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ECONOMIC SUMMIT

TUESDAY, APRIL 30, 1985

HOUSE OF REPRESENTATIVES,
COMMITTEE ON FOREIGN AFFAIRS,
JOINT WITH
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committees met at 10:05 a.m., in room 2172, Rayburn House Office Building, Hon. Dante B. Fascell (chairman of the Committee on Foreign Affairs) presiding.

Chairman FASCELL. This joint session will come to order.

Mr. Secretary, and Senator and Mr. Greenspan, let me, on behalf of the Joint Economic Committee and the Foreign Affairs Committee, thank you for being here today and for sharing with us your thoughts on what should be discussed at the summit. While we may have a variety of opinions, I think we can at least all agree that it is a very important matter and, while I don't want to say that we are at crossroads, it is more than obvious that we need some kind of guidance and benchmarks, rather than what I personally seem to feel has been adrift.

I know that your presentations will be meaningful and will make a very important contribution to a record that we are trying to establish.

Senator, you have a prepared statement. Do you want to put it in the record and summarize it or do you want to read your own statement?

Senator BRADLEY. Mr. Chairman, I will go through it briefly.

STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator BRADLEY. Mr. Chairman, I thank you very much for the opportunity to testify. We just finished 2 days of hearings in the Finance Committee on the Senate side on a similar subject and I think that the record there was very interesting to many of the Members.

I am also honored, Mr. Chairman, to appear on this panel with two gentlemen who know much more about this and have much longer history than I on the subject, so I will try to be as brief, and succinct as possible in framing the issue as I see it.

Mr. Chairman, I want to talk about the specific subject of U.S. objectives in the Bonn economic summit and on the broader issues that were raised in the GATT study group report that I participated in over the 1½ years.

At the beginning, let me say the report is a unanimous document, although all seven members had different nationalities and came from four continents. Before commenting on the relevance of that GATT report, I would like to deal with several issues. First, the economic backdrop to the Bonn summit; second, the agenda we should pursue there; and third, the ultimate values that should drive us in improving international economic relations.

Mr. Chairman, we face two distinct problems in foreign trade that will cast long shadows in Bonn. One is the trade deficit. The other, which I want to keep separate for the moment, is the question of fairness in the trade policies of foreign governments.

As to the trade deficit, I don't need to underscore the link between the flood of imports and the high dollar or the connection of the high dollar and the administration's overseas borrowing. I do not need to add emphasis to the fact that the trade deficit will stay with us as long as we have to finance huge budget deficits with this overseas borrowing.

Let me just, if I can, summarize the situation as it affects the average American citizen. In 1984, every man, woman, and child in the United States bought over $400 of foreign goods on foreign credit. Now, what actually happened was that the U.S. Government did the borrowing abroad and the average citizen bought about $440 more in foreign goods than he or she produced for foreign consumption. But the end result is essentially what I have described.

This has been the ultimate feel-good deficit financing policy. The consumer is happy to have taxes way below the level needed to balance Federal spending and is amazed at the bargains available on foreign merchandise. The trick is that there is a hidden consumer loan that will eventually come due. Worse still, all that Government borrowing has sucked up dollars, most of which would otherwise be spent on U.S. goods and services around the world.

Today's American producer and tomorrow's American consumer have to pay for the administration's feel-good financing policies.

At the same time that we have suffered a back-breaking trade deficit, our frustration—and this is the second part—with the unfair trade practices of foreign governments have come to the boiling point. Now this is understandable. But then we, in the political process, tied the trade deficit to the question of fair market access and put it in a nice little neat package and shifted the whole burden of our trade problems onto the Japanese.

Just a few facts. Fact: Our per capital bilateral trade deficit with Japan in 1984 was less than our deficit with both Taiwan and Canada. Fact: Japan's gross capital outflows last year were $57 billion, much of which is known to have flowed into dollar assets. Fact: Japanese investors helped to fuel our recovery last year, which makes recent trade legislation and administration statements come as a cruel irony. Fact: If we cut our current account deficit with Japan by over a third, we would still have a trade deficit over $100 billion.

Now, Mr. Chairman, I don't want to make light of the notorious Japanese bureaucratic microprotection because it has made a mockery of the GATT codes for nontariff barriers. Intertwined regulatory measures, banking, and trade institutions form a maze that most U.S. producers are still trying to penetrate. But some of the challenges they present to the American marketer may not be unreasonable from the Japanese point of view.

There are dozens of stories of Japanese marketers accepting huge cuts in their standard of living to reside for two years in China before the sponsoring company would even consider marketing a single product line. American in Japanese firms spend much of their lives poring over U.S. journals and newspapers in order to contribute to a handful of U.S. customer accounts.

Some American industries, on the other hand, have tried to reform customer tastes, rather than react to them. As a consequence, U.S. firms never did get around to marketing cars with right-hand drive and a clutch the average Japanese could reach; whereas Toyota very accurately analyzed pent-up U.S. demand for reliable small autos and filled the need.

It is crucial for us to judge the unfair competitive impact of Japanese trade policies and insist on reforms, but that is only part of the problem, given the differences in marketing philosophy that characterize some United States and Japanese industrial and durable goods sectors. To single out Japan as the cause of our economic problems is to turn a vital ally into a scapegoat for the failings of domestic macroeconomic policy. It is to ignore the importance of our strategic relationship and the areas of cooperation in such international institutions as the IMF or other international development banks.

Mr. Chairman, some people argue that as long as Japanese markets remain partially closed, it doesn't really matter whether they are responsible for 1 percent or 10 percent or 100 percent of our trade deficit. But let's turn that around for a minute. What if the trade deficit dropped to zero overnight? Does that mean market access was no longer a problem? Why couldn't there be an enormous one-way barrier against U.S. products, but a low-enough dollar to let some goods and services creep through anyway?

Do we want to tie ourselves down to sitting quietly in the corner despite massive unfair trade practices at some future date because we might happen to have a balanced current account? It makes more sense, I believe, to separate unfair trade practices and trade deficits. Tough enforced trade negotiations can change unfair trade practices and macroeconomic reform can affect trade deficits. That is, I think, all our experience to date really tells us.

The trade problems that plague us domestically are the same as those that dominate the international picture: in other words, failures in trade agreements and conflicting macroeconomic policies. Accordingly, I believe our objectives in Bonn should include two parallel sets of multilateral negotiations to follow up the summit. One should aim for routine intensified efforts at international macroeconomic coordination and the other should kick off a new round of multilateral trade negotiations under GATT.

Our position going into the summit would be better had we seen stronger Presidential leadership in macroeconomic policy. Ideally at the summit, we should argue for four points: We should push tax reform internationally in order to align investment rates and promote growth; we should get agreement on the value and cost of concerted monetary intervention; we should come to an understanding on the coordination of domestic fiscal and monetary policies; and we should begin rescheduling developing countries' debt.

As things stand, the question of monetary policy coordination is the most likely to produce a useful agreement.

Now monetary policy coordination includes possible concerted intervention by central banks to contain exchange rate fluctuations. We should be clear, however, that monetary intervention comes at a price. If intervention is sufficient to affect exchange rates, the history of the end of the Bretton Woods regime shows that it could have an impact on the inflation rates of surplus countries.

Coordinating domestic monetary policies, especially government borrowing, promises to address the cause of exchange rate volatility, but at the cost of limiting the flexibility of individual nations to pursue different economic agendas. Nevertheless, our willingness to discuss what is in the realm of the possible is crucial. Without it, businesses begin to ask themselves whether there is any advantage at all to international negotiations touching on trade.

Second, the question of rescheduling Third World debt is central to any further negotiations we may have on either trade or the international monetary system. If the dollar starts to fall, developing countries will begin losing their ability to finance their debt through exports as their goods increase in price. Coupled with rising protectionism here and in Europe, a low dollar will touch another round of the debt crisis, particularly given our present deficits, and that could lead to higher U.S. interest rates and be more destabilizing for the international banking system than even the last crisis was in 1982.

There is plenty of room for creative proposals for secondary debt and equity exchange markets for Third World loans, but we will not solve anything until we address the cause of the problem, and that is, lenders have not taken into account all the relevant risks, including the risk that our own protectionism would make it impossible for Third World countries to earn the foreign exchange necessary to meet repayment schedules.

The only successful solution will be international agreements to reschedule the debt and to limit barriers to Third World exports.

Third, Mr. Chairman, proposals for a new round of trade negotiations are now fairly widespread, but there has been little discussion of possible agendas. Without going into detail, let me just say we should distinguish goals which will benefit all participants from goals which will benefit only some.

In the first category are measures outlined in the GATT report to strengthen the GATT dispute settlement procedures, for example, and to institute a protection balance sheet reflecting the total costs and benefits to any country of import relief measures that it adopts.

Goals which only benefit some countries include negotiations to reduce subsidies, agricultural barriers, impediments to high tech and service exports, textile quotas, and steel safeguards.

Once again, lack of Presidential leadership has harmed our position. With a clear set of national priorities, we could give some advance notification of which of the goals benefiting other countries we would be willing to include in the negotiations to obtain a better trade environment for our own agricultural products, high tech industries and services. But as things now stand, we may have to settle for a diluted agenda.

Finally, Mr. Chairman, trade policy is a technical issue and one that encourages us to get lost in detail and ignore fundamental values. Let me finish by stating the values I believe should underlie any set of negotiating objectives and our trade policy in general.

First is the importance of growth and turning change to our advantage. Most of the economic growth of the next 50 years will take place in developing countries: China, Brazil, and elsewhere. We have to lay the foundation today for any participation in that growth that we may need tomorrow. To turn our back on developing countries through trade barriers at this time would be regrettable. Theirs are the great markets of the future, but also the great sources of production. The more we open ourselves to their economies and embrace the changes they cause worldwide, the more we shall benefit from their growth.

Second value: The values of community are terribly important and those values distinguish America's economy from any other in the world. After all, the United States enjoys the largest unified market in the world. But where is the real advantage of that unification if it is not in our ability to adjust to change by sharing the gains and burdens of a world of volatile growth? From this, it is clear that the only way to tap our tremendous advantage in size is to pursue reinvigorated trade adjustment assistant programs. Sure, it will be hard to engineer an adjustment program that truly helps displaced workers while not crushing incentives in the workplace. But short of that effort, what does our greatness get us?

Finally, let me just stress the importance of rules and try to do this realistically. The GATT report is a book about rules, discipline and fairness. Some would say that our altruistic adherence to the principles of liberalized trade in an international environment of aggressive business-government industrial strategies is a little like leaving an open crate of gold bullion in the middle of the street and expecting to find it untouched 1 week later.

But this view misses the point. The longer you live under a set of rules, the more they define a range of possible options. In pursuing a rule-based trade system, we may seem a little naive to our European colleagues. But it is the only long-term strategy that promises growth for our children and keeps change on our side.

Thank you, Mr. Chairman.

[Senator Bradley's statement follows:]

PREPARED STATEMENT OF Hon. BILL BRADLEY, A U.S. SENATOR FROM THE STATE OF NEW JERSEY

Thank you, Mr. Chairman, for this opportunity to testify on the specific subject of U.S. objectives in the upcoming Bonn economic summit, and the broader issues raised by the GATT study group in our report on problems facing the international trading system. The report is unanimous even though all seven members had different nationality and came from four continents. Before commenting on the special relevance of the GATT report today, let me comment on:

- the economic backdrop for the Bonn summit,
- the agenda we should pursue there, and
- the ultimate values that should drive us in improving international economic relations.

We face two distinct problems in foreign trade that will cast long shadows at Bonn. One is the trade deficit. The other, which I want to keep separate for the moment, is the question of fairness in the trade policies of foreign governments. As to the trade deficit, I do not need to underscore the link between the flood of imports and the high dollar, or the connection between the high dollar and the

Administration's overseas borrowing. And I do not need to add emphasis to the fact that the trade deficit will stay with us as long as we have to finance huge budget deficits with this overseas borrowing. Let me just summarize the situation as it affects the average citizen. In 1984, every man, woman, and child in the U.S. bought over $400 of foreign goods on foreign credit. Now, what actually happened was that the U.S. government did the borrowing abroad, and the average citizen bought about $440 more in foreign goods than he or she produced for foreign consumption. But the end result is the same as what I described.

This has been the ultimate feel-good deficit financing policy. The consumer is happy to have taxes way below the level needed to balance federal spending, and is amazed at the bargains available on foreign merchandise. The trick is that there is a hidden consumer loan that will eventually come due. Worse still, all that government borrowing has sucked up dollars most of which would otherwise be spent on U.S. goods and services around the world. Today's American producer, and tomorrow's American consumer, have to pay for the Administration's feel-good financing policies.

At the same time that we have suffered a back-breaking trade deficit, our frustration with the unfair trade practices of foreign governments has come to a boiling point. This is understandable. But then we tied the trade deficit and the question of fair market access into a neat little package, and shifted the whole burden of our trade problems onto Japan.

- Fact: Our per capita bilateral trade deficit with Japan in 1984 was less than our defict with both Taiwan and Canada
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- Fact: If we cut our current account deficit with Japan by over a third we'd still have a trade deficit of over $100 billion.

Of course, notorious Japanese bureaucratic microprotection has made a mockery of GATT codes for non-tariff barriers. Intertwined regulatory, banking, and trade institutions form a maze that most U.S. producers are still trying to penetrate. But some of the challenges they present to the American marketer may not be unreasonable from the Japanese point of view. There are dozens of stories of Japanese marketers accepting huge cuts in standard of living to reside for two years in China before the sponsoring company would even consider marketing a single product line there. 'Americanists' in Japanese firms spend much of their lives poring over U.S. journals and newspapers in order to contribute to a handful of U.S. customer accounts. Some American industries, on the other hand, have tried to reform customer tastes rather than react to them. As a consequence, U.S. firms never did get around to marketing cars with right-hand drive and a clutch the average Japanese could reach, whereas Toyota very accurately analysed pent-up U.S. demand for reliable small autos and filled the need. It is crucial for us to judge the unfair competitive impact of Japanese trade policies and insist on reforms. But that is only part of the problem given the differences in marketing philosophy that characterize some U.S. and Japanese industrial and durable goods sectors.

To single out Japan as the cause of our economic problems is to turn a vital ally into a scapegoat for the failings of domestic macroeconomic policy. It is to ignore the importance of our strategic relationship and the areas of cooperation in such international institutions as the IMF and Developmental Bank.

Some people argue that as long as Japanese markets remain partially closed, it does not really matter whether they are responsible for 1%, 10%, or 100% of the trade deficit. But turn that around. What if the trade deficit dropped to zero overnight? Does that mean market access was no longer a problem? Why couldn't there be enormous one-way barriers against U.S. products, but a low enough dollar to let some goods and services creep through anyway? Do we want to tie ourselves down to sitting quietly in the corner despite massive unfair trade practices at some future date because we might happen to have a balanced current account? It makes more sense to separate unfair trade practices and trade deficits. Tough, enforced, trade negotiations can change unfair trade practices. And macroeconomic reform can affect trade deficits. That's all our experience really tells us.

The trade problems that plague us domestically are the same that dominate the international picture: lapses or failures in trade agreements, and conflicting macroeconomic policies. Accordingly, our objectives in Bonn should include two parallel sets of multilateral negotiations to follow up the summit. One would aim for routine, intensified efforts at international macroeconomic coordination, and the other would kick off a new round of multilateral trade negotiations under the GATT.

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Monetary policy coordination includes possible concerted intervention by central banks to contain exchange rate fluctuations. We should be clear that monetary intervention comes at a price: if intervention is sufficient to affect exchange rates, the history of the end of the Bretton Woods regime shows that it could have an impact on the inflation rates of surplus countries. Coordinating domestic monetary policies, especially government borrowing, promises to address the cause of exchange rate volatility, but at the cost of limiting the flexibility of individual nations to pursue different economic agendas. Nevertheless, our willingness to discuss what is in the realm of the possible is crucial. Without it, businesses begin to ask themselves whether there is any advantage at all to international negotiations touching trade.

The question of rescheduling LDC debt is central to any further negotiations we may have on either trade or the international monetary system. If the dollar starts to fall, developing countries will begin losing their ability to finance their debt through exports as their goods increase in price. Coupled with rising protectionism here and in Europe, a low dollar will touch off another round of the debt crisis that could lead to higher U.S. interest rates and be more destabilizing for international banking than the last crisis. There is plenty of room for creative proposals for secondary debt and equity exchange markets for LDC loans. But we will not solve anything until we address the cause of the problem: lenders have not taken into account all the relevant risks, including the risk that our own protectionism would make it impossible for third world countries to earn the foreign exchange necessary to meet repayment schedules. The only successful solution will be international agreements to reschedule debt and to limit barriers to LDC exports.

Proposals for a new round of trade negotiations are now fairly widespread, but there has been little discussion of possible agendas. Without going into detail, let me just say we should distinguish goals which will benefit all participants from goals which will benefit only some. In the first category are measures (outlined in the GATT report) to strengthen GATT dispute settlement procedures and to institute a protection balance sheet reflecting the total costs and benefits to any country of import relief measures it adopts. Goals which only benefit some countries include negotiations to reduce subsidies, agricultural barriers, impediments to high-tech and service exports, textile quotas, and steel safeguards.

Once again, lack of Presidential leadership has harmed our position. With a clear set of national priorities, we could give some advance notification of which of the goals benefitting other countries we would be willing to include in negotiations to obtain a better trade environment for our agricultural products, high tech industries, and services. As things stand, we may have to settle for a diluted agenda.

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Trade policy is a technical issue, and one that encourages us to get lost in detail and ignore fundamental values. Let me finish by stating the values I believe should underlie any set of negotiating objectives and our trade policy in general. First is the importance of growth and turning change to our advantage. Most of the economic growth of the next 100 years will take place in developing countries, particularly China and Brazil. We must lay the foundation today for any participation in that growth we may need tomorrow. To turn our back on developing countries through trade barriers at this time would be regrettable. Theirs are the great markets of the future, but also the great sources of production. The more we open ourselves to their economies and embrace the changes they cause worldwide, the more we shall benefit from their growth. Second, are the values of community which distinguish America's economy from any other in the world. After all, the U.S. enjoys the largest unified market in the world. But where is the real advantage of that unification if it is not in our ability to adjust to change by sharing the gains and burdens of a world of volatile growth? From this, it is clear that the only way to tap our tremendous advantage in size is to pursue a reinvigorated trade adjustment assistance program. Sure it will be hard to engineer an adjustment program that truly helps displaced workers while not crushing incentives in the workplace. But short of the effort, what does our greatness get us?

Third, let me stress the importance of rules in international trade. The GATT report is a book about rules, discipline and fairness. Some would say that our altruistic adherence to the principles of liberalized trade in an international environment of aggressive business-government industrial strategies is a little like leaving an open crate of gold bullion in the middle of the street and expecting to find it untouched one week later. But this view misses the point. The longer you live under a set of rules, the more they define a range of possible options. In pursuing a rule-based trade system, we may seem a little naive to our European colleagues. But it is the only long-term strategy that promises growth for our children and keeps change on our side.

Mr. BONKER [presiding]. Thank you, Senator Bradley, for an excellent statement and for your leadership on this timely issue.

I apologize for being late and while I do not have an opening statement, I would like to offer a few comments.

CURRENT TRADE STATISTICS

The joint hearing today is timely for at least three reasons: First, the Department of Commerce just released today the trade deficit figures, not only for the preceding month, but also for the first quarter of this year; second, the President departs this afternoon for his trip to Bonn to represent the United States at the summit meeting; and third, the remarkable statement by Secretary of Treasury, Jim Baker, this morning with respect to the issue of an international monetary conference and our official position on this issue at the summit meeting.

I think you would be interested in knowing the trade figures that were released as of 8:30 a.m. this morning. For the month of March 1985, the trade deficit was posted at $11.1 billion. That compares to $11.4 billion in the month of February and $10.3 billion in January. Down slightly. Imports are still up, but exports were up a little bit higher.

With respect to the quarter report, for the first 3 months of this year, the amount was $32.8 billion, compared to the first quarter of 1984, which was $27.9 billion.

I am hopeful that the President will at least respond to the concerns of others at the summit who wish to deal effectively with the misalignment of currencies. While we all support a new multilateral round to deal with trade distortions, hopefully we won't insist that the cart come before the horse since international monetary reform is No. 1, apparently, on everybody else's agenda.

Mr. Roth, as the ranking member, do you have an opening statement before we proceed with Secretary Blumenthal?

Mr. ROTH. I thank you, Mr. Chairman. I would like to offer just a few quick remarks.

I want to compliment you and Chairman Hamilton for holding these very timely hearings. I think they are most appropriate. As I look at recent economic summits, however, whether held in London or Williamsburg, there doesn't seem to be too much that has come by way of tangible results from these summits. Instead they have often been missed opportunities and little more than media events. I hope that that is not the case with the Bonn summit.

After all, we do have a $123 billion trade deficit and, Mr. Chairman, if your figures are correct, it would seem that this year we are going to have a $135 billion trade deficit. For every $1 billion we have in a trade deficit, we are losing 25,000 to 40,000 jobs, according to the Commerce Department. Thus, we could lose close to 2 million jobs because of our trade deficit.

This is, of course, a very serious and disturbing situation. I hope that, Mr. Chairman, the Senate follows your leadership in the passage of the Export Administration Act because certainly that would be something positive we could do here on the Hill to try to make some improvements for America's exporters.

TRADE REORGANIZATION

But, Mr. Chairman, I don't think that we are ever going to come to a resolution of the trade problem until we get own house in order. We have got trade in every department in the Government, whether it is Treasury, Commerce, Defense, USTR, or Customs. Everyone is involved in trade. Until we get a Department of Trade, we are never going to be able to straighten out these problems. So I think it behooves us to set up a Department of Trade and get away from this haphazard approach to trade.

After all, our markets are international markets. And millions of American jobs hinge on trade. Trade is one of the most crucial issues we are facing on Capitol Hill. Our trade deficit is every bit as serious as our huge fiscal deficit.

Thank you, Mr. Chairman.

Mr. BONKER. Thank you, Mr. Roth.

I would now like to ask our next witness to present his statement. He is the Honorable Michael Blumenthal, formerly the Secretary of Treasury in the Carter administration and now the chief executive officer of Burroughs Corp.

Secretary Blumenthal, it was a different international economic scene when you were in that position, so we are very interested in your perspective.

Chairman FASCELL. And the deficit was smaller.

STATEMENT OF W. MICHAEL BLUMENTHAL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BURROUGHS CORP.

Mr. BLUMENTHAL. Mr. Chairman, distinguished members of the committee, I am very pleased and honored to have the opportunity to appear on this panel before this committee and to present my views on the issues to be faced at the forthcoming summit.

I have a prepared statement which I have submitted to you for the record. With your permission, I will not read it in its entirety, but will seek to summarize the major points.

Mr. BONKER. Your statement, without objection, will be included in the record and we appreciate your brevity.

Mr. BLUMENTHAL. I might say for the record, also, Mr. Chairman, that I can now look back on quite a long period in international business—a whole lifetime, really—spent at the firing line, so to speak, with regard to issues involving trade, investment, protectionism, currency rates and instability of markets. That period of activity in international business, has been interspersed with two tours of duty in the Government, one in the 1960's as the chairman of our delegation negotiating what was then called the Kennedy round, a major round of GATT talks; and second, of course, under President Carter for 2½ years as Secretary of the Treasury. So my views on the summit are formed by those experiences and by my participation with the President of the United States at three summits: in London in 1977; Bonn in 1978; and Tokyo in 1979.

My own view is quite different from the view expressed by some that summit meetings are little more than photo opportunities and ceremonial occasions with a lot of political posturing but no real substance. I feel that summits do represent an important occasion for a whole host of reasons; the single most important being that they dramatize for all the world to see the very close interrelationship between the economies of the various countries around the world.

They dramatize a fact that I believe is too little understood by many political leaders or legislators in the various countries, including, I might add, here in the U.S. Congress, which is that none of us are any longer totally masters of our own fate in domestic economic affairs. All of us have to pay, whether we like it or not, increasing attention to the impact on other countries of what we do or do not do in managing our own economic affairs. All of us are dependent on our trading partners for sensible actions on their part, lest none of us are able to achieve the goal of growth with stability that we seek for our people.

The reason for that interdependence, of course, is obvious. In the last 20 years the volume of world trade has risen twice as fast as did GNP. For the United States, international trade as a share of our GNP has doubled during that period. World investment in the period 1960 to 1983 has increased eightfold. And the principal debator and creditor nations are a more diverse lot. Increased foreign investment has meant more foreign production across national boundaries in many different industries, not just a few as 20 years ago.

Trade and services have mushroomed and are critically important, particularly as technology becomes defuse across national boundaries. Communication advances have tied the world much more closely together. And capital markets, just as much as the market for goods and services, have intertwined the economies of all of the principal countries.

So with that as a background, the issues and opportunities for this summit meeting for which the President departs today are manyfold, and I think at this time serious indeed. As one sits back and reviews the scene, one has to say that the agenda of issues to be faced is larger, more difficult and more urgent than I would say at any other summit that I recall.

Let me briefly summarize for you what I believe the four principal issues are that require discussion at the summit and urgent attention on the part of the heads of state representing the major nations gathered there.

The first one quite simply is the issue of how best to work together to ensure the continued economic growth with stability of all of our countries. That is not an easy question to answer. Almost everything else, everything that Senator Bradley has already touched on, flows from that.

We begin with what appears to be a slowdown in the U.S. economy, at least based on the figures of the first quarter. So we have to ask ourselves, as our economy slows down—which indeed may be desirable—what is it that the other countries might do in order to take up the slack to some extent so that we don't together fall back into a world recession of the kind we had a few years ago.

In other words, what is the right mix of monetary and fiscal policies each of us should follow over the next couple of years in order to maintain the forward momentum that has been created by growth in the United States in the last 2 or 3 years.

Second—and that is, of course, the point that Senator Bradley has so eloquently addressed himself to, how do we safeguard the world trading environment. How do we continue the momentum of progress that has been created in the postwar period which has resulted in an increase in world output in little more than 20 years and a tremendous increase in the rate of world trade. How do we maintain the healthy, open collaborative world trading environment which has been a major engine of world growth and prosperity.

The frustrations with the huge trade deficit in the United States and the frustrations with the bilateral deficits with particular countries, including Japan, are creating an atmosphere of irrationality within the halls of this committee and throughout Congress. And I am sure you reflect the views of many American citizens who can't understand why we are losing American jobs to foreign competition at the rate at which we are, which is really a very, very serious matter.

The talk of import surcharge coming from Congress, which I gather has to be taken seriously, is a good example of the kind of irrational, in my judgment, counterproductive measures that are being discussed. The talk of moving away from most-favored-nation treatment and returning to a kind of bilateralism is another example. The same can be said of various forms of threats of retaliation urged against individual countries.

Clearly, what we must do above all, and what the leaders at the summit must do, is discuss ways of counteracting protectionism, or finding mutual constructive approaches to dealing with the very serious imbalances and disequilibrium in trade. We must protect an open trading system as a key element to world growth.

Third, clearly, is the related question of how to deal with the overvaluation of the dollar that has such serious consequences on our trade balance and, I would add, on the volatility in exchange rate movements recently. I think it was Mr. Fascell who commented on the fact that—I think you did, Mr. Chairman—that conditions were different a few years ago when I was in the Treasury. That is true. I don't know whether I should explain or remind you gentlemen that during that period, the dollar was seemingly in a free fall and was way undervalued.

Within a few short years, we have moved from one wide swing with the dollar excessively undervalued to another wide swing with the dollar excessively overvalued. Both of these extremes are very damaging. In addition, today, exchange rate values can change several percentage points in the span of a few hours which creates a great deal of uncertainty and therefore instability in exchange markets. This clearly demonstrates that there is work to be done in the exchange rate area, that the viewpoint that everything is really working quite well, that free-market forces can totally be dependent upon to keep things on an even keel is not the full answer.

So we have to deal with how to bring the dollar down gradually, because we don't want it to decline in value precipitously which would be very dangerous. And we have to review how, perhaps, the volatility in exchange rate markets, in currency markets, can be reduced.

Finally, the fourth issue is the issue of less developed country debt. I think it is encouraging that we have been able to stabilize the situation and that some of the countries have made, with the help of the commercial banking system and official agencies, some encouraging progress in this area. But clearly, as Senator Bradley has pointed out, there is work to be done. There are a great many fundamental problems that need to be worked out which will be more difficult to deal with than the immediate stabilization problem, and certainly will require the collaboration of the countries gathered at Bonn.

So, to sum up, the problems that I have cited are, of course, interrelated. They require close collaboration between the major countries and they relate to various, quite serious current disequilibria on the international scene. Disequilibrium on trade, disequilibrium on capital movements, and disequilibrium on currency. Correction is needed, but correction has to be done gradually while we maintain forward momentum and growth.

Now, what are the suggestions that I can offer for progress at Bonn? I think it is clear to everyone that the first and single most important issue, the key to any progress on dealing with any of these issues has to be a firm commitment by the United States for serious and immediate action to reduce the Federal budget deficit. Everything else is dependent, in my judgment, on the willingness of the United States to give a clear signal that we are going to take action on this matter.

What is required is not merely a deal on this year's budget. That is a good beginning, but that is only a beginning. What we require is a clear signal that there will be a multiyear effort involving a significant, steady reduction in the deficit down to where, at a maximum, it represents no more than 1½ or so percentage points of our GNP.

It is equally clear that the time is already overdue when that should have been done and, I say this advisedly, I think it is little short of a national disgrace that somehow we have been unable to deal with that problem. I am not here to point fingers; I am a private citizen; I am free to do that if I wish; but I am not going to do that. I think there is plenty of blame to go around.

I think what is urgently needed is for the President of the United States to accept the leadership responsibility and start moving. I can well understand that it is difficult for the Congress to move in the absence of Presidential leadership, but clearly the Congress also needs to act and needs to act now. The longer we wait, the more serious, difficult and painful the adjustment process is going to be.

It is time to stop talking and to start acting. I see nothing, nothing in the newspapers that gives me a great deal of confidence that anyone in Washington is really willing and ready to deal with the problem. You argue about how to cut $50 billion from the budget and meanwhile, what you have done is reduced the budget deficit from $200 billion-plus to $150 billion or so. That is still totally unacceptable. That will not cure the problem next year much less the following years.

So, it seems to me that unless in Bonn the President of the United States is willing to indicate clearly that he will lead the fight to reduce the deficit, I have some doubt about whether the other issues can be effectively addressed.

If action on the budget can be taken, then I think the United States is in a very strong position at Bonn to take the leadership for a range of other commitments from other countries that are the counterparts to budget action on our part. In the first place, it is clear that if budget action is taken, then there can be a gradual easing of monetary policy in the United States by the Federal Reserve. That will begin to bring interest rates down slowly.

The counterpart to that from the Europeans is that we should expect them not to take counterproductive action in monetary and fiscal policy. That is, not to tighten their fiscal policies as we tighten ours; and secondly, at the same time, not to liberalize, but to tighten, their monetary policies, as we liberalize ours. That would further promote a change in the relationship of real interest rates and result, hopefully, in a gradual reduction in the value of the dollar. This should eventually bring about a reduction in our unconscionable trade deficit which is costing so many American jobs.

Third, with regard to trade, we are in the moral position to take the lead and insist on starting another discussion on trade matters sometime next year.

It has been my experience that it is important to press for a specific starting date for the talks because otherwise nothing gets done. At the same time, I hope we won't be hung up on a particular month or a particular day because, clearly, the subject requires careful preparation. The GATT Ministerial meeting in 1982 indicates that without careful preparation there can be more damage done than benefit from calling a hasty meeting.

To go over the principal issues, I wish to add my voice to thank and commend Senator Bradley for the outstanding job that has been done in putting together this document "GATT Trade Policies for a Better Future" March, 1985 which is a very good blueprint for the kind of work that would have to be taken up in the context of another round of GATT talks.

Finally, the fourth issue on which the countries in Bonn should agree is, of course, the issue of dealing with LDC debt. As I have said, a good beginning has been made. It requires a continuing commitment to be cautious and intelligent about how we work with the developing countries to get their house in order.

The domestic economic situation in the western world is clearly the key. We must maintain an export market which is large enough to help provide the foreign exchange they need to service their debt. If we can do that, if we can keep the trading environment open, that will be the single most important step for these countries.

Second, we need to make sure that they continue their adjustment programs, but not at a level which damages their economies and destabilizes their political situations at home.

It seems to me that those are the four principal issues to be discussed at Bonn. They begin, and they stand or fall, on the issue of the budget deficit of the United States. If there is one message that I would like to get across to you and your colleagues, Mr. Chairman, it is my strong view that that is the case.

Thank you very much.

[Mr. Blumenthal's prepared statement follows:]

Prepared Statement of W. Michael Blumenthal, Chairman and Chief Executive Officer, Burroughs Corp.

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEES:

I appreciate the opportunity to appear before these two distinguished Committees of Congress in order to present my views on the forthcoming Bonn Economic Summit to be held May 2-4, 1985.

I am currently Chairman and Chief Executive Officer of the Burroughs Corporation, one of the world's major information systems companies, employing 65,000 persons in the United States and almost 100 countries around the world. My previous principal business association was with the Bendix Corporation. I was employed by Bendix for ten years and served as Chairman and Chief Executive Officer from 1972-1977.

My business career has been intermingled with two tours of duty in the federal government. In the period 1961-1967, I served as Deputy Assistant Secretary of State for Economic Affairs from 1961-1963, and as the President's Deputy Special Representative for Trade Negotiations from 1963-1967. In the latter assignment, I was the head of the United States Delegation to the Kennedy Round of trade talks in Geneva, Switzerland. My second and most recent federal government service was from January, 1977 until July, 1979 when I served as the 64th U.S. Secretary of the Treasury. During that period, I participated with President Carter in three Summit Meetings at London, Bonn and Tokyo respectively.

This morning, I would like to address two separate questions.

First, how important are Economic Summits? Should we expect these meetings of heads of government to reach major decisions? Or are Summits largely ceremonial affairs, long on pomp and circumstance but short on basic decisions of real substance?

Second, what are the critical issues confronting Summit participants? Are there opportunities for constructive progress toward common policies to promote growth with stability in world economic development for the years ahead? What positions should the United States take at Bonn?

SECTION II

Although I recognize that the past record has been mixed, I do not subscribe to the view that Summits do not matter. That was certainly not my experience in the period 1977-79, and I do not believe that it is the case today.

It is true that Summits rarely break new ground. Government Leaders meeting for a few hours once a year do not initiate major new policies, nor can they be expected to negotiate on difficult, often technical issues of great complexity.

That does not mean, however, that no useful purpose is served at the Summits. In my view, these annual gatherings of the seven heads of state are significant, if for no other reason than to dramatize the growing interdependence of the world's major economic powers. They underscore a present day reality, the implications of which are still insufficiently understood by policy makers and legislators around the world. This is that domestic economic policy making can no longer be carried out in isolation. If we do not work together, none of us can separately hope to achieve our domestic goal of healthy and stable economic growth.

This fact of life of growing economic interdependence has been with us for some time. Yet too many legislators in too many countries still have not fully accepted it or completely grasped its significance. Summits provide an opportunity to remind us what the reality is.

Since 1962, world GNP has grown seven and one-half times, but the volume of world trade has risen almost twice as fast. All countries, the U.S. included, have grown more dependent on the international exchange of goods and services. For the U.S., international trade as a share of our GNP has in fact about doubled in the last two decades.

Another index of our growing interdependence is the rapid increase of worldwide foreign investment from about $4 Billion in 1960 to $31 Billion in 1983. Greater diversification of the principal debtor and creditor nations has tied the countries together more closely then ever before.

As the U.S. has declined in importance as the world's major creditor nation, other countries such as Germany and Japan have increased their shares. Similarly, the principal debtor nations have changed over the last twenty years from the developed to the developing countries in Asia and Latin America, except, of course, for the U.S. which incredibly seems headed for principal debtor status as of 1985.

Increased foreign investment has meant more overseas production, which further ties countries together. For example, U.S. companies producing autos, chemical, tires, and farm equipment have recently joined companies in the electronics industry which have traditionally relied on overseas production to make goods not only for international markets but also for sale in the U.S.

Advances in technology have also had a dazzlying effect on international travel and communications, bringing nations into closer and more frequent contact. The Concorde and COMSAT are just a few of the tools that have helped make the world a smaller and smaller place.

Finally, along with these real effects of greater international economic involvement, a number of dramatic events since the 1970s have produced a heightened awareness of both international interdependence and its fragility. These include the poor harvests of 1972-1973, the oil price shocks of 1973-1974 and again in 1979-1980, and the LDC debt crisis which became apparent in 1982 and continues today.

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As individual actors in a global marketplace, with ever more closely interwoven relationships in trade, currency, finance and communications, none of us have remained fully independent masters of our separate economic fates. All countries are now tied together within a common fabric and collaboration is the key to the prosperity of all.
The Annual Summits, then, serve to symbolize the commitment of the world's major trading nations and their leaders to this collaborative effort. While the work should go on throughout the year, the Summit can be a focal point for a review of problems and prospects and for agreement on an agenda of issues to be resolved.

SECTION III

This year's Summit takes place at a time when the list of world economic problems looms unusually large and when the issues facing us are difficult and complex. More than ever, there is urgent need for clarity in understanding what needs to be done.

I see the problems as follows:

1. How to insure economic growth with stability for all.
   The latest statistics show a decided slow-down in the U.S. First quarter GNP growth has been less than 2% and Final Sales have been anemic. Possibly, therefore, the U.S. can no longer be counted on to continue as the motor force which has lifted all countries out of the deep recession of three years ago.

As the U.S. economy slows down, the whole world will follow unless the countries of Europe and Japan somehow take up the slack.

We need a careful consideration of the appropriate mix of monetary and fiscal policies in the various countries so as to leverage the effect of national efforts for maximum effectiveness in a world context.

2. <u>How to safeguard the open world trading environment of the post-war period against the rising risk of protectionism.</u>

The unprecedented postwar volume in world trade flows has doubtlessly been a major reason for growth of world prosperity. It is vital that all major trading nations remain committed to the maintenance of an open world trading system and to avoid a return to the discredited protectionist policies of the inter-war period.

More than twenty years ago; President Kennedy noted that increasing levels of world trade are akin to "a rising tide which lifts all the boats." That observation is as true today as it was then. Yet the threat of a return to protectionism has never been greater. In part, the reason lies in the present dangerously large disequilibrium in world trading patterns, as reflected in a U.S. trade deficit currently estimated to exceed $120 Billion in 1985.

Our bilateral trade deficit with Japan alone will reach an unprecedented $40 Billion this year. The mirror image of these deficits can be seen in the tremendously large surpluses of some of the world's other trading nations, principally Japan.

The Bonn Summit must urgently focus on ways to renew the commitment to open trade and to discuss ways of ameliorating the current disequilibrium in trade patterns.

3. <u>How to correct the present over-valuation of the U.S. dollar while exploring ways to reduce volatility in world currency movements.</u>

Even after the retreat from the highs of last February, the dollar remains heavily over-valued, perhaps by as much as 30% or more.

The dollar problem without question has been the major cause for our large and rising deficit on trade account. Its consequences for the U.S. economy are increasingly serious and involve a steady loss of jobs for industrial America. While heavy foreign inflows of funds have temporarily helped to finance our trade deficit and to reduce inflation in the U.S., this disequilibrium in worldwide trading patterns is clearly untenable over the medium and longer run.

As a consequence, the voices of protectionism are rising everywhere and threaten to disrupt the whole fabric of beneficial trading relationships built up between the U.S. and its trading partners over the entire post-war period. Moreover, once other countries become unwilling to continue to finance our trade deficit, the severe belt tightening which would have to occur in the U.S. could lead to a serious and sharp recession and to permanent damage to the U.S. and the world economy.

In addition, currency markets have become increasingly volatile and nervous as the disequilibrium in trade and currency markets has grown. Swings of several percentage points in currency values now occur regularly within a span of hours, injecting a bothersome element of uncertainty into the world economic scene.

There is considerable evidence that this increasing dissatisfaction in the markets is directly related to the disequilibrium in trade. It is understandable, therefore, that some of our trading partners are linking the issue of greater stability in exchange markets to the trade question.

4. How to find constructive solutions for the continuing serious problem of LDC debt without unduly harming the economic development needs of the LDCs on the one hand and protecting the world commercial banking system on the other.

Joint efforts by the world commercial banking system and by national and international financial government agencies have so far successfully contained the serious problem of the large LDC debt overhang which threatens world financial stability. With the help of the IMF, and much cooperation amongst commercial banks, the major LDC debtor nations have succeeded in stabilizing the immediate situation. And some countries have, in fact, made rather encouraging progress.

Nevertheless, the fundamental problem remains unresolved and will continue to call for close cooperation amongst developed countries and between the developed and developing world.

Measures to ensure stable and growing markets in the developed world are the best guarantee for a longer-run solution of the LDC debt problem. This issue should not be ignored at the upcoming Summit.

SECTION IV

There is considerable opportunity for dealing constructively with each of these four issues at the Bonn Summit, and it is my hope that President Reagan will take the lead in pointing the way.

Without a doubt, the single most important prerequisite for progress in all four areas is a commitment by the United States to take decisive and timely action to reduce our unconscionably bloated federal budget deficit.

What is required is for the President to pledge his Administration to a program of substantial deficit reduction over the next two to four years, leading to a deficit no greater than 1-1/2 to 2% of GNP.

In my view, the present Congressional effort to cut approximately $50 billion from this year's budget is no more than a welcome beginning. What is needed is agreement on a multi-year program to bring the deficit down to no more than $50-60 billion within three years.

I recognize that there is no dearth of ideas on how to achieve such a result, and I shall resist the temptation of suggesting my own preferred approach. I am persuaded, however, that for reasons of fairness as well as practicality, a rational analysis of the budget must lead to the inescapable conclusion that a multi-year deficit cutting program requires an equal sacrifice from all sectors except the very poor.

We need more cuts in defense and we need equal and balanced reductions in the growth in entitlement programs targeted for the middle-class. We need to find additional across-the-board cuts in spending in other government programs, and we will also have to find new sources of revenue. Everyone will have to compromise lest the present unacceptable stalemate in Congress continues for too long.

The message is clear: a commitment by the United States at Bonn to work toward the achievement of a major correction of the present untenable budget situation will go a long way toward ensuring a satisfactory Summit. As the budget deficit comes down, pressure on U.S. interest rates will gradually ease. And with a tighter fiscal policy, a somewhat easier approach to monetary policy by the Fed is to be expected. As real interest rates decline relative to other countries, we should then see a reduction in the flow of funds into the U.S., leading eventually to a gradual reduction in the value of the dollar.

That is my preferred scenario. It begins with a U.S. commitment to "bite the bullet" on the budget. At Bonn, we can ask our trading partners to make their own commitments for a contribution toward a return to a more stable world economic environment.

Europe and the Japanese should be asked to pick up the slack as the U.S. economy slows down and our fiscal policy remains tight. We should also ask for cooperation from our partners on the monetary front. As the U.S. eases the monetary reins, the others should be expected to tighten gradually. The resulting shift in interest rate levels will help to reduce the value of the dollar to more sustainable levels.

In that regard, I fully support the U.S. proposal that agreement be reached as soon as possible on a target date sometime next year for the opening of a new round of trade talks.

Experience has taught us that once the major trading nations are focused on preparing for a new round of trade negotiations, the pressure to resort to protectionism is bound to ease.

The opening of the date for trade talks should be set so as to permit careful preparation and prior exploration of all issues involved. We should be careful not to call for too early a date, lest lack of progress increase the possibility of a failure.

In the meantime, the Japanese government should be pressed hard to make a special commitment for interim measures designed to open its markets to more imports and to make a special contribution to the re-establishment of a better balance in world trade patterns. Our trade relationship with Japan is deteriorating rapidly; we cannot afford to wait until the opening of a new round of trade negotiations to begin dealing with this situation.

The recent indication by Secretary Baker of a U.S. willingness to consider hosting a meeting to explore new and better ways to limit excessive fluctuations in world currency markets is a welcome change in Administration policy.

I have a great deal of sympathy for the viewpoint that the excessive gyrations of the present system have not worked well. I, therefore, support the idea that a parallel effort to seek new forms of collaboration on currency matters should be undertaken as we prepare for a round of trade talks.

I would resist, however, a tight linkage of these two efforts lest we run the risk that no progress can be made on one issue before we have solved the other.

Finally, it would be my hope that the Bonn Summit include a reaffirmation of the commitment of the heads of government to work cooperatively with the developing world in finding solutions to their economic development needs. The debt problem will require continuing attention. Progress must be made while avoiding permanent damage to the growth needs of these countries.

It goes without saying that the most important means of enabling the LDCs to achieve stable growth and to service and reduce their foreign debt is to ensure the growth and stability of the developed countries economies. A program to eliminate the present disequilibrium in trade and payments, the commitment to continue an open world trading environment, and recognition of the need to cooperate in shaping national economic policies in a world context will go a long way to achieving this goal.

Mr. BONKER. Thank you, Mr. Secretary.

We will now hear from Alan Greenspan, formerly the Chairman of the Council on Economic Advisers in the Ford White House, if I recall, in the days when we probably did not have a trade deficit. He is now an economist with Townsend & Greenspan and continues to be a highly respected voice on financial and economic matters.

Mr. Greenspan, we are delighted that you are with us today.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I am delighted to be invited in such distinguished company and especially when I find so little to disagree with either Senator Bradley or Secretary Blumenthal.

I am, however, a bit of a skeptic on the possibilities of major success in Bonn. I doubt that we can effectively integrate major macroeconomic policies of sovereign nations. I am not sure, given the state of our knowledge, that we should try to do too much. This is not to say that summit meetings are of no value. On the contrary, I think that the ability of heads of government to periodically meet, exchange views on economic affairs, values, policy philosophies and the like, is a very valuable institution. It very specifically underscores the interrelationship that exists amongst our countries.

However, over the years, the belief in the ability to fine-tune our economies by modest calibrations and fiscal and monetary policies has undergone a significant revision. Economies, for example, react in a very complex way to large deficits generated by central governments. Furthermore, it is by no means clear that there are simple and invariant relationships between changes in money supply and economic activity. There has, accordingly, been a very considerable reduction in the degree of confidence in macroeconomic fine-tuning. This is especially true in Europe, where the old conventional wisdom would have dictated that double-digit unemployment rates require a massive attempt at fiscal and monetary expansion.

While we are showing a considerable and sensible reserve about the interface of macroeconomic policies on domestic economic activity, we seem nonetheless to have confidence in what are far more sophisticated and complex central relationships among the fiscal and monetary policies of individual nations. In truth, the international economic system is far more complex than its individual parts. The presumption that there are simple ways to generate subtle international financial shifts based on preagreed changes in the macropolicies of major countries is, in my judgment, not supported by solid evidence.

I am not saying that there are not economic goals that are mutually advanced by large numbers of major world powers to their mutual benefit. Certainly GATT reflects broad agreement that lowering of tariff and nontariff barriers does augment trade amongst nations and that the international division of labor enhances the mutual welfare of countries.

Exchange values are another question, however. It is difficult to determine whether a specific currency move is a function of a fundamental realignment which cannot readily be stemmed by currency intervention, either unilateral or mutally agreed upon, or whether it is a speculative aberration which could be and would best be suppressed.

This distinction is generally clear in retrospect, but it is rarely accessible at the time the exchange rates were moving. I have no doubt that in the summer of 1981, for example, as the dollar rose to 2.5 deutsche marks from a previous low of 1.7, many argued that this clearly was an aberration and that the Federal Reserve and the Deutsche Bundesbank should take steps to bring the exchange rates back into more sensible levels.

Massive intervention probably could not have successfully stopped the shift in the exchange alignment of these currencies, but the attempt would have generated other major problems. The Federal Reserve would have accumulated huge blocks of deutsche marks which would have had to be neutralized in the monetary base for fear of significant monetary instabilities in the United States.

The best we can do is probably what we are, in fact, endeavoring to do in today's environment; namely, to coordinate policies in a manner which does not throw a major country significantly out of line with the rest of its trading partners. Clearly, it would be a highly desirable state of affairs if we were capable of doing the type of subtle macroeconomic coordination that many believe possible a decade or more ago.

A great deal of work and effort has been engaged in trying to tie together the internal econometric models of different countries. I would scarcely argue that no useful information has been achieved from this exercise. On the contrary, I believe a good deal has been learned. Nonetheless, I would deny that these offer significant analytical regimes for knowing how a specific change in macropolicy in country A, for example, will affect countries B, C and D, et cetera.

We do know that high U.S. interest rates affect interest rates abroad and that capital moves back and forth accordingly. We suspect, with perhaps some degree of reasonableness, that a significant drop in interest rates in the United States will be paralleled by similar drops abroad. That, in turn, may do more for unemployment rates in Europe than most anything else which we can conceive.

Clearly, some actions which individual countries take affect other nations. At the same time, grandiose schemes which require fine tuning on the part of one country relative to another seem to press the state of our knowledge far beyond the reasonable. Therefore, they not only may not work, but could have unanticipated and potentially troublesome effects.

Moreover, the types of problems which we are likely to face are by no means clear. Two months ago, it appeared as though these would stem from a very strong dollar. Now we are not so sure. The international difficulties confronting us in the period ahead may well reflect a weaking, rather than a strengthening dollar.

Since we have no historical experience against which to measure the extraordinary strength of the dollar, there is no set of criteria to determine its peaking on the basis of historical analogies. Nonetheless, there are a number of compelling reasons for thinking that the dollar is probably close to its peak if it has not already topped out. The only analytical problem is that a year ago, many of the same forces implying a weaker dollar seemed to be emerging, yet the dollar continued higher for a goodly number of months thereafter.

While we cannot say for certain that the markets have peaked, nonetheless, we can say with a reasonable degree of confidence, that the process which the dollar is currently going through—specifically the associated capital flows—suggests that at some point in the not terribly distant future, international economic policy will have to confront a falling dollar and its consequences.

Mr. Chairman, in my testimony, I go through a number of technical issues which suggest why basic capital flows will continue and will eventually glut the markets. That will, in turn, bring down the dollar in the exchange market.

It is very difficult to say where the saturation point is in foreign investment in the United States. Now that nearly 900 billion are held on foreign account, the rate of increase in such portfolios does not seem likely to accelerate. It does seem reasonable to expect that even though there appears to be no diminution in confidence in the American dollar as an ideal safe haven, as well as the area which is perceived to provide the highest rate of return, the glutting of balance sheets suggests that the need for further increases in dollar-denominated securities as a safe haven seems to have run its course.

If so, the rally we are now experiencing in the dollar's exchange rate in foreign exchange markets is merely a technical reaction of what is overall a bear market.

After an appropriate time delay, a weakened dollar and softer U.S. economic performance is likely to shift a number of the problems which are currently confronting us into reverse gear. Japan and Europe are going to find it more difficult to profitably ship goods to the United States. Presumably protectionist pressures in the United States will then begin to wane. As our trade deficit shrinks, as it inevitably would, the absorption of foreign savings by U.S. credit markets will decline in tandem.

Unless we expect U.S. interest rates to be significantly lower, which seems to me unlikely, the credit problems of the less-developed nations probably will intensify again. As trade surpluses shrink in the developing nations, especially Latin America, the dollar earnings required to pay service charges on the debt will decline.

In short, the agenda for the 1986 summit may well look a good deal different from the one now currently on the table.

Thank you.

[Mr. Greenspan's prepared statement follows:]

PREPARED STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Over the years the belief in the ability to fine-tune our economies by modest calibrations in fiscal and monetary policies has undergone a significant revision. Economies react in a very complex way to large deficits generated by central governments. Furthermore, it is by no means clear that there are simple and invariant relationships between changes in money supply and economic activity. There has, accordingly, been a very considerable reduction in the degree of confidence in macroeconomic fine tuning. This is especially true in Europe where the old conventional wisdom would have dictated that double digit unemployment rates require a massive attempt at fiscal and monetary expansion.

While we are showing a considerable and sensible reserve about the interface of macroeconomic policies on domestic economic activity, we seem, nonetheless, to have confidence in what are far more sophisticated and complex interrelationships among the fiscal and monetary policies of individual sovereign nations. In truth, the international economic system is far more complex than its individual parts. The presumption that there are simple ways to generate subtle international financial shifts based on preagreed changes in the macro policies of major countries is, in my judgement, not supported by solid evidence.

I am not saying that there are not economic goals that can be mutually advanced by large numbers of major world powers to their mutual benefit. Certainly GATT reflects broad agreement that lowering of tariff and nontariff barriers does augment trade amongst nations, and that the international division of labor enhances the mutual welfare of countries.

Exchange values are another question, however. It is difficult to determine whether a specific currency move is a function of a fundamental realignment which cannot readily be stemmed by currency interventions, either unilateral or mutually agreed upon, or whether it is a speculative aberration which could be, and would best be, supressed. This distinction is generally clear in retrospect, but is not always assessible at the time the exchange rates are moving. I have no doubt that in the summer of 1981, for example, as the dollar rose to 2.5 deutsche marks from a previous low of 1.7, many argued that this clearly was an aberration and that the Federal Reserve and the Deutsche Bundesbank should take steps to bring the exchange rates back to more sensible levels. Massive intervention probably could not have successfully stopped the shift in the exchange alignment of these currencies, but the attempt would have generated other major problems. The Federal Reserve would have accumulated huge blocks of deutsche marks which would have had to be neutralized in the monetary base.

The best we can do is probably what we are, in fact, endeavoring to do in today's environment, namely, to coordinate policies in a manner which does not throw a major country significantly out of line with the rest of its trading partners.

Clearly, it would be a highly desirable state of affairs if we were capable of doing the type of subtle macroeconomic coordination that many believed possible a decade or more ago. A great deal of work and effort has been engaged in trying to tie together the internal econometric models of different countries. I would scarcely argue that no useful information has been achieved from this exercise. On the contrary, I believe a good deal has been learned. Nonetheless, I would deny that these offer significant analytical regimens for knowing how a specified change in macroeconomic policy in country A will affect countries B, C, D, etc.

We know that high U.S. interest rates affect interest rates abroad, and that capital moves back and forth accordingly. We suspect, with perhaps some degree of reasonableness, that a significant drop in interest rates in the United States will be paralleled by similar drops abroad; that, in turn, may do more for unemployment rates in Europe than most anything else which we can conceive. Clearly, some actions which individual countries take affects other nations. At the same time, grandiose schemes which require fine tuning on the part of one country relative to another seem to press the state of our knowledge far beyond the reasonable. Therefore, they not only may not work, but could have unanticipated, and potentially troublesome, effects.

Moreover, the types of problems which we are likely to face are by no means clear. Two months ago it appeared as though these would stem from a very strong dollar. Now we are not so sure. The international difficulties confronting us in the period ahead may well reflect a weakening, rather than a strengthening, dollar.

Since we have no historical experience against which to measure the extraordinary strength of the dollar, there is no set of criteria to determine its peaking on the basis of historical analogies. Nonetheless, there are a number of compelling reasons for thinking that the dollar is probably close to its peak, if it has not already topped out. The only analytical problem is that a year ago many of the same forces implying a weaker dollar seemed to be emerging, yet the dollar continued higher for a goodly number of months thereafter. While we cannot say for certain that the markets have peaked, nonetheless, we can say with a reasonable degree of confidence that the process which the dollar is currently going through, specifically the associated capital flows, suggests that at some point in the not terribly distant future international economic policy will have to confront a falling dollar and its consequences.

We know in principle that if that the sole use of the dollar were for transaction purposes, that is, the purchases of goods and services across borders, the value of the dollar vis-a-vis other currencies would tend to gravitate toward what economists call purchasing power parities (the exchange rates of the dollar vis-a-vis other currencies which would enable a purchaser to buy equal quantities of goods and services for the same amount of dollars, whether those goods were purchased in the United States or in other countries).

While our price data are somewhat less than adequate for precise calculations, at its peak earlier this year, the dollar probably was trading about 30%-40% over its purchasing power parities. The reason was an ongoing, and in recent years an increasing, demand for dollars for investment purposes. In short, the accumulation of dollars in international currency portfolios, including dollar denominated securities, created a sufficient secondary demand for dollars to lift the exchange rate and hold it significantly above what the dollar could purchase in terms of goods and services.

There is no question that a major part of this demand for dollars reflected the fact that for much of the last several years interest rates on dollar denominated securities, in both real and nominal terms, were increasing relative to those for competing currencies. Nonetheless, it is fairly clear that one cannot explain all of the rise, perhaps not even more than half of the rise, in terms of desired improved rates of return. Much of the accumulation in dollars and, hence, the rise in the exchange rate, has reflected the strong demand for dollars for what we call a safe haven. This reflects the desire to put capital into dollars, not for greater return, but for preservation of principal.

It is very difficult to know when such a major movement of capital can end, that is, when there is a satiation of demand for safe havens. Nonetheless, we can at least measure the capital flows which are pushing the dollar higher and estimate when their rate of accumulation is likely to cease. In 1981 and 1982, significant shifts into U.S. dollars was evident in the Eurocurrency market, clearly a major factor pressing the exchange rate higher. Since 1983, however, while the share of U.S. dollars to overall holdings in the Eurocurrency market has risen when denominated in dollars, it is wholly the result of the rise in the dollar and the consequent deflation of nondollar holdings when expressed in dollars. When Eurocurrency holdings are weighted in terms of fixed exchange rates as of 1977, net holdings of dollars have actually shrunk as a share of total outstandings.

Hence, the apparent major thrust into U.S. dollars has occurred as a consequence of accumulation of investments in the United States net of U.S. investments abroad. There was a fairly rapid buildup in the rate of flow into the United States on the gross basis, led by large direct investments by foreigners and purchases by them of U.S. securities. Adjusting for the major shift toward International Banking Facilities in 1982, the rate of increase of U.S. assets denominated in dollars has slowed. There is some evidence that the rate of accumulation is now peaking. Since it is the rate of gross flow into a currency, as distinct from the aggregate level of holdings, which determines the exchange rate premiums over purchasing power parity, the slowed pace of investments into the United States should be removing some of the upward pressure on the dollar's exchange rate.

The slowdown in the demand for dollars is apparently coming mainly from a slowing in the rate of investments abroad by U.S. residents. The lessened rate of direct, portfolio and loan investments abroad has lessened the demand for foreign currencies in terms of dollars. Accordingly, it has reduced the downward pressure which such outflows of dollars have on the U.S. dollar's exchange rate. While direct investment abroad has slowed, of far more importance is the decline in loan growth of U.S. banks on foreign account.

Obviously, not all of this lending requires direct purchase of foreign currencies. Part merely reflects the borrowing of dollars which are immediately used to pay for U.S. goods, without actual exchange rate effects. A goodly portion, however, is converted into domestic currencies for purposes of meeting financing requirements on internal projects.

Putting all of the various pressures together suggests that the aggregate amount of flows have affected international financial portfolios in a way which makes it rather difficult for increasing rates of further accumulation to occur without glutting the balance sheets of those who are major purchasers of dollar denominated securities and investments. Further reductions, or liquidations, in the outstanding U.S. investments abroad do not appear likely. Consequently, the upward push on the dollar resulting from the decline in net lending abroad is probably close to its end. Similarly, a resurrection of increased demand for dollars in the Eurocurrency market does not seem to be pending, especially now that total holdings of dollars represent 80% of the aggregate. Even though there has not been, on net balance, accumulations of dollars in the last couple of years, the rising exchange rate has increased the dollar value of portfolios; hence, has increased the saturation of dollars in that market.

It is very difficult to say where the saturation point is in foreign investment in the United States. Now that nearly $900 billion are held on foreign account, the rate of increase in such portfolios does not seem likely to accelerate. It seems reasonable to expect that even though there appears to be no diminution in confidence in the American dollar as the ideal safe haven, as well as the area which is perceived to provide the highest rate of return, the glutting of balance sheets suggests that the need for further increases in dollar denominated securities as a safe haven seems to have run its course. If so, the rally we are now experiencing in the dollar's exchange rate in foreign exchange markets is merely a technical reaction of what is, overall, a bear market.

After an appropriate time delay, a weakened dollar and softer U.S. economic performance is likely to shift a number of the problems which we are currently confronting into reverse gear. Japan and Europe are going to find it more difficult to profitably ship goods to the United States. Presumably, protectionist pressures in the United States will then begin to wane. As our trade deficit shrinks, the absorption of foreign savings by U.S. credit markets will decline in tandum. Unless we expect U.S. interest rates to be significantly lower, which seems to me unlikely, the credit problems of the less developed nations probably will intensify again. As trade surpluses shrink in the developing nations, especially Latin America, the dollar earnings required to pay service charges on the debt will decline.

In short, the agenda for the 1986 Summit may well look a good deal different from the one now currently on the table.

Mr. BONKER. Thank you, Mr. Greenspan.

A TRADE ROUND AND/OR A MONETARY CONFERENCE

Senator Bradley, you served as a member of this distinguished, international panel that was established by the Secretary General of GATT to study and report on the problems facing our global trading system. The report states, "it is a strong, unequivocal endorsement of the economic benefits of free trade." And among other things, you have called for a new round of GATT negotiations. It is not terribly surprising since many members of GATT also support a new round.

But now the issue of a new GATT round takes on a political dimension in the upcoming summit meeting since the Reagan administration has stated that a new round of trade negotiations is high on the priority list. President Mitterand, on the other hand, who is quoted in today's Washington Post, wants to link talks on trade negotiations with international monetary reform. He says that "if currency negotiations are refused, then I say it is not possible to accept this negotiation on trade matters." Secretary of Treasury, of course, has rejected this notion saying that we ought to address only global trading problems or trade distortions.

Your colleagues in the Senate, a few weeks ago, held a press conference in which they stated that international monetary reform ought to be first on the list and that trade negotiations, particularly multilaterally through GATT, will not deal with the immediate trade problems that face the United States.

I wonder whether you feel that these issues are mutually exclusive; that the summit meeting ought to address one and not the other, or whether it is possible to take up both issues and put them on parallel tracks?

Senator BRADLEY. Mr. Chairman, as I hear what Mr. Mitterand is saying, I tend to believe we ought to call his bluff. And my sense is he really doesn't want the new trade round. The French are notoriously protectionist, and so he takes the pretext of an overvalued dollar, chaos in monetary movements, and volatile exchange rates to say, well, we can't talk about trade barriers until we essentially have a new Brenton Woods.

Now just in practical terms, we have some precedent for trade rounds that have produced success. Mr. Blumenthal clearly has been active in one of those rounds. We have had only one Brenton Woods. And then we had a kind of convening in a crisis in 1971 when we went to floating exchange rates. There is, in my view, no reason why these things can't proceed simultaneously.

However, even though the attitude now is that the present trade round has not been prepared adequately, I think that it would move much faster than would an ultimate agreement on some new world monetary system, not to say we shouldn't move toward it. There are plenty of things to discuss, but in this summit, if I were the administration, I would call Mitterand's bluff and say, "Fine, let's talk about both. Are you ready to go to the table and talk about trade? We will talk about some monetary reform simultaneously."

Mr. BONKER. His invitation was that we should talk about both and that we shouldn't exclude a monetary policy in favor of exclusive talks on trade negotiations. So, you would support the notion that we should address both issues?

Senator BRADLEY. I would certainly support the notion that we should address both issues, but I am trying to convey to you that I think that he spoke with the belief that we wouldn't go along with the monetary negotiations, and therefore he would never have to get serious on a new round of trade negotiations. That is my personal view.

Mr. BONKER. Chairman Fascell.

Chairman FASCELL. Thank you very much, Mr. Chairman.

U.S. BUDGET DEFICIT

Gentlemen, I find very little to disagree with the discussion here. I want to predicate what I am saying here, not with purposes of starting a new debate, but simply to lay a phenomenon on the table.

The U.S. deficit has been politicized and has caused polarization in this country on economic theory. And the difficulty was exacerbated, at least in my opinion, by the fact that we took $750 billion out of revenue before we got a handle on expenditures. And that was a determined step as part of an economic theory. We find that the administration is having difficulty within its own party reaching an agreement and getting a handle on the deficit that went from a $60 billion high to a $200 billion high.

It became obvious that something had to be done with the deficit. We finally got an agreement with respect to a deficit reduction package of $80 billion over a period of 3 years, which is like shoveling sand against the tide. But it was an effort. Now, because the chairman of the Federal Reserve Board says the monetary markets need some kind of a symbol, we have reached into thin air and grabbed the figure $50 billion as a deficit reduction on a $200 billion deficit extended out through 3 or 4 years. And again, I think it is a fine symbolic move, but I agree with the former Secretary of the Treasury that we are just shoveling sand against the tide even if we reached an agreement on that package.

And it might be a good symbol. I don't know what the reaction will be. Mr. Volcker thinks it will settle things down. But I don't see that the United States is prepared to go into this summit conference. And this is what I am getting at. If we don't have an agreed upon agenda, this summit will meet to decide what the agenda is going to be. And we will be lucky to come out with an agreement that the next summit meeting will have something to discuss.

How does it appear to you? Do we have a definite agenda? Will any country agree to a position that the United States is taking going in?

Mr. BLUMENTHAL. Well, Mr. Fascell, I would like to make two comments. One, I would like to remind the members of the committee that about 2½ years ago five former Secretaries of the Treasury and one former Secretary of Commerce, three Democrats and three Republicans, put together a statement which said that the deficit problem was urgent. We suggested a multiyear program to cut taking $150 billion from the budget. Contributions would come from Defense, entitlement spending targeted to the middle class—I know that is tough, but it has to be done because otherwise nothing will work—and other kinds of spending as well as $50 million in additional sources of revenue. I know the latter is very unpalatable, but it also has to be done because otherwise the numbers just don't hang together.

That is the package. If we had implemented it, then by the fourth year, we would be saving $40 or $50 billion in interest on the debt. That type of package is what is required. And sooner or later we are going to have to do it.

That is what I mean when I say that cutting $50 billion here or $30 billion there doesn't solve the problem. Unless you show the markets—and I'm sure Mr. Volcker would agree with this that you are committed to a path to correct the fundamental problem, they are going to shrug their shoulders and say, "That isn't enough." And that's really what needs to be done, and the sooner it is done, the better.

Now with regard to Bonn, I think that nobody wants to leave with a failure. Therefore, they will agree on a communique, which has probably already been drafted. And the draft may have only a few bracketed phrases left in it or it may have been worked out entirely. I don't know.

A TRADE ROUND AND A MONETARY CONFERENCE

And that communique clearly will make a bow in the direction of the budget deficit. And I am sure the President will say something that sounds good. And in turn, there will be, I think, some agreement on working together to maintain an open trading system. The question is whether they will agree on a starting date for a new round of trade talks, or whether they will just agree on the need for trade negotiations.

I agree with Senator Bradley that the French position is a traditional one. They always look for linkages, for tying something to something else so that nothing happens on trade. And their hope is that nothing happens on trade. The main thing that we have to be careful of is that we don't agree to a position where we are committed not to sign anything on trade unless something is signed on monetary reform.

As long as we agree to go forward on two separate tracks in parallel, that there is no linkage between the two, we are OK. So I think at this point, we could probably agree there is a chance that they will agree to the notion that we move in both directions. On the one hand, we go forward with the preparations for the trade talks or we set a date sometime next year. And now that Secretary Baker has said the United States is willing to consider the issue of reform in the monetary area, we can use that position to call the bluff of the French as Senator Bradley has suggested.

Mr. BONKER. Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

A NEW TRADE ROUND?

Senator Bradley, on Thursday or Friday your Democrat colleagues in the Senate said that they were opposed to a new round of trade negotiations. How do you feel about that?

Senator BRADLEY. I don't think that they said they were opposed to a new round of trade negotiations. They said they wanted a new round of trade negotiations to be adequately prepared and that they felt that when you confronted the issue of the $120 billion trade deficit, the value of the dollar was as important as any particular trade impediment or lack thereof.

And I think that the purpose of the statement was to indicate clearly that in the trade area, the most pressing action that has to be taken is to get the value of the dollar down so that our exports would be more competitive and so that our imports would—so that we wouldn't have our markets flooded with imports. That was the purpose of the statement.

So I don't think that they said" no new trade round." It is my view that the purpose of the trade round, obviously, is to increase world trade overall. It is to promote a rising standard of living. That is a kind of theoretical purpose. But if you want a more open trading system, frequently the only time in our present political circumstance that you are able to martial those people who want an open trading system is when they have something to gain—which is during a trade negotiations.

If there is no trade negotiation going on, only those people who lose from open trade are speaking up. So I would support a new round of trade negotiations. I have stated that. I think it should be adequately prepared, and I think that you can also move on actions to get the value of the dollar down simultaneously.

BIPARTISAN COMMISSION ON THE DEFICIT?

Mr. ROTH. I would like to dove-tail my next question to what the chairman mentioned about the politicization deficits. I would like to ask Mr. Blumenthal and Mr. Greenspan, why don't we set up a bipartisan Commission like we did with Social Security. Would that solve our problem? Because, quite frankly, having served on the

Hill for 6 years and seeing this issue paddled back and forth like a ping pong ball, I don't think we are getting anywhere.

The President just gave what I though was a magnificent speech. He asked the American people to call their Congressmen and to call their Senators. I haven't had a single call. And I am sure that that is probably the case with many other Members.

Mr. BONKER. Maybe that is because they know where you stand.

Mr. ROTH. Maybe so, but I would like to ask either of you your opinion on a bipartisan commission.

Mr. BLUMENTHAL. I would be glad to answer, but I think Mr. Greenspan served on one of those commissions. Didn't you?

Mr. GREENSPAN. I suspect that that may be the only way of resolving this question, because there is something quite different about the type of problem which we currently have, different in a very fundamental way than I think has confronted the Congress in the past. It essentially requires that in our political system we find a way for repossessing benefits previously bestowed to constituents and/or raising taxes, none of which is the type of thing which, politcally, is very easy to do.

And what we learned in the Social Security Commission, in fact, what we have learned in all of the processes of recent years, that it is only in a final negotiation where in effect various different political albatrosses are sort of traded one group against another, that we have any capacity to strike a deal which cuts the deficit.

The Social Security experience, I think, is a microcosm of a much larger issue. It told us a great deal. Specificallly, you may recall that both this House and the Senate voted overwhelmingly, as the sense of the Congress against taxing Social Security benefits. When an agreement was finally reached in which that was reluctantly a significant part of the solution, there was virtually no opposition in either House. And the reason there wasn't is there is a general recognition that you cannot vote up or down on a whole series of individual items which contribute to the deficit.

You have to have a bipartisan agreement beforehand in which all of the difficulties are worked out, and the leadership of both Houses with the President comes to an agreement on a specific budget which they are willing to support in total. Were that to come to pass, we would in fact resolve this budget deficit problem. I doubt if that doesn't come to pass, that we have any way of coming to grips with this issue. There is no way to reduce the budget deficit by voting in both Houses line by line, up or down on whether any cuts are made or taxes are increased.

We have got to do something on a much broader bipartisan basis. I am facetiously sponsoring the resurrection of the smoke-filled room because it strikes me that the principal which we looked upon with disdain in those earlier years, actually was an integral part of our democratic process which was far more important than I think we realized.

Mr. BONKER. Mr. Blumenthal?

Mr. BLUMENTHAL. Well, I agree with what Mr. Greenspan has said. I do think that this is a very much more complicated issue than even the Social Security issue. And I think—there is no question that there has to be a bipartisan deal struck. But the deal has to be struck within the Government and include not only the legislative, but also the executive branch.

I am not totally sure that the addition of private members to work out that kind of a deal where there is so much complexity, so many individual issues that have to be tied together, would do a great deal.

Then I think Mr. Greenspan is right that you have to present it as a package, tie it up as a package, and vote on it as a package so that in fact people can't pick it apart, or that the temptation to pick it apart, is resisted.

Let me tell you about one experience we had. When the six secretaries—now, incidentally, that suggestion by the six secretaries was signed by hundreds of businessmen, economists, and academic people of both parties—marched around here in Washington to try to get support for our program, we found that we were well-received by Democrats and Republicans in both Houses.

We got a lot of indication from the leadership that this was the kind of package that they could support, and they were serious. And they kept asking us whether we had gotten a similar indication from the other side of town. But we had to confess to them that though we were a bipartisan group with a lot of experience between us, we had managed to get as far as one of the President's assistants; that there had been no interest on the part of the White House to even receive us or to consider this because it contained a suggestion that there might be some cuts somewhat deeper on defense than had been planned and because there was a suggestion that additional sources of revenue might have to be found.

Of course, there was also the suggestion that there ought to be a lot of spending cuts. Because of that, we never got through the front door. I am saying that a package deal really has to involve a commitment by the executive branch as well as the legislative branch to come together on a deal and put it across.

Mr. ROTH. Thank you very much, Mr. Chairman.

Mr. HAMILTON. I want to thank the panelists for a stimulating morning. I agree with your observations about the package deal. And I agree with Mr. Greenspan's observations about the necessity of a commission. The President keeps repeating over and over again, however, that he will not accept any kind of a tax increase, and so long as that is the case, it doesn't seem to me that politically it is at all feasible to put together the kind of a package you are now talking about.

We are all practical politicians around here and we recognize what can be done and what cannot be done. And it can't be done at the present time. I think your solution is a good one. I'd vote for it today with a modest tax increase and sharp reductions in spending.

IMPLICATIONS OF CONTINUED LARGE BUDGET DEFICITS

Now I suppose we can't put it together. And I don't want to be too pessimistic here, but let's follow it through for a moment. Suppose the U.S. Congress and the President cannot agree on an effective package for the multiyear period that you suggest in your statement, what are the implications then of that for the world economy, for trade, for the United States?

You see, one of the problems that you have as a politician out here is persuading people that these big deficits hurt. Not everybody thinks they do. And I get the argument a lot in Indiana, that if it ain't broke; you don't fix it.

Mr. GREENSPAN. Well, Mr. Hamilton, let me take a shot at this. The difficulty, unfortunately, is that if we wait until it is broke, it is going to be very difficult to fix.

What we do know is that the current deficit is absorbing a very large chunk of U.S. savings, but it has been significantly offset by a major flow of foreign savings into the U.S. credit markets, and that $100 billion annual rate is—depending on how one measures it—20 to 25 percent of the net savings of our total system, starting from scratch, from zero as recently as 4 or 5 years ago.

The flow of funds into the United States is initiated from abroad. Indeed, that is the cause of the very strong dollar. There seems, however, to be a limit to how far that can go and we may very well have reached it. And when the propensity of foreigners to purchase U.S. dollars for investment reaches its peak rate of accumulation, the upward pressure on the dollar will cease. They arrive at a point when their balance sheets of internationally mobile currencies are filled with dollars to the extent that they would like them to be.

At that point they stop the purchase of dollars, which is no indication of their saying the dollar is not a good investment. At that point, the flows into the United States fall sharply, as indeed the exchange rate would fall as well. And the offset to the very heavy borrowings of the U.S. Treasury is lost. At that point we begin to get very significant pressures within the U.S. credit markets. It is very difficult to know when that is. There is a possibility that we could go on for 2 or 3 years.

Mr. HAMILTON. What are the implications of it?

Mr. GREENSPAN. The implications are, a significant rise in U.S. interest rates and/or a significant acceleration of inflation, major problems in the U.S. economy so far as economic growth is concerned, difficulties on the part of foreign economies who are using the United States as a major export market for them, and the transmission of the inflationary pressures from the United States to foreign account even though the dollar is falling. And to the extent that we have seen unquestioned buoyancy in the world economy as a consequence of the U.S. strength, I would think we will begin to see the reverse.

So, while I am not a great advocate of major international negotiations to get fiscal and monetary policies joined, I certainly agree with what has been said today, especially by Secretary Blumenthal, that the most important international economic policy that all nations can implement is to get the U.S. Federal deficit down.

It is a very major issue. Unless and until we do that, we have an economic outlook in the longer term which is less than favorable. And to the extent that we are in that position, clearly the rest of the world will be influenced significantly.

Mr. ROTH. Mr. Hamilton, I wonder if you would yield for 1 second?

Mr. HAMILTON. Yes.

Mr. ROTH. Thank you.

I agree strongly with the views you have expressed, but when I have made these arguments to some people, they say: "Look, we've heard these dire predictions before; they've never come true; why are they going to come true now?"

How do you rely to that contention, Mr. Greemspan?

Mr. GREENSPAN. It is certainly the case that there have been a number of people who have been forecasting so-called crowding out prematurely. There have been innumerable cases where, in order to emphasize the deficit, there has been a tendency to make statements which I think were stronger than in fact the evidence warranted.

The problem, unfortunately, is that what is involved here is an arithmetic set of relationships which are inexorable. What we don't know for certain and even now don't know for certain is the timeframe in which that arithmetic inevitably takes place.

If somebody were to say that the crowding out effect will happen in 2 years and you wait 2 years and it doesn't happen, that does not mean that therefore nothing will happen. There is no way to get around the arithmetic. If it doesn't happen tomorrow, it will happen the next day. And if it doesn't happen the next day, it will happen the day after.

It is not an issue of whether. It is only an issue of when. And it is true that the when part of this forecast is not something we are strongly in control of.

EXPLAINING THE IMPLICATIONS OF LARGE DEFICITS TO CONSTITUENTS

Senator BRADLEY. Mr. Hamilton, if I could, I think that both of you wouldn't dispute this analysis. Your problem is how to communicate it to your constituents when you don't want to be the bearer of bad news. You want to be the Congressman who is positive and looks to the future and not Chicken Little saying the sky is going to fall tomorrow.

It seems to me that therefore you have to be able to point to the detrimental impact of the budget deficit on their lives today. A possibility is to point out to them that last year in order to finance this budget deficit we borrowed $100 billion from foreigners. Establish that fact. Underline foreigners. Then ask, did any of you pay taxes? Some of them did. Most of them did. Hard-working people paid their taxes.

Where was the first place that those tax dollars went? It wasn't to build the national defense. It wasn't for education or environmental cleanup. The first place the tax dollars went was to pay interest to wealthy foreigners who take that interest, invest it in their plants whose exports over here, take jobs.

Now, the spin on that ball is a little different than the one that you have been serving probably. There are some substantive problems in that argument. But it makes the point clearly to people who are listening that the cost of this trade deficit is immediate, and it deals with where their tax dollars go. If the deficit were more in balance, their dollars would go to finance defense and education, not to make foreigners who loan us money wealthier.

Mr. BLUMENTHAL. Far be it from me to compete with Senator Bradley in debating with you how best to put something in political terms that appeals to your constituencies, but I want to make this observation.

I am a bit surprised that you say it is still difficult to explain that issue to your constituents. I was at a very, very——

Mr. HAMILTON. I am continually trying to explain the urgency of addressing the deficit.

Mr. BLUMENTHAL. My experience is a little different. What you say is true because the deficit is a very esoteric subject to most people. Last Sunday, I was at home in Detroit in a place called Cobo Hall, having dinner, believe it or not, with 7,200 other people. It was the largest dinner I have ever attended. Our speaker was Lee Iacocca, who was pretty good at excoriating all and sundry on trade matters, which he did very effectively, excoriating all of you for not taking care of the budget and allowing this trade deficit to get so large.

He pointed out in the course of his speech——

Mr. HAMILTON. That we bailed him out?

Mr. BLUMENTHAL. He acknowledges that, but he takes credit for a lot of good things. He's a good fellow.

I want to make this point. He pointed out that he had just been to Japan to talk to Mitsubishi Motors about importing more automobiles to the United States. The reason was the overvalved dollar, which is the result of the budget deficit and results in the trade deficit. When he said this, nobody in that hall did not understand what more imports meant to them and to the security of their jobs with Chrysler or Ford or General Motors. Now, that same argument can be made in your State of Indiana, where clearly there are machine tool operations and other manufacturing operations. I used to work for a company that had lots of operations in South Bend, IN which are closing down or have closed down, partly for the same reasons.

You can relate the budget deficit to the loss of jobs and the overvalued dollar. And I have a sense that people do begin to understand that increasingly.

Mr. HAMILTON. Thank you, Mr. Chairman. I got good economic and political advice. I appreciate it very much.

BUDGET REDUCTION AND THE INFLOW OF FOREIGN CAPITAL

Mr. LAGOMARSINO. Mr. Greenspan, we talk about crowding out, and you all talk about the millions of dollars that are coming from foreign sources. It is kind of an interesting situation, though. If the interest rates were to go down, we were successful in starting on a budget reduction package, and the financial markets here responded in a way we hope they will, and I think they will, what would happen then with regard to this inflow of capital from other countries?

Mr. GREENSPAN. Well, I must admit I don't fully agree with the proposal that, if the budget deficit is brought down, that therefore the flow from abroad will slow down. I think it is a more complex problem, as I see it, in the sense that there are two issues involved in the inflow of capital. One is indeed an attraction of high interest rates, which do unquestionably reflect our budget deficit.

The other is the perception of the United States as a safe haven, which essentially is a view that this is the ideal place to invest money for the preservation of principal, not so much higher interest rates.

While undoubtedly there would be a significant easing in the event that interest rates fell in the demand for dollars for investment and that in turn would weaken the dollar and affect the trade deficit, it is by no means clear that a resolution of our budget deficit problem may not make this country a better safe haven. So, there are two conflicting forces. I am not certain which way they come out.

BUDGET DEFICIT, EXCHANGE RATES, AND TRADE BALANCE

Consequently, I would argue that the deficit is a very dangerous thing. Our Federal deficit is a very dangerous thing for the long-term stability of this country and for the rest of the world. I would not like to hang that issue very specifically on the issue of the short-term movement of the exchange rate.

I think that the reasons to reduce the deficit are sufficiently compelling that it should be done. I would hate to have it be because our purpose is to bring the trade deficit down. I am fearful that we may go through a huge budget deficit reduction with very positive impact on the United States and not get the type of response in the trade area that we want and therefore would assume that we made a mistake. I would not like that to happen.

Mr. LAGOMARSINO. That is a very good point. There are a lot of other factors obviously involved in the trade deficit. Not all are related to the deficit here, and certainly not all related to the value of the dollar. Other countries have developed in the last 40 years, since the end of World War II. They are good. We are the best, I think, but we are not that much better than some of the rest of them. They have good products. They have good services. As Senator Bradley pointed out, they work at it very hard, harder than we do, I think.

Senator BRADLEY. Could I respond to that question briefly? And, Mr. Chairman, would it be permissible, I have to get back to the other side. Thank you, Mr. Chairman.

I would like to address, if I could, what Mr. Greenspan says happens if you do get a decline in the dollar and the trade deficit doesn't go down. That leads to the other things that we must be thinking about, if we are to be a country that continues to embrace change. Now, you know, we might have come to a saturation point where multilateralism is over and you're going to put barriers up. That means that, if you go that route, you have to buy all of the implications, which would mean less opportunity for your children; that's basically what it means.

If we are going to accommodate change, it is my argument that we have to have a policy that addresses the concerns of those workers who are going to lose their job in this process. And it isn't simple adjustment assistance. It isn't simple retraining vouchers. But it has got to address their fears about medical costs, about pensions, as well as the prospect of getting another job.

In the absence of that kind of policy—and it doesn't have to be a gigantic policy, but it has to exist—in the absence of that kind of policy, with deficits where they are now, you will be presented with two alternatives. That is, you save jobs or you lose jobs. And the saving-jobs argument will be a protectionist argument that will lead to less opportunity for your children.

There is a middle ground here that we have not explored as much as we should as legislators, that will allow us to move over the shoals of this very difficult period, which, as both speakers have stated again and again, is based primarily upon the macroeconomic failure of the last several years.

Mr. BONKER. Mr. Lagomarsino, before you proceed, I'd like to thank Senator Bradley before he departs. We appreciate very much your presence today. The fact that you stayed around long enough for us to have a dialog reflects your deep interest in this subject.

Senator BRADLEY. Mr. Chairman, I thank you for holding this hearing as a joint committee exercise. I think, frankly, this is one of the issues that is going to tax the best of all of us over the next couple of years if we are going to get out of this thing without some major shock that will endanger all of us.

Mr. BONKER. With that final word, we will turn to Mr. Lagomarsino again.

THIRD WORLD DEBT AND TRADE

Mr. LAGOMARSINO. A related consideration, and several of you mentioned this, involved Third World debt and, of course, its relationship to trade. How should the United States address this matter at the summit?

Mr. BLUMENTHAL. I would say that I suspect that the best that can be expected from the summit is some general reference to that issue in the communique. A reference that would underline the commitment of the countries there to continue to work together to ensure, first of all, a general economic environment in which these countries can continue to have export markets and to earn foreign exchange to service their debt and, second, to work together to support the commercial banking system and the other public financial organizations to continue the progress that has already been made.

This leaves unspoken the issue that Senator Bradley has addressed head on, whether or not there ought to be a rescheduling. That is a very touchy and difficult subject. Every banker gets terribly nervous when you start mentioning that. I think that is not going to really be dealt with at Bonn.

Mr. BONKER. Thank you.

Dr. Greenspan?

DEBT REPUDIATION

Mr. GREENSPAN. There is a crucial issue here which, I think, doesn't get discussed but it is what is enabling us to gradually unwind this debt as commercial banks put in more reserves, are able to readjust their schedules, and make deals on lower interest rates. And that is the issue that it is to the interest of the debtor nations that repudiation is something which would harm them more than it would harm us. The fact that they have in fairly well unanimous agreement decided that they will not unilaterally repudiate has given the process a chance to work.

It is terribly important, in my judgment, that the members of the Bonn summit communicate directly or indirectly that this process has to continue and that any major repudiation by any of the major debtors would break apart the whole structure. I don't know how they do that except perhaps in quiet diplomatic manner. But probably more than anything they can do on this issue, to communicate that diplomatically to the debtors may well be the most important thing to keep the process going.

If you allow time—and, as Secretary Blumenthal says, keep our, that is, the developing countries', markets open so they can earn the exchange to pay back their debt—then we will eventually resolve this problem. If we do neither, we are in for a very nasty financial crisis.

Mr. SMITH of Florida. Thank you, Mr. Chairman.

I want to say first that I appreciate the chairman putting on this joint meeting, especially with the distinguished panel which you have had. It is not often you get a chance to discuss these matters of importance with people who have so much knowledge in the field.

I am just surprised that Chairman Greenspan didn't bring his American Express computer with him today and figure out how we could possibly balance our budget, since he's doing so well at home on his own little computer.

Mr. GREENSPAN. Mr. Smith if it would be helpful, I will be delighted to bring it.

Mr. SMITH of Florida. If it would be helpful.

I am sorry that Senator Bradley left, because I had one thing that I wanted to ask. It is not an appropriate question for you gentlemen, but just to postulate. While everyone can dispense advice about how best to sell the understanding of the budget deficit and how it impacts upon your individual constituencies, it is very easy to do that in a vacuum. But when you have an administration that is consistently telling people something other than what we are attempting to tell them, it becomes a more difficult issue. So, politically it becomes more of a volatile issue, because people aren't readily capable, even if they believe you, of believing that that is the only side to the issue.

That is really the difficult part of this. There is no consensus opinion on what we should do in order to solve some of the problems.

IMPLICATIONS FOR U.S. TRADE AS DEVELOPING COUNTRIES BECOME DEVELOPED

Let me ask you this. In Senator Bradley's comments he indicated that countries like China and Brazil are going to be the developed countries of the future. To turn our back on these countries at this time would be regrettable. Theirs are the great markets of the future but also great source of production. The more we open ourselves to their economies and embrace the changes they cause worldwide, the more we shall benefit from their growth.

It seems to me that is a very nice ideological way of putting it, but we have had experience in the past showing us that these countries, as they are developing, tend to want to cooperate fully with us. But as they become more developed and in fact take a superior position to a lot of other countries, they begin to want to protect what they have already. And that is when the United States begins to suffer again. We help them through the developing process, and then we become the beneficiary of their negative reactions to us.

How do we ensure in the future that, as some of these countries do develop with the help of the United States, assuming that we are in a position to help them, that they don't turn around on us, as Japan has done? I mean, a specific example is Japan over the last 25 years or so. As we have cooperated in full with them in trying to do that, we now have such a difficult time in trying to get them to agree to do for us what we did for them over the years. How do we ensure that that happens, as opposed to being ultimately paid back by a slap in the face?

Mr. BLUMENTHAL. Mr. Smith, I don't think there is any way we can ensure that for the future. It is true that, when the infant industry argument is applied to a developing country, and we extend to them, for example, tariff preferences, as we have, they are quite reluctant to acknowledge that their development has reached the stage where they are no longer infants but where they now can play the game as everybody else does. There is no substitute for the normal procedures of diplomacy to achieve that recognition in our relationship with these countries.

The only other thing to do is to have rules, for example, that specify very clearly that, when you have reached a certain stage of economic development, you pass from one category into the other.

The second way, I think, that we can ensure that is as these countries negotiate in the GATT or elsewhere with us, they have lots of products that they would like to export. I think we would simply have to indicate to them that, whatever is of interest to them will not be acted on if they don't give us commitments in return.

OVERVALUED DOLLAR

I want to say a word about Japan. Senator Bradley refers to the Japanese in his testimony. He points out that Japan is a very major trading partner for us. We have not until very recently had a bilateral trade deficit with Japan. In fact, we have traditionally had a surplus with Japan for many years. Certainly a good part of the reason for the present unsatisfactory situation is not a sudden emergence of excess protectionism by the Japanese, but the dollar problem has a great deal to do with it.

So, I don't think the Japanese are really a case that we could cite too effectively as a warning example of what's wrong with the trading system. The Japanese have been integrated as a major and equal trading partner in the world trading system.

The Brazilians have a long way to go. The Chinese have hardly begun.

HIGH U.S. INTEREST RATES

Mr. SMITH of Florida. Let me ask you this. You talked about the dollar problem, and I agree that that has a severe impact on this particular problem. During the course of your tenure we were looking at some rather high interest rates and a high inflation rate. In fact, the difference between the interest rate and the inflation rate, the real interest rate, was rather lower than it is today. We have today a real interest rate somewhere in the neighborhood of 10 percent which, except for one little aberration in time, never was approached during the Carter administration, except when the interest rate shot up to 21.5 and then fell back rather rapidly. Inflation was running around 12.

To what do you attribute this continuing tendency to find almost a structural breeding of a very high real interest rate, a very low inflation rate running now somewhere between 3.5 and 4, and money still costing the average consumer in the neighborhood of 13 to 14 percent? I am curious as to what directly are we looking at as the initial cause of that? How can we turn that around, because it has such unbelievable ramifications in almost every other aspect of our trade policy?

Mr. GREENSPAN. I think you have to differentiate between long-term interest rates—mortgages, corporate bonds, U.S. treasuries—and short-term interest rates. There is a dispute as to whether in fact the high nominal long-term interest rates reflect a major and unprecedented rise in the real long-term interest rates or an increase in inflation expectations over the longer run, in a sense an inflation premium embodied in long-term interest rates, which has risen.

Without going into the detailed evidence, I suspect that it is more likely the latter, that is, an inflation expectation rather than a major increase in real long-term interest rates. Short-term interest rates are another story. They are clearly high in real terms, meaning adjusted for the rate of inflation, because there is no way to believe that a 90-day Treasury bill has built into it an expectation of inflation that differs from 3 or 4 percent.

There we are probably looking at the fundamental deterioration in the balance sheets of American business. One of the key characteristics is a very major rise in the ratio of short-term debt to long-term debt, a desire and, in a sense, a need as perceived by a lot of businesses to continuously borrow short, for reasons which are created largely by the problems of what high nominal long-term interest rates do.

When you have very large amounts of short-term debt outstanding which has to be turned over all the time, there is a very high demand for short-term credits in our system. That presses real interest rates higher. That in turn is probably being very significantly exaggerated by the Federal Treasury's borrowing requirements. And they in turn are reinforcing that whole structural imbalance that we get in our private financial statements.

So, what we have is something which is probably without precedent in this country. It is potentially a dangerous problem because it has as its financial counterparts things such as loan portfolios in the commercial banks which are not terribly good because, obviously, if the borrowers are not in great shape, the lenders cannot be holding paper which is terribly first rate. It also has some marginal implications about our thrift institutions which are potentially in very poor shape. In other words, what we have got is a set of interrelationships in which one basically can say that the amount of debt relative to equity, the amount of Federal borrowing relative to private borrowing generally and the aggregate amount of debt outstanding is creating problems in which, in order for the markets to equilibrate, real interest rates have got to rise, as indeed they have.

They will not go down unless and until we resolve this Federal budget deficit problem.

Mr. SMITH of Florida. That was going to be my final question, Mr. Chairman. Given what Mr. Greenspan has said—and, Mr. Blumenthal, certainly you know a great deal more than I do, and I think probably would tend to agree with Mr. Greenspan——

Mr. BLUMENTHAL. I do.

Mr. SMITH of Florida [continuing]. Isn't the reality that, if we made a significant reduction in the budget deficit, we would tend to see a significant reduction in the impact of these short-term rates and this tremendous imbalance in the borrowing?

Mr. GREENSPAN. Mr. Smith, I think that the payoff in resolving this budget deficit is so large that one can't even remotely consider how we will not do it. We are talking about a decline in mortgage interest rates of 3 or 4 percentage points, just as a starter. That will make housing starts go from 1,700,000, 1,800,000, to 2,200,000. It will create a major change in a whole capital investment attitude, especially for long-lived investments, which have been very severely constrained by these high interest rates.

The impact is really extraodinary. It is so large that one perceives the tradeoff as an academician and says, there's no choice here; it's self-evident. But it isn't.

Mr. SMITH of Florida. Mr. Blumenthal, do you agree basically?

Mr. BLUMENTHAL. I have nothing to add. I think Mr. Greenspan has stated it very well.

Mr. SMITH of Florida. Thank you, Mr. Chairman.

Mr. BONKER. We have a special guest who has just arrived from the other body and would like to present a statement. We are indeed pleased that you are here and welcome your statement, Senator D'Amato.

ACTIONS BY JAPAN TO OPEN ITS MARKETS

Senator D'AMATO. Mr. Chairman, thank you very much. While we have the benefit of my two good friends, Mr. Greenspan and Mr. Blumenthal, recognized experts in the areas that we seek to get some answers, let me pose to anyone the question or first a statement. Obviously the Congress, certainly the Senate, and I would imagine the House, shares a great concern for what we view as the trade imbalance. More particularly, we are concerned with what we view as restrictive trade policies, the bureaucratic red tape that is used particularly by the Japanese to make it difficult for our exports.

Having said that, I for one must say that I am running out of patience with what I hear. For example, the Japanese are now going to open up their market, their $4.5 billion telecommunications market, to some American products. It seems to me to be a gesture that does not address the essence of the problem, window dressing.

What do we do?

Mr. BLUMENTHAL. Senator, I am not sure that you will like my answer.

Senator D'AMATO. Have I framed the question giving it the proper perspective? There is the frustration of Congress. There is the reaction of the Japanese. You know, it's not just telecommunications. If they said you can have all $4.5 billion, as far as this Senator is concerned, that doesn't mean anything unless there is a basic reformation there.

What would you do?

Mr. BLUMENTHAL. Let me say that I have had 20 years of experience negotiating with the Japanese, going back to the Kennedy round of 1963. So, I have been through it all: The first textile agreement, the second textile agreement, 4 years of negotiation.

We are not in a good position to beat the Japanese over the head at this point, until we deal with our budget deficit, because it is the budget deficit that has led in important measure, not totally but in important measure, to an overvalued dollar. And that is what makes it difficult for American companies to sell abroad. And that is what causes the flood of imports into this country. That is the largest single cause.

So, first of all, I would have to say to you, Senator, we have got to get our house in order. We have got to make some major step in that direction.

Second, we have to remember that in the trade field there are no saints and sinners. Countries can't possibly be categorized according to varying degrees of sin when it comes to protectionism, if you consider protectionism to be other than a virtue. The Japanese are in some sense protectionist. So are we, so are we. There are plenty of examples.

Somebody pointed out to me the other day that it is difficult to get American beef into Japan. Well, it's difficult to get certain farm products into the United States. We tend to forget that.

Until very recently we did not have a trade deficit with Japan, Senator. Until very recently our bilateral balance with Japan was positive. In fact, if you count up the postwar years, you will find it has been positive much more often than not. This extraordinary $40 billion deficit that we have with them now is the result of an extraordinary situation.

Having said all that, what do we do? I think we should get tough with them. I think we can demand that they make real moves and not token moves. I think we can say to them that they cannot count on Congress to maintain an open trading environment which is in their interest around the world if they do not make real moves. And that should be said with confidence and with basis in fact.

Of course we can demand an equal share, and we should. We have to be tough with them because they have lots of ways to put us off. It is difficult for us to understand their culture and their economy. There are a lot of things that they have no control over in their country which has to do with the habits and idiosyncrasies of their people, who don't want to act sometimes in the way in which the Government wants them to act.

But I think it would be a mistake to vent our frustrations over the disequilibrium, the imbalances in the world trade situation, on the Japanese. Let's first look to ourselves. And I would say again, as I said at the beginning of my testimony, let's look right here, Senator, to Washington. It's us. It's you, to be perfectly frank, that hasn't done the job in dealing with this budget deficit. Until you do, we are really not in a very good position to deal with the Japanese.

Senator D'AMATO. I am going to vote on the budget deficit, not for a Social Security cut, however, but the rest we'll take.

Let me ask you this. Again this is not unique to Japan. Look at our allies in Canada. They are decimating us with their dumping of agricultural products. And I say dumping. They are absolutely subsidizing their farmers for export into this country, and our farmers can't compete. They just can't. It is industry, after industry, after industry.

IMPACT OF THE BUDGET DEFICIT ON THE TRADE DEFICIT

The question was, can you quantify how much of that trade deficit comes about as a result of the high dollar, as opposed to protectionist policies? I think that is important as well.

I believe that, if we are going to lay it all at the door of the high dollar, that is just inaccurate. That is not the case. Historically that has not been what the argument was. And we can go back to the 1970s, when the argument was the low dollar.

Mr. GREENSPAN. Senator, let's assume we do all the things that are implied in this discussion.

Senator D'AMATO. Cut the budget.

Mr. GREENSPAN. No; stop the Canadians from exporting to the United States——

Senator D'AMATO. No, no——

Mr. GREENSPAN. Stop the Japanese——

Senator D'AMATO. No, I didn't say stop them. Wait, wait——

Mr. GREENSPAN. OK——

Senator D'AMATO. That's not my hypothetical. Take my hypothetical. Let's suppose that we cut the $295 billion, OK, in 3 years we do it. Do you mean to tell me that they are going to stop, that we are going to get a better slice of their market and how much? And are we going to have the same kinds of policies with the Canadians? Are they going to continue to subsidize those agricultural products? They are planting more and more acres, thousands of more acres. And our farmers can't compete, whether it's potatoes, vegetables, et cetera, onions, carrots. They wiped out the carrot industry, timber.

Now, you know, it's nice—I think we are laying it over on this thing about the high dollar. So, we cut the budget $295 billion over

3 years. Do you think that's going to help deal with this trade imbalance, and how much?

Mr. GREENSPAN. Well, we had a slight dispute before you arrived on the scene, Senator, but it is a minor one. I don't think it would cut it significantly.

SOURCE OF THE U.S. TRADE DEFICIT

Let's remember where our trade deficit comes from. First, there has been a significant loss of business to Latin America, wholly as a result of the debt problems which they got into. As a consequence, we had a dramatic drop in exports and trade balance to them.

We had a very major decline in exports to the OPEC nations, when they ran into trouble. It had nothing to do with the dollar.

Similarly, we had a situation in which the extraordinary improvement in agricultural practice around the world has created a major increase in grain crops in our traditional markets, which has meant that not only have our volumes of exports declined, but overall world prices have declined.

Over and above all of that, when you factor the extraordinary rise of the dollar into the agricultural markets, into the industrial markets, into every market in which we deal, there is a major impact. Is it conceivable that if the dollar comes all the way down, all of these problems will go away? Only the ones that relate to the dollar will. We will not reverse the agricultural improvements.

All I would argue is that we be careful about the assumption that protectionism is a solution. If I were a farmer and were undercut by imports from another country, would I be mad? Of course I would be mad.

Senator D'AMATO. What would you do?

Mr. GREENSPAN. What do you do when you are dealing in the domestic area? You're a car dealer and the guy down the block opens up another dealership which competes with you. You try to out compete him. If he's better than you, you go into another business.

Senator D'AMATO. It's taking place in every single area. It's not only the agricultural area. It's the entire industrial base. It's the apparel base. You name it. It's area, after area, after area.

What I think is taking place is basically the State Department and the Defense Department over the years haven't given a darn when there have been systematic violations in every area. The attitude has been so what if one little industry gets hurt. Now it applies to our whole agri-industrial base, not only agriculture.

People say, we don't want to be protectionist. Why don't we want to be protectionist? Please give me an answer. We cure the deficit. Then what happens? Quantify for me, if we reduce the deficit by $300 billion, what will that do with our balance of trade? Has anybody looked at that?

IMPACT ON U.S. TRADE OF A DECLINE IN THE DOLLAR

Mr. GREENSPAN. First of all, leave the deficit aside for the moment. Let's just discuss the issue of what happens if the dollar goes down? If the dollar goes down significantly, say 30 or 40 percent, we will find that the trade deficit over the longer run evaporates quite considerably. You will not, however, restore the markets in South America. You will not restore agricultural prices to where they used to be before we had this remarkable explosion in interest rates.

Senator D'AMATO. What about interest rates?

Mr. GREENSPAN. Interest rates go down if the deficit goes down, and the impact——

FLOW OF CAPITAL INTO THE UNITED STATES

Senator D'AMATO. What about the argument that the dollars from abroad are attracted in as a result of the strength of the dollar and the high interest rates? You know, I hear that, too, by the economists. What happens there?

Mr. GREENSPAN. Well, no, that's where we have this mild dispute. We both agree that high interest rates are attracting dollars to the United States and that that in part has been a factor which has kept the exchange rate high and the trade deficit high. I am also inclined to believe, however, that there is a very major demand for dollars or has been for safe haven wholly independent of interest rates, which has kept the exchange rate high.

Senator D'AMATO. You are saying that, notwithstanding that interest rates may come down two points, there is going to be plenty of foreign capital coming in here because we are America and that's where people want to invest?

Mr. GREENSPAN. No, I am raising a different argument. In my prepared testimony, Senator, I say that we are probably getting to the point where, even with interest rates where they are, and the exchange rate where it is, that that flow of money is going to start to slow down. And that will create a problem for us domestically, wholly independently of foreign trade.

Mr. BONKER. Mr. Greenspan, let me interrupt just for a moment. We have a recorded vote on the floor and possibly 7 or 8 minutes left. I know that Senators don't have the same time limits that we do and we are very appreciative of the Senator's visit here, but if the other two Republicans are going to have an opportunity to question witnesses, I should split the remaining time between them.

Senator D'AMATO. Mr. Chairman, let me thank you for your courtesy in giving me this opportunity to raise these questions with my good friend, Mr. Greenspan, and our Ambassador. I am deeply appreciative. But there is that sense of frustration, because I have seen this as a local official and as a Senator.

I don't think we are making progress. I think maybe we are going to have to establish arbitrary limits, so to speak, and say no more than a certain percentage of a particular product can come in.

Mr. BONKER. Thank you, Senator, so much for being with us this morning.

Senator D'AMATO. Thank you.

COORDINATION OF ECONOMIC POLICIES

Mr. GILMAN. I want to thank the Senator for joining us.

I have just one quick question, because I know my colleague has a question also. You stated in your testimony, Mr. Blumenthal, that as the U.S. economy slows down, the whole world will follow unless the countries of Europe and Japan somehow take up the slack.

Is that likely?

Mr. BLUMENTHAL. I was trying to deal with the problem, if as we slow down other countries follow policies that lead them to slow down, too, then we all go down together. If, however, other countries can anticipate that there will be an inevitable slowdown in the United States, which, in fact, may not be totally undesirable, they can follow monetary and fiscal policies that will maintain world economic growth.

I wanted to say I am not so naive as to believe that you can have a giant fine-tuning of individual monetary and fiscal policies around the world. You can discuss—and this is what I was suggesting for Bonn—you can discuss the major direction of the different economies. And that is really what I had in mind.

Mr. GILMAN. Thank you.

Mr. Chairman, I am going to yield the balance of my time to my colleague, Mr. Burton.

Mr. BONKER. Mr. Burton, you have lots of time that has accrued to you, 5 minutes plus a few.

DEALING WITH THE UNITED STATES/JAPAN TRADE PROBLEM

Mr. BURTON. Mr. Greenspan, we have a terrible problem with Japan. The voluntary auto restraints were just dropped, allowed to be dropped. And they immediately indicated they were going to increase their sales of automobiles to the United States of America. And at the same time you both know, you, Mr. Blumenthal, know that they have erected some barriers against some of our products. You mentioned cattle earlier.

You talked about one auto dealership being down the street. Another fellow opens one up. You were generalizing. What I would like for you to do is give us some specifics on how we are going to deal with this deficit problem and how we are going to deal with people like the Japanese and the Canadians, who are taking advantage of us unfairly.

If the Japanese continue to do what they are doing, we are going to see a rise in unemployment. Now, you are concerned about the budget deficit. For each 1 percent of unemployment, it costs our Federal Treasury approximately $30 billion. So, then stealing jobs from America is leading to an exacerbation of the deficit.

What I would like you to do, you and Mr. Blumenthal, in this brief time that we have is give me some specifics on how we are going to deal with this problem.

Mr. GREENSPAN. Well, first let me raise the serious question of whether in fact our trade deficit overall has lost jobs. In other words, it is certainly true that there have been a lot of job losses in the manufacturing area. But the strength of the dollar, which created this phenomenon, has kept interest rates lower than they otherwise would have been. Inflation has been lower. And capital investment generally and overall activity has probably not been materially hindered.

It is not credible that we can have this extraordinarily large rise in employment that we have had in the last year and assume that simultaneously we are losing huge amounts of jobs net coming from our trade balance. What has happened is a major shift in the nature of employment in the United States.

Second, let me just say that the basic problem that we have got with Japanese cars is not with the Japanese but with American consumers, who insist upon buying them. And we have got a very serious problem in the United States in competing with them because they do produce cars which we as consumers insist upon buying.

Mr. BURTON. I am a free trade advocate. I am a great fan of yours and Milton Friedman and others. But they erect trade barriers against many of our products. I don't mind Americans buying Japanese cars if we have access to their markets.

Mr. GREENSPAN. I fully agree.

Mr. BURTON. What I am asking is, How do we deal with that problem? We don't have much time.

Mr. GREENSPAN. Let me just say where I think the real action is actually on the issue which Secretary Blumenthal mentioned, in the agricultural area. If we had the right to ship beef into Japan and we had the right, in effect, to try to expand their markets and move them from high-cost fish into beef, that probably would do more for us than anything else I think we could conceivably do.

I don't know what you do, except to continually press them to recognize that they live in an open world and that the provincial attitudes of their people have got to change. If you impose quotas or you try to take protectionist action, it may be emotionally satisfying. It may in the short run seem to improve a specific problem. In the longer run, it will do us far more damage than it probably will do to them.

RESTRUCTURING U.S. INDUSTRY

Mr. BLUMENTHAL. I would just add a couple of things. One of them is that I would say to Mr. Greenspan that it may be true that the nature of the jobs in this country has shifted. But I could certainly, just looking at my own industry, say that it means manufacturing jobs are shifted to service jobs. That has a number of unfortunate consequences.

We clearly, because of the high dollar, are sourcing more abroad, buying more components abroad, which we otherwise would be producing in this country. We clearly have trouble exporting in areas because of the high dollar which we otherwise would not have.

I think that we have to do two things. If interest rates could come down and the longer-term prospects could be somewhat more secure, the continued high investment in U.S. industry and the efficiency of U.S. industry, together with the lower dollar would make us more competitive. That is very important.

Finally, we should be very tough with the Japanese in trade negotiations. We should make no bones about the fact that we will retaliate if they take a specific action that is contrary to what we have agreed. If we find they have violated an agreement, we should retaliate. There should be no bones about that.

Mr. BURTON. Thank you both very much.

Thank you, Mr. Chairman.

Mr. BONKER. Thank you, Mr. Burton.

I want to thank both of you for your patience and for your valuable contribution. Obviously, this is one of the great issues that is facing this session of Congress. I am hopeful that all of us can reach a consensus as to what needs to be done to deal both with our domestic and our international economic problems.

Thank you both so much for being here.

The committee stands adjourned.

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

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