensure benefits of pest control are maintained without creating unnecessary risks to man or the environment. Additionally, the Federal Insecticide, Fungicide and Rodenticide Act (FIFRA) requires the EPA to notify the Department and provide for Departmental comment prior to announcing changes in regulations. The EPA has complied with the notification requirements of FIFRA.

We are not aware of an agricultural chemical hit list. The EPA does have a list of agricultural chemicals which are under review as a result of questions arising from their mandated registration review activities.

Senator Jepsen: Are the Canadians subsidizing their wheat export sales? What about the Australians?

Secretary Block: With their monopoly wheat boards, both Canada and Australia have the mechanism in place and would be ready to draw on government funds to keep their wheat competitive on world markets; under their system, this could happen whenever wheat prices fall to a point that is below their guaranteed initial payment levels. At present, neither Canada nor Australia are subsidizing in the sense that compensatory funding from the government is involved. However, in another sense, such government-authorized export monopolies can provide export assistance of another kind in which profit margins on sales to certain countries can be used by the monopoly to finance predatory pricing in certain other markets to achieve new business or an expanded share. Although frequent instances arise in which there appears to be this kind of activity, it is simply impossible to demonstrate or document, because the accounts of such monopoly organizations are not subject to public disclosure and, in some cases, are exempt even from scrutiny by their own government.

Senator Jepsen: We have about eight months left in fiscal 1984. How much of the export guarantee program has already been allocated? What funds do we have left in Title II of P.L. 480?

Secretary Block: Under the Export Credit Guarantee Program, approximately $3.891 billion has been announced in fiscal 1984 (as of February 23). This leaves approximately $100 million available for programing this year from the currently authorized level of $4 billion.

With regard to P.L. 480 Title II, $33 million is available for programing this year. This figure includes both freight and commodity costs. The split between freight and commodity costs is contingent on the cost of shipping to the countries selected.

Senator Jepsen: Are the Canadians subsidizing their wheat export sales, what about the Australians? Do Brazil and Argentina subsidize their agricultural exports? If so, why don't we use the Blended Credit Program to combat these unfair trade practices like we do against the European Economic Community?

Secretary Block: Most countries, such as Canada and Australia do not subsidize their agricultural exports. Brazil and Argentina have engaged in unfair trade practices such as differential export taxes. Brazil's export subsidy program is currently not funded probably due to their poor financial situation.**

Rather than use the Blended Credit Program to compete with Brazil and Argentina, which would result in increased government intervention on all sides, we seek to decrease government intervention through bilateral and multilateral consultations.

Senator Jepsen: It certainly appears that the European Economic Community is going ahead with its threat to tax corn gluten and other U.S. agricultural products. What's going to be our reaction?

Secretary Block: This Administration is very concerned about current EEC proposals to restrict agricultural imports. Of the proposed restrictions, we object most strongly to the tax on fats and oils (other than butter) and the quantitative restrictions on imports of corn gluten feed and other non-grain feed ingredients, which together could affect $5 billion in U.S. exports to the EEC.

Ever since the announcement of the Community proposals last summer, we have sought every opportunity to express our concerns to the EEC Commission and to member state officials. We believe that our representations have had some effect -- the adoption of fats and oils tax now seems much less certain, and, although non-grain feed restrictions are still very much under discussion, the EEC has not yet acted on that matter, either.

In the course of our dialogue on the issue, we have made it clear to the Europeans that any unilateral action on their part would be met with swift and appropriate U.S. countermeasures. The Administration has prepared a list of items imported from the EEC against which the U.S. could retaliate in the case of a move by the Community. Naturally, if the EEC should choose to pursue the matter under the appropriate provisions of the General Agreement on Tariffs and Trade (GATT), the United States would fulfill its obligations under the Agreement by consulting with the Community. Such consultations would have to precede any actions by the EEC and would not obligate the United States to accept either the EEC's proposal or its offer of compensation.

Senator Jepsen: Your outlook for cotton exports is very depressing. Do you see cotton production going the way of tobacco and peanuts?

Secretary Block: There are some factors that suggest total demand for cotton during the next several years may be able to support plantings at an 11- to 13-million-acre level, compared with the 14 million acres averaged during 1977-81. Domestic use has rebounded this season with economic recovery, and exports have exceeded expectations, mainly due to production problems in Pakistan and the USSR. But, large cotton textile imports are expected to continue in the future and limit expansion of U.S. cotton mill use. Large foreign production and greater use of manmade fibers in the Far East--our major export destination--may restrain our cotton exports.

Cotton is not in the same situation as tobacco, where high, rigid support prices have contributed to a surge in imports and a drop in exports. Annual declines in domestic use, exports, and basic marketing quotas for tobacco seem likely to continue, unless U.S. prices become more competitive. As for peanuts, domestic edible quotas have also been lowered in recent years, to bring quota production in line with domestic edible use. We have the opportunity for export growth, which has been helped by keeping prices for "additional" peanuts competitive in world markets. Acreage appears to be heading back toward the 1.5 million acres averaged from 1960 to 1980.

We need to be realistic in our assessment of market prospects for those crops. We face stiff competition. Currently, domestic edible peanuts and tobacco are priced above world markets. Cotton and additional peanuts can compete in world markets, and the total market is likely to grow. Our prospects for sharing in this growth are tenuous but can likely be achieved if we develop our policies and programs accordingly.

Senator Jepsen: Do you have any idea to what extent tax sheltering by non-farm investors increases output -- particularly for livestock -- thus depressing prices for farmers?

Secretary Block: The extent of tax sheltering activities in agriculture is extremely difficult to quantify. An objective standard based on income source alone would undoubtedly classify some bona fide farm operations as tax shelter activities. Despite these limitations, however, an examination of the same 1976 farm tax returns on which the Treasury study was based provides some insight with regard to the magnitude of tax sheltering activities among various farm types. An examination of these returns indicates that two-thirds of all farm returns reported nonfarm income or deficit greater than farm income or deficit. These "tax shelter" farms accounted for one-third of all farm business receipts. With regard to livestock operations, approximately 85 percent of the returns for beef cattle feedlots, other beef cattle farms, general livestock farms and animal speciality farms reported off-farm income or deficit greater than farm income or deficit. These returns accounted for 58 percent of all farm business receipts for beef cattle feedlots, 44 percent for other beef cattle farms, 45 percent for general livestock farms and 73 percent for animal speciality farms. The number of "tax shelter" returns and percent of farm business receipts reported on such returns were much lower for crop, dairy, poultry and hog farms.

Senator Jepsen: In a recent study by the Internal Revenue Service of 1976 farm tax returns it was found that 12,000 farms showed operating losses of $50,000 or more. Yet these same returns also showed an average off-farm income of $122,000. This seems to suggest that the larger the off-farm income, the larger the farm losses. In fact, the IRS found that the average adjusted gross on- and off-farm income of all farms reporting losses exceeded the adjusted gross income of 75 percent of all farms reporting profits in 1976. One-half of all farms -- 1.2 million farms -- have product sales of less than $10,000 per year and these farms always lose money, yet their combined on- and off-farm income in 1981 was over $20,000, which was near the average national household income....could you please comment on the effect of tax sheltering opportunities in agriculture and how does one incorporate into farm programs the consideration of off-farm income?

Secretary Block: Farm investments receive favorable treatment under the income tax rules. Some of the provisions which are responsible for this treatment include the deductibility of certain capital costs, the use of cash accounting, capital gains treatment on assets developed through deductible costs, and favorable treatment for certain assets under the Accelerated Cost Recovery System. These provisions permit investors to mismatch income and the expenses incurred to produce that income by generating deductions and credits in the early years of the investment and delaying the recognition of income from the investment until later years. The benefits from these deductions often exceed any future tax liability on the income from the investment. Since the advantage from such tax-favored investments increases as the investor's income and tax bracket increases, the combined return from the investment and from the tax system is the greatest for high bracket investors. Thus, high income individuals are encouraged to invest in tax-favored industries such as agriculture. This can overstimulate production and lead to lower product prices and in some cases cause the values of limited inputs such as land to increase.

Currently, farm programs are administered on the basis of price and production levels. To administer farm programs on the basis of income levels would greatly alter the direction of farm policy towards one of providing direct income transfers. It is not clear that by considering income levels the inequities in agriculture resulting from the current tax system would be alleviated.

Senator Jepsen: Would you encourage the average farmer to borrow at today's interest rates for the purpose of expansion in light of future income and prospects for world demand, and the uncertainty of farm programs and policies? It seems to me this Administration, through its farm programs is sending a clear signal to farmers--that signal is bright red--imploring farmers to retire, not expand, production capability.

Secretary Block: Today's high interest rates and the current low rate of return on farm production assets has sent a signal to the nation's farmers to borrow less and reduce their debt burden. Farmers have responded to this signal by decreasing considerably the rate of growth in total farm debt. We expect this development to continue. Low rates of return in agriculture suggest that it is appropriate to shift resources out of the sector until profitability is re-established. Any policy initiatives to expand agricultural production at this time, through subsidies or liberal credit programs, runs counter to market forces and will likely exacerbate farmer's cash flow problems in the future.

Senator Jepsen: There is a well-publicized disagreement within the administration concerning the economic impact of deficits and how it should be brought down. I'd be very interested in knowing your view on this subject. Which would have the least negative economic impact on the Agriculture Sector--reduced federal spending or higher taxes?

Secretary Block: The federal budget deficit automatically increases during a recession, as expenditures rise for built-in stabilizers such as unemployment compensation and food stamps at the same time that revenues fall due to lower income levels. These cyclical deficits--related to the business cycle--merely replace falling private sector demand with increased public sector demand and have little impact on interest rates and foreign exchange rates. Furthermore, cyclical deficits can be monetized with little impact on inflation as they only occur during periods of slack in labor and product markets. Thus, cyclical deficits likely benefit agriculture by stabilizing aggregate demand without putting upward pressure on farm costs. However, structural deficits--which measure what the deficit would be if the economy were operating at high employment--compete against the private sector for real and financial resources, putting upward pressure on interest rates and foreign exchange rates. This crowds-out certain components of domestic demand such as housing, consumer durables, fixed business investment, and inventory demand.

The crowding out of fixed business investment is especially detri mental to the economy, as it results in a lower level of capital stock and reduces the economy's long-run growth potential. Furthermore, export demand is weakened by the strong dollar--a process becoming known as "export crowdingout." Structural deficits raise the cost and lower the availability of credit to farmers while drying up their foreign markets. Also, monetizing a structural deficit only leads to inflation, thus increasing farm costs. In summary, cyclical deficits are probably beneficial to agriculture while structural deficits are detrimental. Reducing the structural deficit by reducing federal spending, rather than by increasing taxes, is preferable because it would free up resources for more efficient use by the private sector.

Senator Jepsen: In your statement you allude to the cross-subsidization consequences of commodity programs. That is, PIK improved crop prices substantially which yielded large increases in feed costs which sharply altered the profit outlook for livestock and poultry producers. My point is that because of a farm program crop farmer deficiency payments are now in essence, being paid out of the pocket of livestock producers. As a result aggregate net farm income may show no improvement in spite of spending record amounts on farm programs. Your comments please.

Secretary Block: Feed prices increased 10 percent in 1983 after registering a 9 percent decline during 1982. Feed prices tend to fluctuate with crop output and would have risen without PIK because of drought-reduced supplies. It is possible that on average, feed prices in 1983 may not have risen as much in the absence of the PIK program. However, large stocks overhanging the market were depressing crop prices for the second consecutive year. This could have resulted in massive CCC loan forfeitures and considerable cost to the government for the storage of these commodities.

Although a record $18.9 billion was spent on CCC farm programs in FY83, the amount spent during calendar 1983 was about half this amount. The FY83 outlays benefited 1982 income significantly as net CCC loans, a potentially recoverable cost which accounted for 45 percent of total FY83 outlays, were used heavily in the last quarter of calendar 1982. Net farm income in calendar 1983 is expected to have changed little from the $22.1 billion of 1982 as lower crop cash receipts and a sharp reduction in crop inventories offset increased livestock receipts (due to record output and slightly higher prices), higher government payments, and lower production expenses. However, net cash income, which excludes depreciation, nonmoney income, and inventory change likely increased significantly in 1983 as strong government payments and reduced cash expenses offset lower cash receipts.

Senator Jepsen: I see by your 1984 net income forecasts that you're anticipating a 10 percent increase in cash expenses. This is a dramatic increase compared to recent years. How much of this increase is increases in the price of inputs as opposed to the purchase of more inputs ?

Secretary Block: Farmers' cash expenses are currently expected to increase about 9 percent in 1984. This follows an estimated 3-percent decline in 1983 caused mostly by farm program-induced reductions in farm input use. As acreage in production this year moves back toward the 1981 and 1982 levels, use of agricultural inputs is also expected to rise. Since prices paid by farmers for inputs are expected to rise about 5 percent this year, around 4 percent of the increase in cash expenses will be due to increased input use.

Senator Jepsen: I understand there are those who contend that high commodity loan rates discourage exports. How much of a reduction in loan rates would be necessary, in your opinion, to have any significant effect on export sales. I note that just to offset the increase in the value of the dollar, loan rates would have to fall 25 to 30 percent. Your comment please.

Secretary Block: Commodity loan rates set above world market-clearing prices do result in reduced export potential for our agricultural products. Our exports fall as high loan rates place us at a price disadvantage with our competitors. In addition, our high loan rates encourage producers in competitor countries to expand production. We must work to keep our loan rates at a level that does not interfere with our producers ability to export.

Senator Jepsen: Where is the economic, humanitarian, or political logic -- from a global perspective -- of retiring the most efficient food production resources in the world and as a result encouraging the retention and expansion of less efficient food production resources?

Secretary Block: Our farmers are among the world's most efficient. But, competition in the international market is fierce. Competitor nations, acting on behalf of their own producers, push their surpluses onto world markets. This results in reduced demand and depressed prices for our agricultural products. We are then left with either reducing our production or subsidizing our products abroad. These are tough choices. I look forward to working with members of Congress in addressing these issues and finding solutions that allow our farmers to compete successfully in world markets when we develop the 1985 Farm Bill.

Senator Jepsen: I'm sure you're a believer in free trade and the end result of free trade is comparative advantage, each country producing what it produces best. Continuous unilateral supply control programs is a policy of contradiction. Isn't this inconsistent with U.S. agriculture's economic destiny and obligation? We need not only a long-term farm policy but also one with a global perspective. Don't you agree?

Secretary Block: Let me assure you that I believe in free trade. But, we must also remember that the international market is far from the free trade model which we read about in textbooks. Our long-term farm policy must recognize our role in world markets and the advantages and problems created by those markets. We must continue to work towards farm programs that allow our farmers to respond to market signals rather than producing for government programs. It makes no sense to continue to expand production when there is no market for our commodities, yet our present rigid loan rates often result in just that. I think that we must establish a long-term policy that recognizes the importance of world trade and international competitiveness to the health of U.S. agriculture.

Senator Jepsen: Yesterday Rudolph Penner, the Director of the Congressional Budget Office, appeared before this Committee. CBO is projecting a $326 billion deficit by 1989. I noted that outlays for agriculture are projected to more than double by 1989, the largest percentage increase of any function of Government including defense and social security. Your reaction please.

Secretary Block: Agricultural program expenditures in the recent past have been high. However, as Dr. Penner noted in his comments, the President's budget proposes to freeze target prices at the 1985 levels, which according to CBO's estimates reduces projected outlays by a total of $14.8 billion over the 1985-89 period. This serves to underscore the need in Congress to freeze or even lower target prices. Maintaining an economic safety net is an important goal for our agricultural programs, but, we must do it at reasonable cost to taxpayers.

O