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S. HRG. 99-99

THE 1985 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

FIRST SESSION

FEBRUARY 5, 7, 20, 26, AND 28, 1985

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

47-274 O WASHINGTON : 1985

JOINT ECONOMIC COMMITTEE

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

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THE 1985 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 5, 1985

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

The committee met, pursuant to notice, at 9 a.m., in room SD-342, Dirksen Senate Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Mitchell, Hawkins, Scheuer, Lungren, and Snowe; and Senator Abdnor.

Also present: Scott Lilly, executive director; Robert J. Tosterud, deputy director; Charles H. Bradford, assistant director; Richard F. Kaufman, general counsel; and William R. Buechner, Mary E. Eccles, and Dale Jahr, professional staff members.

9 A.M. SESSION

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. Before we begin the hearing, I would simply like to make one observation. I am not the person who is supposed to be chairing this committee for the coming 2 years. As I think most people know, Gillis Long, a good friend of mine, had been expected to be the chairman of the Joint Economic Committee for the next 2 years, until an act of God changed everybody's plans.

I would simply like to note that Gillis Long would have made an excellent chairman of this committee. He was a fine public servant. He had guts. He understood as much as anybody can these days, some of the forces within the economy that are changing. And I think he would have brought strong leadership to this committee in trying to focus on the changing realities in the American and world economy.

I think he would have brought real leadership to the Congress by his actions in that area. Before we begin, I would simply like to ask that we observe a moment of silence on behalf of Gillis before we begin.

[Moment of silence.]

Representative OBEY. Let me say that I am pleased to welcome Mr. Willam Niskanen here this morning. We were discussing ahead of time, a lot of people refer to me as "Obey," and in my part of the country, we would call him Mr. Niskanen. But, things are different in different parts of the country.

I am very pleased to welcome Mr. Niskanen here this morning as a member of the Council of Economic Advisers and acting chairman, as far as I'm concerned, as the opening witness during the annual hearings on the economy and the Economic Report of the President.

Among all the pulling and shoving by the line agencies in government who have programs to defend and policies to push, it is important that the President have advisers who have no line responsibilities and who can offer him the best possible advice in analyzing problems and looking at longrun trends. That's the purpose of the Economic Advisers, as I see them, the main purpose; that, and analyzing options available to the government.

While the Council certainly hasn't always given the advice that I would have preferred, I would say that its very existence provides pressures and incentives for any administration and the entire political system to look at facts rather than just political preferences. That is the essential service which the Council provides, not just for the good of the President, but for the good of the entire country and the integrity of the debates surrounding economic policy and options faced by all of us.

This year's Economic Report of the President reflects a kind of optimism that has become the trademark of President Reagan. Looking back, the report found 1984 to be a good year. And, in many ways, it was. Our economy grew by almost 7 percent over 1983. Inflation was held down to about 4 percent. Business invested over $420 billion in new plant and equipment. The report is also optimistic about 1985 and the years beyond, and I think it's fair to say that most observers are optimistic about this year.

No one can know what's going to happen down the line. While my own view is that some of the numbers listed for the outyears are probably a mite optimistic, I think that any reasonable observer would say that we expect to do well this year.

As we look beyond 1985, however, it seems to me that there are at least three numbers which are potentially very troubling. One is the unemployment rate. The second is the trade deficit. The third is the budget deficit. They are all related. The budget, as we all know, came down to the Hill yesterday with, I think it's fair to say, mixed reviews.

The trade deficit is a very visible indication of the handicap under which much of the exporting sector of our economy is operating, and under which it is forced to compete.

Even with continued growth in the economy, the projections of the administration appear to indicate a near stall on the employment numbers, for the next year and a half or so, at least, and unemployment is not expected to drop below 6 percent until 1990.

One of the jobs that is still to be done, in my view, by both the administration and the Congress is to learn how to bring that unemployment number down to a lower level without resurrecting inflation. And this is one of the long-term problems that I hope the Joint Economic Committee will be reviewing this year.

As the Joint Economic Committee begins its examination of these kinds of issues, we welcome the council of thoughtful people, like Bill Niskanen, here today, who is our opening witness. I do want to observe that Senator Abdnor has an opening statement which he would like submitted for the record. He will be joining us shortly.

[The opening statement of Senator Abdnor follows:]

Opening Statement of Senator Abdnor, Vice Chairman

Dr. Niskanen, I join our chairman in extending to you a warm welcome as the leadoff witness for our 1985 economic report hearings on the day you are transmitting your annual report and the economic report of the President to the Congress.

We are all pleased with the outstanding performance of the U.S. economy over the last two years. With two glaring exceptions—the farm sector and our international trade sector—1984 was a good year, and in some respects, a great year. Real GNP grew 6.8 percent last year, the largest increase since 1951. Inflation in consumer prices was only 4 percent and, in prices measured by the GNP price deflator, the increase was only 3.7 percent, the best inflation performance since 1967. The unemployment rate began the year at 8 percent, and ended the year at 7.2 percent. While the unemployment rate edged up in January, U.S. job creation has been the marvel of the world the last two years. We have created over 7.3 million jobs since the recession ended in November 1982, more than in any prior 26-month period in our history, and more than in all of Europe combined.

We hope 1985 will be a good year. We look forward to your comments on the outlook. My assessment is that the conditions leading to a recession are not there. We do not have accelerating prices, rising interest rates, excessive inventory build up, production bumping up against factor capacity, or labor shortages.

A downturn typically occurs because of stresses that build during an expansion. We don't have any of these signs of recession. I hope they are some distance away. Can you give us an assessment as to whether you see any problems developing on the horizon? Can we get through both this year and 1986 without a recession?

As I mentioned, however, there are two economic sectors that are not doing well at all—the farm sector and our international trade sector. We are all pleased with the general economic health of our Nation, but what can we do to correct the terrible problems facing our farmers, and to correct the serious imbalance in our international trade situation?

I will appreciate your sharing with us your wisdom in dealing with these two devastating problems.

I look forward to your testimony.

Representative Obey. Before I ask Mr. Niskanen to begin I would ask Congressman Hawkins if he has any short initial remarks he would like to make.

Representative Hawkins. Not at this time, Mr. Chairman.

Representative Obey. All right. The floor is yours.

STATEMENT OF HON. WILLIAM A. NISKANEN, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. Niskanen. Thank you. Thank you, Mr. Chairman and Congressman Hawkins. I am honored to have the responsibility to present the 39th Annual Report of the Council of Economic Advisers. Since established by the Employment Act of 1946, both the Council and the Joint Economic Committee, I believe, have made a substantial contribution to the understanding of economic conditions and the effects of Government policies. An occasional change in leadership has renewed each institution and, after a period of some uncertainty, I am confident that both the Council and this distinguished committee will continue our important advisory roles. My testimony today first discusses the economic outlook and then summarizes the contents of our annual report.

The Economic Outlook

THE EXPERIENCE IN 1984

This is an especially pleasurable time to review the economic outlook because 1984 was a very good year. Since the fourth quarter of 1983, real GNP increased 5.6 percent and real business fixed investment increased 16.6 percent. This strong growth of output reflected an equal 3.1 percent increase in total employment, and a 3.1 percent increase in productivity in the business sector. The civilian unemployment rate declined from 8.2 percent in December 1983 to 7.2 percent in December 1984. The growth of output and the final installment of the reduction in personal income tax rates initiated in 1981 led to a 5.7 percent increase in real disposable personal income. The current recovery is the strongest in 30 years. The American economy is once again the envy of the world.

Moreover, the growth in output in 1984 was not the result of an unsustainable stimulus to total demand. The growth in the money supply was reduced substantially to 5.5 percent in 1984. The growth of total demand, as measured by current dollar GNP, declined from 10.4 percent in 1983 to 9.3 percent in 1984. The broader price indices increased only 3.5 to 4 percent in 1984, about the same as in 1982 and 1983, and was the lowest inflation rate since 1967. Market interest rates at all maturities are now lower than 1 year ago. A continued general reduction in the growth of total demand will be necessary to sustain the improvement in these conditions and to avoid the characteristic problems that lead to a recession.

The current recovery is better characterized as a "supply side" recovery. The reduction of marginal tax rates contributed to the strong growth of the labor supply and productivity. The combined effect of the change in depreciation allowances initiated in 1981 and lower inflation substantially increased domestic business investment. The contribution of real business-fixed investment to the growth of real GNP in the current recovery has been three times its contribution in a typical recovery. And real business-fixed investment is now a higher share of real GNP than at any time in the postwar years. This record should convince anyone that the structure of the tax system for any level of tax receipts has very important effects on economic growth.

We recognize that some industries in some regions have not shared the full benefits of the strong growth of the general economy. Some of these developments are characteristics of a growing economy because growth requires change, the movement of labor and the movement of capital from lower value to higher value activities. Some of these developments, however, are a consequence of conditions that are specific to the current recovery.

Agriculture has been harmed by the combination of outdated Federal agricultural policies and a strong dollar. Some of our import-competing industries have also been harmed by the strong dollar. Borrowers and lenders who expected a high inflation have been harmed by the substantial reduction in inflation. There is only a limited amount that the Federal Government can do, or should do, to alleviate these specific developments except when inappropriate Federal policies are a part of the problem. Our primary responsibility is to maintain policies consistent with general economic growth and general price stability rather than to insure specific groups against economic change.

THE OUTLOOK FOR 1985–90

Two characteristics of the administration's economic projections should be recognized: First, our projections for 1985 reflect our best estimate of conditions this year. But, the projections for 1986 through 1990 reflect our forecast of trend or average conditions during this later period. The data now available provide a basis for a moderately confident forecast for 1985, but do not provide a basis for a forecast of conditions in a specific subsequent year.

Second, the projections represent conditional forecasts, conditional on several major policy assumptions. Specifically, the projections assume the Federal Reserve will maintain M1 growth within its tentative target range for 1985 with a gradual reduction of money growth in subsequent years and that Congress will approve the general dimensions of the administration's fiscal year 1986 budget. In addition, the forecasts are based on the current tax code and would need to be changed if there is a substantial change in the tax code.

Current economic conditions, I believe, provide a substantial basis for optimism about 1985. Most conditions are characteristic of the early stage of prior recoveries. Conditions in the real economy do not indicate any general imbalances or supply constraints. New orders increased sharply in January. The inventory/sales ratio is still low by historical standards, and the capacity utilization rate in manufacturing is well below prior cyclical peaks. Financial market conditions are also encouraging. The real money supply increased sharply since October. The ratio of short-term over long-term interest rates is unusually low for the third year of a recovery. And the stock market recently reached a new high. Several economists have forecast the end of the current recovery in about a year. But there does not appear to be any basis for this outlook other than the view that recoveries have a natural life of about 3 years. Our reading of the evidence, however, is that recoveries end as a consequence of an accumulation of policy errors and unexpected shocks, and are not—not—subject to any regular pattern.

We expect real gross national product to increase 4.0 percent from the fourth quarter of 1984 to the fourth quarter of 1985. This is only slightly higher than the 3.7 percent growth the third year of a typical recovery. But current conditions are more favorable than usual at this stage. The inflation rate, as measured by the GNP deflator, is expected to be 4.3 percent over this same period. The civilian unemployment rate, now 7.4 percent, is expected to decline slowly to 7.0 percent in the fourth quarter. For budget planning purposes, we assume that the Treasury bill rate will average 8.1 percent in 1985, basically where it is now, but this should not be considered a forecast.

The administration's economic forcast for 1985 and our trend projections for the next 5 years are summarized in the table attached to my statement. As the table indicates, we project an average growth of real GNP of 3.9 percent for the rest of the decade. This projection is based on a forecast that both employment and productivity will increase at an average rate of about 2 percent per year. The forecast growth of employment is somewhat higher than our postwar experience, but is consistent with the recent growth in labor force participation and the projected decline in the unemployment rate.

The forecast growth of productivity is equal to the postwar average and is slightly lower than the experience of the past 4 years. The projected decline in the unemployment rate reflects both continued economic growth and a maturing of the labor force into components of the labor force with characteristically lower unemployment rates.

The inflation and the interest rate projections are more directly dependent on the assumed monetary and fiscal policy. The gradual decline in the inflation rate requires a gradual decline in the growth of the money supply and avoidance of measures that would lead to a sharp decline in the exchange value of the dollar. The assumed decline in interest rates reflects both the projection of declining inflation and the administration's proposal to reduce the growth of Federal spending and the debt.

In summary, the administration's economic projections are not, as sometimes perceived, optimistic forecasts of what will happen. They're more accurately described as realistic projections of what can happen, given responsible monetary and fiscal policies. The difference between the administration's projections and those of most private forecasters reflects their pessimism about the prospects for good policies. Our responsibility is to prove them wrong on that count, because good policy is always more important than good forecasts.

Let me now turn to a brief summary of the Annual Report of the Council of Economic Advisers.

The Annual Report

ECONOMIC POLICY FOR GROWTH AND STABILITY

Chapter 1 of our 1985 report integrates our traditional review and outlook chapter with a discussion of the goals and principles of the administration's economic policy. Since I have just summarized the review and outlook, I will now focus on the main themes of this chapter. The fundamental goals of the administration's economic policy are to maintain economic growth and stability. The guiding principles have been a reliance on markets and a maintenance of a longrun policy orientation. And the key elements of the administration's economic policy, since February 1981, have been to: reduce the growth of Federal spending; reduce tax rates on personal income and new investment; reduce and reform Federal regulations; and reduce the growth of the money supply on a slow, steady basis.

The common theme of this policy has been to reduce the economic role of the Federal Government, so that individuals or private institutions and State and local governments will have more resources and more freedom to pursue their own interest.

Much of this first chapter is devoted to the principles that should guide the continuing conduct of monetary and fiscal policy. The chapter emphasizes the importance of monetary policy for both real and nominal conditions. An increase in money growth usually increases near-term output and employment, has little effect on real conditions in the long term, and increases the inflation rate generally within about 2 years and a reduction in money growth has the opposite effects.

The timing and relative magnitude of these effects depends importantly on what effects are expected. The fact that output and employment effects precede the inflation effect, unfortunately, has often induced policymakers with a short horizon to endorse higher money growth and to worry about inflation later. The monetary restraint necessary to brake rising inflation, however, generally leads to a recession. The only way to avoid such a policy-induced cycle is to consistently restrain money growth, in order to avoid an acceleration of inflation in the first place.

The administration endorsed the tentative target range for M1 growth in 1985 that was announced by the Federal Reserve last summer, and we reaffirm that endorsement. We urge the Federal Reserve to focus primarily on M1 rather than the broader aggregates of money and credit. We also suggest two technical changes to the way this range is set. One change would set the base for each year's target range at the midpoint of the prior year range rather than the average money stock in the fourth quarter, in order to avoid a base drift from one year to the next. This change would increase the M1 base for 1985 by $5 billion.

The other change would express the target range as a band rather than a wedge, in order to increase the flexibility of the Federal Reserve in the early part of each year. On this basis, the current money stock is right on track. It is very close to the midpoint of the 1985 range. In subsequent years, as mentioned above, we expect a slow steady reduction in money growth to achieve ultimate stability of the general price level.

This chapter also reflects an increasing recognition that fiscal policy operates primarily through the supply side of the economy and has little effect on total demand. An attempt to use discretionary fiscal policy for stabilization purposes, in addition, has often been mistimed and has created uncertainty for private planning. Fiscal policy, we suggest, should be primarily addressed to providing the desired level of government services at the lowest cost to the economy.

THE FEDERAL BUDGET AND THE ECONOMY

Chapter 2 addresses the primary relation between the Federal budget and the economy. These relations, of course, operate in both directions. Changes in the economy affect the budget with no change in fiscal policy and also affect the choice of policies. Changes in the budget also have substantial effects on the economy, depending on the type of expenditure and on the detailed characteristics of the Tax Code.

The chapter focuses on the effects of two related conditions: Federal spending and the Federal debt are each growing more rapidly than the economy. These conditions cannot continue indefinitely, and they are better addressed sooner than later. Reducing the growth of Federal spending would address both of these conditions. Increasing taxes would reduce the growth of the debt only if spending is also restrained. Federal spending must be financed by either current or future tax receipts, including the inflation tax. There is no way to avoid ultimate tax liabilities for current government services. The substitution of borrowing for current tax receipts only defers the necessary taxation.

The prospective deficits are much too large. A decision to reduce spending or increase taxes, however, is fundamentally a political judgment about the desired level of Federal expenditure. In other words, how big a government do we want? But economic analysis can contribute to this choice. Given the current level of Federal spending and the structure of the tax system, the total cost to the economy of additional Federal spending appears to be about 1.5 times the budget cost, due to the misallocation of private activities caused by both the spending and the tax that's necessary to finance that spending. An increase in Federal spending, thus, is justified only if the value of additional services and transfer payments is more than this additional cost. The administration's fiscal year 1986 budget reflects a judgment that many current Federal programs do not meet this test, and I strongly endorse that judgment.

Our analysis of the Federal tax system leads to a conclusion that a broader based, lower rate tax system would substantially reduce the cost of the economy of a given level of government spending, but may increase the relative size of government. The last section of this chapter discusses several proposed changes in budget concepts, budget processes and in fiscal authority, including the case for a line-item veto and the balanced budget-tax limitation amendment. In this section, Chairman Obey, you will notice a favorable discussion of your proposal for reform of the congressional budget process, a proposal that I'm sure we will see again.

THE UNITED STATES IN THE WORLD ECONOMY

The third chapter develops the important relations between the United States and the world economy. The major lesson of this chapter is that our large current account deficit is made in the United States. Moreover, this current account deficit has both good origins and bad origins. It has both good effects on our economy and bad effects. The current account deficit has increased so rapidly, primarily because the demand for investment in the United States increased strongly, relative to the supply of saving net of government borrowing. This deficit, which represents the net flow of goods and services into the United States, has contributed to the reduction of U.S. inflation and of interest rates, and it has also contributed to the recovery abroad, most importantly in Europe and in Latin America.

This trade and current account deficit, however, has also led to substantial strains within the U.S. economy by reducing the output of some of our export industries and import competing industries. The assertion that our foreign deficit has led to a net loss of U.S. jobs, however, is not correct. Total employment, total industrial production, manufacturing employment and output, have all increased more rapidly in this recovery than in the typical recovery.

Our trade deficit is much like the related budget deficit. Both are too large to be sustained, but there are both good ways and bad ways to reduce these deficits. Measures to promote export or restrict imports would affect the total volume of trade, but should not be expected to directly reduce the trade deficit, it would reduce U.S. economic growth, and is an undesirable instrument in that case. The most productive ways to reduce the trade deficit are to reduce government spending and borrowing and to reduce the bias of our tax system against saving.

This chapter also discusses economic conditions abroad which are improving somewhat more slowly than the United States, recent policy measures affecting trade and financial flows, and the chapter concludes with the case for a new round of multilateral trade negotiations to sustain our commitment to freer trade.

SPECIAL TOPICS

Our annual report this year also addresses three, I believe, very interesting special topics. One chapter summarizes the health status and medical care of the American population. The health status of the American population is steadily improving, but it appears to be only weakly related to the increase in medical care supplied. The major effect of the rapid increase in Federal spending for medical care and the broadening of private health insurance has been a rapid increase in the cost of medical care. In general, both public and private health insurance reduces the incentives of consumers to use medical care services carefully and to buy these services from the most efficient providers. This insurance also reduces the incentive of providers to discipline costs and the complexity of their services.

This administration has made significant progress toward reducing the inflation in medical services, most importantly through the recent changes in the medicare hospital payment system. Further changes in Federal policy affecting both medical insurance programs and the tax system could strengthen the incentives of both consumers and medical care providers.

The second special chapter summarizes the economic status of the elderly. Both the number and the economic status of the elderly have increased dramatically. The share of the American population aged 65 and older increased from 4 percent at the turn of the century, 12 percent in recent years, and is expected to be 20 percent within another 50 years. The average real pretax money income of the elderly has nearly doubled since 1950 and for elderly families, per capita money income is now about equal to that of the nonelderly population. The poverty rate among the elderly has declined substantially and is now lower than that of the rest of the population. Moreover, these earlier measures were based upon pretax money income but the elderly pay lower taxes, have higher income from assets, and receive a higher amount of benefits in kind.

Social security and private pension benefits are now the major source of income of the elderly but the substantial increase in these real benefits has been partly offset by a decline in the share of income attributable to earnings. The remaining financial distress among the elderly appears to be primarily associated with low income prior to retirement and due to the special problems of elderly women who lose their husbands. The economic status of elderly women is likely to improve in the future due to the continued increase in labor force participation and the 1984 pension equity legislation. Further policy changes should focus on reducing the social security penalty on earnings and reducing the bias in our tax system against savings.

The final special chapter addresses the market for corporate control. This chapter summarizes the historical record of mergers and acquisitions in the United States, the effect of these transactions on the economy, and the major relevant policy issues affected by these transactions. The available evidence suggests that these highly publicized contests for corporate control generally increase net wealth and they perform an important economic function. The general effects of such transactions have been the reallocation of assets to higher value uses, improved efficiency, a profitable recapitalization, and improved management.

Competition among bidders and current regulations appear to be sufficient to prevent abusive tactics by bidders in these contested takeover bids. There is more reason for concern that practices by the management of target companies may not serve the interests of their stockholders but since these cases are very fact specific, they are best addressed by court cases under State law rather than by general Federal regulation. State law in this area is evolving rapidly and we believe it would be inappropriate to preempt this development by Federal legislation at this time.

Mr. Chairman, may I again express my privilege to present our annual report to the Joint Economic Committee and I'm now pleased to respond to your questions.

[The table attached to Mr. Niskanen's statement follows:]

ECONOMIC PROJECTIONS FOR 1985-90

[Percent change]

	Real GNP		GNP deflator	
	Year/year	IV-Q/IV-Q	Year/year	IV-Q/IV-Q
Calendar year:				
1985	3.9	4.0	3.8	4.3
1986	4.0	4.0	4.4	4.3
1987	4.0	4.0	4.2	4.1
1988	4.0	4.0	3.9	3.8
1989	3.9	3.8	3.6	3.5
1990	3.6	3.6	3.3	3.2

[In percent]

	Civilian unemployment		91-day Treasury bill	
	Average	IV-Q	Average	IV-Q
Calendar year:				
1985	7.1	7.0	8.1	8.0

[In percent]

	Civilian unemployment		91-day Treasury bill	
	Average	IV-Q	Average	IV-Q
1986	7.0	6.9	7.9	7.8
1987	6.7	6.6	7.2	6.7
1988	6.4	6.3	5.9	5.5
1989	6.2	6.1	5.1	5.0
1990	5.9	5.8	5.0	5.0

Representative OBEY. Thank you very much.

Let me just raise a few points about your specific statement on the first round of questions.

You indicate that this was a supply-side-led recovery and I guess everybody's entitled to their own opinion. But that isn't quite the way I read it.

I think you can make an equally good case that the recovery began about the time the Congress and the President got together and passed TEFRA in 1982 and restored some confidence concretely after an initial judgment was made that the deficits before that time were too large and fiscal policy too loose. The Fed began expanding in about July 1982. The recovery really began a few months shortly thereafter in 1982. The unemployment rate peaked in late 1982 just a few months after that and began to go downward. Interest rates then proceeded to fall 3 to 4 percent, roughly.

And I think it's fair to say that this was a recovery which was stimulated by a changed direction in monetary policy in association with increased consumer demand, and then I can't recall one in history that didn't begin that way.

As I understand it net personal savings as a percentage of disposable personal income remained at about the same level that it was in 1980, around 6 percent. And, certainly, while I would grant that this year the economy is being fueled very strongly by investment it would seem to me that—and I think most neutral observers have indicated that in their judgment the resurrection of the economy, the turnaround, began primarily because of the change in monetary policy accompanied by tightening the fiscal policy above and beyond its initial stages in 1981. Certainly it was preceded by an increase—a significant increase—in consumer spending.

If you want to respond to that please feel free.

Mr. NISKANEN. The timing of the recovery was clearly associated with the increase in money growth beginning in mid-1982 and I think was also possible affected by TEFRA.

The characteristics of the recovery over time, however, have been clearly affected by the prior tax legislation. Over the course of the 2 years, recovery to date, real business fixed investment has contributed roughly three times as much to the growth of real GNP as was the case in a typical recovery.

The early increase in spending was primarily in consumption which is usually the case, but in terms of the general characteristics of the recovery over a 2-year period, the strongest elements clearly have been domestic fixed investment.

I would not in any way contest the importance of the change in money growth in mid-1982 for the timing of the recovery in that we attribute the timing to that change as well. I also believe that TEFRA had an effect. It is a little strange for somebody to argue that fiscal tightening leads to economic growth but I think that there is a case for that particular effect.

Representative OBEY. Let me ask—both Senator Abdnor and I come from this rural district.

I note that you indicate in your reference to the present distress in the agricultural sector that there is only a limited amount that the Federal Government can or should do to alleviate these developments except when inappropriate Federal policies are part of the problem.

Then you go on to say, "Our primary responsibilities are to maintain policies consistent with general economic growth and general price stability rather than to insure specific groups against economic change."

I don't quite know what you're saying underneath that but I would simply observe and I think probably Senator Abdnor would agree that is happening in rural America and those who are concerned about it are not suggesting that farmers or rural America be insulated from change.

What they are suggesting is that farmers have been especially hard hit by reckless fiscal policy which had an impact on interest rates, which had an impact on dropping land values and which put them in a crunch which, in my judgment, was at least significantly caused by what you describe as the exception that ought to be made when inappropriate Federal policies are part of the problem

And while you're certainly not the administration official to respond to questions on that point, I hope that the administration will indicate their awareness of that when they appear before us on Thursday.

Mr. NISKANEN. We have been considering these problems with agriculture and other sectors for some while.

The general point I want to make is that if we try to insure agriculture and other sectors of the economy against change, we're not going to have growth. We can't really do both. And the more generally we try to insure people against change the less growth we can have in general.

Representative OBEY. Well, I agree with that. I just hope that the administration doesn't try to portray efforts within the Congress to mitigate what's happening out there as being efforts to insulate against change rather than efforts to, in effect, help people get over the consequences of inappropriate Federal policy.

Mr. NISKANEN. Mr. Chairman, I think that the most important thing that has happened in agriculture is that people who bought farmland in the late 1970's up until 1980 or 1981 under the expectation that inflation would continue at high rates, have had a capital loss, and the main thing that has happened is that the people who bet on inflation have lost money. That's true of people who bet on inflation in agriculture as well as in any other sectors.

I think that there is an important issue to be addressed as to whether we protect people against losses that are a consequence of their prior investment decisions.

Any number of people who bet on inflation, those who bought homes in the late 1970's were betting on inflation, or who bought commodities betting on inflation, have lost money as a consequence of our success in bringing inflation down.

I do not regard the policies that have brought inflation down by two-thirds as being inappropriate Federal policies. And the issue, I think, is basically whether we should protect a group within agriculture that had bought or incurred debt on the expectation of high inflation rates at a time when those expectations have not been realized.

Representative OBEY. My time has expired. Senator Abdnor.

Senator ABDNOR. Well, thank you, Mr. Chairman. I should have been here sooner. I'm sorry I missed your statement, Mr. Niskanen.

While we're on the subject of agriculture, I'd like to ask you as the acting Chairman of the Council of Economic Advisers, you are the President's Chief Economic Council: that's correct, isn't it?

Mr. NISKANEN. I am serving in the capacity as Chairman of the Council of Economic Advisers.

Senator ABDNOR. What I want to know is, have you offered or has the President ever asked for your evaluation of the economic condition of rural America?

Mr. NISKANEN. We, sometimes with the Department of Agriculture, regularly report——

Senator ABDNOR. No, the President. He's the one who I want to hear this.

Mr. NISKANEN. A presentation was given to the President just last week on economic conditions——

Senator ABDNOR. Just a week ago, though before——

Mr. NISKANEN. Just a week ago.

Senator ABDNOR [continuing]. The President ever realized what's going on out there in rural America? This bothers me. As a matter of fact I'm basing the whole hearing on rural America to try to help you people get familiar with what goes on there.

I've asked some people to come here, like Ms. Norwood, and she admits her figures mean nothing to rural America. When she talks about employment and unemployment and the different parts of it she admits that it really doesn't reflect anything in rural America. Now, I'm not just talking about South Dakota. I'm talking about a heck of a lot of land area and there's a lot of people involved and I see a lot of things happening out there, not just affecting the farmer but whole communities and the deterioration of transportation and everything else.

But when we have a crisis like we're going toward now, you're telling me it was just a week ago that the President first had a real report on what's going on in rural America.

Mr. NISKANEN. Senator Abdnor, the most recent report was a week ago. We brief the President about once a month on general economic conditions in the country and special problems that are developing, and he is brought up to date on the conditions of agriculture typically at that frequency.

We have regular discussions in the various Cabinet councils on the conditions of agriculture. I don't think that there's any basis for a charge that we have been unaware of these issues or have neglected the issues.

Senator ABDNOR. Well, let me tell you the first time in Iowa when I was coming to the committee we finally got the first comments on agriculture in rural America in the economic report. You're not the only ones. I had five economists sitting there one day on an overview of the economy. I listened all morning and not one of them ever mentioned agriculture or rural America. I couldn't believe this. It's still the number one industry in the world.

I mean it's pretty important but somehow it gets bypassed, and I don't mean to be picking on you. It's just that it infuriates me when I see the whole thing and I know what's happening out there and we're finally getting a little excited about it.

Mr. NISKANEN. As you know, Senator Abdnor, we devoted a special chapter to the conditions in American agriculture in our economic report last year. I hope you recognize that not having a chapter on agriculture again this year does not reflect any lack of concern or understanding.

Senator ABDNOR. It's probably worse than it has been in many, many years and I just wondered why it doesn't merit a chapter in your book.

What's happening is not just from your point or from mine—I just know how serious, how damaging it is. I know we're reaping the greatest economic recovery we've seen in a great many moons and all this is wonderful, but that ain't happening out in rural America, let me tell you. People are still working for darn poor salaries, if they can find a job, and our main streets are going down the tube and I'm concerned about it. Not just about the farmer but everyone that's associated with the farmer. It seems to me if ever there was a chapter in a book on agriculture in rural America it ought to be this year. I'm disappointed to find out that it's not going to contain one about it.

What did you tell the President?

Mr. NISKANEN. We summarized for him most importantly the credit situation in agriculture, both as it affects farmers and affects farm lending institutions.

As a consequence of that, as you know, we have recently changed the regulations affecting the money that was set aside last fall.

I suspect that will be the first of a number of discussions on those matters.

Senator ABDNOR. I hope so. I can't plead with you strong enough. I realize when the President travels he can't get out into the real grassroots part of the country. He can't walk into everybody's farm and make sure he hears the right things, but I'm telling you it's tough out there and some day I'd like to take you home with me. I'm going home and talk to about 5,000 farmers next week, and I'd love you up on the platform to explain to them what's going on because I don't know if I can and they're pretty disturbed.

You know, now it isn't just the farmers who are on the rocks. There are people who are in such bad financial conditions that maybe nothing short of a grant might help them.

But there's a lot of those inbetween because of the attitudes of the banks. Those small banks out there are getting regulated from up above and are starting to close out people who never were in trouble before.

The regulators put pressure on the agricultural banks, who in turn must foreclose on loans they wouldn't ordinarily need to in order to come up with equity. It's the farmer who gets hurt in the end. That is the stage that it's gotten to.

Confidence has been destroyed out there. We have to get confidence back in that part of the country again with the bankers and with the farmers themselves. It's absolutely imperative.

My time is up. Thank you.

Representative OBEY. Thank you, Senator.

Congressman Hawkins.

Representative HAWKINS. Mr. Niskanen, in terms of the report which you've submitted to us I'm somewhat amazed that the report does not deal with the statutory requirements of the report but goes off in what appears to be a tangent to speak about projections and forecasts rather than dealing with specific goals that we are supposed to reach on an annual and a 5-year or medium-term basis.

Now, the act is very clear that in each economic report—and I'm reading in part from the act itself—these goals shall specify the reduction of the rate of unemployment to 4 percent by the fifth calendar year and the reduction of inflation to 3 percent by the fifth year. And these goals are to be reached on an annual as well as a medium-term basis. It is the responsibility of the Council and of the President to set forth recommendations of how these goals are to be reached.

Now, I don't see anything in this report that deals with those specific goals.

As a matter of fact, if we look at the last 4½ years we see that the goals have been set aside. The administration started in 1981 with an unemployment rate of 7.4 percent; 4 years and some months later, unemployment has reached 7.4 percent. This certainly doesn't show any progress.

I mean policies that you claim to be so successful, if they can't do any better than to take us back to where we were in 1981, must be defective in some way. Yet I don't see any attempt to explain why we are back to where we were in 1981 after the same policies led us into the worst recession since the 1930's, and you deal in the report with progress that has been made since 1982.

Well, wonderful progress has been made but it's been made based on the worst recession that we ever had, that is, since 1930. So obviously, almost any recovery measured against 1982 would show some results.

I suppose the gist of what I'm trying to find out from the Council is why don't you deal in terms of specific goals and programs to reach those goals, and why don't you deal more with the human aspect of the issue which is how the economy is operating in terms of people.

I applaud the inclusion this year of at least some of the issues on health, medical care, and some of the other chapters which I think are certainly very acceptable.

But it seems to me that the biggest indication of all of the health of the economy—and that includes rural America as well as inner cities and suburbia—is the condition of the people who must work for a living in order that they can pay taxes in order to reduce the deficit.

But you don't deal with that. You don't deal with the 35 million people who are now in poverty as the result of current policies. That is not addressed at all and the number is increasing by 2 million every year as a result of the same policies.

You can't say those policies are all that appropriate if they're adding that many people to poverty each year. And in terms of functional illiteracy, we're becoming a nation of functional illiterates. The Department of Education says that we have 23 million functional illiterates in America and the number is growing at a rate of 2.3 percent each year.

Now, it's obvious that if we want to reduce the deficit, increase productivity, and compete in the world markets, we can't have a nation of functional illiterates. But yet you indicate that the test of programs should be whether or not they add cost, whether the cost exceeds——

Oh, I see my time is up. May I ask that the witness be allowed at least 1 minute to respond and I'll terminate at this point?

Mr. NISKANEN. Congressman Hawkins, we report progress against the goals established in the Humphrey-Hawkins Act of 1978, in the first chapter of our report.

We have come very close to meeting the inflation goal within the 5-year period specified by the act. We have not been successfull in meeting both the inflation goal and the goal for the unemployment rate.

I want to acknowledge that it is very difficult to make major changes on both of those dimensions at the same time.

One of the reasons why the unemployment rate has stayed fairly high—just slightly lower than it was in January 1981 right at the moment—is that we still are having a continued rapid increase in the labor force.

Now in the last 2 years, for example, total employment has increased about 300,000 a month, and for all of that the unemployment rate has started to stall out. This last month in January, for example, payroll employment went up 350,000 and the unemployment rate went up two-tenths of a point.

Our policies, I think, have been consistent with strong employment growth and what helps people is more jobs, better jobs. It has not yet led to a satisfactory level of the unemployment rate which we and you would like to come down but that is because our labor force is still growing at a very rapid rate.

Some other things. The highest increase in the poverty rate was in 1980 before we came on board. We don't know what happened to the poverty rate in 1984; the numbers aren't available yet.

The unfortunate thing is that the poverty rate in this country has been going up for about a decade even with continued economic growth. That's an unfortunate circumstance. It should lead us to question a lot of our prior judgments about what it is that's causing that condition and what may be effective in alleviating it.

I think that, however, it is inappropriate to charge that policies initiated by this administration have led to that condition. Poverty has been increasing for at least a decade, with a much higher rate of increase in that condition prior to our watch.

Representative OBEY. Mr. Niskanen, before I yield to Congresswoman Snowe, I'd just like to clear up one thing. Maybe I misheard you but I thought you were making reference to the rapid growth in the labor force and as I understand it as you compare the percentage change in the growth of the labor force—in 1977 it was 3 percent, in 1978 it was 3.3 percent, in 1979 it was 2.7 percent. Since that time we've had a slowdown in the growth of the labor force. It has grown in 1980, 1.9 percent; in 1981, 1.6; in 1982, 1.4; in 1983, 1.2; and in 1984, 1.8 percent. I would hardly describe that as being a rapid growth in the labor force in terms of historical trends. And I just wanted to get that on the record.

Mr. NISKANEN. The growth of the labor force in the late 1970's was the highest that we've experienced in peace time.

Representative OBEY. All I'm saying is that the implication of your remarks would lead one to believe that the labor force has been growing much more rapidly over these 4 years than it was before and that somehow that's to blame for the fact that unemployment is stuck at 7 percent, and I don't think the numbers bear that out.

Mr. NISKANEN. The labor force has been growing a good bit more rapidly than the size of the adult population which is only growing at about 1 percent a year. That is a favorable condition. We clearly don't want to discourage that.

Representative SNOWE. Mr. Niskanen, you mention in your statement, that the deficits are too large and that reducing the deficits either through spending or by raising taxes is fundamentally a political judgment. Do you believe the Congress should raise taxes in order to reduce the deficit and would that have an impact on the recovery as you see it?

Mr. NISKANEN. I would recommend that Congress not raise taxes but that is based upon our judgment of the administration that a great many Federal programs and activities are not worth the cost that they impose on the economy. That's a judgment that you people will make independently of the administration and we hope that you share our judgment on that matter but it's not something that I, as an economic professional, can say definitively that this, that, or the other program is somehow economically wrong.

My judgment, however, is that the economy would be much healthier if we address the deficit problem by spending restraint rather than by tax increases but ultimately, of course, that has to be a judgment about how big a government we want in the United States. If we want a government that spends 24 percent of our national output, we have to finance it, in which case we would need a major increase in taxes. But if we're prepared to squeeze government back to around 20 percent of national output, then we won't need an increase in taxes and I think that the consequences toward the economy would be much, much healthier.

Representative SNOWE. But in your view would increasing taxes affect the present recovery? Setting aside for a moment what we consider to be essential and nonessential, would raising taxes in and of themselves affect the present recovery as the administration has maintained?

Mr. NISKANEN. Raising taxes would reduce the rate of economic growth over time.

Representative SNOWE. Do you believe there's a correlation between low tax rates and investments made by companies?

Mr. NISKANEN. Yes.

Representative SNOWE. There was a recently released study which indicated that there was no correlation when they analyzed 238 companies across the board that the companies made decisions based on low tax rates or tax incentives passed by the Congress. So you do not agree with that field?

Mr. NISKANEN. No, that study was a survey rather than an examination of actual changes in investment.

The empirical evidence bearing on the overall investment patterns makes it quite clear that reducing the tax rate on the income from new investments stimulates new investments.

Now, in many cases, of course, the investments would have been made without the reduction in taxes or the tax rate on new investment. But the difference is between what would be invested at the lower tax rates and what would be invested at the higher tax rates. A lot of the people who would have invested at the higher tax rates, of course, are still going to invest and those people will say, no, the tax rates didn't affect me. It's the difference that is important.

Representative SNOWE. In your statement, you refer to the fact about the foreign trade deficit and the fact that we still have a net job gain in this country in spite of the trade deficit. Yet, the bottom line would indicate there are many industries in this country that are suffering as a result of the trade deficit and Senator Abdnor mentioned the agriculture community.

I come from the State of Maine and I can list a number of industries, such as the shoe industry, fishing, lumber, and potatoes, it affected adversely because of the substantial increase in imports.

So I don't think that the bottom line should be that we've gained. We've made a net gain in our jobs, but the fact is we have to look at many of the industries that are suffering as a result of imports.

Mr. NISKANEN. Representative Snowe, I'm aware that the change in our trade position has had, in some cases, severe effects on particular industries and regions. And we're sympathetic with those effects.

I think one should not conclude somehow that the Nation has lost 2 or 3 million jobs, the sorts of numbers that have been suggested as a consequence of that. It is quite clear that particular communities in Maine and Iowa and elsewhere have lost employment as a consequence of this.

Representative SNOWE. Well, the reason why I mention it, and I'm sure the same reason as Senator Abdnor mentions his frustration, is the fact that sometimes we look at the bottom line without looking at the particulars involved. In reaching that bottom line and there are a number of companies who are suffering as a result, and there's no question that it is because of the strong value of the dollar and because of unfair trade practices.

And you refer in your statement to free trade, and I endorse free trade wholeheartedly. On the other hand that hasn't always been the case with many of our trading partners and I would hope the administration would keep that in mind as we renegotiate many of our agreements in the future.

Mr. NISKANEN. Representative Snowe, this administration, I believe, has processed more counterveiling duty and antidumping cases than probably all prior administrations. We're processing literally tens of them in a month against foreign subsidies and dumping.

The major trade cases that were initiated in 1984, however, were not based on charges of foreign subsidy. They were escape clause cases, including footwear, not based upon a charge of foreign subsidies.

Representative SNOWE. Thank you, Mr. Chairman.

Representative OBEY. Congressman Scheuer.

Representative SCHEUER Thank you Mr. Chairman. Mr. Niskanen, it's a pleasure to have you here.

Mr. NISKANEN. Thank you.

Representative SCHEUER I hold in my hand Sunday's "Washington Post," page 14. I'm going to read you a quote and ask you if you'd react to it.

This is the quote from one of the President's senior advisers, perhaps it's our witness this morning, who knows.

"There is a fear in the markets that the deficits are now so large and the path the budget is on is so worrisome, that it may get totally out of control. The system will just lose control. There will be a quasi- * * *" he paused, not finishing the word, "a fairly irresponsible financial policy for the long run!"

Now I think that pretty well sums up what bothers a lot of us here. We seem to be in a desperately critical short run, as well longrun situation. We don't see a light at the end of the tunnel. We see this flabbergasting budget deficit, for which we're sopping up every dollar of capital investment around the world that isn't nailed down, and we do that at necessary cost of attracting this capital, by maintaining very high interest rates. The interest rates, in turn, produce a vastly overvalued dollar that makes it difficult, if not impossible, for us to compete in the global marketplace. This, in turn, produces a $123 billion annual trade deficit. This is affecting our competitiveness. There are voices out there that are advocating that we retreat into a sort of a Smoot-Hawley protectionism era. Where are we going? And how are we going to get a handle on this thing?

This committee is the one committee of the Congress that is charged with looking at our economy from the point of view of the long run, and a number of us are desperately concerned about not just the short run, not just the budget deficit this year, but where are we going to be 5, 10, 15, 20 years from now.

I read in the paper yesterday that a 1 percent increase in our interest rate is going to cost the taxpayers $7 billion or $8 billion this year and by the end of the century, I think it was $80 billion.

Where are we headed in the long run? When are we going to get back to the road of sanity? And where are the recommendations coming from from this administration, from people like yourselves who are charged with bringing some sanity, not just for the short run, but showing us what we have to do to produce a light at the end of that tunnel?

Mr. NISKANEN. Representative Scheuer, I commend your attention and that of the committee to longrun considerations.

The official that was quoted in the Sunday "Post" was not me. The deficit is a serious problem, but one of the reasons why it has been politically difficult to address is that most of these apocalyptic conjectures about the effects of the deficit in the short run have not proven to be correct. I think the deficit is much better described as a slow-acting, but potentially lethal cancer, rather than something that is going to have catastrophic events in the next 90 days or the next year or so.

I believe that there won't be a problem of financing it in the limited sense, as the Treasury will be able to borrow the money. I don't think that it necessarily is going to lead to an explosion of inflation or interest rates, but for all of that, that should not relax our concern about the deficit. And you may have a better judgment on this matter than I do, as to how do you energize Congress and the administration to address a problem that has serious longrun consequences, but the shortrun consequences look like they're not terribly awful.

My judgment and the judgment that is reflected in the President's budget for 1986 is that we have to make a major attempt to reduce the growth of Federal spending, that given our economic forecasts that gets the deficit down to a $100 billion range by 1989, but it will take—it is really only the starting point. The amount of spending reductions in the 1986 proposal would just barely stabilize the ratio of the Federal debt to GNP in the 1986 to 1988 period.

Representative SCHEUER. At about 5 percent?

Mr. NISKANEN. It will stabilize the ratio of the Federal debt to GNP.

Representative SCHEUER. Oh, the Federal debt. Excuse me.

Mr. NISKANEN. The Federal debt to GNP in the 1986 to 1988 period. And would get the deficit down to, I think, about 3 percent of GNP in 1988 and 2 percent or so in 1989.

I think that the budget that we have just proposed is going to probably be the most important action to get the deficit under control, but it is probably not the last action. It is probably not the last action that we'll have to consider.

Representative SCHEUER. Do you ever wake up in the middle of the night, fancying yourself as financial adviser to the Saudis or the German investors or the Japanese and counseling them:

> Well, America may not be the safe haven we've considered it to be. They may well collapse someday. They're off the chart, and out of control. Maybe we better think about retrenching our investments and foregoing these high interest rates and investing monies in other countries that may not have the attractive interest rates, but where they seem to have a more disciplined economy and a more disciplined society, where our investments will be safe in the long run?

Do you ever have a nightmare scenario like that? Doomsday scenario?

Mr. NISKANEN. Well, it would be a nightmare if I had that type of vision. And there may be people who are making that judgment. At the moment, of course, people are making quite the opposite judgment. Even though our interest rates have come down and the interest spreads between the United States and foreign countries have come down rather sharply in the last year, the dollar has continued to decline. It went up very strongly again yesterday. And investors, at least at the moment, are expressing a very strong preference for dollar denominated assets. That should be regarded as an asset, not a liability, to the United States. It's a reflection of confidence by foreign investors in the security and rate of return in American assets. And we shouldn't do anything to undermine that situation.

Representative SCHEUER. But I'm worrying that down the pike a way, if we don't do something to produce some rationality in our national financial picture, there may be some doubting Thomases around the world.

Mr. NISKANEN. I agree. If we put off in 1985, in a year in which we're very likely to have a strong third year of a recovery, and it's only right after Presidential election, if we can't make a serious attempt to reduce the deficit this year, then I think that there's reason for lack of confidence in our political system as to how to handle these problems. But on this matter, and almost for the first time in many years, I'm quite optimistic that Congress will give us a budget roughly, at least in magnitude, of what the President has proposed. You will make a different judgment, probably about the composition of that budget, but I think that there is an encouraging prospect that we can make a major attempt in getting the budget down, the deficit down on the spending side, which is clearly the preference of the American people. Do it on the spending side, and then see what the scorecard is at the end of the year and figure out how much we need to do next year. But this year, I think, is the year we have to do it.

Representative OBEY. I apologize for the fact that we're doubling up on hearings this morning, but because of the death of Congressman Long, we've had to rejuggle our hearings.

I have a number of quick questions I'd like to ask you, and I'd appreciate it if you would keep the answers as brief as possible, so we can get through a number of them.

Let me just say that I would congratulate you in the sense that your projections, while they perhaps might be somewhat optimistic in outyears are, in my judgment, more realistic than we've often received in the past. But let me ask you, because I think there are at least some who view those projections on outyears as being at least somewhat optimistic, expecting, for instance, a 4-percent growth out to 1988, how would the deficit figures in the President's budget, in your judgment, be altered if the economy grew 1 percent slower than you project, let's say, by 1986, end of 1986?

Mr. NISKANEN. Congressman, we have a table on page 69 of the report that shows the sensitivity of the budget to changes in economic conditions, specific to fiscal 1986 and 1987. It permits you to isolate the effect of changes in particular conditions, holding other things constant, but of course, in an actual case, if the economy were weaker in terms of real growth, it's also likely to have somewhat lower inflation and higher unemployment, and so forth. So you really have to add these effects; 1 percent lower real growth by itself, with no change in these other conditions, would add about $15 billion to the deficit by 1987, but of course, that would also add to unemployment, is likely to add another $5 billion or $10 billion to that.

Representative OBEY. So, in other words, if that were to happen, there would be no decline whatsoever in those deficits for the next 2 years.

Mr. NISKANEN. If we were to have a recession in the next several years, the combination of the spending actions that we are requesting, plus a recession, would leave the deficit as big as it is now.

Representative OBEY. I'm not thinking in terms of recession. I'm just thinking in terms of slower growth.

I do want to say one thing. While I generally appreciate your statement, I do sometimes get frustrated by rhetoric used not just by you but by a lot of people, which simply doesn't reflect reality. And I'm trying to find the page on which that statement occurs. You discuss the amount of resources that would be available. You indicate that State and local governments under the present budget will have more resources and more freedom to pursue their own interests. And I really frankly don't understand how you can say that, because as I read the President's budget submission yesterday, budget authority for aid to State and local governments drops from $118 billion, in terms of a current policy base, to $92 billion, which is a $26-billion reduction, a 22-percent reduction in budget authority and a 9-percent reduction in outlays this year alone.

And while I certainly support some of the President's suggestions, including the elimination of revenue sharing, because I think that when we don't have the revenue to share it's pretty silly to borrow the money to send it out anyway. I didn't find many mayors or county boards urging me to increase the deficit lately, but nonetheless, I don't understand why the rhetoric, why the pretense that we are not seriously squeezing State and local governments, rather than providing them with more resources, when they obviously are going to be hit quite heavily by the budget recommendations, even though I support some of them.

Mr. NISKANEN. We are clearly squeezing Federal grants and aid to State and local governments. That doesn't change the amount of resources out there in the economy, but it gives them the opportunity to decide how much taxes they want to raise rather than having the Federal Government make that decision, and where it ought to be spent. You know, the resources out there in the economy are not what is at stake here. The issue is to who is going to make the decision.

Representative OBEY. Well, I don't want to debate whether we should or should not do it. My point is simply that to imply that we're making more resources available to the States and locals simply isn't the case. When we take a look at what they're going to be dealing with, and I frankly doubt you're going to see many States, having raised taxes already, unlike the Federal Government, I doubt you're going to see States going that route twice, when we don't have the guts to do it once.

I was intrigued by your statement, and perhaps you answered it in response to Congresswoman Snowe's question. You indicated that your analysis of the Federal tax system leads to the conclusion that a broader based lower rate system would substantially reduce the cost to the economy of a given level of government spending but may increase the relative size of government.

What leads you to say that?

Mr. NISKANEN. Well, a broad based lower rate tax system is a very efficient revenue agent and small increases in rates in that circumstance can generate a great deal more revenue.

I think that it is quite possible that the size of government in a particular country is significantly constrained by how much distortion is caused to the economy by the way it raises taxes, and if you reduce that distortion, you may very well have an increase in the size of government.

Representative OBEY. Well, I know that some have almost a theological approach to the question of the size of government as opposed to a philosophical one, but I don't think you would want us to err on the side of increasing the irrationality of the Tax Code as a lesser evil than a small increase in the size of government, would you?

Mr. NISKANEN. No; but I do think that there are sufficient biases in our present political processes that we may want to pair a reduction of tax rates with a constitutional amendment on total spending authority.

Representative OBEY. So, that it goes into effect in the hereafter but not for those who have to wrestle with it today, I take it.

Mr. NISKANEN. A constitutional amendment would not be a substitute for hard choices. It would just force an earlier resolution of those hard choices.

Representative OBEY. I would like to ask some more questions, but we're running near the end of time for the hearing. Let me ask members of the committee if they have a short question or two which they'd like to ask, before we move on to Mr. Volcker.

Senator Abdnor.

Senator ABDNOR. I would like to add one question to what we were talking about when my time ran out. The one page and a half that I'm referring to in your Economic Report of the President, you say "Returns can be expected to improve over time through a combination of improving market conditions and a reduction of excess capacity. Change in agricultural policies can also help by restoring the growth of agriculture exports."

That's fine. I'm not going to go into exports, but until we do something about getting that dollar in line with other countries, somebody's going to have to help those agricultural exports. A country can buy 4 bushels of wheat from the European Common Community for the same price they would only get 3 bushels from us, that takes a pretty good sales job. Someone, some way, somehow, is going to have to help, or we will go back to a very controlled style of agriculture, and that's not the answer.

The statement,"returns can be expected to improve over time," what do you mean by "over time"? How long are we talking about? This is the kind of question I'm getting back home. What are your views of agriculture down the road? Are things going to improve? In your judgment, what is meant by "over time"?

Mr. NISKANEN. Things for those people who remain in agriculture, their returns will improve faster the more other people leave agriculture.

Senator ABDNOR. Say that again. Those remaining——

Mr. NISKANEN. For those who remain as farmers, providing our food and fiber, their returns will increase faster the more that other people leave the farming community.

Senator ABDNOR. Why? Are they going to raise less?

Mr. NISKANEN. Just in terms of tightening up the available supplies.

Senator ABDNOR. Well, then, what's the answer? To get rid of half of our farmers?

Mr. NISKANEN. Given current conditions, we have excess capacity in American agriculture. And that is reflected by the fact that the returns are fairly low.

Senator ABDNOR. Now, wait a minute. We have excess capacity, that may be true, but if our share of the foreign export sales were keeping up like it ought to, that wouldn't necessarily be true. It has been dropping every year in the last 3 years as a percent.

Mr. NISKANEN. I agree. I agree. The main problem there, in addition to the strong dollar, is that our loan rates set the world price on any number of products. We're supporting that world price by buying commodities.

Senator ABDNOR. Well, I don't want to put words in your mouth then, but I'd have to conclude when you say "by improving market conditions," part of that apparently is caused by dropping out a number of farmers so we don't have as many farming. I can almost guarantee you that land is going to stay in production unless we finally get rid of the marginal land that our tax laws are encouraging to get plowed. The most awful thing that's happening out in my country are those marginal lands that are being plowed up by holding companies coming in because they can write it off as a tax loss and get a huge percentage of the allotments in 2 years and then collect from the Government.

But, how are we going to improve market conditions?

Mr. NISKANEN. I think we should move as quickly as possible to market prices in agriculture and use whatever amount of money we put aside for Department of Agriculture budget to erase the transition of the existing farm community to a market-based agriculture. That condition is more likely to have a viable longrun picture for American agriculture, and for farm implement suppliers and fertilizer suppliers in America, and the rural banks, and everything else, than trying to hold back the tide here.

Senator ABDNOR. I can only say, Mr. Niskanen, that I will want—to a free market. Eventually, it may work itself out after enough people go out of business. I don't see anything that's going to make that price go up. Even the efficient operator right now cannot take that much less of a price to stay in business.

If they had the same problems and the same economic factors involved in their agriculture that they do in Argentina and they do in the European Common Community, it might be all right. But do you really think that the people in this country would see the day when they have to pay 15½ percent of the average salary for food? That is what they are paying.

That's the greatest bargain in the world. I think sometimes people in government, being politicians, like to make the consumer happy, therefore, we keep almost every article that goes out saying, "This shouldn't make consumer prices go up."

Maybe we're going to have to look like Europe and make the people themselves do the subsidizing of the food. England and the European Common Community, that has been doing fairly well in agriculture, couldn't do it. They had to do it on the prices that we receive here.

Mr. NISKANEN. Absolutely. Our conditions are much more favorable than in Europe in that we have low prices and high subsidies and they have high prices and high subsidies. I prefer our situation, but I think that we can do better than that.

Senator ABDNOR. I hope so. Thank you.

Representative OBEY. Congressman Scheuer.

Representative SCHEUER. One last question, Mr. Niskanen.

Paul Volcker has said many times that if the Congress and the President can't agree on at least $50 billion worth of spending reductions, then he would feel that we need revenue enhancement or tax increase, however elegantly you wish to phrase it.

What is your view of the matter?

Mr. NISKANEN. I think the best test is whether we can stabilize the debt to GNP ratio. And the President's proposal is the minimum necessary to do that. Now that's $50 billion in 1986, and a good bit more than that in 1987 and 1988 that are the outyear effects of the actions initiated in 1986.

We cannot continue to increase the debt to GNP ratio. And the President's proposal is just the minimum necessary to do that.

Representative SCHEUER. My question was, if we don't hit the $50 billion in 1986 over here, do you think we're going to need to raise taxes?

Mr. NISKANEN. Or to cut spending more in some subsequent year. Now, at some stage, Congress is going to say, We don't want to cut spending any more. Now my own personal preferences are that we ought to focus entirely on the spending side for as long as it takes to get that down. But the decision ultimately as to whether to raise taxes is a vote that we want bigger government than what our revenues are now generating. That's not my preferences, but it may be that by others.

Representative SCHEUER. Thank you, Mr. Chairman.

Representative SNOWE. Thank you.

Mr. Niskanen, I know time is running out, but very quickly I'd like to raise an issue that was not mentioned in your statement or in the Economic Report. It is the issue of comparable worth. You referred to it last fall as being a truly crazy proposal.

First of all, I'd like to know which proposal were you referring to, and on what basis do you make your comments? There have been a number of studies to the contrary. One most notably by the National Academy of Sciences, and others. In fact, I chaired several hearings sponsored by the Joint Economic Committee concerning women in the work force. Many indicated that after you take away skill, education, responsibilities, interruption because of marriage or child-bearing, there was an unexplained percentage of the wage gap.

So I'd like to hear your comments on that issue, which I consider to be a very important issue.

Mr. NISKANEN. Surely. Let me make a couple of distinctions. One is that the concept of comparable worth should not be confused with equal pay for equal work. Equal pay for equal work is both the characteristic outcome of the market and the law of the land, and we very strongly support that.

Second, if an individual institution, whether it's a firm or university, or whatever, wants to bargain on a particular wage structure and they can come to a deal with the employer, that's none of our business. I think that that should be resolved by a collective bargaining arrangement, or by the competition in the labor market.

The issue, the key issue, is whether Federal law should impose either through administrative procedures or through the courts a standard for wages across different types of jobs. That proposal or that idea that there should be a standard established in the law that bears on wages and labor compensation across the jobs is the sort of proposal that I was describing as being truly crazy.

Representative SNOWE. Well, may I just say in response to that is that, to my knowledge, there is no proposal to advance that kind of notion to set it across the board nationwide.

Mr. NISKANEN. Fine. If individual institutions want to do that, well and good. I think it is not really our business as Federal officials to pass judgment on what they want to do. I think that the important issue is the question of whether the Federal Government should set a standard for, or establish a standard for wage setting across occupations and skills and, on that basis, I would strongly oppose it.

Representative SNOWE. Well, the Federal Government should do it for ourselves, for everybody who is employed by the Federal Government. A number of the State governments have conducted job evaluation studies and have implemented comparable worth programs and done very well by it. And I think that we should follow suit within our own institutions. Thank you.

Mr. NISKANEN. That's their business.

Representative OBEY. Let me just say in closing that there is a statement of yours with which I very strongly agree. You say, "The substitution of borrowing for current tax receipts only defers the necessary taxation. The current deficit is a crude measure of the present value of the amount by which future spending must be reduced or tax receipts must be increased."

Given the rhetoric which was used in the last campaign and given the opportunity that was missed in the last campaign to educate the American citizenry about the specific facts of the budget and the deficit, I have absolutely no intention of voting for any tax increase unless I get a letter with a notarized seal from the President of the United States.

But, nonetheless, I think the Congress ought to meet the President's overall spending target. But I would hope that we could in fact go beyond that. And I think it's a shame that we aren't going to be focusing on the need to avoid shoveling tax burdens on to future taxpayers, because that's really what's happening.

And while I know it is not going to happen, I hope that at some time the parties can get together to face that reality because the only time that you can really provide the kind of public education that is necessary in our system, the only time you can really effectively wrestle with that kind of a problem, is when both parties face up to their responsibilities to do so.

So that the education process takes place so that the public understands why painful tasks are necessary.

I thank you for your testimony today and look forward to seeing you again. And good luck to you and your very important agency.

Mr. NISKANEN. Thank you, Mr. Chairman.

Representative OBEY. If we could break for about 5 minutes, Mr. Volcker is scheduled to appear next, the hearing will resume in about 5 minutes.

[Whereupon, at 10:35 a.m., the committee recessed, to reconvene at 10:50 a.m., the same day.]

10:50 A.M. SESSION

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. We are pleased to have as our second witness today, the Honorable Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve.

Even if 1985 turns out to be a good year for the economy it is going to be a very difficult one for economic and political policymakers. During the next few months, obviously, the Congress and the administration will be tied in knots over the issue of how to reduce the budget deficit. Everyone agrees, I think, that the deficit must be reduced. There's a great division of opinion about how to do it. We also face a trade deficit over $120 billion and the dollar, again, this morning is looking pretty fat and sassy.

Both manufacturing and agriculture are under vigorous attack from foreign competitors who are often doubly advantaged by lower costs and a dollar whose value has gone up by about 70 percent since 1980.

And even though nominal interest rates have declined, real interest rates remain far above historical ranges and both the short and long-term outlook depend heavily on monetary decisions that the Federal Reserve will be making this year. I'm sure the Feds would say their decisions certainly depend heavily on what happens in the fiscal sector as well.

But as Congress and the administration play Alphonse and Gaston over deficit reduction, the Fed will have to design an overall monetary policy with the following goals in mind, continuing the expansion at a rate strong enough to put unemployment on a downward track, keeping inflation under control, stabilizing the dollar and relieving pressure on our manufacturing and agricultural sector, keeping interest rates from rising, and hopefully, eventually getting them headed in a downward turn.

I personally am also very concerned about what may happen to a significant number of rural banks throughout this country, although some of them may not be plugged into the Federal Reserve.

Mr. VOLCKER I welcome you here this morning for whatever comments you might have but before you begin I'd like to ask for the vice chairman, Senator Abdnor, to make a few comments.

OPENING STATEMENT OF SENATOR ABDNOR, VICE CHAIRMAN

Senator ABDNOR. Well, thank you, Mr. Chairman. I, too, welcome Mr. Volcker before the Joint Economic Committee.

Monetary policy, of course, is a crucial factor in the health of the economy. We're very interested in what your comments are going to be on where monetary policy is going to be headed this year.

Mr. Niskanen has just testified 1985 should be a good year for the economy and I certainly hope and pray he's right, but a lot depends on you and your Federal Reserve Board, Mr. Chairman, and I wish you the wisdom of Solomon as you walk that tightrope between inflation and recession.

Now, we're all grateful to see the recent easing in interest rates but I think you and I agree that real interest rates are still too high. I don't want to sound like the only thing I talk about is farmers, but these interest rates are certainly hurting that group in rural America, as well as small businessmen, homebuyers, and many other groups. I am sure as always you are going to tie some of your comments to the deficit, but I think we all agree that interest rates are too high in light of the low inflation rate, and I hope you will go into that today.

I would like to comment on one thing that I think is a major problem. Mr. Volcker, I know I've been in front of committees before with you and I know you've had this brought to your attention, but I look at that chart over there [indicating] that shows the monthly changes in money supply from 1978 through 1984, and do you know what it makes me think of? Someone's EKG from a——

Mr. VOLCKER. With a heart attack, huh? [Laughter.]

Senator ABDNOR. Well, that's what we might be headed for here, a massive coronary if we're not careful. At least in some areas we might be.

This wild fluctuation in the money growth apparently has had an unsettling influence on money markets and the ability to hold interest rates down. I'm told that between June and November of last year our M1 growth was virtually flat and since then it's expanded to an annual compound rate of 14 percent. If there's anything money markets hate it's bad news, their uncertainty and uncertainty in monetary policy causes lenders to add risk premiums to interest rates.

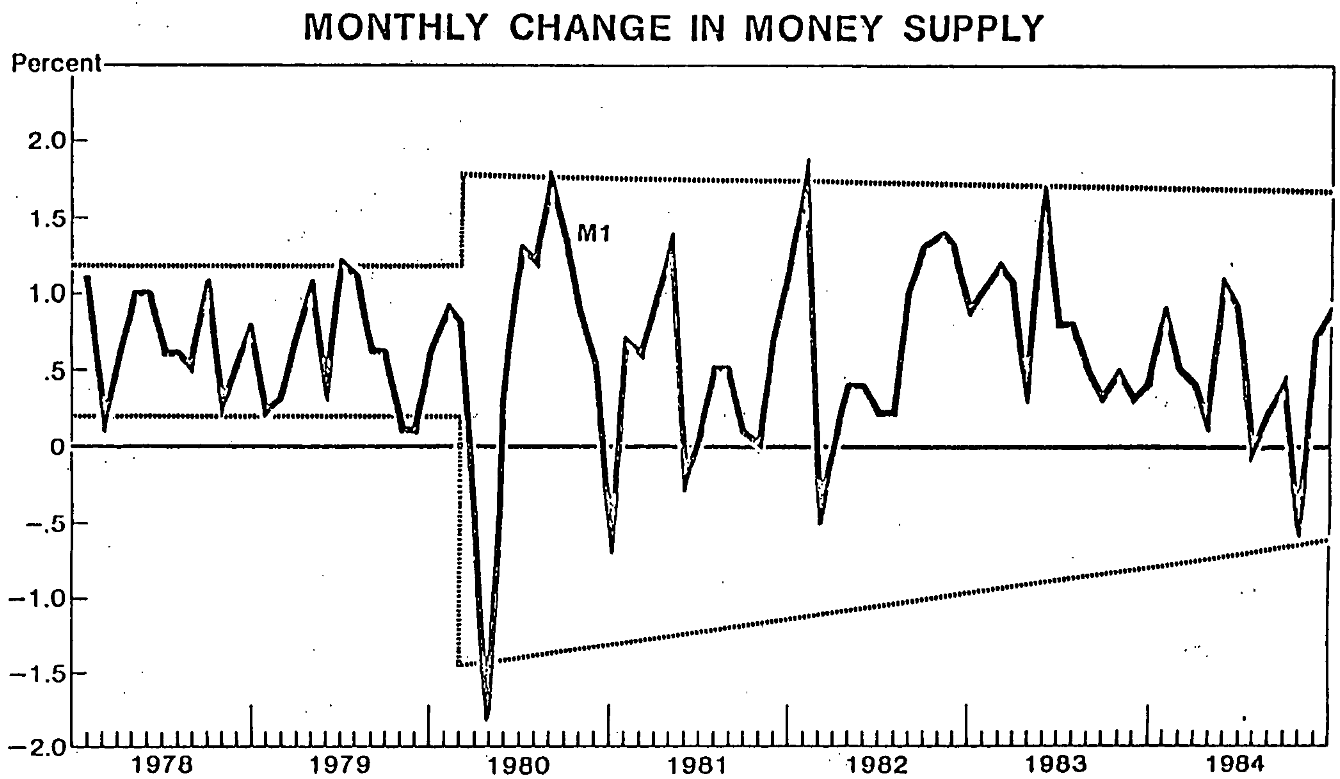
You're the captain of this whole ship, Mr. Volcker, and I am sure it's in good hands, but I hope you steer it on the right course. I'm sure if anyone can do it, you will. But we have to keep trying to shoot those interest rates down; Congress plays a big part in keeping them high, too.

I want to leave a message with you, Mr. Volcker, and it strays a bit from my statement here. When I go back to my State what really disturbs me is that the confidence is gone. The confidence is gone from our bankers, our farmers, and our businessmen. No one has any confidence in anything and that's just about the worst situation possible. Times are tough and there are a lot of people, both in small businesses and out on the farm, that are in horrible, horrible shape. Conditions themselves were bad enough and now the banks are scared too—you know. The lending institutions are becoming extremely upset and concerned with the poorer risks that they've had, and they could well lose substantial amounts of dollars by closing down a lot of businesses and farms. But this disenchantment has now spread into the median area, to people who are now in debt, but who were considered in pretty good shape up until this time. I really think a lot of this is coming from Washington.

The banking industry is very complex. I'm not sure which part Federal Reserve plays in regulation compared with the Comptroller, the Treasury, or the FDIC, but I can think of one bank out in my country which did something wrong and was criticized and told to do three different things. They did what they were told to, but they couldn't get off the regulator list, probably the FDIC.

So now they're scared to make a move and they're closing these people out, people who shouldn't be closed down on. These people are still a good risk. But this fear and lack of confidence is running rampant throughout the whole district and some way, somehow, help has to come from Washington. I don't mean with massive dollars necessarily, although that always helps, but maybe we can instill some confidence or ease off of those bankers somehow in order to give these people a break, because that is what they really need right now if they are going to be able to help themselves. Thank you.

[The chart referred to in Senator Abdnor's opening statement follows:]


MONTHLY CHANGE IN MONEY SUPPLY
Percent
2.0
1.5
1.0
.5
0
-.5
-1.0
-1.5
-2.0
M1
1978
1979
1980
1981
1982
1983
1984

Representative OBEY. Mr. Volcker, please proceed.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Well, Mr. Chairman, and members of the committee I'm happy to be before you once again to discuss the economic situation. As you know, the Federal Reserve will be submitting its semiannual report on monetary policy to the Congress in about 2 weeks. My testimony then will provide a full account of recent monetary developments and will report on the decisions to be taken shortly by the Federal Open Market Committee regarding money and credit targets for 1985. Therefore, in my prepared statement this morning, I will limit myself to a broader view of the current economic setting with some emphasis on the interrelationships between domestic and international developments.

Two years ago, when the current business expansion was just beginning I expressed to this committee my belief that through a difficult period of economic and financial adjustment, we had potentially been laying in the groundwork for sustained growth and prosperity. I felt then, and I feel now, that restoring and maintaining a greater sense of price stability would be central to that effort.

Today, I think it is fair to say that bright promise for the longer run remains. Economic growth has, in fact, been strong over the past 2 years, and inflation has remained at or very close to the much lower levels reached at the start of the recovery period. As 1985 started, most observers have shared the view that prospects for further growth remain good, and expectations of stronger inflationary pressures as the expansion period is extended, quite prevalent earlier, have been at the very least muted.

Nonetheless, clear risks and obstacles remain to making good on our own potential both for stability and growth, and to accomplishing that, as we must, in the context of a more prosperous world. To a considerable degree, the buts and ifs are well understood. Yet, that intellectual understanding will be for naught if the appropriate policy responses are lacking, whether because of unwarranted complacency bred by current performance, because of the inherent political difficulty of reaching the necessary concensus, or because of some combination of the two.

THE EVIDENCE OF PROGRESS

The clearest evidence of progress toward our longrun aims lies in the combination of better than anticipated growth and lower than anticipated inflation over the past 2 years. To be sure, the current expansion began from a low level, and unemployment has not yet been reduced to levels we have enjoyed historically and want to regain. But after widespread doubts about our economic prospects, the recovery of 1983 has blossomed into what has been one of the strongest expansions of the postwar period.

Real gross national product grew more than 5.5 percent over the course of 1984, bringing the cumulative gain in domestic output over the past 2 years to about 12 percent. The rise in production has been associated with an increase in employment of more than 7 million since the end of 1982, and the unemployment rate has fallen about 3.5 percentage points to around 7.25 percent. As part of that general improvement, there has been a sharp rebound in profits and a surge in business investment, factors that should bode well for our future growth potential. Spending for innovative, high-technology capital has grown especially rapidly. Productivity has grown more strongly, although there are still important questions as to how much the underlying trend has improved.

The recent monthly data on consumer and producer prices continue to show only very small increases for a wide range of goods. For some important commodities, including petroleum and a number of raw materials, price declines have been more common than price increases. Prices of most services have continued to increase at a substantially more rapid rate—averaging 5 to 6 percent at the consumer level. Most of our economy today is, in fact, a service economy. Those services are generally subject less directly to competitive pressures from overseas. Moreover, labor intensive sectors of the economy, such as many services, may have less opportunity for productivity growth. Nevertheless, the rate of price increase for services has been significantly less than in the late 1970's and the first years of the 1980's.

Further improvement will be necessary in these areas to maintain progress toward stability. In a direct sense, that depends in considerable part on whether the rate of nominal wage increases continues to decline in service industries to levels more characteristic of the rest of the economy.

With inflation down, workers generally have apparently felt less need to press for large increases to make up for past price increases or to stay ahead of expected inflation. Businessmen and workers in manufacturing, mining, and construction have also recognized they often operate in a more competitive and more international environment—one in which there are obvious perils in rising costs and prices and a premium on efficiency. The restraint on wages and costs generally need not mean, however, reduced prospects for gains in real income. To the contrary, the payoff in a growing economy, with rising productivity and more stable prices, is more jobs and higher real incomes for the average worker.

Success in containing inflation can help to breed further success. It is indispensable to prospects for achieving and maintaining a lower level of interest rates, which, despite declines in recent months, have remained historically high. Over time, expectations of greater price stability should become increasingly woven into the fabric of household, business, and financial decisionmaking. Efficiency and productivity should benefit as less energy is spent in the largely futile search for ways to beat inflation. Pressures for precautionary wage and price increases have diminished. As borrowing and lending horizons are lengthened, the financial structure should be strengthened, and less inflation insurance will be built into long-term interest rates.

OBSTACLES AND RISKS

After all the disappointments of the past with failed anti-inflationary efforts, that process inevitably takes time. Meanwhile, we cannot simply assume that inflation has been conquered, or that we have in fact reached a new era of sustained growth. There are still too many obstacles to permit that kind of satisfaction.

To put it bluntly, there are large and unsustainable imbalances in our economy, and in the world economy. In the midst of the overall improvement that I cited earlier, those imbalances are reflected, for instance, in the intensity of the strains in agriculture and in a number of other basic industries. There have been exceptionally high levels of unemployment in many other industrialized countries, and, looking ahead, too few signs of really significant improvement in that respect. That outlook abroad bears on our own markets. Moreover, the financial position of the heavily indebted developing countries remains vulnerable, and their difficulties can feed back in our own economic outlook and financial system. As I noted earlier, interest rates remain high relative both to historical experience and to recent rates of inflation.

These difficulties arise in part out of structural problems unique to one sector or another, and to that extent must be addressed at that level. The painful pressures on some businesses, farms, and financial institutions also reflect the strain of adjusting to a less inflationary environment, when their financial decisions had, implicitly or explicitly, been based on expectations of accelerating inflation. But these strains are being aggravated by financial pressures and dislocations related to our budgetary problems. Until that underlying problem is dealt with appropriately, we will unnecessarily be putting at risk all those bright prospects for stability and growth of which I have spoken.

The distortions in the economy are manifest in our massive trade and overall current account deficits, which reached levels of almost $110 billion and $100 billion, respectively, during 1984. It is not a coincidence that those external deficits are accompanied by an enormous internal budget deficit—a deficit that, according to both administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy economic growth.

Given the deep recession and high levels of unemployment in 1982, the sluggishness of the world economy, and the strains on developing countries, sizable deficits in our budget and trade accounts could and did serve an important transitional function in helping to encourage recovery here and abroad. Specifically, the domestic deficit helped sustain and increase domestic purchasing power, and the more favorable tax treatment for investment helped encourage capital spending. The growth of our markets has probably been the single greatest expansionary force for other countries over the past 2 years, and our economy absorbed the brunt of the necessary efforts of the heavily indebted Latin American countries to restore external financial and economic equilibrium.

At the same time, the strength of the dollar in the exchange markets, together with the ready availability of goods from abroad, have been potent factors in damping inflationary forces and satisfying our consumption demands.

What then, it might be asked, is the difficulty? Why not rest content?

The answer, most fundamentally, is that economic analysis and common sense coincide in telling us that the budgetary and trade deficits of the magnitude we are running at a time or growing prosperity are simply unsustainable indefinitely. They imply a dependence on growing foreign borrowing by the United States that, left unchecked, would sooner or later undermine the confidence in our economy essential to a strong currency and prospects for lower interest rates.

At the same time, the hard fact is that the budget deficit, on top of the private investment needed to support growth and productivity, outruns our internal savings potential. The largest and richest economy in the world has perforce been required for the time being to draw on savings generated abroad; in that real sense we are living beyond our means. As we continue to draw so heavily on the world's savings, there is a drag on internally generated expansion elsewhere, feeding back on our trading prospects. And, the resulting imbalances and financial strains generate political pressures, here and abroad, for counterproductive protectionism, for economic nationalism, and for excessive money creation that would, if implemented, undercut and jeopardize all the progress we've made.

THE EXTERNAL DIMENSION

While much of our rhetoric still skirts the issue, the time has passed when we can intelligently assess our performance and our policies without considering the external dimension—the implications for international trade and capital flows, exchange rates, and economic and financial conditions elsewhere. Like it or not, world financial markets and economies are integrated as never before. Over time, I believe, we derive enormous benefits from that fact. But it does impose disciplines of its own.

The complications in analysis and the potential for good or ill were amply illustrated in 1984. As you know, the growth of economic activity slowed rather abruptly during the summer and early fall. Following the exceptionally rapid growth over the first half of the year, some slowdown should not have been surprising, given the fluctuations in consumption and inventory imbalances common as an expansion period is extended. By yearend, there was evidence once again of more positive trends in household spending and some inventory imbalances appeared to be at least partially corrected.

But as domestic demands slowed, the more fundamental imbalances remained and became more obvious. Throughout this recovery, domestic purchases of goods and services have increased faster than domestic production. In essence, a lot of demand generated in this country has flowed abroad through our rising trade deficit, providing stimulus for production overseas rather than in this country. The increase in imports didn't seem to matter much so long as output and employment generally were expanding so rapidly. But, even then important sectors of the economy, in a real sense, did not share at all fully in the overall recovery, with trade pressures aggravating deep-seated structural problems. As soon as domestic demand dropped from the extraordinarily rapid rate of the first half of the year, the effects of the demand slowdown on production were amplified by the rising trade deficit.

From 1982 to the second half of 1984, the current account deteriorated by about $100 billion, pushing us into an external deficit equivalent to 2.5 to 3 percent of the GNP. Just as for household or business, current spending abroad can exceed current income only to the extent that we can draw on foreign assets or debt is increased. As a consequence, the United States is in the process of moving from the world's largest creditor to the world's largest debtor.

Thus far in the expansion, the net inflow of capital needed to finance the current account deficit has been readily forthcoming, so much so that the dollar exchange rate has persistently strengthened even as the American current account has deteriorated. No single factor appears to account for that flow. Relatively high interest rates in this country, our success in reducing inflation, and perceptions of political stability and economic vitality all have contributed. But political and economic uncertainties abroad appear to have played a part as well. That strong flow of funds from abroad has been a key factor helping to ameliorate financial stresses in this country, as expansion generated large new demands for private financing on top of the continuing Federal deficit. Two tables attached to my statement illustrate the point.

As indicated there, net domestic savings—personal, business, and State and local government—have increased appreciably as the economy has expanded. The ratio of net savings to the GNP is near the top of its historical range. But those domestic savings have not been nearly enough to finance both rising private investment and the Federal deficit. Those requirements, relative to the gross national product, have risen about 4.75 percentage points in the past two years to about 11.5 percent of the GNP, far above past relationships. About half of that increase was met by higher savings from abroad.

I don't believe we can escape the conclusion that, without the ready availability of savings from the rest of the world, pressures on our financial markets would have been greater and domestic interest rates would have been still higher, at some point undermining the outlook for domestic housing and investment.

The kind of obvious crowding out, so widely anticipated a year or two ago, has been avoided. But, in a real sense, important sectors of our economy are paying the price. Those dependent on foreign markets and those competing with imports are being crowded. To put the point in perspective, the $100 billion deterioration in our current account—a measure of lost markets for U.S. producers—is equivalent in size to about two-thirds of the entire residential housing sector.

As I emphasized earlier, viewed in a world context, our ability and willingness to run a sizable trade and current account deficit during a period of strong domestic recovery had constructive implications for others. But, as we look ahead, neither we nor other countries can expect growth to be maintained indefinitely on a shaky foundation of large and growing trade deficits, massive capital flows to the United States, and accelerating international indebtedness.

The visible strains in some sectors of our economy and interest rates that have remained historically high are clear warning signals. Perhaps less obvious but nonetheless real, the drain of savings from other countries to the United States and the related tendency for their currencies to depreciate vis-a-vis the dollar, appear to be inhibiting more forceful policies to encourage home grown expansion abroad. A healthy world economy—and better export markets for the United States—are ultimately dependent on that expansion. The dilemma is that so long as demands on our own capital markets exceed our capacity to save, the stability of our own financial markets is, in effect, hostage to a large continuing inflow of foreign capital.

That flow, in turn, is dependent on the maintenance of confidence in our own prospects and in our own currency. But so long as the imbalance in our trade persists and increases, the greater the risk that that confidence will be eroded, disturbing our financial markets and jeopardizing our growth. It is that apparent inconsistency that must be confronted.

THE ROLE OF MONETARY POLICY

While I will be testifying with respect to Federal Reserve policy in some detail shortly, a few general observations about monetary policy are appropriate. That policy, in most general terms, is directed toward encouraging the process of restoring price stability while providing enough money to support sustainable growth in demand and output. Reasonable progress in those directions was made in 1984. Indeed, the strength of the dollar, despite the larger current account deficit, helped to reconcile strong growth in demand over the year as a whole with restraint on prices. But, as I indicated a few moments ago, the rising trade deficit, as more of the domestically generated demand spilled over abroad, clearly raises questions of the sustainability of a process dependent on large inflows of capital.

Monetary policy can stimulate growth in the money supply, but it cannot create the real savings necessary to finance high levels of investment and excessive budget deficits simultaneously. That depends upon all the factors inducing individuals and businesses to save for the future. Efforts to, in effect, paper over the difficulty by financing the huge budget deficit by excessive money creation would surely be counterproductive. We would undermine the growing confidence in prospects for stability. That confidence is a necessary ingredient in any effort to see lower interest rates in the years ahead, and it is also essential to maintain the flow of capital from abroad upon which we are for the time being dependent.

In sum, I see no realistic escape from our dilemma by reverting to inflationary monetary policies. They could only accelerate the disturbances we want to avoid. Indeed, without action on the budget and other fronts, the possibility of a reduced flow of capital from abroad would, if it materialized, constrict the flexibility of monetary policy.

THE PROTECTIONIST SOLUTION

The current trade imbalances and the strong pressures on particular economic sectors certainly lead to strong pressures for protection from affected industries. The better approach toward relief is symptomatic, not fundamental. Indeed, yielding to those pressures could only aggravate the difficulties, so long as the underlying financial imbalances persist.

Suppose, for instance, strong protectionist measures actually had a pronounced effect in closing our trade deficit. Then by definition, the capital inflow from abroad would also be reduced, and interest rate and inflationary pressures increased. The benefits to one industry would be offset by greater financial market pressures and damage to others. Or, if the capital inflows were maintained, the dollar would presumably be driven still higher, shifting the burden to exporters and unprotected industries.

More realistically, protectionism here would be matched, or more than matched, abroad, with devastating consequences for world trade and growth.

A CONSTRUCTIVE APPROACH

One lesson of our experience seems clear. The progress that has been made toward greater efficiency, cost restraint, and innovation needs to be continued and encouraged by public policy in a variety of ways rather than discouraged by a retreat into protectionism or into permanent new Federal subsidies that distort the economy and aggravate the deficit.

I do not want to suggest all the burden of sustaining a favorable economic climate and restoring external equilibrium rests on the United States. A number of industrialized countries abroad might reasonably review their own possibilities for stimulus in the light of their own high levels of unemployment and rather sluggish growth, and they could constructively work to remove the structural impediments to their growth. There is too much protection of markets abroad, and the efforts to deal with that need to be maintained and even intensified.

There is no single magic pill to restore equilibrium and assure growth. But neither can there be real doubt that it is within our capacity to take a large step, here and now, to ease the necessary adjustments in agriculture and industry at home, to make us less dependent on foreign savings, to improve trade prospects, and thus to reinforce prospects for growth and stability. That step, of course, would be to make decisive reductions in our budget deficit. Those reductions, to be credible, should be large enough and assured enough to have an impact on expectations and confidence, even if they cannot be fully effective for some time.

That is, of course, by now a familiar plea—but it is no less urgent for its familiarity. To the contrary, the sharply increased size of our external deficit, the tendency for the budget deficit to grow even as the economy expands strongly, and the still high interest rates, should be warning enough that we are on an ultimately unsustainable path.

Deficits that are relatively benign in the depths of recession or in the early stages of recovery turn destructive at a time of relative prosperity. They are reflected in the imbalances in our own economy. At the same time, our dependence on foreign savings can only impede the prospects of self-sustaining growth abroad—and we cannot indefinitely be virtually the only engine for world expansion.

Action now and action large and forceful enough to be seen to be decisive is the constructive way to resolve the impasse and to work toward international balance. In the process, it will help enormously to ensure those bright prospects for growth and stability of which I spoke at the start.

Thank you, Mr. Chairman.

[The tables referred to in Mr. Volcker's statement follow:]

TABLE 1.—DEMANDS ON NET SAVING AND SOURCES OF NET SAVING

[Percent of gross national product]

	Total	Demands on net saving		Sources of net saving	
		Net private investment [1]	Federal budget deficit [2]	Domestic [3]	Foreign [4]
1974	7.0	6.2	0.8	7.2	−0.2
1975	7.1	2.7	4.5	8.3	−1.2
1976	7.6	4.5	3.1	7.9	−0.3
1977	9.0	6.6	2.4	8.3	0.7
1978	9.1	7.7	1.4	8.4	0.7
1979	7.6	7.0	0.7	7.6	0.1
1980	6.4	4.0	2.3	6.6	−0.2
1981	7.2	5.0	2.2	7.4	−0.2
1982	6.7	1.8	4.8	6.5	0.2
1983	8.2	2.8	5.4	7.2	1.0
1984(p)	11.4	6.6	4.8	8.9	2.6

[1] Net private investment is the sum of business fixed investment, residential construction outlays, and the change in business inventories, less depreciation, minus a statistical discrepancy.

[2] NIA basis.

[3] Domestic net saving includes personal saving, undistributed corporate profits, and State and local government surplus.

[4] Equals payments to foreigners for imports of goods and services, transfer payments, and interest paid by Government to foreigners minus receipts from foreigners for exports of goods and services.

Note: These figures exclude depreciation, which amounted to $403 billion in 1984; including depreciation would raise both domestic investment and domestic saving.

Source: Calculations based on data from the National Income and Product Accounts.

p= preliminary.

TABLE 2.—DEMANDS ON NET SAVING AND SOURCES OF NET SAVING

[Billions of dollars]

	Total	Demands on net saving		Sources of net saving	
		Net private investment [1]	Federal budget deficit [2]	Domestic [3]	Foreign [4]
1974	100.4	88.9	11.5	103.3	−2.9
1975	110.6	41.3	69.3	128.8	−18.3
1976	130.8	77.7	53.1	135.9	−5.1
1977	173.4	127.5	45.9	159.7	13.6
1978	196.1	166.7	29.5	181.8	14.3
1979	184.6	168.5	16.1	182.8	1.8
1980	167.7	106.4	61.2	174.0	−6.3
1981	212.6	148.3	64.3	218.4	−5.8
1982	204.6	56.5	148.2	198.1	6.6
1983	272.6	94.0	178.6	238.7	33.9
1984(p)	419.0	242.6	176.4	324.5	94.5

See table 1 for footnotes.

p= preliminary.

Representative OBEY. Thank you, Mr. Volcker.

Let me start by referring to the administration's budget submission yesterday. The January 16 newspapers reported that you had told a group of Senate Republicans that the fiscal 1986 deficit ought to be reduced by a minimum of $50 billion.

What is the economic justification for that specific target?

Given the administration's original intention to reach a deficit reduction target of about $144 billion rather than $100 billion by 1988, what is the best path to follow? How much should we be aiming to cut that deficit this year and by 1988?

Is this target given to us by the administration sufficient or insufficient? Where do you come down on it?

Mr. VOLCKER. My general answer to that would be very clear: Do as much as you can as soon as you can. I don't have any fear that you will do too much in terms of restoring balance to the economy.

I cited that upward of $50 billion figure for the first time a year or more ago. As time passes, it probably should be raised, but that is partly a psychological judgment as well as an economic judgment.

I think the economics all go in that direction and produce favorable results in terms of interest rates, in terms of the trade accounts, in terms of the outlook for investment, and all the rest.

But I cite that figure in answer to the question: What is likely to be convincing and therefore have an impact on expectations and incentives in the market place and have a chance of having an impact on interest rates in the near term—recognizing that even that $50 billion, if you are talking about spending cuts, isn't going to take place for a year or so?

And $50 billion is not enough. That is just the first step. But, of course, if you took $50 billion of spending cuts, that will have cumulatively larger impacts down the road, if you stick to it.

When you look at that administration forecast and see the size of the deficits still projected for 1988 and beyond, in the context of what might be called full employment, those are extraordinarily large deficits for a period of full employment.

Representative OBEY. Well, let me ask you, what would you estimate that those outyear deficits would show if the economy, say, grew at a 1 percent slower rate than is projected in the administration budget?

Mr. VOLCKER. They get bigger.

Representative OBEY. Yes, obviously, but——

Mr. VOLCKER. I think the administration——

Representative OBEY [continuing]. How would you quantify it?

Mr. VOLCKER [continuing]. Gave its own estimates of that. If I remember their figure correctly, it is something like $70 billion bigger when you get out 4 or 5 years.

They say it would be $73 billion bigger by 1990. The effect is not large in the near years, but it obviously cumulates.

Representative OBEY. What kind of effect do you think we could have on interest rates if we hit the administration target of $50 billion this year? How could we reasonably expect interest rates to change over a year's time if that is the case?

Mr. VOLCKER. The only safe thing I can say is they would be lower than they would otherwise be. I have been urged to quantify that from time to time, and I have suggested that economic analysis suggests if your $50 billion program were effective immediately—which is contrary to fact—that they might be on the order of magnitude of 1 percent lower in real terms.

They would be lower than they would otherwise be. I keep reading in newspaper columns and elsewhere that I have projected a level of interest rates. I am not projecting the level. I am saying lower than would otherwise be.

Representative OBEY. Let me ask you another question to put it in perspective.

I can recall in February 1980, when Senator Byrd summoned about 30 of us to his office for 3 weeks to try to reduce spending in the Carter budget, which had just been sent down——

Mr. VOLCKER. In the spring of 1980, I think.

Representative OBEY. Well, we started in February.

Mr. VOLCKER. That is right.

Representative OBEY. Yes.

Mr. VOLCKER. February.

Representative OBEY. And we went on almost a month.

Mr. VOLCKER. That is right, February is the time.

Representative OBEY. And I recall at that time your indicating to us how important it was that we take action to additionally reduce spending beyond that indicated by the Carter administration, and at that time we were projecting a deficit of $55 billion as opposed to the $180 billion which is being projected today.

The deficit as a percentage of GNP was certainly not as high as it is today.

It was panic time then, as you recall. Why isn't the situation equally serious today, given how much those numbers have changed?

Mr. VOLCKER. I think, in a real sense, the problem is much bigger now. As your question implies, the deficits are bigger. You don't have the psychological climate that you had then, largely for one very important reason. You were in the midst, then, of accelerating inflation and a feeling that inflation was going to go up further and that it couldn't be brought under control; the deficit would aggravate that. And you will, I'm sure, recall the atmosphere surrounding those discussions.

Today, we have the inflation rate at a quarter of the level that the Consumer Price Index was running at that time. The trend has been favorable, not unfavorable. There is a lot more confidence in the outlook in that respect, so you don't have that same sense of emergency. But the problem is very real.

Representative OBEY. Let me ask you one other question on the budget. I personally believe that the Congress will meet the President's overall spending number. But I do think that there will be a different mix.

What happens if I'm wrong and there are the normal pressures to partially restore some of the domestic programs that have been deeply cut under the President's budget. You have the pressure to take some of that, or to move it out of the military budget and into those programs. Let's say that the domestic programs would be restored somewhat, but we would not make compensating reductions in the military program so that we wind up, say, with a deficit reduction of, say $30 billion rather than $50 billion.

What do you think happens at that point in the real world outside?

Mr. VOLCKER. Frankly, consistent with my earlier answer, if you went in that direction from the proposals, I don't think you would get the favorable psychological and expectational impact on the market place that you would like to have. Now, to some degree——

Representative OBEY. You would see probably no impact at all?

Mr. VOLCKER. I would think no impact at all; conceivably, an adverse impact. What you can't tell is how much is now expected and anticipated. To the extent that some reductions are built into thinking, it helps keep the atmosphere calmer now with less sense of emergency. To the extent current expectations are disappointed, you could have an adverse impact.

I don't know; I can't make that fine a judgment. But I think I would make the judgment that you would not get the positive impact.

Representative OBEY. Let me ask you another question more directly related to the policies in your shop. My understanding is that within the last several weeks, two members of the Board of Governors, Mr. Martin and Mr. Gramley, have publicly taken somewhat different views of monetary policy with Mr. Martin arguing that monetary policy should be more expansionary, and Mr. Gramley arguing that monetary policy should become more restricted.

Where do you come down on that?

Mr. VOLCKER. We have a democratic organization. I think monetary policy should be just right. [Laughter.]

You know, you can pick up a particular sentence or sentences, from a statement and overinterpret them. There can be differences of views. We have set out tentative targets, as you know, for next year and I don't think I can anticipate or want to anticipate the decisions the committee will be making in meeting next week to confirm or not confirm those targets.

But the targets give a general indication of the kind of monetary growth that we foresee, that we think would be consistent with healthy growth in the economy and reasonable progress on the inflationary side.

The tentative target for M1 is 4 to 7 percent; it is 6 to 8.5 percent for M2; and 6 to 9 percent for M3.

Representative OBEY. My time is expired.

Senator Abdnor.

Senator ABDNOR. Thank you again, Mr. Chairman.

Mr. Volcker, let me commend you for the statement you just made. I believe that you presented the picture as accurately as it could possibly be stated. I wish you had some of the answers though to correct the problems that you say exist or that could well exist the way we're going.

Following the chairman's questioning, let me take it a point further. What if we not only reached that cut of $50 billion in 1986, which would bring us down to 4 percent of the GNP, and then went down to 3 percent in 1987, and 2 percent in 1988. We had those laid out in the outyears.

Would that be even an extra stimulus to bringing down those interest rates?

Mr. VOLCKER. It would certainly bring them lower than they otherwise would be if you project budget deficits of 5 percent of GNP out in those years. But, let me remind you that a budget deficit of even 2 percent of the GNP in those years ahead, in what might generally be called "full employment" years, would be an extraordinarily high deficit for those years.

Senator ABDNOR. I'm not arguing that.

Mr. VOLCKER. Our total savings capacity relative to GNP is reflected on these tables that I gave you. Our domestic savings capacity seems to be stuck in a channel of about 6.5 percent to 9 percent. They're now close to 9 percent, but they've just remained in that channel for years.

So, when you're talking about 2 percent of the GNP as a budget deficit, you're talking about 20 to 25 percent of our savings capacity in a good year.

Senator ABDNOR. I certainly wouldn't argue that. I know that getting the deficit down to $100 billion by 1988 is going to take a lot of doing and a lot of courage from around here.

Mr. VOLCKER. It is a lot better than the present outlook.

Senator ABDNOR. But I would like to think that by showing that courage and by putting it out in a document, these money markets will have enough confidence to drop a sizable percent because the drastic reductions we are going to have to make are certainly going to make it tough in some areas of this country right or wrong. I hope they will have some accompanying benefits that outweigh these costs.

Mr. VOLCKER. As I indicated, I think if the market were convinced of that, it would have the benefits in the direction you——

Senator ABDNOR. Would it be unrealistic to think that some day interest rates might drop as much as 3 percent, if you were to cut the deficit?

Mr. VOLCKER. It's going to depend upon other factors, too. Most importantly, you give me an assumption on inflation. If we do as well against inflation as I think we are capable of doing, interest rates could certainly decline by that much or more.

That depends upon how we do with inflation over the years.

Senator ABDNOR. Let me ask one last thing along that line. Would a tax increase of any dimension have an adverse effect, too, while we're trying to bring this thing under control?

Mr. VOLCKER. I'm now speaking strictly as an economic analyst. You have to balance off many other considerations. I think, from the standpoint of the economy, the more you can do on spending, the better. But I have always said if you can't do it on the spending side, then I think you have to look at the revenue side.

Senator ABDNOR. Quickly then, because my time is running out, you heard me in my comments talk about confidence, and I've heard you use the word four or five times here.

Mr. VOLCKER. Yes, and I wanted to comment on that, go ahead.

Senator ABDNOR. No, I wish you'd go ahead.

Mr. VOLCKER. I think most measures of confidence—which is an intangible in the economy as a whole and which you're going to feel through the country as a whole—suggest a lot more confidence now than a couple of years ago. But I think in an agricultural State like yours, you see a very different picture——

Senator ABDNOR. Right.

Mr. VOLCKER [continuing]. Because there is no question that there are very strong strains on grain farmers in particular that affect businesses in those areas that are dependent upon agriculture and affect financial institutions in those areas, so that the general statement about confidence in the country at large, and confidence by foreigners in this country, I don't think extends to those States that are very heavily dependent upon agriculture at the moment.

Senator ABDNOR. I appreciate your saying that. I just made a comment to Mr. Niskanen who just testified before us here, about how in his economic report there's about a page devoted to the whole subject of agriculture, and I think it is worthy of more than just that at this time. It is one of the biggest problems we have and it is often overlooked when we look at the overall economy. All the optimistic economic signs are fine, but none of them apply to where I come from or anywhere else in rural America.

There is another thing that is a very serious problem, I am not sure who does the regulating from the FDIC to the Comptroller of the Currency, or you and your organization, but I do know we have got to help. These people need it. The banks are not being very understanding right now because of the panic, and I think the Washington regulators are partly responsible for this.

These people are worthy of the confidence.

Mr. VOLCKER. Let me say what our policy is in that respect. We supervise some of those banks. We supervise less than the FDIC and the Comptroller of the Currency. But, some time ago, and on several occasions, we have directed our examiners and discussed with our examiners the need for "understanding", if that's the right word. We told them not to adopt approaches that discourage forebearance on the part of banks with good customers, good farmers whom they feel in the end can weather these pressures.

As a supervisor, we don't want to aggravate the problem. To the extent possible, we would like to be part of the solution and not the source of the difficulty.

Senator ABDNOR. The banks with grave, grave problems are a whole other subject that we have to pay attention to. But, in reference to this particular aspect of the area, we have to give these people confidence and make the banker more understanding of the farmer.

Do you have confidence in rural America at this time?

Mr. VOLCKER. Yes, because I think our potential there is very great, but that does not minimize at all the strains that a very sizable fraction of farmers are under. You know the story, it's those that are heavily in debt that feel the strain. I think the farmer who managed to avoid very large debt burdens is in a manageable, and sometimes in quite a satisfactory, position.

Those who borrowed a large amount of money on sharply inflated land prices, as you know, are the ones who are in difficulty.

Senator ABDNOR. Mr. Volcker, my time has run out but I would like to say that I am pleased to see that you are abreast of what is going on out in rural America.

I think it is imperative that you, the corresponding groups that regulate banks, discuss this situation and lend that confidence back to those bankers in every way possible, because I've talked to a number of them, and I think they need it badly.

I must admit, I wasn't quite as pleased with Mr. Niskanen's comments today. I don't think he has that strong appeal for what's going on out there. If there ever was a time we need to understand the problem, it's now. I thank you very much.

Representative OBEY. Thank you, Senator.

Representative Mitchell.

Representative MITCHELL. Mr. Volcker, good to see you again. You gave your money growth figures as a range from 4 to 7 percent for this coming——

Mr. VOLCKER. That was the tentative range——

Representative MITCHELL. Tentative range.

Mr. VOLCKER. For 1985, for M1.

Representative MITCHELL. Is that slightly higher than the range for last year?

Mr. VOLCKER. The upper end of it is slightly lower for M1 for 1985.

Representative MITCHELL. The upper end is slightly lower?

Mr. VOLCKER. The range was 4 to 8 percent for 1984.

Representative MITCHELL. I see; 4 to 8 percent last year. I'm being corrected. OK. Then that——

Representative OBEY. I'm sorry. I didn't hear.

Representative MITCHELL. Four to eight percent last year. That's why I hesitated a moment.

Then by slightly reducing the upper end, are you giving yourself a kind of flexibility, anticipating perhaps that you might have to curb a little bit an expansion of this program in this nation?

Mr. VOLCKER. Let me repeat, these targets will be reviewed next week by the Open Market Committee and I don't want to anticipate their decision.

Representative MITCHELL. Let me do it another way.

What was your rationale for this change?

Mr. VOLCKER. The general rationale has been an expectation that, over time, these ranges would be reduced as, in fact, inflationary pressures in the economy were reduced. In fact, that is part of the process to reduce the inflationary pressures: You don't need so much money growth; it's desirable to reduce the rate of money growth over time, to encourage a return to stability. We seem to see that process at work.

Representative MITCHELL. All right.

Now, for a number of years since I've been on this committee, I've been concerned about the balance of trade deficit that keeps going up. And it's related, of course, to the posture of the debtor nations.

As I understand it, in order to ensure that the present debtor nations will be able to meet their obligations, in general, the International Monetary Fund is imposing very sharp austerity programs on those debtor nations. I think that's generally true, is it not?

Mr. VOLCKER. It is certainly in the initial stages, yes.

Representative MITCHELL. Right.

My question is, in your opinion, to the extent and degree that we impose greater austerity on these debtor nations, don't we reduce their capacity to purchase American goods and, therefore, potentially increase our balance of trade deficit?

Mr. VOLCKER. I wouldn't use the word "capacity." The immediate impact, typically—and they've been running large deficits—is on our trade position: reduced exports to them and more imports from them. We have seen that impact.

Representative MITCHELL. Yes.

Mr. VOLCKER. But, over time, the purpose of these programs is to restore those countries to a growth pattern, and we see that happening now. We see that beginning to happen in some of these countries where that initial stage of contraction, and initial impact on our trade position, is moving behind us. These countries are now—some of them, the ones that are more advanced—in a position to increase their imports and are importing more from us, as well as from others, and their exports are continuing to increase, as they must.

Representative MITCHELL. Well, could we take a specific case? Mexico, for example, which was heavily in debt?

Mr. VOLCKER. Right.

Representative MITCHELL. Do you have data to show that it has increased its imports from America?

Mr. VOLCKER. Yes; it's increased its imports in the past year or so. The initial phase was a very sharp contraction in imports. Now they are moving and are already some distance along the road to increasing their imports. They're not back to where they were at the most inflated years of imports in 1980 or 1981. But they went through a very sharp contraction and are now on the way back.

Representative MITCHELL. All right, now let me pursue that issue further. I'm really not privy to the data that you have on the conditions in those debtor nations.

What would be your guesstimate as to what point in time or what time span, those debtor nations would begin to approach a more realistic importation policy of American goods?

Mr. VOLCKER. It varies from country to country. I was just handed the figures for Mexico, for instance. Their imports reached a low of 7.7 billion in 1983. They increased by 40 percent last year, up to over 10 billion. We are projecting a figure of something like 40 percent bigger than that for Mexican imports in 1985. We expect to see Brazil's imports begin to increase about now. Those are the two biggest countries. Venezuela had an increase in imports last year after a sharp contraction, and we expect that to continue. So, you see, different countries are in different stages.

Representative MITCHELL. One last question from me and that is on foreign investment in the American economy. I understand it's very good now and it's attracted by a very high American dollar.

I've always had some major concerns as to whether or not there is a point in time in which foreign investment in America might really begin to undermine the American economy. And in addition to that I'd like to get your thinking on whether or not the foreign investment—what kind of role it's playing in the so-called economic recovery.

We know farms are in some trouble and other basic industries like steel are in trouble. How much of this internal economic recovery is directly attributable to foreign investment?

Mr. VOLCKER. What kind of foreign investment are you thinking of when you say that? Are you thinking of direct investment?

Representative MITCHELL. Direct.

Mr. VOLCKER. That has not, I think, been a significant factor in the overall strength of the economy. There was quite a lot of that last year in the form of a couple of big takeovers that affected the figures, but I don't think that direct foreign investment is big enough to have accounted significantly for particular strength or weakness in the economy. I think it's generally a healthy phenomenon to see this investment from abroad or, in some cases, American investment abroad. The great bulk of this money is coming in in financial form, not in direct investment form.

Representative MITCHELL. Yes; not in direct. Well, would you comment on in financial form, then?

Mr. VOLCKER. In whatever form, as I tried to emphasize in my statement I think it has been extremely important in creating a viable balance in our own capital markets, keeping interest rates lower than they otherwise would have been.

While it didn't directly finance housing, it made it possible to have a prosperous housing industry. It helped make it possible for our investment here to grow rapidly, because it provided the financial wherewithal—most cases indirectly—to finance this activity.

Representative MITCHELL. I think I have time for another question.

As you may or may not know—God forbid, I'm now a senior member on the House Banking Committee and that should cause shutters throughout the Nation—and I am concerned about these 750 banks that are in trouble.

You responded to the Senator's question by saying that with reference to the banks over which you exercise some regulation you've simply cautioned—advised—your people to be a little more understanding and a little more sympathetic; that's fine. But apart from that kind of encouragement which perhaps helps a psychological comment, are there any other things specifically that you can do internally in the Federal Reserve System to assist those banks

Mr. VOLCKER. In the normal course of events all these banks, whether or not we supervise them, of course have access to the discount window. If they have a confidence problem that's affected their ability to operate, they have access to the discount window and we can provide that assistance. We have a seasonal loan program which is largely used by agricultural banks where they have, in effect, prior assurance that they can borrow from us for a period of time—not just overnight but for a period of time—to meet, for example, operating loan needs.

Those kinds of programs provide a good deal of assurance about adequate liquidity, but liquidity is not the heart of this problem; most of these banks are quite liquid. Fortunately, most of them are quite well capitalized; the best capitalized banks in the United States tend to be the agricultural banks. Historically, they've been quite profitable, so, fortunately they have a certain financial cushion of liquidity and capital to draw upon. But there is no question that as the financial strains on the farmers are prolonged those strains could push back on the banks too.

Representative MITCHELL. OK. My notice came in time so I can't raise the question about you making some adjustment in the discount rate.

Representative OBEY. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

Mr. Volcker, I certainly appreciate your very thorough and excellent testimony here this morning.

We talked about the level of deficits and how much they should be reduced for 1986 and beyond. What about the timing this year? How important is the timing of enactment of a deficit reduction package. We've been struggling with that in past years and we've not managed to abide by our deadlines. What impact would that have psychologically on the markets and otherwise. I know it should be the sooner the better, but——

Mr. VOLCKER. I think you're dealing with a rather skeptical and even cynical audience, if I may say so. The longer the process is dragged out—if it has a favorable outcome, that's all right—I think you run the risk of prolonging the agony. At the least you defer any favorable effects. Whether any "crisis" emerges I'm not going to predict, but I think the quicker you can do it the better.

Representative SNOWE. Do you forecast or anticipate the likelihood of a collision between Treasury and private borrowing this year at all? I know it's contingent on the inflow of foreign investments, but can you anticipate that?

Mr. VOLCKER. Let me put my answer this way: in some sense I think the collision is there. It's inherent in the fact that we're investing and have a deficit bigger than our savings. The collision has been manifested in drawing all this money from abroad, which in turn hurts the exporter and the fellow competing with the importer.

What you're asking is whether that process in some sense breaks down or becomes diminished during the course of the year. I don't think that's predictable.

We're a big, strong country. We can continue to attract this capital for some time, particularly if there's an underlying confidence that we're on the right track.

I think if you wanted to develop some policies that would bring your hypothesis close—like deciding that the thing to do is to reinflate the economy—I think that would undercut the kind of confidence that these flows rest upon. But the timing of any reversal in psychology is never clear in advance. It's not predictable. We have the advantage of a good deal of psychological and real momentum in our favor, but I don't think we can just afford to count on that persisting. It certainly carried us through 1984 in great style.

Representative SNOWE. We can't predict then the—if it were to occur—the abrupt withdrawal of foreign capital?

Mr. VOLCKER. I think there's no predicting it.

Representative SNOWE. OK.

What about the exchange rate. Could you anticipate any precipitous change in the exchange?

Mr. VOLCKER. I think that's the same question: what would bring the precipitous change in the exchange rate is that same psychology.

Representative SNOWE. Do you view the dollar as being overvalued or that perhaps a permanent realignment is occurring with respect to the dollar value?

Mr. VOLCKER. Those questions are not mutually exclusive, given where it is. There might be some of both, but it's certainly at a level that produces a very large trade deficit that we would have to grow up to one way or another. If we do very well on inflation and productivity and all the rest, we could, in effect, grow up to this dollar. Otherwise, I think you have to say that some day the dollar will go down and prove that it was overvalued.

Representative SNOWE. There's been some discussion recently about our nation and other nations intervening in the foreign currency markets. How do you feel about that? What are the risks and/or the benefits of such intervention?

Mr. VOLCKER. I don't think we should expect too much from intervention as a way of affecting the market. It may sometimes be affecting market psychology, but intervention that runs against more fundamental forces I don't think is going to be successful in the end. Now, viewed in a reasonably limited context, I have never had much problem intervening if, in particular circumstances, it appeared to serve a useful purpose.

As you know the dollar has been strengthening beyond already high levels recently. Apart from any longer term repercussions on us, that has had some unfortunate byproducts, I think, in some foreign countries. At the time of that meeting a few weeks ago to which you referred, there was some discussion of the problem and I think some willingness to intervene on all sides in some amount if it was thought to be helpful in a particular situation on a particular date.

Representative SNOWE. As you know in the past and certainly in this Congress there'll be some legislation introduced concerning institutional changes with respect to the Federal Reserve Board. I'd like to get your response to them.

One is, of course, to require more timely announcements of the monetary policy decisions formulated by the Reserve Board. How would that help in terms of the expectations on the parts of individuals and the investment community?

Mr. VOLCKER. In one sense I would say the operational decisions that we make are reflected immediately, because we have to operate in the market. But there has been discussion of whether we should release the committee discussions and the form of the committee decision.

Let me say, first of all, when we make what I would consider a real policy decision—when we change these targets, for instance—we announce it as soon as we practically can. Within a few days we're writing the testimony and the description, and we announce it. When we change the discount rate, we typically describe the factors that went into that decision.

What we don't announce immediately are the operational decisions that we make to implement the policy of the regular meetings of the Open Market Committee. We obviously don't and won't do that. To debate about it I think is counterproductive. I think we would have more confusion in the market or more guessing of what the particular words of that directive and discussion meant in terms of what may happen in the market than we have now.

Let me give you an example—it wouldn't happen all the time but it might happen on occasion. We try to make those reports a very full reflection of the discussion. They not infrequently take the view and say something like "We're not going to do anything now to change the approach, but if thus-and-so happens we'd tighten or ease."

If you announce that and you haven't really made the decision because X and Y haven't happened yet, the market will read into that announcement something we haven't done yet and react to something that we haven't done. Instead of then being able to observe the market in a pure form, so to speak, we'll be looking at the market as a mirror of what they think we're thinking. The market will always try to outguess us and think about what we're thinking, but I don't want to aggravate that process, and my judgment is it would aggravate the process.

Representative SNOWE. And then finally one last question related to that. What would you think about having the Secretary of Treasury serve as ex officio on the Federal Open Market Committee?

Mr. VOLCKER. I'm not enthusiastic about that particular approach—that puts my feeling rather mildly. That was the case when the Federal Reserve was first formed, and I think Congress, in the exercise of great wisdom and discretion, changed that in 1935. I might say partly at the advice of people who had been Secretaries of the Treasury.

I don't think that announcement policy goes to the philosophy of the Federal Reserve. When you begin talking about that kind of structural change, it does go to a philosophical issue, and I think, in general terms, the present structure has served us well.

Representative SNOWE. Thank you very much.

Mr. VOLCKER. There's no lack of communication with the Secretary of the Treasury, you might say.

Representative OBEY. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman.

Maybe I could just pick up a little bit on that question about giving more timely information and fuller information to the folks out there. You've indicated in your response that you feel there is adequate information and that they'll continue to guess. I'd try and take it——

Mr. VOLCKER. If I make any forecast at all, whatever I say, they'll continue to guess.

Representative LUNGREN. Well, I understand but I'd like to deal with it from the standpoint of some of the folks that I talk with who are the people trying to make some investment decisions and trying to anticipate the performance of the economy back in my district and they ask me what it is you folks are doing and I tell them to read the material. Frankly I do not get the feeling that they feel the information is either timely or as extensive as it should be.

Wouldn't the public be able to make more efficient decisions regarding unemployment or employment, savings, investment, production, and consumption with a more timely explication of what it is you folks are doing and why?

Mr. VOLCKER. I don't think so. That sounds nice, but in the real world I don't think it would work that way.

Again, let me make a distinction. I think the kind of point that you make is a perfectly valid point when you're talking about the basic direction of policy. We do announce those decisions and we announce them right away. We issue a mass of information, including congressional testimony, without comparison in any other central bank in the world.

What we don't do is issue these summaries of discussion and the directive on open-market operations for roughly 6 or 7 weeks, depending upon how long the interval is between meetings.

So you've got a little lag. But that still contains a lot of information. The investment fellow whom you're talking to who wants to know how the Federal Reserve thinks and what considerations are going into its decisions, not only has his testimony—the semiannual statements—he can also look at what was actually said during Open Market Committee meetings, the kind of debate that went on, and the kinds of considerations that different people had in mind. That's all reported.

Indeed, the discussion is reported with a lag, but there's no shortage of information about the kinds of considerations that the committee has in mind.

In the context of changing the structure of the system, this is a small point upon which reasonable people can differ. I will just tell you on the basis of my 30 years' experience in this business that the Federal Reserve gives incomparably more information now than it did 30 years ago. Is there less of the kind of guessing in the market now than there was 30 years ago? I don't think so.

Representative LUNGREN. Well, obviously we have a major disagreement there. I just think more information is, perhaps, better. Somehow it just rubs me the wrong way that the information can be held for 5 weeks and that at the end of 5 weeks, somehow, it is better for those people to learn it and during the intervening 5 weeks they've been making a lot of guesstimates about it.

Mr. VOLCKER. You don't wait 5 weeks to learn what we're doing. When we do something it's there in the market.

Representative LUNGREN. But the reasons for it. That discussion would give far better information.

Mr. VOLCKER. You don't learn some of that discussion.

Let me give you my perspective. There was some mention earlier of two Governors having made speeches recently that gave rise to interpretations in the market. One goes up and one goes down in the market interpretation. Was that a net benefit for the certainty of the market for this particular period? I don't know.

Representative LUNGREN. But if we had that information in the context of a full ranging discussion of all members at a particular time when a decision was made, it seems to me that would be better information to have than separate speeches given by members at separate times.

But let me go on to another point. I remember a year ago, when you were here and you talked about the fact—and I think your phrase was—that we were moving into an economy with a more sustainable rate of growth of approximately 4½ percent and you had contrasted that with the immediate proceeding quarter of about 6½ percent. I asked you at that time where do you reach the point of sustainability and nonsustainability and we danced around that for some time. Now we have seen that we did have a real growth that exceeded what most of us thought it would be and yet at the same time, because of actions that you have taken and other actions within the economy, the inflation rate has by and large remained under control at around 4 percent or less.

My question is this: If in this next year the real growth rate exceeds the projections upon which you're basing decisions now by approximately 1½ percent, would that in and of itself cause you and your colleagues to feel that we should lower the money growth targets? And if so, why?

Mr. VOLCKER. 1.5 percent above what. It wasn't clear.

Representative LUNGREN. Whatever your projection. You didn't give us a projection.

Mr. VOLCKER. Let me say that a higher rate of growth in itself than what I might be expecting at the moment wouldn't be disturbing; it would be good, if a lot of other things were consistent with the judgment that we were on a sustainable path. Or course, one thing you look at in that connection is what kind of inflationary pressures may be building currently or prospectively. That involves analysis of a lot of things.

Representative LUNGREN. No, no. I understand that, but if your analysis showed you that inflation was remaining under control as it has over the last year, that in and of itself would not lead you to tighten up on the money supply.

Mr. VOLCKER. Plainly not. If everything is going better than you expected, that in itself isn't going to be a reason to tighten up.

Representative LUNGREN. If we might be able to look at the EKG chart over here for a second, why——

Mr. VOLCKER. I must give you a comment that one of my staff whispered in my ear; the worst EKG to have is one that's perfectly flat; then you're dead. [Laughter.]

Representative LUNGREN. That's true. Well, you have certainly delivered us from that problem. [Laughter.]

My question is, now that it's been done, can we figure out why the Federal Reserve went from what appears to be the top of the M1 range in later spring to the bottom of the range in the fall. What were we trying to do, and is this the kind of a pattern that we ought to anticipate in the future as well, or is there a hope for the——

Mr. VOLCKER. You certainly ought to anticipate fluctuation, yes, a live EKG.

Representative LUNGREN. But those extremes, though.

Mr. VOLCKER. I don't think it was very extreme last year. The money supply, given historical patterns, last year was relatively smooth, particularly if you look at it on that quarterly basis. It wasn't perfectly smooth. We had a low quarter in there; there's no question about it. I'm taking this against historical experience. You may not believe it from that chart, but our money supply tends to be more stable than the money supply of other countries.

To answer your question, the money supply was running relatively high during the second quarter. In particular, it began getting a little momentum at a time when the economy was running at a very rapid rate of growth, as you will recall.

Evaluating the total situation at that time, taking account of those factors and others, some rather moderate moves were made to slow down the growth of the money supply. We got into the summer and we had level growth in the money supply coming off a high level. That wasn't terribly disturbing in and of itself. We had a flatness after a little bulge. The economy slowed down, the slowness of the money supply persisted. We eased in the operational sense in terms of bank reserves and by November and December, the money supply was rising rapidly again.

Those kinds of lags and fluctuation are not abnormal in the ordinary conduct of policy.

Representative LUNGREN. Well, I understand that money velocity is an important consideration that you use in making your determination about the money supply growth. And in looking at a speech given by one of your colleagues again, Mr. Martin, to the Chicago Council of Foreign Relations on January 23, he indicated that the lower pace of monetary velocity may justify a more rapid growth of M1 and M2, and if it was done with that consideration, this would not imply that the Federal Reserve was abandoning its goal of further gradual reductions in inflation.

Could you comment on that, please.

Mr. VOLCKER. In general, it's certainly analytically correct, that if there were a set of conditions that brought a slower rate of growth and velocity, all things equal, you would then want a more rapid rate of money growth, other things equal, and the more rapid rate of money growth itself would not imply a change in policy and certainly not imply greater inflationary potential.

Now, of course, the difficulty we have is these things are always so much easier in retrospective. We have to deal with policy in the future, and we have to make some kind of broad judgment about what velocity is probable. If you think that chart is unstable, I'll draw one for velocity for you for our next meeting.

Representative LUNGREN. My time is up, so let me just ask one last question. That is, in terms of all the things that you bring into the mix, and you've indicated today and at other times that virtually you look at everything, what part does unemployment play? I know this is a question we're having a difficult time in quantifying, what is full employment in current circumstances, but I happen to think that even with the progress we've made in unemployment rates over the past 2 years, 24 months, that it still is at a rather high——

Mr. VOLCKER. I agree with that.

Representative LUNGREN. Not only the historical rate, but even in the context of where we want to go and recognizing that maybe full employment rates are higher than what we thought before.

What part does the consideration of unemployment and unemployment trends play in determining monetary policy?

Mr. VOLCKER. I think it plays a role at two levels. The first, most general, level is that unemployment, of course, is one measure of the success of policy. You like to see unemployment as low as you can reasonably have it; that's an objective of policy. That's out there as one of your goals and an extremely important one.

In a more technical sense, as you're moving along with policy, it's also one measure of capacity in the economy, and trends of capacity, capacity in the labor market, pressures in the labor market; and it bears upon the inflationary outlook, the rapidity of changes bear upon the sustainability of any increase. It's kind of a technical indicator, but it's also a goal. We haven't many goals. It's an important technical indicator, it's only one of many technical indicators, but it is also an important goal.

Representative LUNGREN. Mr. Chairman, thank you.

Representative OBEY. Thank you.

Mr. Volcker, let me amend one statement I made. I indicated that I thought the Congress would meet the President's overall spending goal on the budget. I still think that's possible, but I would hedge on that by simply saying that I think the biggest impediment to Congress' doing that is the fact that many, many people view the budget in practical terms as screwing down about $40 billion on the domestic side, in order to make room for a $32 billion increase on the military side. When you couple that with the roughly $15 billion increase in interest, it appears to be more of a resource shift than it does a real effort to control the deficit. I would say that if anything brings it down, it would be the inability of all of the parties involved to get over that argument.

Let me followup on Congressman Lungren's question, which relates to the question I asked you earlier about the difference between Mr. Martin and Mr. Gramley. Going back to Congressman Lungren's question on the rate of velocity. I know you don't like answering these questions, but nonetheless, I like to ask them, and I'll ask them again.

Where do you come down on Mr. Martin's judgment about the changing rate in velocity?

Mr. VOLCKER. Let me not comment on his statement, because I frankly haven't read it and I don't know the context, but let me say this much about this Banking Committee type of question, which I'll get 2 weeks from now.

I do think you could reach the judgment—we won't prove this for some while—that in the current deregulated financial environment, given all the technological changes that have been going on, the way we now measure M1, I personally think it is probable that the trend of velocity increase will be slower than was characteristic of the earlier postwar period. It fluctuates a lot from year to year, but if I had to guess at——

Representative OBEY. I guess I would assume that, logically then, if you thought the velocity is going to increase—in other words, if you disagreed with Mr. Martin's judgment, then that would imply that it would be your own judgment, I would think, that the money supply growth ought to be slower.

Mr. VOLCKER. No. I think it will increase, but at a slower rate of speed than was likely to have been the case earlier, so, relative to earlier, the money supply would be higher.

Representative OBEY. Well, let me ask about your statement, and I think I know what you're going to say, but for the record, I'd like you to comment on it.

You say the United States is in the process of moving from the world's largest creditor to the world's largest debtor. If you were giving a lecture to the American people, what would you say if you were asked why should Americans be worried about that?

Mr. VOLCKER. Too many debts eventually get you into trouble. Your vice chairman was talking about the problems of the farmers. We've lots of examples in Latin America, we've lots of examples elsewhere, of people thinking they could borrow money very easily for a while. When conditions change—and they're likely to change very abruptly—you find out that those debts have exposed you to rather severe consequences. We, I hope, are a long ways from that kind of a problem. We're just crossing over the line from creditor to debtor. We're a big country, but the rate of speed at which that debt is increasing—and the rate of speed is increasing from year to year—as things now stand, I think raises enough alarm bells that we ought to worry about it. That is entirely apart from any more general consideration that a country as large and rich as the United States ought to be investing abroad and sending some of its savings to poorer countries.

Representative OBEY. If this were to continue for a period of years——

Mr. VOLCKER. Pardon me.

Representative OBEY. If this were to continue for a period of years, what would the end result be?

Mr. VOLCKER. At some point, if nothing else happened, the debts would get large enough so that that itself would undermine the confidence that facilitated the borrowing now. Once that level is reached, you are, in effect, lost; then you have the crisis. Now I hope that we deal with it before that happens. Otherwise, the consequence, even if that never happened—it would happen someday, but let's assume it doesn't happen—is that we have to pay interest on all this borrowing. It gets more and more expensive for us every year. Let's say we have a trade deficit of $30 billion. In the current account balance, it would be zero or $15 billion, because we could count on, among other things, some interest from overseas and our own savings. Now this is working against us. It's just like when a family is in debt and has to pay interest, it gets more and more expensive. Our children will end up paying for it in a significant way. We're, in a sense, living 2.5 percent above what we're producing now. We're going to have to pay interest on that, more as the years go on. In this case, the adage of "leaving it to your children" has very direct repercussions. They'll be paying for it by someday having to export more and import less, which means by reducing their standard of living.

Representative OBEY. Thank you. You indicated to Congressman Mitchell that you thought that a good number of those smaller agricultrual banks were in pretty good shape.

That is true in parts of my district, but let me tell you what I see in some areas. I go into a community like Thorp, for instance, a very small town, slightly over 1,000 people, and I hit the main street, and I shake hands, and I talk to people, I walk into the bank, the president of the bank comes in, and he says, "Hey, I want to talk to you. What the hell is going to happen?" And then I ask him what's happening in town. And first he talks about the farmers. Then after he's finished talking about the farmers, then he says, "And what's more, I want to tell you what's happening on Main Street." He'll point to store after store after store and tell me how bad off they are, and how close they are to falling off the table. And I've seen some studies, especially one prepared by some Midwest Governors, and they say what's going to happen is that 2 to 3 years from now you're going to probably have 15 percent of the farmers just gone. They are not going to be in rural America. They'll be going to town and trying to get work. And that will be shakeout stage number one.

The second stage will come when you have that ripple effect in all of those rural towns, which, in the judgment of some people would lead to the conclusion that almost no community under the size of 1,000 would be viable for very long, and they are saying that that is when the real crunch appears in rural America.

Then you have the dress shop going out, you got the restaurant going out, you got the farm implement dealer going out, you got the banker going out.

In spite of the statement that you made earlier about the strong conditions of some of the banks, what do you think is going to happen? What do you think we're to see with those banks?

Mr. VOLCKER. The statement I made, just to be clear, was that I think we are fortunate that so many of these banks were in a relatively strong position before this credit situation really began to hit home. They're going to need that strength to cope with it, because there's no question that this situation brings very heavy pressures. We saw more failures of rural banks last year, and we're going to see more this year; there's no question about that. I only mention the strength, in that that does provide a cushion for dealing with these problems.

Representative OBEY. Do you know what the number is of small banks that went under last year?

Mr. VOLCKER. Thirty-some-odd, something like that. There were more in the second half of the year than in the first half of the year, which indicates, at that time at least, where the trend was going.

Representative OBEY. What numbers do you think we could be facing within the next few years?

Mr. VOLCKER. I wouldn't project the numbers. Most of these are very small banks.

Representative OBEY. Yes; but they're very big in their local community.

Mr. VOLCKER. It's a local problem, in that sense, and it's a very big local problem, not simply because it's a bank problem, but because the bank problem really is reflecting all those other problems in the community that you mentioned. There's just no question that it is a very severe problem. I think what we're seeing here is a recapitalization of land values; a lot of indebtedness was undertaken on the basis of inflating, speculative land prices.

Representative OBEY. Well, let me say, that's partially true, but I wouldn't overrate that. I think an interesting thing for people to do would be to go around to different States, go around to different communities and talk to farmers who have had the same property in their family for 100 years. The Governor of my State told me that he ran into one farmer who was receiving an award for being the young farmer of the year. And he told the Governor, "Governor," he says, "I don't have any damn right in the world to accept this award, because I'm going to be responsible for liquidating this farm. It's been in the family 126 years."

I think you are finding a number of other factors. I will grant that land speculation is a major one, but you have a couple of myths out there. One is that only people who bought up significant pieces of land are in trouble. Another is that only the lousy farmers are in bad shape. And I see a hell of a lot of farmers who don't fall in either category who are in tough shape.

So, I guess my question would be, if this continues for another 2 years, what do you think the range of trouble would be for those small banks?

Mr. VOLCKER. I can't give you a sensible estimate. Obviously, if it continued for 2 years, a number of those banks are going to run through that cushion. Some of them already have, as I mentioned , and I don't think that is an unmanageable situation, in the sense of the financial stability of the country, by any means; these banks, as I said, are relatively small, with their deposits fully insured. But it is a very serious matter to those local communities.

Representative OBEY. No; I understand it doesn't have the national impact that, say, Continental Illinois has, but I tell you, what my people are saying is, "Look, you guys"—and they refer to all of us, not just you—they say, "You guys, one bank gets in trouble, and there's a lot of concern nationally." And in my own State, there was a lot of concern, primarily in the larger communities, where you had lots of institutions who had their money in that bank. But within that whole region, it is a significant problem.

Mr. VOLCKER. There's no doubt of that. The totality is very large, but if you look at it bank by bank, they tend to be small banks. Let me say that I would not expect that a failure of a particular bank in a community means that banking services aren't maintained.

It may be in some very small towns that people don't feel adequate to support a bank, but in many of these cases, the bank will be taken over by another bank, and the banking service will be maintained. That is the most typical pattern when you have these kinds of failures; that isn't necessarily possible in every rural community, but that is the preferred solution.

Representative OBEY. One last question.

When I wear my other hat as chairman of the Subcommittee on Foreign Operations of the House Appropriations Committee, we have to deal very directly with the issue of Third World debt. Congressman Mitchell asked you a question earlier which relates to mine. Congressman Kemp, who is the ranking minority member on our subcommittee, is very concerned about the stringency with which the IMF is approaching the Third World debt situation. He feels very strongly that we ought to, in our other bill, prevent AID, for instance, from withholding assistance to countries who are not in compliance with IMF requirements, but that we ease up on Third World debt and give those economies some better opportunity to grow.

What would be your best judgment on that? Would that be a wise course for us to follow on that legislation or not?

Mr. VOLCKER. The general policy of supporting the IMF in this kind of a program, which would mean sometimes turning off money or turning it on in connection with an IMF program is usually very constructive. The effort here is to get sufficient force behind the IMF programs, so that they can be successful. I think it is a mistake in judgment to think the IMF is not interested in growth. There may be some dispute about the best way for laying the foundation for growth, but the IMF often gets the blame for being the messenger. These countries haven't anybody willing to lend them any money, and the IMF comes along and says, do this, that and the other thing, and you'll get your situation in a form where people will be willing to lend you money, and you can begin growing over time.

The reason they can't grow is that nobody's willing to lend them any money, not because the IMF is in there. The IMF, I think, in the end, creates the conditions that help restore growth, as you see beginning to happen now in Mexico, hopefully, in Brasil and elsewhere.

Representative OBEY. Thank you. Given the time, that's all the questions I have.

Congressman Lungren, do you have any questions?

Representative LUNGREN. I'll just ask a question in one area that you've already referred to in part today, it's an area that really intrigues and also confused me. When we talk about the strength of the dollar, obviously a certain part of that is attributable, or at least it is expressed as being attributable to the interest rate differential as it affects the United States. But we've seen at least some lessening of interest rates. Somebody even suggested the differential may have shifted against us in certain circumstances.

How much of the dollar's strength is due to our fairly successful program in bringing inflation down, the idea of safe haven, the idea that the United States, even with all its problems, still has the strongest economy. In other words some people, when they talk about the high interest rates, almost seem to suggest or lead people to believe that if we bring those interest rates down, we won't have the strength of the dollar, and therefore these other things will fall into place. Yet I always wonder, on the positive side, how much of the strength of that dollar is the result of the fact that we have the best economy relative to others?

Mr. VOLCKER. Obviously, I can't answer your question statistically, but I would say it must be quite a lot. We had a demonstration in recent months of a rather sharp decline in interest rates during a period when the dollar was going up; we had a sharp reduction in the differentials with some other countries, and the dollar went up. We've had the dollar going up when interest rates go up and when they go down. Recently, we've had the dollar go up with interest rates going down and with a very big current account deficit, which, normally, you would expect would tend to weaken the dollar. So, the kind of considerations that you mention, I think, must be important.

Representative LUNGREN. Is there any estimate you can give as to what degree of the strength of the dollar is really not reflected in the strength of the economy, that is, the overpricing of the dollar as a result of perhaps interest rates differential or the expectation that there will be interest rates differential in that direction?

Mr. VOLCKER. I don't know of any reasonable calculation, and if somebody tried to make one, I wouldn't have enough faith in it to give you an answer that a certain percentage is due to one factor or another. I don't know. There's another factor here, the inverse of that you mention. I think it depends upon appraisal of prospects elsewhere, as you implied in your comment. We're looking pretty good. We're looking pretty good relative to elsewhere, and if the psychology and expectations about the performance abroad improved, that could have influences upon this capital flow, just as the change in appraisal of the United States directly.

What concerns me is that that favorable kind of psychology toward the United States, which is very real now, I think, over time, is undercut by the very massiveness of the capital inflow and the size of the trade deficit, and someday it'll jump up and bite you.

Representative LUNGREN. Thank you.

Representative OBEY. Thank you, Mr. Volcker. We appreciate your being here.

Mr. VOLCKER. Thank you.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 7, 1985.]

THE 1985 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 7, 1985

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

The committee met, pursuant to recess, at 10 a.m., in room SD-342, Dirksen Senate Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representative Obey and Senator Abdnor.

Also present: Robert J. Tosterud, deputy director; Charles H. Bradford, assistant director; and William R. Buechner and Dale Jahr, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. Good morning, Mr. Secretary. I would like to welcome you to the committee today. We are pleased to have you here this morning as we continue to look at what is happening to the U.S. economy. We began our hearings this year with Mr. Niskanen and Mr. Volcker earlier in the week. You are our third witness since the committee has been reorganized.

As you know, the economy seems to be recovering for the time being quite nicely in a number of areas. However, I'm sure you also know as Secretary of Agriculture, that certain parts of our economy are not doing all that well. Certainly one of them is agriculture. As I'm sure Senator Abdnor can tell at least as well as I, there is great concern and great distress across the country in small town America and in the countryside, especially in the Midwest. Rural America is trying to climb out of the recession and trying to face long-term as well as short-term problems.

Let me just explain to you what I see happening in a typical small town in my district. You can pick almost any town where agriculture dominates. All you have to do is take Highway 29 in my district, for instance, and stop in Stanley or Boyd or Cadott or Thorp or you name it. If you're in a department store or if you're in a local bar shaking hands, people will come up to you and say, "Congressman, what's going to happen? What are you going to do?" As I told Mr. Volcker earlier in the week if I go into a town like Thorp, go down Main Street, and come to the bank, the president or the vice president of the bank will come out and call me into his office, close the door, and say, "What's going to happen out there?" And he will tell me what's happening in terms of farm loans on the edge. Then he will begin to point out the window to different businesses on Main Street and say, "Now let me tell you about him, let me tell you about the dress shop over there, let me tell you what's happening all down the street," and you see about a third of the businesses are in trouble.

When you talk to people who are looking at various studies about what's going to happen long term, they indicate that what will happen if this present trend continues is that within 2 or 3 years we will probably have 15 percent of the farmers in the upper Midwest gone. They will be in town working or trying to, rather than being on the farm. That will be one shakeup.

But then people who know what's happening in rural America say the next shakeout is going to be even rougher. After the farmers shake out you will then have the whole question of what happens on Main Street and what happens to the survivability of a number of those small banks. I think that is what people are concerned about.

As I told Mr. Niskanen last week, I do not certainly believe and I don't think Senator Abdnor believes—I don't think any thoughtful person believes, in contrast to the implication left by Mr. Stockman's statement a couple days ago—that this country has an obligation nor can afford to insulate farmers or anybody else in this country from the consequences of change. But I do think, as you have indicated in your prepared statement, that there is a primary obligation on the part of the Government to ease that transition. It is fine to look at economic issues solely in terms of mathematical models or in terms of economic philosophy or theology, but the fact is that I would prefer to simply ask the question not only what makes sense and what can be justified in straight economic terms, but also what is politically and socially sustainable over the long haul.

To me, that's the key to American policy whether it be foreign policy or policy which eases the ability of the economy to modernize technologically. I also think it's the key to the survivability long term of any farm policy being followed by an administration, hopefully with the concurrence and support of Congress. And so what we are anxious to hear from you today, having read your prepared statement, is what specific plans the administration might have to deal with these problems, what specific actions you think can be taken to deal with the credit crunch, the export problem, and some of the other real issues facing agriculture today.

I, for instance, am very interested to know exactly how you would quantify the problem which we see in rural America. How many farmers do you think are really in trouble? What do you think the situation is with a lot of those rural banks? How serious is that problem? What are we talking about in terms of numbers?

I think if the administration and the Congress are to deal sensibly with this problem, we not only need to understand what happens to us on an ad hoc basis as we go through our communities, but we also need to know in fairly specific terms the nature of the problem, the size of the problem, the shape of the problem, the numbers you're talking about, and the specific alternatives that can be considered in order to deal with the problem.

So we are very anxious to hear your testimony and to hear you respond to questions today.

Before I ask you to begin, I would ask the vice chairman of this committee, Senator Abdnor, for any observations he might make. I would point out that Senator Abdnor from his past comments over a long period of time has indicated his concern about this problem. He shares with me those concerns because we come roughly from the same districts, although obviously his district produces different commodities than does mine. In addition to his being vice chairman of this committee, he is also the chairman of the agriculture task force of this committee and will be conducting a series of hearings on the entire problem relating to rural America.

I would ask Senator Abdnor for his comments before you begin your testimony.

OPENING STATEMENT OF SENATOR ABDNOR, VICE CHAIRMAN

Senator ABDNOR. Thank you, Mr. Chairman. I would like to make some comments. The Secretary knows that. He and I have had this same kind of meeting a number of times over the last 2 years and they have been good ones and I certainly welcome you back today. I know as a public servant you sometimes have to take quite a beating from all of us. We all have our own thoughts, like foreign policy, I guess we all think we're Secretaries of State, and maybe we all think we're Secretaries of Agriculture, and how to run America.

Well, all the news has been, on the face of it, Mr. Secretary, not for agriculture. But just to look at how well America is doing, the figure the President talked about last night in his State of the Union Message was great and outstanding and we have a long period of economic recovery, and that's good. But I don't think I need to tell you that the job is not done, not by a long shot, I'll tell you. Rural America is not back. Rural America and its economic foundation, whether it's agriculture or anything else in rural America, the small towns are on the road to economic oblivion. It's really what I term "the forgotten economy."

I had the Chairman of the Economic Advisors here before us. He devoted one page of his whole 350-some page report in the Economic Report to the President on agriculture, and a little bit about rural America. I think that's really inexcusable and that's the concern I have.

I know you're the spokesman for rural America, but when you're an advisor to the President he ought to have an interest in that because he's interested and will be advising the President on all of America. That's been the trouble and sometimes I have that problem with the economists. They come in before us and never once do they ever make any reference to that whole block of territory out there called rural America, the little towns of this country, the farms. They totally ignore it. All they talk about is the GNP growth and how many cars are getting produced and all those things and that doesn't help out there. That's not what keeps it alive.

So we do have a lot of questions and they are being asked back in rural America. Is anyone in Washington listening? I'm going to have a hard time convincing 7,000 farmers who are going to be meeting with me Tuesday, I assure you; and does the Reagan administration care, they will ask. Is the President presiding over the demise of a way of life that is the cornerstone of this great Nation? We always brag about the life in rural America. Is rural America in jeopardy? I think it is. I seriously believe it.

While the early and mid-1970's showed a healthy rural economy, it's been going down and down and down. We have lost one-fourth of their population in over 800 counties in the United States. Nonmetropolitan income and employment growth is not keeping pace with metropolitan measures. I know. I've had farmers out in my county and small businessmen out there who made less net income than the unemployment compensation checks that went to the people in the cities that are out of jobs. I'm not condemning the ones in the cities, but I'm telling you we weren't on the rolls of anyone because they have been working, but barely at a break-even proposition.

I think the facts are there. We are in the midst of the worst agricultural recession since the 1930's and nobody, including the Department of Agriculture, Mr. Secretary, is predicting when it's going to end. That's the problem. In contrast, since the fall of 1982 when the national economic recovery began, everything was bright except when we get to agriculture. Employment in agricultural industries has declined by over 100,000 jobs. The per capita personal income for rural residents increased 40 percent less than that of metropolitan residents. Farm equity, land values, have fallen by $64 billion. Capital expenditures in agriculture remain virtually unchanged. The volume of agricultural exports has declined 9 percent. And that's the sad picture in this whole thing, really sad. Total farm production expenses have increased $3.1 billion while total farm marketing receipts rose but $500 million.

Then we wonder what's happening to them out there. Your department, Mr. Secretary, reports that America's farmers and ranchers will realize no net income from the sale of their products in 1984 because marketing revenues will be completely offset by production expenses. What net income farmers and ranchers realize in 1984 will be in the form of changes in the value of inventories, the value of farm home consumption of farm produced commodities, income from for hire custom work, and government payments. Government payments are probably the biggest thing, even though it's disheartening. That's the biggest source of income.

In 1980 less than 4 percent of farm net cash income came from Government payments, but in 1984 over 22 percent of farm net cash income will be in the form of public aid programs. And I contend that this dramtic increase in the dependence of the American farmer on public assistance during the last 4 years may be our greatest economic failure and political embarrassment. It means we are not doing something right.

I take this opportunity to alert you, the President, and other influential Federal decisionmakers to a clear and present danger—I just can't visualize an America without agriculture the way I knew it, and because of our misguided policies, I think we are rapidly yielding this country's largest, and perhaps its last, international comparative advantage. A consequence of such a failure will be a rural America without economic purpose and an America without its heritage. Be warned—I'm telling you—the continued failures of our farmers, our rural bankers, our Main Street merchants will leave rural America devastated and the consequences will ripple disastrously throughout the fabric of our national life for generations to come.

Mr. Secretary, we have been down this road before where we were once a proud country with industries such as the autos, steel, and textiles, which were once on the cutting edge of a global domination, but today they are becoming mere shadows of what they could have been. Rural America and agriculture are exhausted and embattled. We need your help and that of the President and plead for your patience and understanding. Anything less will dishonor the hard-working, honest people who constitute the backbone of this Nation and it's time for a national commitment to rural America. The national goal of keeping a farm family on its land is no less grand than President John Kennedy's commitment of putting a man on the Moon.

I look forward to hearing your testimony, even if I did make a speech first. Thank you.

Representative OBEY. Mr. Secretary, if I could ask you to proceed and take 15 or 20 minutes and just summarize your prepared statement. Let me apologize ahead of time if I walk out. It won't be because I'm upset with you. It's because we also have in the House Appropriations Committee this morning Mr. Stockman, Mr. Niskanen, and some other cabinet officials testifying and I do have obligations over there as well. So I will be turning the hearing over to Senator Abdnor when I leave. Please proceed.

STATEMENT OF HON. JOHN R. BLOCK, SECRETARY OF AGRICULTURE, ACCOMPANIED BY RANDELL RUSSELL, DEPUTY ASSISTANT SECRETARY FOR ECONOMICS

Secretary BLOCK. Thank you very much, Mr. Chairman and Mr. Vice Chairman. I have with me today Randy Russell, Deputy Assistant Secretary for Economics and I am delighted to have the opportunity to testify before this committee.

Mr. Chairman, I am aware of your interest and concern about agriculture and small town U.S.A. because I know your country, where you live, and I know the people and I know that they are good people and I know they have a lot of problems. I know the vice chairman and have known him well and have worked with him. I have great admiration and respect for his effort to represent his people and try to find solutions to the problems that the people in rural America face today. And what we are trying to do is find solutions and build new opportunities for them. I appreciate the great frustration and concern because I guess I live it every day, as you live it, as we try to ensure opportunities for people in this country.

Furthermore, Mr. Chairman, I think the point you make about being able to get a handle on just what is the situation and ensuring that we continue to monitor the situation is very important and I will be honest with you, it's been difficult for us because farmers generally don't want to talk about their financial situation until it becomes completely desperate and, of course, the lending institutions—it's not good business for them to be talking about where they are at either with the customers. So we have tried and continue to work on gathering information, but I confess oftentimes it's a little bit behind the curve. We just need to continue to try to do a better job of that.

And I also would agree, as has been suggested, as a nation, the economy as a whole has improved dramatically. We're proud of that and pleased by that, but American agriculture is really not back and is really not participating in the growth and prosperity that the rest of the country is. And I say American agriculture—rural America is American agriculture. You cannot separate the two. I don't believe that it's a forgotten economy, although I know you talk about Mr. Niskanen's testimony. I'll just tell you very honestly that the Council of Economic Advisers, including Mr. Niskanen, and the Cabinet Council of Economic Affairs previously headed by Secretary Regan has heard this subject of the problems in agriculture almost to where I think they probably would like to see some other subjects come forward, but it has dominated the discussion the last month with the four or five meetings with this the main subject, and Cabinet members are there. We have had one full Cabinet meeting where the President has heard the whole subject, so it is at the top of his mind and the highest priority of the highest representatives of the administration right now. I think that rural America should know that. Rural America should know that it is being given the highest priority in this administration.

That doesn't mean that we have all the answers because I don't think anyone does, but it does mean that I believe that we are aware of what's happening.

I want to, as the chairman suggests, review a little bit with you before I go ahead and take your questions. We will start with 1984, a year of increased production, sluggish demand, and new financial concerns.

When I last appeared before this committee, we had just completed a year of major events in agriculture. The PIK Program had been instituted as a measure to deal with the record surpluses overhanging the market. The worst drought in nearly 50 years had dramatically reduced corn and soybean yields. Trade values in fiscal year 1983 had fallen by 20 percent from fiscal year 1981 levels, continuing to reflect the strength of the dollar and large foreign debts.

In 1984, we experienced a year of increased production, lower prices, and new financial concerns. For 1984 crops, we conducted a limited PIK Program for wheat only, and weather conditions were less severe, so that U.S. crop production returned to a more normal pattern. U.S. meat and poultry production remained large, primarily due to beef and broiler output. Dairy production, however, was below year earlier levels, largely because of new dairy policies that lowered price support levels and offered other incentives to reduce production.

In 1984, we continued to experience problems with foreign markets. With the world economy still under stress, the volume of U.S. agricultural exports dropped another million tons. The high value of the dollar, together with larger foreign production and the lingering difficulties of debtor nations, combined to pressure American exports. Despite the volume decline, however, export values rose for the first time in 2 years, to $38 billion, as a result of higher 1983 crop prices.

With the lower projected farm incomes, sluggish export demand, high interest rates and a third year of declining farmland values in some regions, problems have intensified for some highly leveraged farmers. Those who counted on the inflation of the 1970's are now under economic stress. Without inflation-based increases in land prices, they find themselves unable to qualify for credit, and thus they face a major readjustment in their farming operations. There are no precise data on the number of farmers in financial trouble or on the extent of their difficulties—although I will try to put the issue into perspective a little bit later on.

All of this has put increased importance on the outlook for 1985—the topic I shall now turn to.

The 1985 commodity outlook. The 1984–85 marketing year apparently will mark the likely return of the global grain market to the surplus supply conditions that characterized the earlier 1980's. In contrast to last year, when the largest year-to-year drop in world grain production in more than 20 years was recorded, farmers this year are bringing in a record crop, almost 10 percent above 1983–84, even with almost record acreage reduction programs announced in the United States. The 1984–85 harvest will be large enough to facilitate both record consumption and a substantial rebuilding of global stocks that were cut by more than one-fourth in 1983–84. Projected ending stocks of grain for 1984–85, at a little more than 210 million tons, still fall short of the 1982–83 record stockpile of 252 million tons.

Perhaps the most striking developments in this year's market are the extraordinary increases in production by China and the European Community. The Chinese achieved a fourth consecutive record grain harvest, 5 percent above last year's excellent crop and nearly 30 percent above 1980–81. Government policies of China embodying more of a private enterprise approach to grain production, plus continually favorable weather, have been key to China's success. In the EC, remarkably good weather, larger plantings, and increased used of higher yielding varieties, particularly of soft wheats, led to an unprecedented 21 percent increase in grain output.

Another important factor this year has been the magnitude of Soviet buying in the world grain market. The U.S.S.R. harvested a grain crop that apparently was one of its worst in a decade, then embarked on an import program that should surpasss 1981–82's record 46 million tons, and will probably total approximately 50 million tons this year and we have a long-term agreement with them. They have been buying at a record pace with the United States thus far this year and we project that they will buy a record amount from the United States this marketing year.

In the United States, the return of more normal weather permitted grain growers to rebound by increasing production nearly 50 percent from 1983–84's low production level. With planted acreage still well below earlier levels, U.S. grain production in 1984–85, at 308 million tons, fell short by 7 percent of reaching the 1982–83 record.

Let's turn to 1986 and beyond because I know that was one of the questions you asked, Mr. Chairman—What's going to happen and what are we looking at? We will give you the best review available.

At the beginning of my statement, I characterized the outlook for 1985 as one of continued adjustment in agriculture. I believe that if agriculture is to continue to be a dynamic sector of the American economy, adjustment must continue in 1986 and beyond, as conditions warrant. Opinions differ about the role of the Government in modifying these adjustments, however, and this has raised the level of interest in the 1985 farm bill and the credit conditions of American agriculture.

During 1984, we put in place a process that generated a record amount of debate and interest in the 1985 farm bill. I was proud to have led that debate and fostered that process. At our listening sessions around the country, we heard hundreds of persons and received thousands of pages of testimony.

People at these hearings reminded us time and again that over the past 50 years, we have witnessed a tremendous change in agriculture, and we have not had the proper tools to deal with the situation. We have been playing catchup—chasing a rapidly changing agriculture with the same outdated farm programs developed in the 1930's and 1940's. And now, with declining exports and prices and rising costs, we have reached the point at which we no longer can continue.

Agriculture policy is at a crossroads. There is a desperate need for an agricultural policy that is flexible, consistent, and long term in design.

Agriculture, by its very nature, is subject to inherent volatility and uncertainty. Many of the factors that significantly affect agriculture are out of anyone's control and beyond the reach of farm policy. Thus, the public should support some reasonable level of income protection for the farm sector in order to ensure a continuous adequate and wholesome supply of food and fiber.

As a consequence, there is a continued need for a Government role in agriculture. However, if Government is to play a role, it must first acknowledge its responsibility in shouldering some of the blame and burden for the problems that continue to face agriculture.

At earlier hearings, this committee permitted a distinguished group of past Secretaries of Agriculture to testify. They all suggested the need for change. Let me quote from the statements of two of them, one a Republican and one a Democrat.

Earl Butz said:

> What we have been doing obviously doesn't work. Farm income can never be enhanced and rural welfare can never be achieved, in the long run, through a program of restriction, of rising unit costs, of market withdrawal, of expanded governmental controls.

Secretary Bob Bergland said:

> The farm programs with which we are familiar generally are rooted in the 1930's based on a notion that all farms are alike . . . that's not the world in which we live any longer; we have seen a complete change in the structure of American agriculture primarily since 1945.

The real era of change in agriculture is probably just beginning. Many believe that even greater developments lie ahead—farmers and ranchers using ever more sophisticated production and marketing techniques, becoming even more efficient and more productive.

With this outlook, the Government must take the lead in instituting more effective and responsive programs and policies. The administration will be sending its proposal to Congress within the next few days. At this time, however, I would like to share with you the goals and objectives that are the basis for the administration's 1985 farm bill.

First, long-term agriculture policy. The 1985 farm bill must be based on the longer term prospects for U.S. agriculture. It should focus on creating a policy environment in which the full potential of U.S. agriculture can be realized. Today's agriculture requires long-term capital commitments which cannot realistically be made in the absence of a relatively stable and certain farm policy environment. Agriculture faces enough uncertainties without injecting persistent policy shifts.

Second, market oriented. Agricultural legislation must be market oriented in its approach. Irrespective of how the market is defined, most farmers would rather respond to that market, not to artificial price levels maintained by Government acquisition of commodities or Government controls. Loan rates and target prices must be tied to market price movements and the Government must be eliminated as a market alternative. Government would still provide price and income support but not through the physical acquisition of commodities.

Enhance U.S. competitiveness. The legislation should not compromise the competitiveness of U.S. agriculture. It faces a decline similar to that suffered by the autos, steel, and textile industries of this country. We don't want this to happen. We must stay competitive. We must be in the business to produce, compete, and maintain our market share.

Orderly transition. The legislation should provide for an orderly transition period from current programs to the more market-oriented provisions. I believe this is important.

Equity. For the first time, agriculture legislation should be fair and equitable to every producer. That means more uniform treatment for different commodities, which now have different programs that have been built up over the years with special attention. After 5 years U.S. farm programs should provide some kind of safety net that don't give certain commodities special treatment.

Budget restraint. The new legislation must provide fiscal restraint. The budget deficit and the corresponding impacts on economic growth, interest, inflation, and exchange rates have had a devastating effect on key sectors of this economy, such as agriculture. The lack of budget restraints has had a far greater impact on American agriculture than any farm policy decisions. It is in the best interest of farmers and the Nation to implement an effective means of controlling budget outlays. It is imperative we develop effective agricultural legislation that recognizes the need to reduce farm program expenditures.

In summary, I believe it is the Federal Government's responsibility to provide leadership in charting a new course for agriculture—a path that is market oriented, yet provides a compassionate transition period until the sector makes the necessary adjustments. It is the responsibility of the Federal Government to provide a more long-term, consistent agricultural policy that farmers can depend on year after year; one that ebbs and flows with the market, allowing adjustments to be made. It is also the Government's responsibility to challenge our competitors rather than aid and abet them, and to address difficult and important issues such as soil and water erosion, in a direct but reasonable manner.

The legislation I am forwarding to Congress addresses all of these issues. But I am going to need the help of the Members of Congress and members of the agricultural industry and people of this country to get the job done. If we do not achieve a timely resolution, neither farmers not the Nation will be well served and all will suffer.

I know at the top of everyone's mind is agricultural credit and a few words on credit.

During the late 1970's, many farmers borrowed heavily to finance annual production costs, new capital equipment and increasingly expensive land. Cash receipts from agriculture production could not cover the cash flow needed for such purchases.

Beginning in 1981—and I can tell you that I lived those years in rural America on a farm and I know what we all lived with at that time and if a young man came back to the farm from college all the universities and everyone was suggesting that the way to stay in business and get ahead and be efficient was to add another 160 acres, build another barn, and put some livestock in, gear up your production, because there was no way we could raise enough food and fiber to satisfy this world of ours. The people in agriculture all across the board, farmers and those in the service industries, responded and expanded production.

As we moved in to the 1980's, with high real interest rates, we saw dramatically lower inflation rates, weak commodity prices, and these all combined to halt the increases in land values and asset values, particularly land and machinery. Farm assets values have declined about 10 percent since 1981 and are now just over $1 trillion. But land prices have dropped to 1977 levels in some cornbelt and North Central States, and some who started farming or purchased land after 1977 have debt-asset ratios of over 100 percent on that land. Many farmers discovered that they could no longer finance an inadequate cash flow by borrowing. At the same time, the cash flow required to service existing debts increased as interest rates remained high.

The result of this cash-flow squeeze has been played out over several years. Initially expecting a return to the three-decade-old trend of rising land prices, farmers used their equity to borrow new operating funds. But the farm financial problem became more and more apparent as land prices continued to fall and more and more farmers exhausted their remaining equity. As a result, some producers and even some financial institutions are having financial difficulties.

Financial analysts generally agree that farms with debt equal to 40 percent or more of asset values face problems in making principal and interest payments, and that those with debt-asset ratios of over 70 percent are likely to be under extreme stress. Often, however, these guidelines do not apply to very small or very large farms, those with income of over $500,000. The credit problem is centered on those in the income area of $50,000 to $500,000. Those are the farms under the most stress today.

Of these farms, an estimated 114,000 have debt-asset ratios of between 40 and 70 percent of their assets. Some in this latter group, perhaps as many as half, are technically insolvent.

Senator ABDNOR. How many?

Secretary BLOCK. Altogether, the 178,000 middle-size farms with serious to extreme financial problems constitute less than 8 percent of all farms, but they account for nearly 18 percent of all output.

The situation continues to deteriorate as commodity prices remain weak, interest rates remain high, and land values continue to decline in key farming areas. We expect that we will see increasing proportions of farmers with financial problems, continued declines in farm asset values, increasing proportions of debt, in trouble, and increasing problems of lender distress.

The question is, what steps, if any, should the Federal Government take to alleviate these problems? On September 18, President Reagan announced a plan for restructuring farm debt. I'm not going to go over the details, but what it is targeted to is a narrow band of farmers that are on the brink of financial disaster. The Farmers Home portion of that plan has worked well. The bankers did not accept the portion which was designed for them which required them to write down part of the principal that the borrower might owe them. They have asked for a change in that and just yesterday I announced a change in that which is designed to satisfy the question of most of the banking institutions, at the request of many Members of Congress.

As I said at my press conference yesterday, the steps that we are taking in this move will not solve all the problems for everyone. States can be helpful too, and I urge the States to reach out and see what they can do to help. I know local communities are involved and I believe they can be helpful. A team effort is urgently essential if we are going to get the job done. I think everybody will have to play a part in addressing the whole question.

This concludes my remarks, Mr. Chairman, and I'm delighted to be here and have a chance to respond to your questions.

[The prepared statement of Secretary Block follows:]

Prepared Statement of Hon. John R. Block

Mr. Chairman and members of the Committee, I appreciate this opportunity to appear before you and discuss the outlook for agriculture in 1985. I also appreciate the keen interest and deep concern this Committee has demonstrated over the economic health of the agricultural economy.

Before I go into a detailed discussion concerning the agricultural outlook, I would like to review some of the events that took place in 1984, for they set the stage for continued adjustment for agriculture in 1985. And, following my discussion of agriculture's outlook for 1985, I will review two areas that I believe are critical for the future prosperity of American agriculture--the 1985 Farm Bill and the credit conditions in U.S. agriculture.

1984 -- A YEAR OF INCREASED PRODUCTION, SLUGGISH DEMAND AND NEW FINANCIAL CONCERNS

When I last appeared before you, we had just completed a year of major events in agriculture. The PIK program had been instituted as a measure to deal with the record surpluses overhanging the market. The worst drought in nearly 50 years had dramatically reduced corn and soybean yields. Trade values in FY 1983 had fallen by 20 percent from FY 1981 levels, continuing to reflect the strength of the dollar and large foreign debts.

In 1984, we experienced a year of increased production, lower prices and new financial concerns. For 1984 crops, we conducted a limited PIK program for wheat only, and weather conditions were less severe, so that U.S. crop production returned to a more normal pattern. U.S. meat and poultry production remained large, primarily due to beef and broiler output. Dairy production, however, was below year-earlier levels, largely because of new dairy policies that lowered price support levels and offered other incentives to reduce production.

In 1984, we continued to experience problems with foreign markets. With the world economy still under stress, the volume of U.S. agricultural exports dropped another million tons. The high value of the dollar, together with larger foreign production and the lingering difficulties of debtor nations, combined to pressure American exports. Despite the volume decline, however, export values rose for the first time in two years, to $38.0 billion, as a result of higher 1983 crop prices.

With the lower projected farm incomes, sluggish export demand, high interest rates and a third year of declining farmland values in some regions, problems have intensified for some highly leveraged farmers. Those who counted on the inflation of the 1970's are now under economic stress. Without inflation-based increases in land prices, they find themselves unable to qualify for credit, and thus they face a major readjustment in their farming operations. There are no precise data on the number of farmers in financial trouble or on the extent of their difficulties--although I will try to put the issue into perspective later.

All of this has put increased importance on the outlook for 1985--the topic I shall now turn to.

1985 COMMODITY OUTLOOK

The 1984/85 marketing year apparently will mark the likely return of the global grain market to the surplus supply conditions that characterized the earlier 1980's. In contrast to last year, when the largest year-to-year drop in world grain production in more than 20 years was recorded, farmers this year are bringing in a record crop, almost 10 percent above 1983/84, even with almost record acreage reduction programs announced in the U.S. The 1984/85 harvest will be large enough to facilitate both record consumption and a substantial rebuilding of global stocks that were cut by more than one-fourth in 1983/84. Projected ending stocks of grain for 1984/85, at a little more than 210 million tons, still fall short of the 1982/83 record stockpile of 252 million.

Perhaps the most striking developments in this year's market are the extraordinary increases in production by China and the European Community (EC). The Chinese achieved a fourth consecutive record grain harvest, five percent above last year's excellent crop and nearly 30 percent above 1980/81. Government policies embodying more of a private enterprise approach to grain production, plus continually favorable weather, have been key to China's success. In the EC, remarkably good weather, larger plantings, and increased use of higher-yielding varieties, particularly of soft wheats, led to an unprecedented 21-percent increase in grain output.

Another important factor this year has been the magnitude of Soviet buying in the world grain market. The USSR harvested a grain crop that apparently was one of its worst in a decade, then embarked on an import program that should surpass 1981/82's record 46 million tons, and will probably total approximately 50 million tons.

In the United States, the return of more normal weather permitted grain growers to rebound by increasing production nearly 50 percent from 1983/84's low production level. With planted acreage still well below earlier levels, U.S. grain production in 1984/85, at 308 million tons, fell short by seven percent of reaching the 1982/83 record.

Food Grains

Wheat

World wheat production in 1984/85 is expected to be record large for the fifth consecutive year, and probably will exceed 500 million tons for the first time. The most substantial gains in output occurred in the EC, the United States, China, Eastern Europe, and India. Canada, Australia, and the Soviet Union suffered reduced production because of unfavorable weather conditions.

Although global wheat consumption also is projected to be at a record this year, use probably will again fall short of production and cause the fourth straight increase in year-ending stocks. At the close of 1984/85, global wheat stocks as a percent of utilization are likely to remain at about the 21-percent level experienced in the past two years.

Global wheat trade will grow by about three percent from last year's record. The United States appears to be capitalizing on that expansion by increasing its wheat export volume by nearly seven percent from last year's level. The projected volume of 41.5 million tons is the second highest on record. The U.S. share of world wheat trade will likely increase to 39 percent in 1984/85.

The increased exports should help offset a seven percent increase in production and a slight decline in domestic use for feed, so U.S. ending stocks of wheat this year should grow only slightly. Prices, however, may not reach last year's average of $3.54 a bushel, and currently are forecast in the $3.35-3.50 range.

Rice

The world rice situation is little changed from last year. Record consumption will nearly offset record production, resulting in only a slight buildup in stocks. The global stocks-to-use ratio for rice should remain at about six percent, as it has been the past two years.

Global rice trade will decline somewhat from last year when Thailand was able to take advantage of its record production and low prices to export twice as much rice as the United States. U.S. rice exports will decline about 10 percent this year and probably will be only about two-thirds of 1980/81's record level. The U.S. share of the world market continues to decline from a high of nearly 30 percent in 1974/75 to less than 20 percent projected for 1984/85.

U.S. production has rebounded strongly from last year's PIK-reduced harvest. With production up nearly two-fifths, declining exports, and only a modest expected gain in domestic use, U.S. ending stocks of rice are projected to rise more than 30 percent this year. As a result, prices have been well below 1983/84's average of $8.79 a cwt. and are projected to average in the $8.00-8.60 range--very near the $8.00 loan rate. As much as 15 to 20 percent of the crop is expected to be forfeited to the Commodity Credit Corporation when loans mature this year.

Coarse Grains

Global coarse grain production--which includes corn, sorghum, barley and oats--is rebounding from last year's 11 percent decline with a projected 15 percent increase to a record 790 million tons in 1984/85. The United States is leading the way, with a 70 percent increase from 1983/84's PIK and drought-reduced crop. Despite an estimated 20-percent drop in Soviet production, foreign coarse grain output is rising slightly this year, due primarily to large gains in China and Europe.

World consumption of coarse grains will be record large, but will fall far enough short of production to permit a sizeable rebuilding of stocks. Global coarse grain carryover, which last year dropped by one-half, should climb about 28 percent by the end of 1984/85. The expected stocks-to-use ratio of 11 percent still is well below 1982/83's 18 percent, but is about in line with the average of the mid-to-late 1970's.

Global coarse grain trade also is rebounding from last year's level, due mainly to a surge in Soviet buying. The Soviets are expected to import a record 23 million tons of coarse grains in 1984/85, and the United States appears to be reclaiming much of its share of this important market. Also significant this year is the transition of two traditional major importers -- China and the EC -- from importers to net exporters of coarse grains following major increases in production. While some observers suggest that China will have to return to the importer category within a few years as its livestock industry expands, EC production and trade policies suggest that the EC's move to the position of a net exporter may be permanent.

With the help of the Soviet buying, U.S. corn exports in 1984/85 should exceed 51 million metric tons. This would be the highest level in four years.

Despite the resurgence of exports, a probable seven percent gain in domestic feed use, and record food and industrial use of corn, U.S. stocks are expected to rise substantially this year due to the 80 percent increase in corn production. Projected 1984/85 corn carryover of 1.2 billion bushels would be about two-thirds above last year's low level, and would represent a more normal stocks-to-use ratio of 17 percent, compared with last year's 11 percent. With larger available supplies, prices are projected in the range of \$2.60-2.75 a bushel compared with last year's average of \$3.20.

This year's sorghum crop is estimated at 813 million bushels, a 70 percent increase from 1983. Feed use should rebound this season as sorghum becomes more price competitive with wheat and the number of cattle on feed rises in the Southern Plains. Nevertheless, stocks at the end of the season will be about 40 percent higher, and farm prices are expected to average between \$2.35 and \$2.50 per bushel.

The U.S. barley supply for 1984/85 is at an all-time high, while the oat supply is one of the smallest on record. Farm prices for barley are expected to average between \$2.30 and \$2.40 per bushel, down slightly from last season, while oat prices are expected to be \$1.60 to \$1.80 per bushel, or about the same as in 1983/84.

Oilseeds

The 1984/85 outlook is dominated by a recovery in supplies for soybeans and other oilseeds following drought-reduced crops in 1983/84, and by slow growth in demand for oilseed meals, particularly outside the United States. Strong demand for soybean oil in a number of key world markets, particularly India, has only partially offset the weakness in protein meal demand. Short supplies of palm oil, which were a strong positive influence on 1983/84 soybean oil use and prices, also are contributing to strong soybean oil use and prices in the first half of 1984/85. However, a substantial recovery in Malaysian palm oil output in late 1984 and projected strong gains in 1985 are expected to weaken world demand and prices for soybean oil later this marketing year.

For all of 1984/85, producer prices for soybeans and other oilseeds are forecast to average about 20 percent below year-earlier levels. Soybean prices are forecast to range between \$5.75-\$6.65 a bushel compared to the \$7.35 per bushel average in 1983/84. Most of the drop is due to soybean meal prices, which averaged 40 percent below year-earlier levels in the first quarter of this marketing year and for the entire year are forecast to average 25 percent below last year. Soybean oil prices may be down only about 10 percent.

The decline in soybean meal prices is sparking a good gain in soybean meal use in the United States, where a 14 percent rise was recorded in the first quarter as many users took advantage of the lower prices to replenish inventories. Gains in soybean meal use in the United States for the rest of the year are expected to continue, but by less than the first quarter's inflated gains due to inventory rebuilding, with the full-year gain estimated to increase seven percent.

In other major markets, a strong dollar has largely offset U.S. market price declines, resulting in only slightly lower prices for foreign buyers. With weak economic recovery in these countries as well, soybean meal use is not expected to increase significantly. As a result, U.S. exports of soybeans and meal are expected to be about the same as in 1983/84.

Livestock, Poultry and Dairy

Beef

Liquidation of the U.S. cattle inventory continued in 1984. Cow slaughter was up 14 percent from the previous year as producers sent more of their breeding stock to market. Increased dairy cow slaughter, particularly early in the year, contributed to a larger total cow slaughter. But the majority of the increase came from beef herds. Contributing to the large beef cow slaughter have been poor returns to cow-calf operations, droughts in some parts of the country, and financial conditions in much of the agriculture sector.

Cattle feeding activity was up in 1984, and declining feed costs improved returns for cattle feeders. Feeding, which was down sharply in the Corn Belt where corn supplies were low during much of the year, was up in the Plains region where wheat supplies were plentiful and favorably priced for feeding. The number of cattle on feed was up at the beginning of 1985. With the lower feed prices, placements of cattle on feed probably will be relatively large during most of this year. Fed cattle marketings for 1985 may exceed the 1984 level, resulting in an increase in fed beef output. Cow slaughter is expected to decline as returns improve for the cow-calf operators. The amount by which cow slaughter declines will depend on forage conditions, producer returns, and the general financial condition of the farm sector. Total beef production should decline in 1985, as lower nonfed output more than offsets a larger production of fed beef.

Cattle prices were up in 1984 and further increases are anticipated for this year. Choice slaughter steer prices averaged about $3 a cwt. higher in 1984 than in 1983. Feeder cattle prices also rose, but the increase was not as much as that for slaughter steers. Fed cattle prices will be under the pressure of large fed cattle supplies early this year, but they should strengthen later in the year as beef production declines. Lower pork output will be positive for cattle prices, but a larger broiler production will help hold prices down. With a tightening of the feeder cattle supply, feeder cattle prices in 1985 probably will increase more than fed cattle prices. Lower feed costs also will help strengthen feeder cattle prices. Retail beef prices held relatively steady in 1984, averaging less than one percent above the year-earlier level. Reduced output of beef and pork probably will help boost retail beef prices slightly this year.

Pork

Pork producers, reacting to low hog prices and high feed costs in 1983, and early 1984, reduced pork output last year. Production remained above the year-earlier level during the first quarter but dropped below during the rest of the year. For the year, production was down three percent. Even with improved returns in the latter months of 1984, the hogs and pigs inventory remains below year-earlier levels. Also, producers indicated in December that they planned to farrow fewer sows during the next six months than they did in the previous year. If producers carry through with these intentions, it will mean a year-over-year decline in pork production throughout 1985. For all of 1985, pork production may decline around four percent.

Last year hog prices averaged a little above the 1983 level. With lower red meat production in 1985, hog prices should strengthen further. Price gains, however, will be moderated by large broiler supplies. Retail pork prices averaged slightly below the year-earlier level in 1984 but, as pork supplies are reduced again this year, prices probably will rise.

Poultry

Despite high feed costs during much of the year, broiler producers had good returns in 1984. Strong broiler demand kept prices up and output increased about five percent. Demand remains relatively strong and prices are holding at levels that will stimulate further increases in production. Lower feed costs and favorable broiler prices should result in good producer returns again this year.

In 1984, turkey production held near the 1983 level. This level of output combined with strong demand to result in higher turkey prices. During the fourth quarter of 1984, lower feed costs and higher turkey prices resulted in favorable returns for turkey producers. Production is expected to increase in 1985, but a good demand for turkeys likely will keep prices at relatively favorable levels for producers.

Egg prices fluctuated widely in 1984. Reduced production and concern over avian flu early in the year resulted in record high egg prices. Producers responded to the higher egg prices and by the spring, egg production was above year-earlier levels. The increased production resulted in a sharp decline in egg prices. Prices remained under the pressure of larger supplies through the rest of the year and producer returns were squeezed. Egg production in 1985 is expected to be up from 1984 because of a larger laying flock and more eggs per hen from a younger flock. The higher output probably will keep prices under pressure most of the year.

Dairy

Milk production for 1983/84 totaled 137.4 billion pounds, down 1 percent from the previous year. The number of milk cows declined and output per cow was up only slightly. CCC net purchases under the milk price support program totaled 10.4 billion pounds (milk equivalent, fat-solids basis), down from 16.6 billion the previous year.

Milk production is expected to rebound when the Dairy Diversion Program ends in March. Producers appear to be holding heifers for increased production as the number of milk replacement heifer per 100 dairy cows was a record 45.6 last July 1. In addition, output per cow, which has been below year-earlier levels during the program, is likely to increase and offset the lower number of cows. Also, a large number of replacement heifers will enter the milking herd this year. Milk production for 1984/85 may be down slightly, but the decline is likely to occur in the first half of the year. Commercial use probably will continue to improve. Net purchases by the Commodity Credit Corporation are expected to decline from the 1983/84 level but the decline is likely to occur during the diversion program.

Cotton

The most dramatic development in the cotton world centers on China. As recently as 1979/80, China was a major importer, taking 4.1 million bales--more than two million from the United States--to help supply its growing textile industry. However, since 1979/80, China has more than doubled its production to an estimated 26 million bales this season and now is self-sufficient. Chinese mill use during 1984/85 is estimated at 16.5 million bales, which means China has a tremendous surplus of cotton. Even though quality and marketing problems are limiting exports, shipments are increasing rapidly and may total about 1.2 million bales this season. The implications for longer-term U.S. cotton exports are not encouraging.

Record world production of 81.8 million bales in 1984/85 is exceeding consumption of 69.7 million, resulting in a 12-million-bale-buildup in stocks from last season's level of 24.3 million. Larger crops in China and the United States account for most of the increase in global production and stocks.

Despite China's large export potential, near-term U.S. cotton export prospects have brightened in recent months. Tight early-season supplies in some exporting countries, coupled with reduced crops in the Soviet Union and Egypt, may enable U.S. exports to nearly equal last season's 6.8 million bales. However, foreign competition is expected to increase later in the season, likely holding U.S. exports to the 6.5 million-bale level.

Sugar

The 1984/85 season will mark the fourth consecutive year in which world sugar production has matched or exceeded consumption, resulting in a substantial buildup in stocks and low prices. Production is estimated at 97.5 million tons, up about two million from last season. Sugar use may total about 96.1 million tons in 1984/85, compared with 95.6 million last season. Global stocks total more than 40 million tons, equal to five months' consumption. These burdensome stocks have caused prices to plummet to the current level of about four cents a pound. However, with the aid of the 18-cents-a-pound loan rate and import quotas, U.S. prices are averaging about 21 cents.

Although overall U.S. per capita sweetener consumption has remained relatively constant over the past decade, use of sugar has declined dramatically. Increased use of lower-priced high fructose corn syrup (HFCS) is responsible. Since 1970, HFCS use jumped from virtually zero to about 36 pounds a person in 1984, while sugar use declined from more than 100 pounds to 67.5 pounds per person.

Fruits and Vegetables

January 1 prospects indicated a 1984/85 citrus crop of 11.1 million tons, five percent more than last year, but still 17 percent below the 1982/83 crop. However, a hard freeze on January 21 and 22 probably resulted in substantial damage to citrus trees in large areas of Florida. Temperatures in Ocala, at the northern edge of the citrus belt, dropped to as low as nine degrees. Significant ice was found in cut fruit as far south as Vero Beach--an area which escaped damage in the December 1983 freeze. Early reports indicate the potential for greater losses than a year ago.

The January 1 forecast for U.S. orange production, excluding Texas, was 176 million boxes, four percent above 1983/84, but 22 percent less than 1982/83. Severe damage has been reported from the January freeze with much of the unharvested crop destroyed. About 25 percent of the crop had been harvested prior to the hard freeze. Prior to the freeze, the 1984/85 grapefruit production, was forecast at 51.8 million boxes, five percent above last season, but 10 percent less than the 1982/83 crop. Lemon production in Arizona and California is expected to total 26.5 million boxes, 25 percent more than the 1983/84 crop.

Supplies of noncitrus will likely be smaller during 1984/85, primarily reflecting smaller crops of grapes and winter pears. Reduced shipments have left cold storage holdings of apples moderately above a year ago, however. The small supplies and rising demand should keep retail prices for most fresh and processed fruit firm.

Increased supplies of commercial vegetables, potatoes and pulses will put downward pressure in 1985 prices. Based on 1984 production, the 1985 supply of processed vegetables, potatoes and dry edible beans are forecast to be higher through the first two quarters. Also, strong 1984 prices for fresh vegetables suggest that growers will increase plantings in 1985.

Increased production of dry edible beans and continued slack export demand is depressing farm prices. The average U.S. grower price for dry edible beans in December was $18.10 a cwt, down $6.20 from a year earlier.

1985 FARM ECONOMIC INDICATORS

The economic performance of the farm sector in calendar year 1985 is expected to continue sluggish as nominal net cash income remains near the level of 1984. As a result, land values could remain soft and machinery sales will probably continue weak. In 1985, net cash income, which is a measure of the dollar income farmers actually receive in a calendar year, is forecast to range from $31 to $36 billion, compared with the $34 to $38 billion expected for 1984.

Direct government payments (which mainly consist of deficiency payments and diversion payments) are forecast to fall to $4 to $7 billion in 1985 following the $7 to $8 billion total expected for 1984. With the ending of PIK disbursements, all of 1985's direct Government payments will consist of cash disbursements. These lower Government payments in combination with a small rise in cash expenses will likely outweigh stronger receipts from crop and livestock marketings, prompting the forecast for a slight decline in current dollar net cash income.

In 1985, much of the gain in crop receipts will be due to expected larger marketings from the 1984 and 1985 crops. This follows two years of reduced marketings in 1983 and 1984 caused by reduced production in 1983. Assuming no widespread weather problems in 1985, crop output could rise slightly, but with somewhat stronger exports and feed use, farm inventories would not change dramatically. Given that inventory change will likely play a minor role in 1985, net farm income, which measures income generated from a given calendar year's production, will probably fall within a range of $19 to $24 billion. This compares with the $29 to $33 billion expected for 1984 and $16.1 billion for 1983.

In 1985, continued moderation in prices farmers pay for production inputs, combined with stable input use, will likely lead to a one-to-five percent increase in farm cash expenses. With depreciation, the largest single expense category, expected to decline, total farm production expenses (cash expenses plus noncash items) will likely rise one to four percent in 1985. Expenses for inputs originating on farms, such as feed and feeder cattle, and for manufactured inputs, such as fertilizer and pesticides, are expected to rise two to four percent. Meanwhile, other cash operating expenses are expected to rise only slightly, mainly because of the tapering off of the deductions levied on milk marketings. Interest expenses, which now make up an average 20 percent of a producer's out-of-pocket expenses, will also likely rise only slightly as average debt burdens are reduced and average interest rates remain near or fall below those of 1984.

Farmland Values Decline for Third Consecutive Year

Land values peaked in 1981 after three decades of uninterrupted increases. In all but a handful of states, land values rose more than 30 percent during the inflationary 1978-81 period, adding $243 billion to landowners' assets.

With lower expected returns to agriculture, farm real estate values declined about seven percent nationally between early 1981 and the middle of 1984. Although values have increased in some areas, in the Corn Belt and Lake States land values have declined quite sharply. For instance, in Iowa, the net cash returns in 1984 averaged $125 to $175 per acre, compared to $200 per acre in the late 1970's. Land prices have dropped from about $1,900 per acre in the late 1970's to about $1,400 per acre today. In Nebraska, land values have declined from about $660 in 1980 to less than $500 in 1984, and they appear to still be declining.

A decline in real estate value has led to reduced equity and cash flow difficulties for many existing farmers. At the same time, lower farmland values or rental rates have helped those who want to get started in farming.

Farm Debt Slows

After several years of rapid advances, total farm debt is forecast to remained unchanged during 1985 at around $210 billion. Relatively high interest rates, reduced equity, the need to conserve cash flow and lower inflation rates will dampen borrowing for the next few years. While rapidly rising land values and low real interest rates led many producers to expand their operations in the

1970's, in contrast, the 1980's seem likely to be characterized by financial conservatism. Farmers and lenders will probably continue to attempt to reduce their financial risk.

Although it has become more difficult for farmers to qualify for credit, money is available. Farm lenders are paying close attention to the condition of the farmer's financial statements before providing any new credit, however.

Farm Equity Down Slightly

Farm sector equity will again decline very slightly in 1985, falling to about $805 billion. The debt/asset ratio is expected to be about 21 percent on January 1, 1986, which should equal 1984's level. While the nearly 21-percent debt/asset ratio is higher than in recent years, it still is somewhat lower than nearly 25 percent debt/asset ratio average for non-farm, non-corporate businesses. But the comparatively low farm industry average disguises the difficulties that some individuals--those with debt/asset values of 70 percent or more--are facing in certain areas of the U.S.

Export Values Likely to Decline

After reversing a two-year decline in fiscal 1984, the value of U.S. agricultural exports is expected to drop from $38.0 billion to $36.5 billion in fiscal 1985. Lower prices will offset anticipated increases in the volume of grains and soybeans and cause our export values to fall. A strong dollar will continue to affect exports, as will larger foreign production and new competitors, such as the EC in feedgrains. The strong U.S. dollar will also lend to increases in imports, which are forecast to rise marginally from fiscal 1984's record $18.9 billion. Thus, the agricultural trade surplus will likely fall to about $17.5 billion, nearly $2 billion below last year's level.

Food Prices Continue to Rise Moderately

Retail food prices rose over three percent in 1984, compared to two percent in 1983. This was the sixth consecutive year in which retail food prices rose less than the Consumer Price Index. These small increases are a result of low farm prices and a general reduction in inflation which has held down labor, processing, and other food manufacturing and distribution costs. Costs for fuel and power rose only slightly more than one percent. While prices for most energy sources remained steady, electricity rates increased about five percent.

If food prices had gone up as much as the general rate of inflation in the last five years, consumers would have spent about $50 billion more for food last year. Moreover, the average consumer in most other countries in the world spends well over 20 percent of disposable income on food and beverages, while the average American consumer spends only about 15 percent--less than the proportion spent 10 years ago.

The general economic and farm sector outlook suggests that food prices may increase about two to five percent in 1985. Nearly all the increase will likely be due to a rise in the farm-to-retail price spread, consisting of costs of food processing and distribution. Marketing charges account for two-thirds of expenditures for food in grocery stores and have been the main cause of rising food prices over recent years. Farm prices of food commodities in 1985 will likely average slightly below last year's level.

1986 AND BEYOND

At the beginning of my statement, I characterized the outlook for 1985 as one of continued adjustment in agriculture. I believe that if agriculture is to continue to be a dynamic sector of the American economy, adjustment must continue in 1986 and beyond, as conditions warrant. Opinions differ about the role of the Government in modifying these adjustments, however, and this has raised the level of interest in the 1985 Farm Bill and the credit conditions of American agriculture.

1985 Farm Bill

During 1984, we put in place a process that generated a record amount of debate and interest in the 1985 Farm Bill. I was proud to have led that debate and fostered that process. At our listening sessions around the country, we heard hundreds of persons and received thousands of pages of testimony.

People at these hearings reminded us time and again that over the past 50 years, we have witnessed a tremendous change in agriculture, and we have not had the proper tools to deal with the situation. We have been playing catch up -- chasing a rapidly changing agriculture with the same outdated farm programs developed in the 1930's and 1940's. And now, with declining exports and prices and rising costs, we have reached the point at which we no longer can continue.

Agricultural policy is at a crossroads. There is a desperate need for an agricultural policy that is flexible, consistent and long-term in design.

Agriculture, by its very nature, is subject to inherent volatility and uncertainty. Many of the factors that significantly affect agriculture are out of anyone's control and beyond the reach of farm policy. Thus, the public should support some reasonable level of income protection for the farm sector in order to insure a continous, adequate and wholesome supply of food and fiber.

As a consequence, there is a continued need for a government role in agriculture. However, if government is to play a role, it must first acknowledge its responsibility in shouldering some of the blame and burden for the problems that continue to face agriculture.

At earlier hearings, this Committee permitted a distinguished group of past Secretaries of Agriculture to testify. They all suggested the need for change. Let me quote from the statements of two of them, one a Republican and one a Democrat.

Earl Butz said, "What we have been doing obviously doesn't work. Farm income can never be enhanced and rural welfare can never be achieved, in the long run, through a program of restriction, of rising unit costs, of market withdrawal, of expanded governmental controls."

Bob Bergland said, "The farm programs with which we are familiar generally are rooted in the 1930's based on a notion that all farms are alike...that's not the world in which we live any longer; we have seen a complete change in the structure of American agriculture primarily since 1945."

The real era of change in agriculture is probably just beginning. Many believe that even greater developments lie ahead -- farmers and ranchers using ever more sophisticated production and marketing techniques, becoming even more efficient and more productive. For example, seed treatments now being tested in the Pacific Northwest may increase wheat yields 30 to 40 percent; growth hormones produced from the new genetic engineering technology may increase production per dairy cow by as much as 40 percent with virtually no increase in feed. Likewise, a new high-yielding semi-dwarf variety of long-grain rice is boosting yields by as much as 40 percent--because of its ability to withstand lodging caused by excess water or winds. And these are but a few examples.

With this outlook, the government must take the lead in instituting more effective and responsive programs and policies. The Administration will be sending its proposal to the Congress within the next few days. At this time, however, I would like to share with you the goals and objectives that are the basis for the Administration's 1985 farm bill.

- <u>Long-Term Agricultural Policy:</u> The 1985 Farm Bill must be based on the longer term prospects for U.S. agriculture. It should focus on creating a policy environment in which the full potential of U.S. agriculture can be realized. Today's agriculture requires long-term capital commitments which cannot realistically be made in the absence of a relatively stable and

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certain farm policy environment. Agriculture faces enough uncertainties without injecting persistent policy shifts.

- <u>Market Oriented:</u> Agricultural legislation must be market-oriented in its approach. Irrespective of how the market is defined, most farmers would rather respond to that market, not to artificial price levels maintained by government acquisition of commodities. Loan rates and target prices must be tied to market price movements and the government must be eliminated as a market alternative. Government would still provide price and income support but not through the physical acquisition of commodities.
- <u>Enhance U.S. Competitiveness:</u> The legislation should not compromise the competitiveness of U.S. agriculture. U.S. agriculture possesses a basic comparative advantage to the rest of the world in the production and delivery of many agricultural products. New legislation should not constrain that basic advantage by artificially raising prices above world market levels and thereby forfeit markets to less efficient producers. Nor should it remain silent with respect to policies of other countries which attempt to offset our basic advantage through the use of subsidies or barriers to entry. If our domestic policies are to foster the competitive advantage, then our international trade policy must be consistent with that goal.
- <u>Orderly Transition:</u> The legislation should provide for an orderly transition period from current programs to the more market-oriented provisions. There must be a recognition that government, through actions such as the Soviet grain embargo, has

been a root cause for some of the problems that agriculture faces today. Therefore, any new agricultural legislation must contain a transition program, where price and income supports become market-oriented over a period of three to five years.

- <u>Equity:</u> For the first time, agricultural legislation should be fair and equitable to every producer. At the end of the orderly transition period, producers should be put on an equal footing since, after five years, all commodities should be treated alike and provided the same relative level of price and income support.
- <u>Budget Restraint:</u> The new legislation must provide fiscal restraint. The budget deficit and the corresponding impacts on economic growth, interest, inflation, and exchange rates have had a devastating effect on sectors such as agriculture. In many cases, these impacts have been far greater than any farm policy decisions. It is in the best interest of farmers and the nation to implement an effective means of controlling budget outlays. It is imperative we develop effective agricultural legislation that recognizes the need to reduce farm program expenditures.

In summary, I believe it is the Federal Government's responsibility to provide leadership in charting a new course for agriculture--a path that is market-oriented, yet provides a compassionate transition period until the sector makes the necessary adjustments. It is the responsibility of the Federal Government to provide a more long-term, consistent agricultural policy that farmers can depend on year after year; one that ebbs and flows with the market, allowing adjustments to be made. It is also the government's responsibility to challenge our competitors rather than aid and abet them, and to address difficult and important issues such as soil and water erosion, in a direct but reasonable manner.

The legislation I am forwarding to Congress addresses all of these issues. But I am going to need your help to get the job done. If we do not achieve a timely resolution, neither farmers nor the Nation will be well served and all will suffer.

Agricultural Credit

During the late 1970's, many farmers borrowed heavily to finance annual production costs, new capital equipment and increasingly expensive land. Cash receipts from agricultural production could not cover the cash flow needed for such purchases. But, as long as land prices were rising rapidly, farmers were able to borrow against rising asset values to cover cash flow shortfalls, debt repayment and crop failures. Because inflation was well above interest rates, borrowing costs were for some years negative, and lenders were willing to loan even more than requested. But this growing debt rollover became unsustainable after 1981 when global markets declined and commodity prices fell. The agricultural sector in 1981 began to face the bitter realities of squeezing the inflation of the 1970's out of the economy. It became apparent to us all that the trends of the 1970's--that is, rising demand, prices and land values--were not going to be the trends for the remainder of the 1980's and probably beyond.

Beginning in 1981, high real interest rates, dramatically lower inflation rates and weak commmodity prices combined to halt increases in asset values, particularly land and machinery values. Asset values have declined about 10 percent since 1981 and are now just over $1 trillion. But, land prices have dropped to 1977 levels in some Cornbelt and North Central states, and some who started farming or purchased land after 1977 have debt/asset ratios of over 100 percent on that land. Many farmers discovered that they could no longer finance an inadequate cash flow by borrowing. At the same time, the cash flow required to service existing debts increased as interest rates remained high.

The result of this cash-flow squeeze has been played out over several years. Initially expecting a return to the three-decade-old trend of rising land prices, farmers used their equity to borrow new operating funds. But the farm financial problem became more and more apparent as land prices continued to fall and more and more farmers exhausted their remaining equity. As a result, some producers and financial institutions are having financial difficulties.

Financial analysts generally agree that farms with debts equal to 40 percent or more of asset values face problems in making principal and interest payments, and that those with debt/asset ratios of over 70 percent are likely to be under extreme stress. Often, however, these guidelines do not apply to very small or very large farms. Most small farms, those with less than $50,000 in annual sales, receive more income from off-farm sources than from the farm enterprises. They often borrow against farm assets for nonfarm purposes, and repay the loans with nonfarm income. So it is difficult to say whether a small farm with a high debt/asset ratio is in trouble or not, without examining each individual case.

A significant proportion of very large farms, those with over $500,000 in annual sales, are normally highly leveraged. But they are often specialized operations, such as vineyards, nurseries, orchards or vegetable farms, that operate in a different environment from field crop enterprises--and often carry large debt/asset ratios. These very large farms are thus less likely to be in financial difficulty than the statistics might suggest.

The family-size commercial farm generally falls in the middle, with sales of $50,000 to $500,000 annually. Of these farms, an estimated 114,000 have debt/asset ratios of between 40 and 70 percent or more of their assets. Some in the latter group, perhaps as many as half, are technically insolvent. Altogether, the 178,000 middle-size farms with serious to extreme financial problems constitute less than eight percent of all farms, but they account for nearly 18 percent of all output. Although there are some farms under stress in all regions, the largest numbers are concentrated in the Corn Belt, the Lake States and the Northern Plains.

The situation continues to deteriorate as commodity prices remain weak, interest rates remain high, and land values continue to decline in key farming areas. We expect that we will see increasing proportions of farmers with financial problems, continued declines in farm asset values, increasing proportions of debt in trouble, and increasing problems of lender distress.

The question is, what steps, if any, should the federal government take to alleviate these problems. On September 18, President Reagan announced a plan for restructuring farm debt. The program contains four provisions:

- o The Farmers Home Administration will, on a case-by-case basis, defer up to 25 percent of the principal, to a limit of $200,000, and interest payments owed by selected farmers for up to five years.
- o Federal guarantees of $700 million are being made available to private farm lenders who agree to write off 10 percent of farm debt owed in selected problem farm situations.
- o Experts from local communities are being asked to help farmers develop financial and production management plans.
- o FmHA is contracting out some routine paperwork to private banks and other financial institutions in order to reduce backlogs.

The debt restructuring plan that was announced last September gave many farmers a chance to put together a stable financial future. The plan has been well received by Farmers Home Administration borrowers. Over 100,000 current FmHA borrowers have applied for loan restructurings under the plan.

However, the portion of our program designed to help other troubled borrowers is not being utilized by private banks and other commercial lenders to its fullest advantage. The additional initiatives I announced yesterday will enhance the effectiveness of the program announced last September. The initiatives included:

- o Create a Farm Credit Coordinating Group, chaired by the Secretary of Agriculture. The group will include the Chairman of the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Assistant Secretary of Treasury for Domestic Finance, the Governor of the Farm Credit Administration, the Under Secretary of Agriculture for Small Community and Rural Development and as an observer, the Vice Chairman of the Federal Reserve Board. The group will coordinate activities of the Federal and financial regulatory agencies having responsibilities for dealing with the current farm problems.

o Create an emergency "Credit Assistance" program. FmHA guarantees of up to 90 percent on operating loans would be made to eligible producers previously served by failed lending institutions. They would be applicable to new crop loans on a one-year basis. Eligibility would be limited to producers with substandard loans who can meet a cash flow test on new credit extensions. The assuming institutions may write loans under a quick certification procedure to be established by emergency regulations.

o The Department of the Treasury will work with the FDIC, the Comptroller of the Currency and the Federal Reserve to implement a policy to avoid supervisory actions that may discourage banks from exercising forbearance or from working with farmers and small business borrowers who are experiencing temporary difficulties in meeting their debt service obligations.

Even with these initiatives, I would contend that the government cannot stop the direction of the adjustments now taking place in the agricultural sector but can minimize the pain of the adjustments that are taking place. Economic forces have dictated that asset values must decline, if the sector is to remain competitive. Land prices cannot be set at values that do not reflect expected cash returns. Even if the government were to make efforts that went way beyond the September credit initiative, such actions would fall short of the mark for they would not make up for the $100 billion decrease in asset values since 1981.

The Farmers Home Administration is already the lender of last resort, extending credit to those farmers who cannot obtain credit elsewhere. On January 1, 1985, FmHA held about nine percent of farm real estate debt, and about 15 percent of farm operating and other debt. FmHA has stayed with 98 percent of its borrowers. As a result, on June 30, 1984, 35 percent of active FmHA farm borrowers were delinquent. Of the $25 billion in FmHA farm loans outstanding, over $5.4 billion were delinquent. Most of the delinquent debt was for emergency disaster and economic emergency loans, which were extended in the late 1970's in an attempt to help some farmers stay in business.

I don't believe that pouring more money into FmHA programs is the answer. Those producers facing severe financial problems might be helped for a year or two if more FmHA funding were made available, but most would likely leave agriculture eventually despite FmHA funding. In the meantime, the budget deficit would be aggravated by the larger levels of additional government spending. The increased spending would put further pressure on interest rates paid by all farmers, and would help keep the U.S. dollar at a relatively high level, making our exports less competitive in world markets. Thus, once again, a well-intentioned attempt to help some producers would likely not only fail to accomplish its goal, but could adversely affect all our farmers and agribusinesses.

Summary

This is going to be an extremely tough but important year. We must not let our emotions or short-term views keep us from getting agriculture back on track with a reduced budget, more fairness in our taxes, a more responsive farm policy, and a trade policy that challenges unfair trade practices. These are policy changes that will provide for long-term prosperity in the agricultural sector. We must never lose sight of these major goals that are so crucial to agriculture's survival.

Thank you. I will be happy to answer any questions you may have.

Representative OBEY. Thank you, Mr. Secretary.

Let me begin with the specific and move to the general. First of all, I want to ask you about a specific policy problem within the ASCS. I have received a good many letters from farmers recently indicating that there's a policy change being implemented by ASCS which is troubling many of them. It affects farmers in the milk diversion program who also have a farm storage facility loan agreement with ASCS made before August 4, 1982. My understanding is that those loans are usually paid off in annual installments and that a 12-month grace period has normally been allowed in which the farmer might make his payment without being considered delinquent.

The farmers are writing me now telling me that those farmers who are in the diversion program will have a portion of their diversion check deducted in order to pay those other loans, even though they are still falling within the 12-month grace period, whereas farmers who are not in the diversion program would not be subjected to that same policy.

I am writing a letter to Mr. Rank on the subject. I would also ask you to take a look at it because many farmers feel that they were assured that this policy change would not take place when they signed up. They feel it's another barrier in the ability to demonstrate success of that program—certainly psychologically to farmers. I would appreciate it if you would take a look at it and get back to me about what's going on and whether that policy can be changed. It would seem to me that it's changing horses in the middle of the stream, which I don't think is equitable.

Secretary BLOCK. I'll take a look at it, Mr. Chairman. I don't have any information on it at this time.

Representative OBEY. OK. Second, I'm a little confused by the numbers that I see in the administration budget estimates for the expected cost of the dairy program in the next fiscal year.

As you know, the diversion program is scheduled to end in just a few months. As you indicated in your prepared statement, we have a lot of milk replacement heifers just waiting to come on line. And the problem, as you indicated yourself, is that with this diversion program ending, and no other one to take its place, farmers are going to try to beat the system by getting in with more production.

It would seem to me that ginned-up production would cost us more, not less, on the budgetary end this year and yet unless I'm misunderstanding something, the administration budget estimate indicates that there will be a drop of some $230 million in the estimated cost of that dairy program.

I find it hard to understand how the cost to the Government will drop if production is increased.

Secretary BLOCK. Mr. Chairman, I may ask Mr. Russell to comment on that, but in this current year, of course, the costs are held down in part by the dairy diversion program. People can't get into the program the latter half of the year. As you suggest, they may be coming on with more cows and production may increase and the question is, what happens in 1986? I think fiscal 1986 is what you're talking about and I believe the deterrent to production there would be the price being somewhat lower.

Representative OBEY. My point is that your own statement seems to imply an accurate recognition of the fact that you have a whole lot of milk about to come into the pipeline with the end of the diversion program and you say milk production is expected to rebound when the dairy diversion program ends. I agree with the statement. I just don't agree with the administration's budget numbers.

Mr. RUSSELL. Mr. Chairman, two points on that. First of all, we're talking about two different marketing years. Right now I think the comments Secretary Block was referring to is what's going to happen this marketing year. That runs from October through the end of September 1985. Your comments relate to fiscal year 1986 and our budget shows a decline in outlays. That reflects the administration's farm bill proposal for dairy which will be assuming that we will be at $11.60 a hundred weight starting October 1, 1985, we would make a 50-cent reduction in support price on April 1, 1986, if CCC projected net removal for greater than 5 billion pounds. That's what's reflected in this cost estimate for fiscal 1986.

Representative OBEY. I understand that. I guess the point I'm trying to make is that I might agree with your numbers in a longer timeframe, that over the year or year and a half after this program ends what you are first going to see is an increase in production. I think it will be a significant increase in production, not just on the part of the middle-size farms, but by a hell of a lot of other bigger ones. I think that the numbers, therefore, in the admininistration's budget estimate are squishy at best and quite unrealistic. It may be illegal to bet on elections but I don't think it's illegal to bet on the outcome of the budget, and I'd be willing to bet you the biggest martini in town that I'm going to be closer to the real numbers than your budget estimate.

Mr. RUSSELL. Well, one thing that does cause us great concern is, as you cited and we cite in our testimony, milk replacement heifers for 100 dairy cows are now about 45, where at the start of the expansion 6 years ago it was 39. So that does cause us some concern certainly.

Representative OBEY. Mr. Secretary, you announced your new farm credit program yesterday. I have not had an opportunity to really fairly evaluate it. But I did notice, for instance, that Senator Kassebaum indicated yesterday that she said she couldn't embrace a program that offers too little assistance and too little hope and is still inadequate.

An official of the Independent Bankers Association indicated that there's nothing new. These are totally insignificant changes.

Let me try to evaluate that. What are your specific numbers? You indicated that the banks had not accepted the plan. My understanding is they had only taken advantage of it to the tune of about 10 percent of the offer you made them last September. How many dollars are you prepared to put in the emergency loan program with the FHA?

Secretary BLOCK. The program called for about $650 million and the alterations or the adjustments we made in the program we feel will make the program more workable and will make it possible that the banks will go ahead and use that money, at least we hope they will. And that's how much money is in there. We are going to wait and see if they do go ahead and use it, frankly.

Representative OBEY. What's your estimate of how much of that will be used?

Secretary BLOCK. I would hope they would use it all, but I guess it really remains to be seen. My personal estimate is that I think they probably will use most of it, maybe all of it, but I don't know for sure. Because you know last fall I was fairly optimistic because they signed on the program last fall.

Representative OBEY. That's my concern because only 10 percent was used under that last offer and I would be skeptical that they would use that full amount.

But let me just at this point put two additional questions in the record for you to respond to because we are squeezed for time. Let me move on to these two other questions before I turn it over to Senator Abdnor.

I agree with the administration's assertions that many of these farm programs are not sufficient to meet modern economic conditions. I certainly agree with you that the thrust of whatever programs the Government continues ought to be aimed at this middle-size band of farmers who produce 40 percent of the Nation's food. They are largely the family farmers or full-time farmers who are not the big boys. I noticed Mr. Stockman recently talked about farmers trying to get rich. In my district, the average dairy herd is about 50 cows. I don't think anybody gets rich on 50 cows.

But I'd just like to make an observation and then ask you to comment. You may not like the observation but let me toss it out there anyway.

My favorite philosopher is Archie the cockroach and he once said, "Did you ever notice that when a politician does get an idea he gets it all wrong?" I think that can be said very often for administration people as well as people in the Congress.

You said in your prepared statement that we ought to have fiscal control as a goal of our farm policy. I certainly agree with that, but I'd like to cite some numbers not to be partisan but simply to lay the numbers accurately out there on the table.

My understanding of the cost of farm programs in the last 15 years would be roughly this. In the early 1970's, on average, our farm programs usually cost the Treasury about $3 billion. My understanding is that during the late 1970's, under President Carter, that rose to about $4 billion per year. However, under you and Mr. Stockman—and I don't know which one to shoot at because I recognize that sometimes you're not calling the shots as fully as you might like and I'm not quite sure who is the general here that I want to talk with—but my understanding is that under the stewardship of you and Mr. Stockman and others that the cost went up to about $19 billion.

Now what I think we have here, at least in part—and let me stipulate there's plenty of blame to go around. I think you've made some mistakes. I think we've made some mistakes. But what we have had at work in the administration is a pursuit of economic theology rather than a pursuit of what works. And what happened was this: a lot of people saw coming on the horizon large crop yields, huge output by our farmers.

The administration, because of its economic commitment to free markets and I don't object to that but I do have some concerns when that commitment becomes almost theological—I think the administration in the beginning was almost holier than the Pope pushing for an absolute, hard-rock, straight commitment to free market forces. So even though a number of people were giving advice to provide some kind of supply control to prevent an explosion in production, you resisted it. Farmers planted post-to-post and then when those huge crops came in, also after the grain embargo, the political system could not resist the inevitable pressure. What happened was that you went from being holier than the Pope to being an agnostic. What happened is you produced the PIK program which produced incredibly high costs.

So we've had these wild swings. It just seems to me that a free market is fine, but what we have to do is to try to reach agreement between you and us, between the administration and the power structure in agriculture, and in the economy of this country, so that we recognize that we are not trying to insulate farmers from change but we are trying to provide the ability for those middle-size farmers to get through the very tough years which can occur because of accidents of weather, accidents of Federal policy, grain embargoes, or you name it. We are trying to get the good farmers through those years still in a position to produce without creating these wild swings.

I think farmers expect to take budget cuts. But I think if we can't reach a rational agreement about what's sustainable over the long haul, we're going to continue to have these wild swings between a commitment to free market forces 1 year followed by wild overreactions, as represented by the PIK Program afterward, and we're going to continue to have these huge expenses during every cycle.

That's a long speech, but go ahead and respond to it.

Secretary BLOCK. Thank you, Mr. Chairman. First of all, I'm pleased—really, I think overall there's quite a bit of agreement between us. We might disagree on some specific points. I believe the PIK Program was the right program for the times. Now some would say, well, why didn't you have stronger controls the years before, but if we had had the 1983 drought in 1982 instead of the 1983 drought at the same time as the PIK, I think those 2 years would have evened out pretty decently. It didn't work out quite that way and weather is one thing that none of us have any control of.

But the point really is—when you boil it all down, even the last 4 years, as well as the previous 50 years—efforts to control production have given us an agricultural industry in the last few years that has been giving up markets to other countries because they have come in and taken our markets. We believe that a long-range policy, as I have talked about, with less Government involvement is the right policy.

Representative OBEY. But is it really going to lead to less Government involvement? Can you really sustain that? Is it practical to talk about that long term? Don't you build in a political inevitability for the demands that caused you to create that wild, expensive PIK Program?

Secretary BLOCK. I don't believe that that has to be true, but I do agree that when you have a farm law written in such a way that leaves all these options open so that you can do almost anything, then the political pressures come on to do all kinds of things and the tendency of course in Washington, DC, is to react and try to do whatever that may be authorized under the law.

I think we need legislation that does authorize acreage retirement in the long range. We can phase that out. It doesn't authorize some of these wild things that really get agriculture into trouble.

Representative OBEY. And you really believe, the way the political system works, that if that law had not been on the books you would not still have had sufficient pressure in this town to require you to produce legislation allowing you to do that?

Secretary BLOCK. Well, it's easier to live by the law and hold something in place when it's already authorized; and everyone says, well, you're supposed to do it under certain circumstances.

Furthermore, I think it's important to keep in mind we are in a different situation now. I think we have gone through some efforts in agriculture to address certain problems and there's a general disenchantment in America with the way acreage reduction and Government controls have served this industry. There's a hard core of solid farm people that want change and they want to move in the direction where Government has less involvement. You know, if we assume that we can't wean ourselves away from Government somewhat, I think it's a sad situation. I think we have to have the faith and confidence that this industry has finally arrived at a time when we are ready to back away from Government and say we should go primarily, principally on our own, and we want our income out of the marketplace and we want less Government.

I hope this industry can do that and, of course, our legislation would move us that way and we will try to get the job done and that would mean we would arrive at that budget control that you and I say is important, and I don't think that there are only two alternatives. If we're going to have budget control you only get there two ways. One way you get there is you have some kind of Government controls on production and you don't pay farmers for that control or pay them very much. That way you have finite budget control. The other way is you let the farmers produce and compete the best they can and let the economic system sort the situation out and you let supply and demand undermine price and the Government, once again, will have a minimum responsibility in paying direct support to agriculture.

Those are the two ways you get there and I think the second way is far superior to the first.

Representative OBEY. Well, I would simply say I agree with your goal but I have some grave questions about it. You have had control leverage for 4 years and that $19 billion balloon doesn't look to me like we have Government out of it.

Before I turn it over to Senator Abdnor, because we have a rollcall vote in progress in the House, I would simply make the point that in the case of the dairy diversion program well over 90 percent of the cost of that program is being financed by the farmers themselves rather than by the Government.

Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Chairman.

Representative OBEY. Thank you for coming, Mr. Secretary.

Secretary BLOCK. Thank you, Mr. Chairman.

Senator ABDNOR [presiding]. Mr. Secretary, just looking and reviewing the whole picture of agriculture, if you could do one thing, what do you think is the most important thing we really have to do out there? I don't mean you yourself, but as Congress and President Reagan working at it?

Secretary BLOCK. The most important thing we must do is do something to bring interest rates down and whatever is necessary to see that the dollar's relationship—it would be nice if it would moderate some compared to other currencies around the world. Most people say if we can attack this deficit problem and get spending into line this will help a tremendous amount and the President's budget and many members, as you, are committed to addressing Government overspending. I believe if we can do this aggressively, that's step number one.

Senator ABDNOR. Let me back up. I don't really think it is. Mine is a simpler thing.

Secretary BLOCK. All right. The best farm program is to address the deficit problem and then we need to write sound agricultural policy which will give us a brighter future of growth. Now there may be intermediate things we can do and this credit thing is upon us today; but I believe those are the two biggest things that must be done.

Senator ABDNOR. OK. But I want to go back to something I think at this moment is more important than credit or anything else. The one dominating situation that's going on out in rural America today is a lack of confidence. The sad part about this situation is that it not only affects the devastated and the bankrupt farmers and not just the bankrupt businesses—which we are certainly trying to help survive—but it's hurting the people who have no business worrying about it, the people who are really in relatively good condition and in some cases excellent position. This thing is kind of spreading over them. My gosh, they see their neighbor in trouble and think "this could happen to me." From this end, we make it tough for our lending institutions, not just banks, but everyone. Some of the regulatory rules they have to live by cause them to get a little scared. They tell these bankers, "You have to watch out," and they start putting a squeeze on farmers they wouldn't have ever troubled before. Because of this you have a situation where the confidence factor is really rock bottom. I tell you, Mr. Secretary, that disturbs me. I'm going to be honest while we're talking here. I was disappointed last night.

I don't know what this credit program is going to do but it has to help. I have to believe it isn't going to go as far as we would all like to have it go, but it's a step. This would arrest the fears that one sector that has some debt also has serious problems. It's no sin to have debt. Farmers and businessmen have had debt all their life, paying off land and things. There are a lot of those who are in that middle sector who are getting the squeeze and are scared to death.

Here you're giving that person at least a little backup assurance that if things got more difficult he'd have something to turn to.

I was hoping last night the President would have talked about this for a second and say we're going to give that word of confidence out there because they are not feeling it like they are in the rest of the country. As I've told you, it is because all the signs are go and everything is on the pickup. However, in rural America it isn't, and these people need a pat on the back. They need a good word. They want people to know we're interested and concerned and, by gosh, we're going to help them. You made quite a step yesterday with the restructuring of the credit program. I don't know how it's going to work because I have not delved that far into it. I know I could arrest some fears of some of those that shouldn't be concerned, and really didn't need it, but it ought to help.

Secretary Block. May I comment that I think the confidence in the country can be forthcoming and I agree with you wholeheartedly, we need more confidence out there, and I believe that an important step in getting that confidence, though—and if you talk to farm people, as I know you do constantly—if the Congress and the administration can aggressively address the deficit and say, "Listen, we're going after it; we're going to get the job done; we're going to make meaningful reductions in that deficit," that will put enormous confidence in the farm community, in the lending industry, Wall Street. It will all help to put this thing together and it will ease a lot of the frustration in rural America.

I believe there's a great future in rural America. I think we have a tremendous future, but we really are today, as you suggest, at a low ebb here and we need to come up out of here and move ahead.

The President last night did talk about the importance of reform in our farm policy. He talked about the tough times on the farm. He also talked about a resolution to require a constitutional amendment to require us to balance the Federal budget. He talked about getting at that budget deficit. I believe that these are the kinds of things we have to do.

We can't just talk about confidence. We have to demonstrate that we mean to do something about restoring confidence and I believe that's what it's all about.

Senator ABDNOR. Well, I appreciate that and I'm not quarreling. I know the importance of the deficit. But right now at this very moment, on the minds of those people out there, cutting the deficit is not the major concern. That will be a followup of the problems, I'm sure. There's nothing worse than the high interest rates we're facing, but it's more instantaneous right now than just that. Right now they are saying: "I can't sit around here for this Congress to do something. My gosh, they're going to close me out and I've been here all my life. My father and all my family heredity has been on the farm and I'm going to lose it." This guy may not even be close to losing it, but he's scared to death right now because he sees it happening around him faster and faster.

The results of a new survey in the Farm Journal show that in just one year's time twice as many farmers are on the ropes than before. So this fellow thinks, "I'll be there next year."

The deficit is a big problem, I agree, and I haven't found any Democrats or Republicans around here who don't say that. We'll see how far we're going to go with that, but the point is, right now they need that confidence. Hopefully, the loan package you have might help a little, and the fact that Congress takes the right steps in the immediate future. I don't know whether you want to add anything to that.

Secretary BLOCK. No. The declines seem to become a self-fulfilling prophecy, as you suggest.

Senator ABDNOR. When do you think rural America is going to start coming back? Let's say your program went into effect. Let's say we received a $40 billion reduction in government expenditure.

Secretary BLOCK. Let's try for $50 billion.

Senator ABDNOR. All right, $50 billion. That would make it easier on you.

Secretary BLOCK. It's a good number. It's easy to understand.

Senator ABDNOR. If we start the program you suggest, which I'm not endorsing in any way, how do you picture it then? I asked you that the other day.

Secretary BLOCK. All right. Let me give you a scenario that will look a lot better than some people might want to paint. The scenario could well be that as a result of having the courage to address the deficit, get our house in order here, that we would see interest rates continue to come down and the real rate come down, too. It would make an enormous difference for the farmers and really will improve the psychology when you go in to see the banker for one thing. You could go ahead and see consequently some change in the strength of this dollar relative to other currencies. I can't visualize how long we can keep up the kind of trade deficit we have right now and I just happen to think it will swing back the other way, and that's a big thing for agriculture. If this swings back, we're going to see more sales and we're going to see credit demand.

Senator ABDNOR. If you're going to see those sales, you're going to have to get that price down to compete because everything is against the farmer on that. That's one thing I wish we had time to go into. I resented Mr. Stockman's statement that the farmer's problem is solely his own problem. The 30 percent overvalued dollar in relation to other currencies certainly isn't the fault of the farmer. In addition, they are being undersold because other countries are heavily subsidizing. The European Common Community is one example. The EC and other countries can probably sell for as little or less than we do and I just wonder how farmers can prosper with less than today's prices?

Secretary BLOCK. I don't believe that in the end they will have less than today's prices.

Senator ABDNOR. Why would they go up?

Secretary BLOCK. They will short term. The prices when we lower the loan rate will be competitive in international trade and the prices will go down some, but they will still be protected by a target price to help them through this transition. And at the same time there will be a new trade title in our agriculture legislation that's going to be tough, that's going to tell the other countries that the United States of America has had all they can stand of protectionism and keeping our products out, all we can tolerate of export subsidies, stealing our markets, and we're not going to tolerate it any longer. We will inflict pain on you if you continue to do that and we will be obligated to do that. I believe we could open up opportunities for agriculture here and this pendulum can swing our way, and I would say that 1985 could well be the year of change. And I'll have to say one other point. We desperately need that change in direction for agriculture today.

Senator ABDNOR. I guess I don't have that optimism.

Secretary BLOCK. You have to have the optimism or you can't get the confidence, Senator.

Senator ABDNOR. What are you going to tell the European Common Community? We have to insist they stop preventing the inflow of our products like wanting to put another tax on sugar and soybean oil. But I don't see how you can stop them from offering a product to another country. That's not a barrier. They're just outbidding us. I don't know how you could quarrel with that.

Secretary BLOCK. That isn't fair when they go out and buy markets with the money out of their treasury and I think we have to—we have to charge them with this unfair practice but we have to really put them on notice that we are not going to tolerate it any longer and when we lower our support levels I think we're going to have quite a bit of grain moving into the world market that wouldn't ordinarily move in there and income is not just price per bushel; income is price times volume. If we move more volume, even if we got a lower price, we're going to get more money in total, I would suggest, and we will have more efficient operations. You don't have efficient farming operations when you close down part of your plant and you try to adhere to Government programs that are bureaucratic and hard to manage and hard to deal with. I just think that if we open it up we will have an opportunity to see this industry really flourish and you're going to have higher cattle prices this year, Senator. They're going to be better this year.

Senator ABDNOR. I'm going to go home and tell my ranchers.

Secretary BLOCK. You can talk about something. Go back and talk about cattle prices.

Senator ABDNOR. Hogs are doing better, too.

Secretary BLOCK. Hogs are going to do better, too.

Senator ABDNOR. One of my pork producers told me the other day that there was more pork to come across the Canadian line in December than all the previous 11 months which they had been complaining about. We're awfully generous in this country. There's a good example of subsidizing pork in Canada, and that kind of a situation is affecting our markets. It's grossly unfair, and we've been such nice guys for so long. I had the opportunity of expressing my concerns to the agricultural minister in England. I thought nobody else remembered it but I ran into a lady who worked for the embassy in England that said, "That was quite a conversation they had after I left," because we're far too kind to these people. I'd like to see you get tough and make sure things happen. That would go a long ways.

Let me ask you. The other day the economic adviser was here and he inferred that the solution to the agricultural financial problem is to have fewer American farmers and lower output. You would never agree to that, would you?

Secretary BLOCK. I don't think we ever want to see fewer American farmers. I think we would acknowledge we've seen evolutionary change over the years in the number of farms, but it's a part of the process of new technology coming on line and just agriculture is not a static industry; it's a dynamic, changing industry. We don't promote that, of course, and we prefer not to see it happen, but there is some change as our way of life changes in this country.

Senator ABDNOR. Well, I hope so. I hope I still see the family farm being able to operate without trying to have to compete with the big farms.

I hesitate asking this but it's on my mind. It's probably embarrassing for you. You recall Mr. Stockman's statement yesterday. He made the charge on agriculture. I think he's wrong. If he had said it in a little softer language it would have made it a little easier to accept. He also attacked the military and the military personnel and their retirement system, but I did note in the paper that Caspar Weinberger was incensed over this. I hope you are equally incensed over what he said about agriculture because we have to have fighters. I don't know if I should put you on the spot, though.

Secretary BLOCK. You certainly wouldn't expect a farmer, a West Point graduate, to agree with those statements, would you, Senator?

Senator ABDNOR. I can't agree with this one, either, when Mr. Stockman commented to the effect that Government owes nothing to farmers. Farmers didn't create all this problem. I can name you problem after problem that's in front of us, the grain embargo for starters, or this great agreement that we made to help the shipping industry. It cost the farmers a lot of money to try to compete.

Again, I won't quarrel over it except that's not the farmers' fault that they have that added expense.

The trade barriers that stare them in front of their face all the time. That's not their fault. The inflated dollar, 30 percent, to try to sell 30 to 40 percent of what they produce. That's not their fault. I could go on and on and on, and Stockman is not going to come back here and tell me that it's all the farmers' fault that they got themselves into this mess. It isn't. There's a lot of fault. I guess I could take some of it for some of the things I voted for. I voted for that grain reserve that went into effect. I had real doubts about it, but at one time we had this situation in pretty good shape as far as millions and millions of bushels of grain being stored. That was Congress, but I've also seen things come out of the Department of Agriculture that I wasn't happy with. To sit here and try to put all the blame on the farmers, I can't accept that and I hope you can't either. We all have our share of fault for things that helped contribute to the problem we have today.

I have a piece of legislation I introduced the other day, S. 371, The Emergency Farm Credit Assistance Act of 1985. This legislation would basically do two things. First, it would permit the Farmers Home borrowers to use some of their earned income to pay for normal living expenses and operating expenses to put in this year's crop.

Second, poor economic conditions are added as a qualification to get a Farmers Home loan deferral.

How do you feel about that? Is there a chance of getting your support for that?

Secretary BLOCK. I haven't studied it.

Senator ABDNOR. Will you look at it?

Secretary BLOCK. I definitely will and I am aware that you have introduced this legislation. This came to my attention today. We will look at it very carefully.

Senator ABDNOR. There's another piece of legislation that I have in and I'm going to South Dakota for this committee to hold hearings for a kickoff of it. It merits being looked at. It's legislation which would limit to $21,000 the amount of off-farm income which could be sheltered by farm losses. When we're talking about all these great new farm programs, that's fine and dandy and you can rely on market system if you want to, but a lot of our problems started with legislation that got passed in this Congress by something other than the Agriculture Committee. I would like to tell you what's happening out in my country.

Let's go to hogs for a second. Hog numbers grew. We have hog confinement facilities around this country we never had before because we put in the new feature of the accelerated depreciation so one can write it off in 5 years. That had nothing to do with agriculture or the Department of Agriculture. However, there are a lot of groups into farming. That's what I'm fighting in my water bill which I'm chairman of. The barges are all having a tough time. They have more barges than they know what to do with because of the leaseback and the fast depreciation that we passed.

Secretary BLOCK. That's right.

Senator ABDNOR. The holding companies, an outside interest, are coming into my State and buying thousands of acres of marginal fragile land that should never have been touched and never has been by the good farmers. They come in and they plow up the hills and virtually destroy the land. They farm it for wheat for 2 years, solid with wheat, and do you know what happens at the end of 2 years? They have the biggest wheat allotment of anyone in the country because we take the previous 2 years production. This is done by somebody who knows nothing about farming other than the fact that he has some money invested in it. Some of the land should never be farmed. Some poor farmer that has a history of farming all of his life who treats the land like it should be, he loses his shirt in total acreage under the allotment system. After you take the 2-year average, the one who tore up the land can go into the program and get one of the biggest farm payments of anyone in the country. And then they wonder what's wrong with farming. There are a lot of features that affect farmers that are not done in the Agriculture Committee or by the Department of Agriculture. I hope you will put some pressure in some of those areas and make some of the Members of this Congress and other people realize that it is some of our fault and that we also have a lot of blame to take.

Secretary BLOCK. I'd like to comment on that second one. I think that's S. 244, at least as I understand it, and I strongly support reform of this tax system as it relates to agriculture. The system has encourged outside investment in the agricultural industry that was not economically warranted but was only driven there because of the tax opportunities or the tax savings opportunities, and it's time we changed that because what it's done is it has caused a distortion in the production levels and it has hurt a number of family farms, just as you suggested, Senator, and you will find that I will be supporting that approach agressively.

I might also add that—I was going to say Secretary Regan—it's now Secretary Baker's tax program or the President's tax program, the tax reform that he talked about last night in the State of the Union address does effectively address this.

Also, our Department ran a very careful analysis of it and concluded that it did a good job of addressing this. I think it's vitally important to agriculture and I firmly agree that just addressing the farm program is not enough. Let's address the other factors that are already in place. They are hurting our family farms too.

Senator ABDNOR. Well, thank you. I appreciate that.

I have a lot of questions. Could I put a couple in writing? I have an airplane to catch.

Secretary BLOCK. You can put them in writing and we will answer them for you and we would be delighted.

Senator ABDNOR. Thank you. I have a good question here I wanted to ask you quickly. Should the Congress fail to put an acceptable farm bill on the President's desk, is this administration prepared to implement permanent legislation which calls for marketing quotas, acreage allotments, and producer certificates?

Secretary BLOCK. Let's not assume that the Congress is going to fail to do that because I have every confidence that the Congress will put a good bill on the President's desk.

But we are going to be prepared to revert the old law into permanent law if we have to.

Senator ABDNOR. The implementation of this permanent legislation would also bring to an end Public Law 480, agricultural research and extension programs and a host of other activities. We have to keep some of those things in mind.

Secretary BLOCK. It's not good. We know that.

Senator ABDNOR. Thank you. It has been a pleasure to have you and we would have stayed here a lot longer if we had more time. The committee stands recessed.

[Whereupon, at 11:35 a.m., the committee recessed, to reconvene at 9:30 a.m., Wednesday, February 20, 1985.]

THE 1985 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 20, 1985

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

The committee met, pursuant to recess, at 9:30 a.m., in room 2167, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Hamilton, Mitchell, Scheuer, and Snowe.

Also present: Robert J. Tosterud, deputy director; and William R. Buechner, Christopher J. Frenze, Kent Hughes, Sandra Masur, and Nathaniel W. Thomas, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. If we can begin this morning, we are on a very tight schedule because Mrs. Thatcher will be in the House at 11 o'clock and we need to conclude this hearing as close to 10:30 as possible, so I hope we can be as succinct as possible in our statements and questions this morning.

Before we begin, I'd just simply like to make a very short series of comments.

It seems to me that we have a rather ironic thing happening in this country because over the past few years we have been debating the merits of an industrial policy and the administration has clearly opposed that idea. It has argued that Government has no business picking winners and losers and a lot of people have agreed with that. But the greater irony which we face today is that we do in fact have an industrial policy, even though it may not be a conscious one, because of the deficit policies being followed at the present time by this government and this administration.

This industrial policy is nowhere more evident than it is in trade. The budget deficits and the high dollar are creating de facto sets of winners and losers in the American economy. In fact, we are making losers out of proven winners. Some of our most competitive firms and farmers are losing the battle for foreign as well as domestic markets because the policy is totally out of their hands and out of their control.

For example, for the first time in 1984 the American electronics industry had a deficit, exporting less than was imported. The share of foreign semiconductors in the U.S. market rose from 6 percent in 1979 to 14 percent in 1984. Agriculture wheat and coarse grain exports in volume terms fell from 55 percent in 1980 to 48 percent in 1984. Basic manufacturing's share of global markets fell from 11.5 percent to 9.4 percent.

We have with us this morning our very distinguished Trade Representative, Mr. William Brock, who is a former colleague of a number of us in the Congress in years gone by.

Mr. Brock, your statement devotes considerable attention to the evils of protectionism and I think most of us would agree with that at least in theory, but at least as I see it, it is highly unrealistic to expect that the Congress as an institution is going to resist protectionist pressures if day in and day out they continue to hear from firms crippled because of the strong dollar which at least in part is created by our own fiscal policy.

I think the auto quota legislation and the general import surcharge legislation are simply the two most visible manifestations of that pressure and that pressure is going to get worse.

I know the administration and you yourself are talking about a new round of trade negotiations. It would be pretty embarrassing I would expect for you to be going into those trade negotiations trying to debate the merits of a free and open market if some of that legislation passes, but it seems to me that it is going to unless there is a significant reversal of existing Government policies on fiscal and budget issues.

There are a couple others which I would hope you would address. One is the issue of the Exim Bank. I note that the administration has argued, for instance, that we ought to maintain funding for the MX missiles so that it would serve as a bargaining chip in negotiations on arms talks with the Soviet Union. There are a lot of people who believe that if that strategy is sensible, that the Exim Bank ought to fall in the same category, and yet they feel that because of the elimination of support for direct credits we are in fact unilaterally disarming in terms of our efforts to persuade the Europeans to knock off export subsidies. We are in effect using one strategy in trade and quite a different strategy in arms control talks.

These are some of the questions that bother me and I think other members of the committee.

I would like to, at this point in the record, insert an opening statement that the vice chairman of this committee, Senator Abdnor, would have made had he been able to be here.

[The opening statement of Senator Abdnor follows:]

Opening Statement of Senator Abdnor, Vice Chairman

I WOULD ALSO LIKE TO WELCOME AMBASSADOR BROCK HERE THIS MORNING, AND LOOK FORWARD WITH INTEREST TO HEARING HIS TESTIMONY.

AS WE ALL KNOW, THE 1984 CALENDAR YEAR INTERNATIONAL MERCHANDISE TRADE BALANCE OF THE UNITED STATES REACHED A RECORD HIGH DEFICIT OF OVER $123 BILLION, ALMOST AN 80 PERCENT INCREASE OVER JUST LAST YEAR. TRADE DEFICITS HAVE ACCELERATED IN RECENT YEARS, HAVING GROWN FROM $36.4 BILLION IN 1980. AS RECENTLY AS 1975, THE MERCHANDISE TRADE BALANCE OF THE UNITED STATES WAS IN SURPLUS.

WHAT HAS HAPPENED TO OUR INTERNATIONAL COMPETITIVENESS DURING THE LAST DECADE? IN 1975, UNITED STATES MERCHANDISE EXPORTS WERE CLOSE TO 7 PERCENT OF OUR GROSS NATIONAL PRODUCT WHILE OUR IMPORTS WERE UNDER 6-1/2 PERCENT OF GNP. IN CONTRAST TO THIS, DURING 1984, EXPORTS HAD <u>DECREASED</u> TO ABOUT 6 PERCENT OF GNP, AND OUR IMPORTS HAD <u>SURGED</u> TO OVER 9 PERCENT OF GNP. BEHIND THESE FIGURES ARE SIGNIFICANT BUSINESS IMPACTS IN INDUSTRY AND AGRICULTURE, RESULTING IN LOWER PRODUCTION AND DECREASED EMPLOYMENT IN HARD-HIT EXPORT AND IMPORT COMPETING SECTORS OF OUR ECONOMY.

OF PARTICULAR CONCERN TO ME AND MANY OF MY COLLEAGUES IN THE CONGRESS FROM RURAL AMERICA IS THE ANGUISH CURRENTLY BEING FELT BY OUR FARMERS.

AGRICULTURAL EXPORTS FROM THE UNITED STATES GREW FROM $7.4 BILLION IN 1970 TO $44.0 BILLION IN 1981. IF THAT GROWTH TREND HAD CONTINUED, WE MIGHT HAVE EXPECTED -- AND MANY DID EXPECT -- AGRICULTURAL EXPORTS TO BE ROUGHLY $54 BILLION IN 1984. INSTEAD, IN THE LAST QUARTER OF 1984, AGRICULTURAL EXPORTS WERE RUNNING AT A $37 BILLION ANNUAL RATE. THIS IS 31 PERCENT BELOW THE NOMINAL PROJECTION FOR 1984 BASED ON 1970-1981 TRENDS.

IF THIS MORE RECENT DOWNWARD TREND CONTINUES, THE UNITED STATES COULD POTENTIALLY LOSE ITS LARGEST, AND PERHAPS ITS LAST, INTERNATIONAL COMPARATIVE ADVANTAGE. THIS MEANS SERIOUS TROUBLE NOT ONLY FOR RURAL AMERICA, BUT FOR THE ENTIRE NATION.

MR. AMBASSADOR, IT IS TIME FOR THE UNITED STATES TO CORRECT THESE IMBALANCES. IT IS MY BELIEF THAT WE MUST TAKE A STRONGER POSITION WITH OUR TRADING PARTNERS IN NEGOTIATING TRADE AGREEMENTS AND IN RESOLVING TRADE DISPUTES. WE MUST ACCELARATE OUR EFFORTS TO REMOVE FOREIGN MARKET ACCESS BARRIERS TO U.S. GOODS AND SERVICES, PARTICULARLY IN THE FAR EAST. WE MUST CONTINUE TO PRESS FOR THE ELIMINATION OF UNFAIR EXPORT SUBSIDIES BY FOREIGN GOVERNMENTS, ESPECIALLY IN EUROPE. FINALLY, WE MUST ASSIST THE LESS DEVELOPED COUNTRIES OF THE WORLD TO EXPAND THEIR ECONOMIES SO THAT THEY, AS WELL AS THE UNITED STATES, CAN BENEFIT FROM INCREASED TRADE.

IT IS THE SPECIAL RESPONSIBILITY OF THE UNITED STATES TRADE REPRESENTATIVE TO STRUGGLE WITH THESE COMPLEX ISSUES AND TO SEEK THEIR RESOLUTION. YOU AND YOUR HIGHLY-COMPETANT PROFESSIONAL STAFF ARE TO BE COMMENDED FOR YOUR EFFORTS IN THIS REGARD. I DO BELIEVE, HOWEVER, THAT

THESE EFFORTS MUST BE INCREASED IN THIS TIME OF POTENTIAL CRISIS FOR THE INTERNATIONAL TRADE COMMUNITY. OUR COUNTRY CANNOT PROSPER OVER THE LONG-TERM WITH THESE CONTINUING IMBALANCES IN OUR TRADE AND CAPITAL ACCOUNTS.

WE SEEK YOUR COUNSEL THIS MORNING ON THIS CRITICAL SUBJECT. WE WOULD BE PARTICULARLY INTERESTED IN HEARING YOUR SPECIFIC PLANS FOR THE COMING MONTHS. WE WOULD LIKE TO KNOW YOUR SHORT-TERM GOALS AS WELL AS YOUR LONG-TERM OBJECTIVES. AND, FINALLY, WE WOULD LIKE YOUR BEST ESTIMATE OF WHAT THE UNITED STATES INTERNATIONAL TRADE POSTURE WILL BE IN A YEAR OR SO.

AGAIN, I AM PLEASED THAT YOU COULD BE WITH US TODAY AND I LOOK FORWARD TO HEARNG YOUR INSIGHTS ON THIS DIFFICULT ISSUE.

Representative OBEY. Mr. Ambassador, I welcome you here this morning and welcome your views, please proceed.

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

Mr. BROCK. Thank you very much, Mr. Chairman. I cherish the too few years that I had on this committee and I appreciate the chance to come back and join you. I think you're the only member who doesn't have gray hair it's good to see.

I will try, if I may, to very briefly summarize my prepared statement, addressing first the larger questions of the deficit and then to respond explicitly to your concerns, which I frankly share.

The deficit in trade is a matter of very real concern. It's risen from $42.7 billion in 1982 to $123.3 billion last year and I think the prospects are for it to continue to increase, perhaps more slowly, to somewhere between $140 and $160 billion this year.

That's a matter of concern for several reasons. As the chairman has pointed out, it does lead to an erosion of public support for open market policies and at the very time when the rollback of protectionist measures taken around the world in recent years is most urgently needed.

It is also worrisome that our deficit is forcing us to acquire foreign debt at a significant rate. Our future living standards will be burdened by the service of this debt to foreign nationals in future years.

The third concern I think clearly is the burden placed, as the chairman noted, on U.S. firms and workers who must compete against that competition. In just two years, the real volume of manufactured imports has risen by over 50 percent. Textile imports are up 55 percent over the last 2 years and steel in the first 6 months of 1984 imports were up 70 percent in that one 6-month period alone. Unemployment remains above 10 percent in both industries.

Despite modest growth in recent quarters, the real volume of U.S. exports remains 14 percent below prerecession levels.

Fortunately, we have had six quarters of strong domestic growth which helped cushion losses from rising imports. GNP grew at an average annual rate of 7.2 percent during these first six quarters, despite those imports, and I think it's fair to state that a higher rate of growth would have been very difficult to achieve without inflation.

Eight and a half million new jobs were created in that same period and that rise in employment during a period of historically rapid growth suggests that the import surge so far in the initial stages of our recovery did not cause substantial losses, but imports do weaken the recoveries of vulnerable domestic industries such as steel and textiles where the unemployment rates remain too high.

As our growth slows to a more sustainable rate, however, imports and the trade deficit could become even more injurious to profits, employment, and growth prospects for those firms exposed to foreign competition. Rising imports met nearly half the increase in domestic demand between the first and second half of 1984. The textile industry profits which recovered substantially in 1983 have fallen in every quarter of 1984. Nevertheless, the U.S. economy did create another million new jobs between June 1984 and January 1985.

There is a tendency to attribute our large trade deficit to the foreign protectionism. As serious as this problem of protectionism is, it is not the principal cause of our overall trade deficit. It is at the level of domestic policy, Mr. Chairman, as I think you noted in your opening statement, not trade policy, where we can take the most important steps toward improving the trade balance.

In a technical sense, the high value of the dollar is largely responsible for our current difficulty. The fundamental causes of the deficit, however, are the underlying macroeconomic conditions which have so appreciated that dollar.

At the heart of the problem is the fact that we as a nation are not saving sufficiently to meet the investment needs of our expanding economy. The gap between what America has been willing to save and wanted to invest has been filled by borrowing from abroad. As foreign investors buy dollars to invest here, they bid up the dollar's value in foreign exchange markets, making imports cheaper for our citizens and exports more dear abroad.

When all of the figures are in for 1984, we will show a current account deficit slightly in excess of $100 billion financed by a like amount of net capital borrowing from abroad.

During the recovery our investment has risen by an annual rate of $285 billion. Only $160 billion of this increase was financed by increased domestic saving. Another $30 billion was financed by a reduction of combined Federal, State, and local budget deficits. The rest, or better than $95 billion, was financed by borrowing from other people in other lands.

To a certain extent, this foreign credit has played a positive role, for without it, our interest rates would have been higher, inflation stronger, and the recovery weaker. As it has been, our economic success has made foreign residents willing to invest here. Our strong growth rate relative to the rest of the world and the safe haven aspect of the U.S. economy have contributed to attract foreign funds. There is no doubt, however, that inadequate private saving in the United States has contributed to real interest rates being higher here than abroad and that those higher U.S. interest rates have acted as a mechanism by which we have attracted foreign funds to fill our domestic savings-investment gap.

The positive case for capital inflow should not be overstated however. Similar benefits for the U.S. economy could arguably have been achieved without such a rapid buildup of foreign debt and large trade deficits had we provided more of our domestic investment needs through higher levels of domestic saving.

In sum, reducing the U.S. trade deficit crucially depends on raising the domestic saving rate to narrow our savings-investment gap. This is where the Federal budget deficit enters the picture.

Our savings pool is fed by three sources. Private saving comes from the retained earnings of U.S. corporations and the personal saving of U.S. households. When governments run surpluses, as is the case presently at the State and local levels, these too contribute to the national savings pool. On the private side, tax cuts have raised the rates of saving and cash-flow for business. But as a percentage of disposable income, U.S. household savings fell to 5 percent in 1983 and recovered only modestly to about 6 percent in 1984. These are well below the savings rate of 8 percent in the early 1970's.

The rate of savings in most of our competitive industrial countries is double or more of that in the United States. It is against the background of such low private savings in the United States that the danger of Government deficits must be gauged.

State and local governments last year ran a surplus of about $500 billion. When governments run deficits they subtract from rather than add to the pool of national saving available to finance investment. That's why last year the Federal Government's deficit of $172 billion reduced national saving by more than the total saved by households, some $150 to $160 billion. Clearly, were the Federal deficit substantially reduced, the U.S. saving pool would be increased, interest rate pressures would moderate, and with them the net inflow of foreign capital would then moderate the value of the dollar, clearing the path for an improved U.S. trade balance.

The argument is made that our performance domestically has been so attractive relative to that of our competitor nations that the inflow of foreign capital is unstoppable. I think that is an exaggerated position. Two conditions have been present to create the type of massive net capital inflows we have recently experienced. First, the willingness of foreign residents to invest here and, second, the need of our economy to borrow foreign savings created by inadequate domestic savings and expressed by excessively high U.S. real interest rates. And I do stress the real because I think that is the fundamental problem, not the nominal rates. Cutting Federal deficits and increasing domestic saving will materially alter the second condition, ease foreign borrowing, and reduce the trade deficit. The correction would take place through increased U.S. capital exports as U.S. interest rates fell as much as through some reduction in gross capital inflows. Either would reduce our net borrowing from abroad.

It is true that our interest rates have declined and the dollar appreciated further in recent weeks. I, frankly, find the argument surprising that interest rates are the sole cause of the strength of the dollar.

Despite the falling interest rates, the differential favoring investment in the United States has been erased. Current inflation-adjusted returns on Government bonds are slightly in excess of 7 percent in the United States, which is 1.5 or 2 percentage points higher than in Japan or Europe. If we used the numbers at which people and businesses borrowed, the spread would be substantially larger.

I think you could also suggest that the strength of the dollar in recent terms has been supported by the projections of renewed economic growth in 1985. Some feel that growth prospect also suggests the prospect of rising U.S. interest rates later in the year if measures are not taken to avoid a clash between Government borrowing and private investment needs over limited domestic saving.

Our large budget deficit creates many potential domestic economic dangers as well. Government's interest payments on the national debt have risen from 1.75 percent of GNP to 3.5 percent of GNP, and there is no end in sight to the increase so long as the deficits are not brought down.

The accelerating interest payment burden on the taxpayers may at some future date, though certainly not in the near term, increase the political temptation to monetize more of the public debt even at the cost of higher inflation.

Many also fear that the cost of large budget deficits and limited national saving will ultimately squeeze domestic investment when foreign credit is no longer so readily available. This would frustrate the goal of sustained economic growth as even higher real interest rates began to seriously limit expansion possibilities.

Our trade deficit problem and these longer term dangers for the domestic economy can only be substantially reduced by actions to cut Federal spending and deficits. I am confident the problem can be resolved and the President has made his proposals. There are a number pending in the Congress and it is fundamentally important that we act cooperatively to strengthen the foundations for sustained, noninflationary economic growth and improved U.S. trade performance by acting on those recommendations.

Let me look very briefly—and I will try just to state this as quickly as I can—at the international context.

We have faced two or three specific problems. First, the collapse of a number of LDC economies as a consequence of commodity price collapses, exploding interest rates, and the energy crisis of the 1970's. The trade balance we have in developing countries deteriorated by $34 billion from 1982 to 1984.

Slow growth in Europe at between 1 and 2 percent has reduced U.S. export possibilities and our trade balance deteriorated in Europe by nearly $23 billion in the same period.

The resistance of the Japanese market is the third factor. Our bilateral deficit with Japan increased by $18 billion between 1982 and 1984. Widening access for U.S. exports in these markets is absolutely essential.

Now I think it is true that our trade deficit has contributed to economic recovery of LDC's and somewhat to Europe. Some of those countries would have had no choice other than insolvency had it not been for the ability to sell to the United States. We take 58 percent of the Third World's manufactured exports to the industrial world into this country alone. Europe takes 28 percent, Japan takes 8 percent. So the United States has been the engine of recovery for the world economy.

There is a limit to that capacity but we have contributed massively and far more than any other nation or any combination of other nations to that effort.

In Europe, rigid labor practices, excessive government regulation, overly large and expensive governments, inadequate levels of investment, and insufficient incentives to entrepreneurial endeavor have sapped the Community's economic vitality. The only thing that has contributed a great deal is the access to the U.S. markets.

I think what is needed clearly is more vigorous worldwide economic growth. Again, the United States cannot be the sole engine of that growth. It is a prerequisite of significant improvement in our trading situation that the economic performance of other nations follow a parallel track.

In the longer term, I think it is true that we in the United States have leaned down and become much more productive and much more competitive. Our productivity improvement in 1984 was remarkably good and labor has been responsive. Business has been willing and able to shave its overhead costs enormously. We have a more efficient corporate plant system which will pay off with an easing of the dollar problem.

We are going to face very difficult adjustments because the world is far more integrated than it has been and the pressures on individual industries are going to remain very high and in some cases, such as basic industries—textiles, steels, consumer electronic areas—the pressure will at least maintain if not increase.

Automation may increase our competitiveness but it also has a jobs impact that will cause adjustment difficulties.

In agriculture, the trend toward self-sufficiency and overproduction has led to increased dumping on the world markets disrupting the traditional export markets of efficient agricultural exporters such as our own. The high value of the dollar has compounded the foreign trade problem and contributed to our agricultural difficulties.

I think if I can just summarize, you know my feelings against protectionism. I think it is a self-defeating device that will further strengthen the dollar and make matters worse. If we are going to ease the value of the dollar we have only two opportunities. The first is to reduce Government spending and deficits. The second is in tax reform that would increase the incentive and the opportunity for net savings in the United States.

The last issue that I would mention very briefly is the need to continue U.S. leadership in the strengthening of a world trading system with greater capability and greater discipline. We are discussing in full measure now the possibility of a new round. The United States views that as important not just to ourselves but to all the participants in the trading system. We seek strict limitations on agricultural export subsidies because of their disruptive effect and their unfair effect on our farmers and farmers in Brazil and other developing countries.

We will seek the development of rules against new barriers to trade in services and thus establish procedures for further liberalization in new areas of trading—the national property rights, high technology, and so on.

We intend, in the process of pursuing that, to put a major effort on the cleaning up on the present GATT system, shaping up rules in some areas.

I think the essence of my statement, Mr. Chairman, is that there is no one step that can be taken to resolve this issue. It is a deeply complicated and complex issue that has to be addressed on a number of fronts.

The first step is to clean up our own house here at home and, second, to further strengthen a world system that has been very dependent on the United States in the last 35 years by improving those rules and disciplines that will allow our business people, farmers, and consumers to live in a marketplace where they are not burdened by unfair competition and competition that is governed by government intervention in the marketplace.

If we can achieve that, the long-term prospects of the United States are remarkably good, but we have much work to do. Thank you.

[The prepared statement of Mr. Brock follows:]

Prepared Statement of Hon. William E. Brock

"THE U.S. TRADE DEFICIT"

The U.S. Foreign Trade Deficit: A Matter of Concern

I am pleased to be with you today to discuss the U.S. foreign trade deficit. I will focus my remarks on the causes and cures of trade deficits and implications for U.S. foreign trade policy.

As we are all aware, the U.S. trade deficit has ballooned since the end of the recession. The deficit has risen from $42.7 billion in 1982 to $123.3 billion last year. This year it may well reach $140 to $160 billion, or somewhere around 4 percent of our gross national product.

This huge trade deficit is alarming on several accounts. In terms of trade policy, the deficit is leading to an erosion of U.S. public support for open market policies. Yet, a rollback of trade barriers accumulated in recent years is urgently needed. Not only do many of our foreign trade partners need trade expansion to rekindle their sagging economies, but even the United States can only reach its fullest economic potential in a system of open world trade.

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A second worrisome feature of the trade deficit is the foreign debt America is accumulating to finance it. Our trade deficit in goods and services represents the extent to which America is living beyond its means, consuming more than it produces. We are paying for the excess of our imports over exports by credit borrowed from foreign lenders.

Capital inflows from abroad exceeded American exports of capital by more than $100 billion last year. Our borrowing is so great that, though we have been a net creditor to the rest of the world since 1917, we will on current trends become a net debtor before the year is out. There are many disturbing aspects of this growing indebtedness of America to foreign creditors, not the least of which is the future burden on our living standards of servicing this debt with remittances, interest and dividend payments to foreign residents.

Yet another matter of concern is the burden our trade deficit has placed on U.S. firms and workers who compete against foreign competition. In just 2 years, the real volume of U.S. imports of manufactures has risen over 50 percent. Most of the $230 billion of manufactured goods we imported last year were directly competitive with U.S. producers. For a number of U.S. manufacturing industries, rising imports have meant a sluggish recovery from the recession. Textile imports have risen 55 percent over the last 18 months, steel imports increased by 70 percent in the first 6 months of 1984 alone. As a result, employment and profits in both of these industries improved only modestly in the course of economic recovery, and unemployment levels remained above 10 percent.

Nor is the picture any more reassuring on the export side. Although there has been some modest growth in recent quarters, the volume of U.S. exports still remains about 14 percent below pre-recession levels.

The high value of the dollar which is the immediate, if not fundamental, cause of our trade deficit, has made the price of U.S. exports so high in foreign markets that even when U.S. firms are able to sell abroad their profit margins are cut to the bone. While the strong dollar squeezes the profits of U.S. exporters and import-competing firms as well, it has the opposite effect on foreign firms selling in the United States, swelling their profits and encouraging investment and growth in these foreign industries.

The strong pace of the U.S. growth during the first 6 quarters of recovery through mid-year 1984 meant that rapidly expanding domestic sales did help cushion the losses many U.S. manufacturers suffered from sluggish growth in foreign export markets and rapidly rising U.S. imports. Our economy could not have grown much more strongly than it did without the risk of price inflation.

GNP grew at an annual rate of 7.2 percent from the last quarter of 1982 to the second quarter of 1984, despite the import surge. From January 1983 to June 1984 U.S. civilian employment rose from 97.3 million to 105.7 million, adding 8.4 million jobs. The sharp rise in employment during a period of historically rapid growth in production suggests that the import surge in the initial quarters of recovery did not cause substantial job loss.

U.S. expansion has slowed significantly in the last half of 1984 and will hopefully now settle at a more sustainable rate in 1985. There is evidence, however, that with slower growth, imports and the trade deficit have become more injurious to the profits, employment and growth prospects for U.S. manufacturers exposed to international competition. For example, textile industry profits which recovered substantially in 1983, have fallen in every quarter of 1984 as import penetration continued to rise. Nearly half the growth in domestic demand from the first to the second half of 1984 was met by imports. As the growth of U.S. demand slows down, as is normal in a maturing recovery, the worsening trade deficit may cut more critically into U.S. industry's ability to expand output and employment.

Our Large Trade Deficit: Domestic Causes

There is a tendency to attribute our large trade deficit to the protectionist actions of foreign governments limiting access for U.S. exports or to subsidization of foreign exports to our own market. There are serious problems for many U.S. export and import-competing firms. However, foreign protectionism is not the principal cause of our overall trade deficit. In fact, neither U.S. trade policy nor the trade policy of foreign governments is responsible for the large U.S. trade deficit. The principal causes of the trade deficit are actually found in broader U.S. and foreign macroeconomic conditions. It is at the level of domestic economic policy, not trade policy, where we can take the most important steps for improving the trade balance.

In a technical sense, the high value of the dollar is principally responsible for the U.S. trade deficit. The expensive dollar reduces the price competitiveness of U.S. exporters while increasing the price competitiveness of foreign exporters to the U.S market. What is important to understand, however, are the underlying conditions that have continued to appreciate the dollar.

At the heart of the problem is the fact that as a nation we are not saving sufficiently to meet the investment needs of our rapidly expanding economy. The gap between what America has been willing to save and wanted to invest has been filled by borrowing from abroad. As foreign investors buy dollars to invest here, they bid up the dollar's value in foreign exchange markets. Our citizens find imports cheaper, foreign residents find U.S. exports more expensive. And so our foreign borrowing, working through the dollar exchange rate, results in a deficit in trade in goods and services equal to the net foreign capital inflow. So long as we continue to be a large net importer of capital from abroad, it is inevitable that we will have correspondingly large trade deficits. In 1984, for example, when all the numbers are in, we will show a current account deficit, slightly in excess of $100 billion, an amount financed by net capital borrowing from abroad.

The relationship between the domestic investment/saving gap and our trade balance is illustrated by the following numbers. From the fourth quarter of 1982 to the third quarter of 1984, the level of private investment in the United States increased by an annual rate of $285 billion. Over this same period, private saving increased by only $160 billion. The difference of $125 billion was financed in part by foreign residents through a $95 billion increase in our current account deficit, and in part by government through a $30 reduction in the combined, local, state and federal budget deficits.

To a certain extent, this foreign credit has played a positive role in helping to finance our domestic recovery. Without the foreign credit, interest rates would have been much higher over the last two years and the recovery weaker. In addition the strong dollar has helped keep U.S. inflation low, perhaps a full percentage point lower over the last two years than it would have been in the absence of dollar appreciation. Also, the foreign borrowing over the last two years has been used to finance a very substantial investment boom in the U.S. rather than unusually large increases in current consumption.

In fact, the attractiveness of investing in the United States has been one of the principal reasons foreign residents have been willing to lend massively to America. We are the world's most prosperous and stable economy. And thus the dollar has become the world's hedge in periods of crisis -- and there have been many. Capital in flight from politically volatile regions of the world find safe haven in the United States. Our vigorous recovery and expansion as well as our open investment policy have also attracted foreign investors. And the fact that real interest rates in the United States have been well above those in most other countries has stimulated the inflow of capital in search of maximum return. The foreign investment boom in the United States will contribute directly to the growth, productivity increases and the improved fundamental competitiveness of U.S. producers in the years to come. As I mentioned earlier, however, all is not positive about the foreign capital inflows. Similar benefits for the U.S. economy could arguably have been achieved without such a rapid accumulation of foreign debt and large trade deficits had we provided more of our domestic investment needs through higher levels of domestic saving.

Reducing the U.S. trade deficit crucially depends on narrowing the gap that exists between domestic saving and domestic investment. This could be accomplished on either the saving or the investment side of the equation. Most would agree however that public policy should not aim at reducing investment to close the gap; the price of lowering our trade deficit by this means would be reduced economic growth at home or even a recession.

The more positive approach is to raise the level of domestic saving in order to finance more of our own domestic expansion. This is where the Federal deficit crucially enters the picture. America's saving pool is fed from three sources. Private saving comes from the retained earnings of U.S. corporations and the personal saving of U.S. households. When governments run surpluses as is the case at the state and local levels, these too contribute to the national savings pool. On the private side, tax cuts have raised the after-tax profits of corporations which increased their contribution to saving and investment. However, for reasons not yet fully understood, tax cuts and saving incentives for individuals in the early 1980's were followed by record low levels of household saving. As a percentage of disposable income U.S. household saving fell to 5 percent in 1983 and recovered only modestly to about 6 percent in 1984. These are well below those in excess of 8 percent in the early 1970's. Household saving rates are double or more in most other industrial countries. The overall U.S. private saving rate of households and corporations combined remain slightly below the average for this point in previous U.S. post-war business cycles. It is against the background of such low private saving in the U.S. that the danger of government deficits must be gauged.

State and local governments last year ran a surplus of about $50 billion, directly contributing to the U.S. saving pool. When governments run deficits however they subtract from rather than add to the pool of national saving available to finance investment. Last year the Federal Government's deficit was $172 billion, a reduction of the national saving pool so large that it more than exceeded the $150 to $160 billion saved by all U.S. households. Clearly, were the Federal deficit to be substantially reduced or eliminated, the U.S. saving pool would be substantially increased, thus reducing interest rate pressures and the net inflow of foreign funds. As foreign investors purchased fewer dollars in foreign exchange markets, the dollar's value would moderate, clearing the path for a reduction in the U.S. trade deficit.

Some have argued that our economic performance has been so attractive relative to foreign economies that the inflow of foreign capital has become unstoppable. I believe this position to be exaggerated. Two conditions have been present to create the type of massive net capital inflows we have recently experienced. These are, first, the willingness of foreign residents to extend credit and, second, the need of our domestic economy to borrow foreign saving because of inadequacy of domestic saving to meet domestic credit and investment requirements. Cutting Federal deficits and raising domestic saving, I believe, stands a strong chance of reducing our saving/investment gap and trade deficit. I cannot predict precisely how the adjustments would occur; the correction could take place as much from increased U.S. capital exports as from reduced foreign capital imports. Both would reduce our net borrowing from abroad and reduce the trade deficit.

In recent weeks, U.S. interest rates have declined while the dollar reached new highs. Because of these developments, doubts have been created about the ability of lower interest rates to moderate the dollar and improve the trade balance. It is, however, the higher level of U.S. interest rates adjusted for inflation which contributes to the strength of dollar. Despite the recent fall in U.S. nominal interest rates, differentials in real rates favoring investment in the United States have not been erased. Current inflation-adjusted returns on Government bonds for example, were slightly over 7 percent in the United States, compared to 5.6 percent in Britain, 5.4 percent in Germany, 5.3 percent in France and 5.2 percent in Japan. Also, the recent change in outlook toward stronger economic growth in the United States in 1985 holds out more than the prospect of improved U.S. equity and direct investment returns to foreign investors. It also suggests to some the possibility of rising U.S. interest rates later in the year if measures are not taken to avoid a clash between Government borrowing and private investment needs over limited domestic saving.

Reducing Federal spending and deficits would also lessen their potentially harmful domestic effects. I mentioned several of these domestic dangers, because, when combined with the damage being done to our foreign trade, I believe that they make an overwhelming case for the urgent need to cut deficits.

Current public borrowing is saddling the future with increasing tax liabilities to cover payment of interest on the public debt. Interest payments on the public debt are the fastest growing element of Federal spending. In the last five years the government's interest payments on the national debt have risen from 1 3/4 percent of GNP to 3 1/2 percent of GNP, and there is no end in sight to the increase so long as measures are not taken to reduce substantially the deficit.

Some fear the added danger that the longer the national debt continues its current upward spiral, the more likely the possibility of a return to high U.S. rates of inflation. Increasing the taxpayer's burden to pay more and more interest on an escalating public debt is politically difficult. As interest payments rise, the political temptation may grow - though certainly not under the current Administration - to monetize more of the public debt, even at the cost of higher inflation.

Finally, many increasingly fear that large budget deficits, by limiting national saving, will ultimately squeeze domestic investment when foreign credit is no longer so readily available. This would frustrate the realization of the goal of sustained U.S. economic growth as even higher real interest rates begin to seriously limit expansion possibilities.

Our large trade deficit is thus closely linked to the problem of the Federal deficit and the other dangers for our economy inherent in a failure to make substantial progress in reducing Federal spending and deficits. I am confident, however, that the problem can be resolved in a positive manner. The President has proposed an effective package for reducing spending and the deficit, and the Congressional budget process is now in motion to make the reductions in current Federal spending and the deficits necessary to strengthen the foundation for sustained, non-inflationary economic growth and improved U.S. trade performance.

Our Large Trade Deficit: International Context

Although we have more ability to change U.S. policies aggravating our trade deficit, there are important international dimensions as well. The debt crisis in many developing countries has substantially reduced U.S. exports to these countries. It has also induced these countries to reinforce their efforts to expand their own exports to the United States. From 1981 to 1984 the U.S. trade balance with 6 high-debt Latin American countries deteriorated by $21.5 billion - from a $5.4 billion surplus to a U.S. deficit of $16.1 billion. The U.S. trade balance with developing countries as a whole, deteriorated by $34 billion from 1982 to 1984. This is fully equal to one third of the deterioration of the trade deficit. U.S. exports to LDC's fell by $9 billion, even though the world economy and world trade were expanding. U.S. imports from LDC's increased by $25.3 billion during this period.

Slow growth in Europe at between 1 and 2 percent has reduced U.S. export opportunities. Between 1982 and 1984, our bilateral trade balance with Europe deteriorated by $22.6 billion. U.S. exports fell by $2 billion, while U.S. imports increased by $20 billion. Had there been stronger growth performance in Europe, our exports would have increased rather than decreased. The deterioration of our trade position *vis a vis* Europe was also strongly related to the high value of the dollar.

The resistance of the Japanese market has been a third factor in the trade deficit. Between 1982 and 1984, the U.S. trade balance vis a vis Japan deteriorated by $17.9 billion, from a bilateral U.S. deficit of $18.9 billion, to $36.8 billion. U.S. exports to Japan increased only $2.6 billion, while U.S. imports from Japan increased by $20.5 billion. Undoubtedly, the exchange rate was the most important cause of our worsening trade position with Japan; nevertheless market access problems were also a significant factor, and it is absolutely critical that we reach an effective understanding soon with the Japanese on the serious problems of access to the Japanese market.

From the European and developing country perspectives, U.S. trade deficits have played an important and positive role for their economies over the last two years. The U.S. trade deficit has provided vital export markets for many LDC's with debt problems, helping them to earn enough foreign currency to avoid national insolvency and crisis in the world financial system. The U.S. trade deficit with Latin America was about $19 billion last year; this represents more than 100% of Latin America's total economic growth last year. Take away the increase in U.S. trade deficit, and you have no solution to the debt crisis and no growth in Latin America. Overall the United States now absorbs almost 60% of all the manufactured exports the LDCs ship to the industrial world.

The European Community is suffering from seemingly chronic high unemployment (11 %) and low growth. It faces substantial problems in attempting to improve economic performance. Rigid labor practices, excessive government regulation of economic activity, overly large and expensive governments, inadequate levels of investment and insufficient incentive to entrepreneurial endeavor have sapped the Community's economic vitality. Increases in net exports to the United States have been a boost to Europe and kept its economy from performing even more poorly than it otherwise would have.

The United States has managed to keep its markets open despite domestic pressures to do otherwise. This has been a valuable assistance to struggling foreign economies. Stronger world expansion, however, would help our trade situation. More growth in these foreign markets would increase our exports, ease the U.S. trade deficit and benefit the economies of our trading partners. The policies that have resulted in our strong performance may, and in some cases already have, serve as an example to others. We have also been working closely with our trading partners to convince them of the need to roll back the protectionist barriers that have grown in recent years through the negotiation of fairer and more open trade conditions. Trade liberalization is a major part of the solution to their growth problems as well as to our trade deficit. In addition to decreasing

Federal deficits and increasing domestic saving, I believe nothing could contribute more to reducing our trade deficit than stronger economic growth abroad. Of the tools available to U.S. policy to encourage foreign recovery, none is more important than new multilateral trade negotiations in the GATT to make the trade system fairer and more open for all its participants.

Long-Term Structural Changes and Their Impact on U.S. Trade

Until now, I have essentially considered the causes and cures of the U.S. trade deficit from a shorter-term perspective. Some, however, fear that our deficit is indicative of a longer-term loss of fundamental competitiveness on the part of U.S. industry. While the increasingly integrated and competitive world economy has caused our firms to face the same pressures for structural adjustment as those in other industrial countries, we have done fairly well overall in meeting the challenge. Our current trade deficit reflects a loss of price competitiveness due to the high dollar far more than a loss of fundamental competitiveness because of low investment, inadequate research and development or inefficient resource use. If anything, the pressure placed on many U.S. firms by the high dollar has led to increasingly efficient management and production techniques. The underlying strength of U.S. industry will be more fully revealed if we can pursue policies that will lead to an easing of the dollar.

There are a number of long-term changes in the world economy that affect U.S. trade and the health of U.S. industry. The high value of the dollar has had a larger impact on U.S. industry in the last few years than many of the long-term structural changes; nevertheless, these long-term changes tend to impact many of the same industries that are put under pressure by the dollar exchange rate. In effect, these industries are under double pressure. The principal source of concern at the moment is not the fundamental pressures for change coming from an evolving world economy. These we must respond to positively by adjustment and growth if we are to maintain our leadership position in the world economy. The more urgent problem is that the strong dollar so artificially boosts foreign competition that U.S. firms which would otherwise successfully adjust at home increasingly move abroad or even find their survival seriously threatened.

One major source of long-term structural change is the increasing competitiveness of some developing countries or so-called NIC's in basic manufactures such as textiles, steel and consumer electronics. Increased automation in the United States can offset the loss of competitiveness in some areas, but such automation reduces the demand for labor in those industries. The reaction of other developed country governments to their lost competitiveness, in turn, creates a new set of problems. As other industrial countries have tried to overcome their deteriorating position through government subsidies, dumping and import restraints, they have diverted competitive LDC exports to markets that remain open. Ultimately, the pressure on the few markets that remain open becomes so great that they too find it necessary to restrain imports. Steel is probably a prime example of this phenomenon. Thus, while it is extremely important to reduce exchange rate pressures on vulnerable basic industries, the trade policy problem of reaching agreement among industrial countries on a positive and equitable response to changing world competitive conditions in basic industries remains vital.

High technology industries and services have become more important, both in terms of their contribution to growth of employment and in terms of their contribution to the overall competitiveness of the economy. Moreover, with the growing significance of knowledge, intellectual property issues have also assumed greater importance. Countries that lag in the development of the new technologies are often tempted to try to catch up through domestic subsidies and import restraints and many countries have given in to these temptations. The net effect of these trends has been to reduce the export opportunities of U.S. industries also adversely affected by the high value of the dollar and slow economic growth abroad.

A growing trend toward self-sufficiency and overproduction in agricultural products by more and more countries, and the dumping of surpluses in international markets, has increasingly disrupted the traditional export markets of efficient agricultural exporters. The high value of the dollar also has reduced U.S. export sales in agricultural products, contributing to the drop in farm income. As we look a few years ahead, advances in bio-genetics promise to worsen the effects of government subsidies for agricultural production and exports. Over-production and the dumping of agricultural surpluses in world markets could become worse causing our trade problems to become more severe.

What Can We Do To Solve Our Problems?

There is a temptation to see import restriction as the sword which can cut through the Gordian knot of our trade problems. In fact, U.S. import restrictions create more problems than they solve. General tariff increases, by limiting U.S. imports, tend to appreciate the U.S. dollar, further hurting U.S. exports. To the extent that tariff increases raise Federal revenues and reduce budget deficits, the U.S. trade deficit may decline. But any tax increase raising a similar amount of revenue would be equally effective in reducing the trade deficit. The alternative I prefer to any form of tax increase is reduction in Federal expenditures. A tariff surcharge is a particularly undesirable tax increase for two reasons. First, the general tariff increase has an anti-trade bias which limits U.S. exports as well as imports and reduces the real income and efficiency gains the United States derives from world trade. And second, tariff increases invite foreign retaliation and move the world trade system in the direction of more restriction when more liberalization is desperately needed. More selective import restriction hurts not only U.S. exporters but also intensifies the competition faced by other non-protected U.S. import-competing industries.

If increased protection of U.S. markets is not the solution to America's trade deficit, what are the appropriate policies? Let me touch on each of the problem areas discussed above and suggest an approach that will help cure the problem.

First, what can we do about the high value of the dollar? We need urgently to reduce government spending and the budget deficit, and to pass a tax reform bill that will increase incentives for saving and reduce incentives for buying on credit. These measures stand a strong chance of moderating interest rates and the need for foreign capital to finance U.S. investment and government borrowing. These measures do not have to eliminate all capital inflows to improve the trade balance, nor would they be likely to since foreign residents will probably still find it attractive to invest in United States because of our favorable business climate and strong economic performance.

Once the major debtor countries have made the current adjustments, we and other developed countries might find new ways of helping the LDC's to develop sources of capital. We might encourage a greater flow of equity capital to LDC's. Tight budgets don't leave much room for increased aid. But increased U.S. private foreign investment could help restore growth abroad, reduce our own net borrowing of foreign capital and stimulate U.S. exports.

Slow growth due to labor market and other rigidities in Europe, and the adverse impact of foreign trade barriers on U.S. exports call for the same remedy - new multilateral trade negotiations to increase competition and expand export opportunities. Such negotiations will also require us to face up to some adjustment problems, and that will not be easy.

What we need is a long-term view and a package approach. We need a domestic economic program that holds out prospects for a lower dollar and a durable basis for U.S. growth. Such a domestic program should be pursued in conjunction with the initiation of new multilateral trade negotiations. Such negotiations will undoubtedly take a number of years and will take even longer to implement. What is important is that we start the journey, because it will lay out a long-term direction of policy. It will encourage business confidence in making long-term investment decisions aimed at an expansion of the international market.

Key to the package approach I envisage are new multilateral trade negotiations in the GATT and what we may hope to accomplish there. There is increasing concern about the adequacy of current trade rules to assure a fair and open trade system. We should seek specific changes which strengthen the fairness of the system with respect to procedures for both the settlement of trade disputes and the imposition of temporary safeguard measures.

Other, equally important objectives, should be central to U.S. concerns in a new round. We should seek the establishment of strict limits on the use of agricultural export subsidies to remove the major obstacle to U.S. agricultural exports. We should encourage the development of rules that would limit the introduction of new barriers to trade in services and thus establish the basis for the negotiated reduction of existing barriers to services in the future. Also important is the reduction of barriers to United States exports of high technology products, including restrictive government procurement and standards practices in telecommunications, inadequate protection for intellectual property rights in computers and pharmaceuticals, and reduction of high tariffs on electronic equipment and parts. We should also seek the establishment of limits on the use of investment-related trade barriers such as local content and export performance requirements as central to an expanded and strengthened multilateral discipline for foreign investment. Past U.S. proposals regarding a "GATT for Investment" were unsuccessful, but we must try again to persuade other countries of the desirability for such rules.

In conclusion, let me say that we have difficult and controversial decisions to make both with regard to domestic economic and foreign trade policy. We should remind ourselves, however, that we are enjoying the best economic growth performance since 1951. Prolonging that growth should be worth a major effort. I firmly believe that domestic spending reductions and tax reform as well as international negotiations to strengthen trade rules and open markets are vital, not only to improving our foreign trade posture, but also to fulfilling our commitment to sustained, non-inflationary domestic economic growth.

Representative OBEY. Thank you. Let me congratulate you on a very thorough and thoughtful and candid statement. I would make this observation, I especially appreciate getting your statement, you were especially frank. In fact, I cannot recall anyone else from the administration pointing out very frankly that the individual tax reductions which took place over the last 3 years have not led to an increase in the personal savings rate. I think that is an important observation and I appreciate your candor on that.

As I look over your prepared statement, I guess about the only disagreement that I would find is your indication that you thought that the administration has sent down an effective proposal to deal with the deficit. Maybe the budget itself will do it, but I just have to tell you, when I went to my district this week, I had the damnedest experience I've ever had in my life because, with the exception of the chambers of commerce with whom I met around the district, with most other groups with whom I spoke I had a little chart to show them what was happening with the deficit and what was happening with government spending as a percentage of GNP, the whole bit. I talked about austerity and told them that businessmen will have to support cutting UDAG and cutting revenue sharing. And I told other people interested in social programs that I was going to be supporting some of those cuts. And the reaction I received was, "What are you talking about? What's all this deficit thing? The President said things were fine. Why don't you support him?"

The mood that he conveyed in that State of the Union message certainly was not a mood that made it easier for me to go home and explain to my constituents why we had to cut the hell out of every program that they wanted me to preserve. It frankly left me buffaloed because I had assumed that there was a growing awareness of the problems faced by the country if we don't control that deficit.

Let me just ask one question. I noted that you indicated in your prepared statement that:

Our current trade deficit reflects a loss of price competitiveness due to the high dollar far more than a loss of fundamental competitiveness because of low investment, inadequate research and development or inefficient resource use.

I noted a somewhat different tone taken by the report of the President's Commission on Industrial Competitiveness, which said that:

While the strong dollar has contributed greatly to the trade deficit, our competitiveness problem is much broader. Our slow productivity growth, wages, and high capital costs are not caused by the strong dollar. Thus, a fall in the value of the dollar will not solve the long-term problem.

Exactly where do you come down on that issue? How much of the trade deficit would you attack as being traceable to the dollar and other factors, if you had to quantify them?

Mr. BROCK. If I were looking at the last 4 years and particularly the last 2 years when the deficit has been increased so significantly, on almost a parallel track with the strength of the dollar, my own judgment is that the strength of the dollar is responsible for probably 75 to 80 percent of the trade deficit.

Just look at the farm area. You can find very quickly what happens in a price sensitive commodity when the dollar goes up this fast and you're trying to sell wheat or corn on the basis of a nickel a bushel and that's the competitive margin, and the value of the dollar changes the price of that by $1 or $2 or $3 a bushel. It's almost impossible to cope with that magnitude in that short period of time, no matter how efficient our farmers are, and they are efficient.

Let me agree with the Commission in the same breath and say that I don't urge an attack on the dollar. I'm not wise enough to know what the real value of the dollar is. It's valued by millions of people in the marketplace every day and their judgment is collective and certainly superior to mine or anybody else's judgment. I do think what the Commission is trying to say is that we have to look at fundamentals and the rate of savings and the rate of investment and the rate of improvement in productivity in the last 10 or 15 years in this country really has been inadequate and in that sense they are actually right. Now that's improving. We have had an investment recovery as a consequence in part of that tax cut in 1981. We have had some slight improvement in savings rate but nothing adequate to deal with the overwhelming problem that's put upon the capital pool by the Federal deficit.

I think you have to do both. I don't think you can argue just on the dollar argument and I hope I didn't do that. But in terms of this broad analysis, on the face of it right now, that surge in the dollar has been so rapid that nothing else we could have done would have compensated for it in that short period of time that I know of.

Representative OBEY. We are going to be short of time so we are going to be operating under a strict 5-minute rule this morning. My time is up but I will get back to that later. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman, and Ambassador Brock, it's good to have you here today and I certainly appreciate your testimony.

As you know, many of my industries in the State of Maine have been affected whether it's shoes, potatoes, or lumber, and I appreciate your efforts on their behalf.

What concerns me about your prepared statement here this morning, particularly where you mention that foreign protectionism is not the principal cause of our overall trade deficit, is if the United States is recommending that we enter into a new round of trade negotiations, but we're not willing to fight for our industries, and we're not willing to recognize that there are too many countries that are erecting tariff and nontariff barriers disguised as domestic regulations, I'm fearful about what those new agreements will produce in the long term.

So I would like to hear your attitude concerning those countries that have erected those kind of barriers. You're very familiar with all the industries in Maine that are suffering from surging imports and as you know it isn't just because of the high dollar. That may be a factor, but nevertheless, I think we are very familiar with the countries that have erected the kind of barriers that have limited our access to their markets or have been flooding our markets. The shoe industry is a great example, as you know, now that the imports comprise 75 percent of our domestic market, and the potato industry is experiencing severe problems because of Canadian imports and I know you're going to be engaged in talks with the Canadians next week concerning lumber.

But again, I think the problem is that if we're not willing to stand up for our industries and fight in the new round of negotiations because we think everything is our fault, I'm just kind of concerned about what kind of agreements we will produce, and whether they will support our industries in the long term.

Mr. BROCK. If I left the impression earlier that everything was our fault, I want to apologize. I certainly did not intend to do that. I was trying to say that fundamentally we have to clean up our own house. That's why I put the emphasis on the deficit and tax reform.

But you're absolutely right and I would mention not just tariff and nontariff barriers. The biggest problem we face in the world today is not that kind of protection but in the new form of protection that comes in the form of subsidies, direct subsidies that come to industries either for domestic use or for export. Farmers particularly have been burdened by this and the European Community are just exorbitantly inexcusable and they take markets that our farmers would otherwise earn by simply being more productive and more competitive than anybody else in the world.

I think the answer to your question is that we can't ignore [illegible] things and we do have to take action. We have taken more trade actions under U.S. law in this administration than in the last four administrations put together. It's not a matter of not trying. There are some areas where the rules simply don't cover some of these problem areas. We do not have an adequate definition of subsidies in world trade. We have to deal with that in the new round. That's one of the fundamental goals. We have virtually no protection against so-called gray areas that are taken outside of the regulations of GATT. We have to tighten that up so that GATT covers all acts of protectionism and puts a discipline and a penalty on those countries that engage in that practice.

I guess one of the reasons that I am so committed to some form of international trade negotiations on a multilateral basis—and I can argue about whether there should be a new round or not but that's not the issue—but we try to deal with these problems one at a time and I promise you 100 U.S. trade representatives over the next 100 years would never be able to negotiate enough bilateral agreements to deal with these problems because governments can invent them faster than we can negotiate them away. The fastest and most effective way that I know how to deal with this proliferation of new forms of protectionism is with a multilateral discipline that gives us a place to go to seek and achieve relief.

It is abundantly true that a lot of governments simply cannot domestically agree to give up subsidies. They don't have the political will to do it. But if we get them into an international forum where all countries are doing it, then we can give them a cover for actions that they know they ought to be doing anyway.

I think we have to negotiate. I think we have to negotiate as aggressively as we can bilaterally and I think we have to enforce U.S. law as tightly as we possibly can and I think we have to seek significant strengthening of the multilateral system as well. No one thing is going to solve the problem.

Representative SNOWE. I thank you for your comments. I know my time is running out but I just have one quick question.

Do you expect any resolution to come from the lumber talks with Canada that you will be engaged in next week?

Mr. BROCK. I think that's premature. I really think these talks are going to be pretty exploratory. What we are going to try to do is explain to them that we have a real problem with a number of practices. They are in some cases not defined as illegal either by U.S. law or international agreement, but we still have a problem and we'd like to find some way to resolve that. We will begin that. We are consulting closely with our industry and hopefully over a period of time we can make some progress. I do put some hope there because the President's trip offers us the possibility of pursuing these kinds of issues aggressively.

Representative SNOWE. Thank you very much. I appreciate it.

Representative OBEY. Congressman Mitchell.

Representative MITCHELL. Mr. Ambassador, I also serve on the House Banking Committee which at least theoretically has jurisdiction over the Export-Import Bank. I noted that the President has decided to strip the Export-Import Bank of its financial capabilities.

Did you participate in the decision to strip Exim?

Mr. BROCK. Yes, I did, Congressman.

Representative MITCHELL. You fully supported that decision?

Mr. BROCK. I don't think we have much choice. I don't think it would be possible to put any more emphasis than I did in my statement on the deficit and the need to reduce it. I can argue frankly with our accounting methodology that treats a loan as a cash expenditure. I wish that we had a better methodology, maybe more of an accrual basis accounting system, but the fact is that the deficit is driven by loans just as much as it is by cash outlays for Social Security. And what we are trying to do is to not eliminate the Exim Bank's support for our ability to compete overseas. We did support that interest buy down. If interest rates stay at a reasonable level, that will be adequate to provide the same support that was given by the direct loan program. So I really don't think it's a stripping of the activities of Exim. It is a quantitative shift to a different kind of support, but it is not necessarily a reduction.

Our problem will come if interest rates begin to grow in particular areas like aircraft.

Representative MITCHELL. Obviously I'm in some disagreement with you. I deliberately used the word "stripping" because that's what it appears to be, and your response, it seems to me, flies somewhat in the face of your response that you just gave to Congresswoman Snowe. You talked about the inability of your operation to force foreign governments to end their subsidies.

How are you going to go to our allies in Europe and tell them that we insist on their stopping subsidizing exports and we can't even threaten them with any subsidies of our own?

Mr. BROCK. Congressman, back in 1981 we had a debate on Exim, if you recall.

Representative MITCHELL. Very well.

Mr. BROCK. And I suggested to my friend, David Stockman, that we were in a table stakes poker game and when you're in a table stakes poker game you have to able to shove a bunch of chips on the table and sometimes you can win a pot that you might not otherwise win.

I would have been delighted to have had $20 billion for Exim Bank. I guarantee you we would have negotiated to end all subsidies pretty quickly. The fact is that even without that, given both the congressional and the administration decision on Exim funding at that time, 1981 and 1982, we have been pretty successful. We have negotiated a significant reduction in interest rate subsidization, particularly from the industrial countries in most areas.

The problem that has popped out to the surface recently has been the problem of mixed credits, but that's not covered by the OECD credit arrangement that we have arrived at. I think it's fair to state that there is significantly less pressure, though, on U.S. firms from traditional forms of export subsidies from other governments than there was 4 years ago. We have made a lot of progress in reducing the abuse in that area and we are meeting within the month on the mixed credit issue and hopefully we will make some more progress there.

So I really can't accept the argument that we are unilaterally dismantling Exim—you didn't make that but I've heard it from others—and I think if the $100 million is used efficiently for interest buy downs in areas where we have to have it for competitive purposes we can remain competitive. I grant you it is not table stakes poker.

Representative MITCHELL. I have time for one more question. I will be very quick. In your prepared statement, you indicate that the American rate of savings is not sufficient to meet our investment needs in this economy. You go on to indicate that the rate of savings elsewhere around the world is higher than ours and therefore we can attract needed foreign investment into our economy.

More specifically, my question is, do you anticipate that at some point these countries will reach a saturation point in terms of the savings levels, the amount that can be invested in our economy?

Mr. BROCK. Not as long as we have high rates of growth and low rates of inflation. I think the United States is so big and powerful that we are like the U.S. Government. When the U.S. Government wants to borrow money it can borrow money because it can compete with anybody and nobody can stop it and we can preempt the marketplace. As a country we're big enough to do that, too, but there's a price to that. The price is an increase in the level of interest rates here because in order to buy that money we're going to have to pay more for it as the capital pool worldwide is sopped up. That means that ultimately higher prices for money are going to slow down growth here and are going to slow down growth elsewhere and both of us are going to lose. We cannot continue to do this for an unlimited period of time. That's the hazard we face and that's why I think we have to deal with it.

Representative OBEY. Congressman Scheuer.

Representative SCHEUER. Let me tell you how much I admire this fine statement of yours. It's very thoughtful and very candid and I appreciate it. I would join with Chairman Obey in saying about the only thing I would object to in the whole statement is your use of the adjective "effective" in the administration Deficit Reduction Program. We don't think it's effective. There's no point in embroiling you on whether we should take another $10 or $20 billion off the military budget.

Mr. BROCK. Congressman, I believe in the constitutional process. I've served on this committee and in this body and I believe in accommodation and I think we're going to work this thing out together.

Representative SCHEUER. I agree with you and I want to say what a terrific Senate leadership we have now between Senator Dole and Senator Packwood and Senator Domenici and Senator Simpson. We have an outstandingly fine team.

Mr. BROCK. I think so, too.

Representative SCHEUER. I think we can rely on them to work very effectively with their House colleagues.

Let me present to you a sort of nightmare scenario. You say that the way we bring down the interest rates is to reduce the deficit and that's the conventional wisdom. I think all of us here agree with that. But let me throw one possibility at you.

Is it conceivable that if we really get our act together and we do bring down the budget deficit so that over a 5-year period we can see the light at the end of the tunnel, is it conceivable that even though we have eliminated perhaps a great deal of the need for these foreign borrowers to finance this crazy activity of ours, that the investors around the world will be so impressed with our performance that even though interest rates here—dollar interest rates from the purely economic course of work—would tend to go down, the safe haven philosophy and the increased respect and the excellent functioning of our economy that this would engender around the world would still promote the kind of pressures for investment all over the world of every free dollar that isn't nailed down that wants to come to our economy so that would in any event tend to sustain current high interest rates even though we have reduced what we think now are the endemic causes of our high interest rates?

If that's true, so that we have a heads-I-win-tails-you-lose situation, we really have to think about structurally high interest rates for a long period of time, what does that mean for our manufacturing industries, our export industries? What does that mean for our competitiveness in global trade?

Mr. BROCK. That's a good question. Let me draw a distinction between the level of interest rates and the level of the dollar. Last year, about a year ago now, I was arguing with a number of people that the dollar was going to get stronger and a lot of business planners and people in economic situations in this town were saying, "Oh, no, it can't." I said, "Hypothetically, think about the possibility, if U.S. interest rates fell to 6 percent what would happen in the United States?" At the time they were around 12 or 13 or maybe a little more. And the response was, "We'd probably be doing pretty well. We would have an economic boom." I said, "That's absolutely right and what that would do is draw more money into this country because we would still be the best place in the world, the best safe haven in the world." There's no question we would be blooming like a new garden in that situation.

So the dollar could remain at a very high level. That is a legitimate concern. But it is not true, under those circumstances, that interest rates would stay high. I think you could expect real interest rates to drop to somewhere like 2.5 to 3 percent in real terms.

Representative SCHEUER. Let me just interrupt because the real problem with our export industry and our inability to compete around the world is the overvalued dollar. Now I tend to agree with you that there is this specter that even if we do get our house in order the confidence that this would engender around the world would still lead to a further rush of investment based on the safe haven principle.

What does this mean in the long term to our export industry, to our smokestack industries, to out ability to compete in a global market?

Mr. BROCK. I personally think we would have sufficiently strong growth under that circumstance, with low interest rates and a booming economy, to not have to worry too much about that.

The problem would be different with each country at that point because some countries would say, "Hey, the United States has done it. We have to do the same thing." And their policies would engender the growth and would allow our exports to grow and their currencies would strengthen. What you're going to see in the next 5 years—and I have no credentials—but I think anybody could reasonably forecast that whatever the value of the dollar, some currencies are going to go up and others are going to go down depending on the economic performance of those individual countries.

We simply have to say we need, first of all, a healthy United States. A good booming economy here will solve almost all issues. Other countries that perform well are going to be good export markets for us. Those that don't will try to subsidize them. That's where we have to defend ourselves against unfair trade practices very agressively to be sure that our recovery is balanced and across the board. It's a fair question.

Representative SCHEUER. Thank you very much.

Representative OBEY. Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

Mr. Ambassador, we welcome you back to the Hill and this committee.

Mr. BROCK. Thank you.

Representative HAMILTON. First, just a question of clarification on the morning's headlines about the car quotas being left up to Japan. Is that a final decision now at this point or does the President now review that?

Mr. BROCK. It is by no means a final decision. The President has to make the final decision and I think the article in the morning Washington Post—I would never dispute the Washington Post or not very often—but the article was generally correct in evaluating the mood of most of the President's advisors, but there's been no decision by the President and no presentation to the President.

Representative HAMILTON. When would such a decision be forthcoming?

Mr. BROCK. I honestly don't know. I would expect it would be in the reasonably near term. We only have 6 weeks or so—8 weeks before this thing expires. I would imagine some time in the next very few weeks but, to my knowledge, no schedule has been given to us for any presentation.

Representative HAMILTON. I don't know, Mr. Ambassador, whether you've had a chance to look at this new study out by the Harvard Business School on U.S. competitiveness.

Mr. BROCK. I have not.

Representative HAMILTON. I have been looking at it and it has me shaken up a bit and I want to just cite to you some of the conclusions to that study and get your reaction to it.

One of its conclusions, for example, is that for some 15 years the United States has been losing its capacity to compete in the world economy and it bases that on all kinds of measures of our ability to compete—declining incomes for the labor force, declining market share in almost all major sectors of industrial activity, declining profitability, declining levels of investment to the worker, unusually low rates of productivity. It's not a problem of recent years. It's a problem that goes back to the early 1960's, according to this study.

I guess the first question then is, Do you have the sense that you would agree with this conclusion that the United States really is losing its capacity to compete in the world economy, not from the perspective of 2 or 3 years but from the perspective of 15 or 20 years?

Mr. BROCK. No, sir; I do not. I have thought a lot about this subject and spent a lot of time trying to study the question and read everything. I have not seen this most recent work. It is just not possible to make the statement, that the United States is less competitive, without looking at individual industrial components of our economic matrix. And if you do that, you're going to find that we are far more competitive in some areas and considerably less in others and that is an absolutely natural process for the evolution of a healthy economy.

I do not believe that you make the case that we are less competitive. Again, the Industrial Bank of Japan, as I recall, did a comparative productivity study and found that the United States as a total economic system was 65 percent more productive than Japan and a bit less than that in some European countries, but yards ahead of any other country in the world.

Representative HAMILTON. But that's one of the things this study points out, and that is that in those sectors where Japan really chooses to compete, they just put us to shame. There are large sections of the economy that they don't choose to compete in, but where they do choose to compete, they beat us and they beat us badly.

Mr. BROCK. Well, I think you could ask IBM the question, and if they decided to compete I think they have, and AT&T.

Representative HAMILTON. Well, I think they have. I don't have any doubt you can pick out certain areas where we have done very well and areas where they've done very well, but I'm trying to get a feel of the overall.

This study, which I really commend to you—I don't know the authors of it. I have skimmed through a lot of the chapters and it looks to me to be a very impressive study. It's put out by the Harvard Business School, "U.S. Competitiveness in the World Economy," and I would commend it to you and your staff as a serious work and one that you ought to look at and one that raises an awful lot of questions.

One of the points it makes, for example, is that our principal competitive challenge comes today not from Western Europe but from the new countries, the so-called "new Japans," where they follow different kinds of national strategy than we follow.

Would you, for example, think that the major challenge to our competitiveness today comes from Japan and South Korea, Taiwan, Singapore, Hong Kong, those countries, rather than from Western Europe?

Mr. BROCK. Yes, sir. Europe has become too inflexible. There's too much government intervention. Taxes are too high. Regulations are far too strict. It is very difficult for them to match foreign competition right now.

But I want to point out to you two or three things. First of all, I accept the fact that in the 1960's and 1970's things were a lot too easy for too many companies and too many got fat. There was too much featherbedding in management and in labor, too much inexcusable sloppiness in performance, too little pride in quality of work, quantity of output. All of those things are true in some fields. They are certainly not generally applicable. If you look at the industrial base of the United States, it is stronger than it was in 1970. We're the only country in the world that has had a net increase in manufacturing employment. Europe has had a substantial decline. In the last 14 years, despite the influx of women in the work force, and the biggest baby boom in our history, we have created 23 million new jobs. The performance of this economy is actually spectacular by any measure. Half of all our new jobs are in companies that are less than 4 years old. Most of them are in small business. That's where we are competitive.

It's in large businesses where Harvard Business School has taught them to look at the quarterly profit statement and evaluate their long-term goals on next week's sales forecast that have us in trouble with some of these people. Now I'm not going to come down on Harvard. That's not fair. But we have had too much of a short-term profit ethic in this country. Where firms in other countries have had a longer term perspective, were willing to commit to the long-term sustained competitive effort, we have gotten in trouble. Foreign firms beat us unless we decide to compete on those terms.

Representative HAMILTON. In that respect, the study does agree with you because it points out that these nations—the "new Japans"—operate from a coherent national strategy which puts a great deal of emphasis on work, savings, and investment as a long-term approach, as you're suggesting.

Mr. BROCK. That's right.

Representative HAMILTON. While in their view, one of our problems is that we have operated on the basis of a strategy that emphasizes more of the distribution of our income and the security of it.

Mr. BROCK. That's true.

Representative HAMILTON. And much more emphasis on consumption at the expense of long-term investment.

Mr. BROCK. That's absolutely true. And we have become a throw-away society, Congressman, like styrofoam cups. We do too much of that, too much planned obsolescence and too much short-term thinking, not enough willingness to fight for a market for a long period of time, and we have to change that. But you can't put that on their back. That's for us to change.

Representative HAMILTON. That's exactly right and that's one of the points that was made. The national strategy that is followed is more important than trade barriers and nontariff barriers and all the rest. Those are not unimportant, obviously.

Mr. BROCK. No, they're not.

Representative HAMILTON. I don't suggest they are. But the fundamental problem of competitiveness relates more to the national strategy than it does to the——

Mr. BROCK. That's absolutely true. If you look at Japanese companies, they have a very low rate of equity. They have a high leverage. We much prefer equity because there's more control implicit in that, but you can't have a very high rate of leverage if your interest rates are high. So we have no choice other than to emphasize equity, but they can because their interest rates are low and therefore they can leverage themselves.

Representative HAMILTON. I thank the chairman.

Representative OBEY. Mr. Ambassador, let me just make one comment on the Exim Bank. I appreciate your comments but I frankly think something different is going on in the Exim Bank situation.

When I'm wearing my other hat, I'm also chairman of the Foreign Operations Subcommittee of the House Appropriations Committee and we have the responsibility for funding the Exim Bank. What I really think is going on is very simple. I think that what is happening is OMB simply decided that they knew there was great support for Exim in Congress and they wanted to be able to appear to cut the foreign aid budget and so they simply cut it out expecting that Congress is going to restore it.

I am a believer in the Exim Bank but I am not a believer in being a sucker and I don't have any intention at this point of restoring a dime for the Exim Bank and I think any funds that would be included in that appropriations bill this year would be over my dead body.

Mr. BROCK. Good.

Representative OBEY. Because I don't expect to catch the heat for something which I think the administration really wants restored. Those are my views.

Mr. BROCK. I hope you are successful.

Representative OBEY. I hope I am, too.

Let me just ask a couple quick questions. Congressman Hamilton raised the point about the Cabinet counsel on trade in their meeting yesterday with regard to the voluntary restraint agreement.

What was the total level of exports to Japan prior to becoming our trade deficit?

Mr. BROCK. I don't have those figures—the deficit was $21.8 billion in 1981.

Representative OBEY. My understanding is that our total level of exports to Japan was about $21 billion.

Mr. BROCK. OK.

Representative OBEY. Do you know what the level was last year?

Mr. BROCK. It was $23.6 billion.

Representative OBEY. $23 or $24 billion?

Mr. BROCK. Yes.

Representative OBEY. So that probably means in real dollar terms they aren't buying any more now than they were 4 or 5 years ago?

Mr. BROCK. That's correct.

Representative OBEY. In discussing this whole issue of the Japanese trade barriers and their general trade performance and their cooperation in trying to achieve an open market, have they been fairly forthcoming in your judgment and fairly forthright and reliable in doing what they say they are going to do about removing the trade barriers?

Mr. BROCK. Two and a half years ago I said in some public forum that my nightmare is that the Japanese Government would do everything we asked them to do and nothing would change. I'm living that nightmare now because I think the Japanese Government has in the five rounds of packages removed a number of governmental barriers that we have identified and nothing has changed. Part of that is the dollar. Part of that, maybe in a few cases, where the firms are not exercising enough effort, but a significant part of that is that the Japanese market is simply not as open a market as ours and that goes to the business community, it goes to cartels, it goes to bureaucratic reluctance to allow changes to translate into changes of substance, and that's a very different thing to deal with, but it is not much improved in sections.

Representative OBEY. I guess I'd simply observe that I don't like something like voluntary restraint agreements because they allow people like Lee Iacocca to run around the country pretending that they're a capitalist when they're really doing it on Federal money and getting good help from the Government in terms of trade assistance.

But having said that, I would also say that it would seem to me that this situation is parallel to the Exim Bank, that if we are unilaterally disarming before we go into serious discussions with them, I would doubt very much that they would be concerned about our ability to reward friends and punish enemies.

Mr. BROCK. I don't think we're unilaterally disarming. There's a fair question as to who has the most benefits out of the VRA. We've been paying, according to many, $1,000 per car. I understand there are at least some in Japan who think it would be nice to carry that on.

Representative OBEY. Let me ask you, how many additional cars would you expect to see imported if the VRA was lifted?

Mr. BROCK. I would not be surprised in the 12 months following to see the rate increase by as much as three quarters of a million cars a year.

Representative OBEY. Three quarters of a million. Which American companies do you think would be most severely injured by that?

Mr. BROCK. I think all would face great difficulty. Ford and GM, the two large ones, would be affected because they would be deprived of the small car sales and that would make them in violation of the CAP mandates of the U.S. law and that would put a double burden on them. Not only would they lose the sales but they would be paying the burden of an additional penalty to the U.S. Government. Chrysler and American Motors would be affected because they are focused in the small car area and competition would be extremely difficult for them. So I think all would face a much more competitive situation.

Representative OBEY. What kind of impact do you think an end to that arrangement would have on the plans of American motor companies to invest significant amounts in trying to continue to compete in the small car market?

Mr. BROCK. They are better able to answer that than I am. I would imagine that at least some or several, if not all, would consider more outside sourcing.

Representative OBEY. I have a number of other questions I'd like to submit to you for the record. In the interest of time I will do that rather than ask them.

Mr. BROCK. Thank you.

Representative OBEY. Any further questions by anyone on the committee?

Mr. BROCK. Congressman, I'm really running very short of time now with the speech.

Representative OBEY. Thank you very much, Mr. Ambassador.

Mr. BROCK. Thank you, Mr. Chairman.

[Whereupon, at 10:40 a.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 26, 1985.]

[The following written questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. WILLIAM E. BROCK TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE OBEY

CAUSES OF THE TRADE DEFICIT

Question 1. Mr. Brock, as in previous testimony before this and other committees, you cite three major factors causing the enormous trade deficit: the value of the dollar; slow growth in Europe relative to the United States, and the international debt problem. You ascribe only a small amount of the deficit to unfair trade practices.

How would you weigh the various causes of the trade deficit today?

What percentage of the trade deficit would you ascribe to the dollar?

Answer. There is no fully satisfactory way of measuring the exact proportionate share of each factor's contribution to the U.S. trade deficit. Early last year my best estimate was roughly half for the value of the dollar and a quarter each for differential growth rates and LDC adjustment to their debt-related payments difficulties. A year later, I would estimate the responsibility of the dollar to be much greater, perhaps for three-quarters of the deficit. My increased emphasis on the role of the dollar in the U.S. trade deficit is based on two factors. First, differentials between U.S. and foreign growth have been reduced and, second, the LDC's have made continued adjustment progress over the last year, reducing the role of these factors in the deficit. At the same time, U.S. reliance on borrowed foreign saving and net capital inflows from abroad has grown, driving the dollar up further. Because of these developments, I have especially emphasized in recent months the need for domestic tax reform to raise the U.S. saving rate and reductions in Federal spending and deficits to limit the drain on U.S. private saving as the means of reducing the trade deficit. As concerns unfair foreign trade practices, this issue is of extreme importance because of the economic losses created for U.S. exporters, the U.S. economy, and the economies of barrier-imposing countries. However, the existence of unfair trade practices contribute little to the overall merchandise trade deficit of the United States.

Question 2. Mr. Brock, most experts outside the Administration say that the dollar is overvalued by about 30 percent. Administration officials, however, resist the term and merely state that the dollar is strong and reflects the underlying strength of the domestic economy.

Would you say that the dollar is overvalued, and if so, by how much?

If the dollar is the reason for 30 or 40 percent of our trade deficit, isn't it fair to say that the dollar is therefore overvalued by that amount?

Answer. The disagreement over whether the dollar is overvalued or not is largely one of semantics. When the discussion turns to analysis rather than labels, disagreement largely disappears. The balance of payments of the United States is composed of trade in goods and services on the one hand (the current account) and international capital flows on the other (the capital account). When the U.S. current account records a deficit, the capital account will show a net inflow (or surplus) of foreign capital of like amount to finance the trade deficit. Conversely, when the current account is in surplus, the U.S. capital account will show a net outflow (deficit) or like amount as foreign residents borrow dollars to finance their nations' trade deficits with the United States. How is it that the dollar value of our current account balance just equals the dollar value of our capital account balance (with reverse sign)? Under the current system of flexible exchange rates, it is the dollar's exchange value which moves to bring equilibrium between these two markets. In this technical sense the dollar is neither overvalued nor undervalued, it is simply the market clearing price of our national currency in terms of foreign currencies assuring equilibrium in our overall balance of payments.

What we are really concerned about is the current structure of our balance of payments—the large trade deficit (and the costs it is imposing on certain sectors of the U.S. economy) and the buildup of U.S. foreign debt to finance the trade deficit. I strongly believe that we need to make the domestic policy adjustments necessary to reduce our reliance on foreign credit and to bring down the trade deficit. These adjustments (tax reform to raise U.S. saving rates and Federal deficit reduction) would bring about these desired changes in the structure of the U.S. balance of payments by a moderation of the dollar's foreign exchange value.

THE DOLLAR

Question 3. Regardless of whether the dollar is "overvalued" or just real strong, it's quite clear that from your perspective, you'd like to see a lower valued dollar. The standard prescription for a lower dollar is lower Federal deficits, which will reduce pressures on interest rates, and thus reduce the value of the dollar. Mr. Brock, you've certainly argued for deficit reduction on that basis.

What happens if we reduce the deficit, and the dollar stays strong or rises even further because foreign investors have even more confidence in this economy as a result? Is that a possibility you've contemplated?

Some forecasters think that the high dollar is here to stay, at least for another couple of years or maybe more. What would be the implications for U.S. exporters, and import competing firms if the dollar stays high for years?

The flip side of the problem. What happens if the dollar were to fall, obviously making our exports more competitive, but also increasing the price of imports and thus, increasing pressure on inflation? How does the Administration propose to handle that scenario?

Is the high dollar essentially the Administration's principal anti-inflation tool? If so, what does that say about the Administration's commitment to our exporters, and the importance of American competitiveness in global markets?

Answer. It is not a reduction in the Federal deficit per se which would ease the dollar; it is, as I stated in my testimony, a narrowing of the gap between domestic saving and investment which is needed. Federal deficit reduction would help. Just as importantly, tax reform measures designed to raise the domestic saving rates would also contribute to the desired effect. I have emphasized the saving rate both because the current U.S. rate is low by historic standards and very low in comparison with other industrial countries. To restate the question then, what happens if we substantially raise the U.S. domestic saving rate and the dollar still remains as strong? I sincerely doubt that this would occur, but it is within the realm of possibility. It would mean that U.S. private investment as a share of GNP had risen correspondingly in order to maintain the same gap between substantially higher levels of domestic saving and investment. U.S. private investment is already extremely strong. Were it to rise substantially as a share of GNP, we would have such unprecedently strong peacetime economic growth in the United States that a then persistent trade deficit would become somewhat less damaging to the fabric of our economy.

A too rapid decline in the value of the dollar could be damaging, particularly if measures were not in place to offset the loss in foreign credit with higher levels of domestic saving. Reduced credit availability could put pressure on interest rates as well as force a reduction in domestic investment. The scenario of a rapidly falling dollar, while unlikely given the current strong performance of the U.S. economy, is nevertheless another example of the potential vulnerabilities of and inconveniences to the U.S. economy caused by inadequate domestic saving and excessive reliance on foreign credit. The Administration is focusing its efforts on obtaining the required reduction in Federal spending and deficits and an appropriate tax reform package *before* such an eventuality becomes a serious danger.

Support for a Federal Reserve policy of consistent, moderate monetary expansion, economic deregulation, sustained expansion in U.S. output of goods and services, and Congressional reductions in Federal spending and deficits are central to the Administration's approach for sustained, non-inflationary growth. The Administration has had as policy objectives neither the elevation of the dollar to its current high level nor the use of the dollar's high level as an anti-inflationary tool.

WINNERS AND LOSERS

Question 4. Mr. Brock, as I mentioned in my opening statement, it seems to me that this Administration has got an industrial policy, and its right in your bailiwick. We're picking winners and losers through the back door of our fiscal policy. In fact, it strikes me that we're making losers out of our winners.

Mr. Brock, just who are the losers from the Administration's "industrial policy"?

What's happened to basic manufacturing exports over the past four years?

What's happened to our agriculture exports over the past four years?

What's happened to our high technology industries in markets abroad and competing at home over the past four years?

What about machine tools? How are domestic producers faring against imports in our own markets?

I would appreciate it if you would run through some of these categories with me for the record, so that we can get an accurate picture of how they're faring under the current set of fiscal and monetary policies.

Answer. The Administration is committed to a policy of sustained, non-inflationary expansion for the U.S. economy, with maximum scope provided to the operation of free markets as the chief determinants of U.S. resource allocation and production patterns.

It is true that imports have risen substantially in the last four years while exports have not yet recovered to their level of 1980. The volume of U.S. imports of manufactures has risen 70 percent in four years. The volume of manufactured exports is down 19 percent, of agricultural exports down approximately 10 percent. For a number of sectors, imports have risen as a share of domestic consumption. Apparel imports, for example, have risen from 13 percent of domestic supply in 1980 to 20 percent in 1984, while the share for machine tools has risen from 20 percent to 37 percent in 1983, the latest year available.

The rise in imports, however, should not obscure the fact that the U.S. industrial recovery has been substantial, even relative to four years ago. Manufacturing output in 1984 was 15 percent above the level of 1980 and rising. Non-electrical machinery production was up 11 percent and electrical machinery, much of which is high tech, was up 26 percent. Even an industry as import-sensitive as apparel has seen its output rise 8 percent relative to 1980 levels. The record for our trading partners has been much weaker. Japan's output of manufactures rose slightly more than our own (18 percent) from 1980 to 1984, but European production has fallen—down 5 percent in Germany and 17 percent in France—and Canada produced no more manufactures last year than in 1980.

What appears to have happened is that during the first six quarters of recovery, through the first half of 1984, U.S. demand rose so sharply that domestic production was strongly stimulated despite rising imports. As the U.S. recovery slows down, the possibility increases that imports cut more severely into domestic production. Such a development is not part of a putative industrial policy or any other Administration economic policy objectives. On the contrary, the Administration urges Congressional cuts in Federal spending and deficits and action on tax reform as the most effective means for reducing the U.S. trade deficit and stimulating the U.S. traded-goods sector.

Question 5. Aside from losing markets both at home and abroad—markets which it may take years to recoup, if ever—there seems to me to be another problem associated with the current "industrial policy," and that's the question of companies moving their plants and investment abroad. Motorola, Caterpillar, and Chrysler have all announced plans to locate new plants in foreign countries. These companies have come to the conclusion that they can't compete globally from the United States high dollar economy. No doubt, other companies are contemplating the same kind of move.

What's the Administration's response to this kind of action by American companies?

What is the Administration going to do to lure them to keep their plants and jobs at home, or doesn't the Administration care about this phenomenon?

If this trend continues, and more companies locate abroad, what effect will that have on America's long-term commitment?

Answer. Evidence—even anecdotal—of major U.S. firms investing abroad because of the impact of the high U.S. dollar on the competitiveness of their U.S. production is disturbing. Yet, we should not mis-read the overall situation. At no other time in the 20th Century has the international flow of resources been so favorable to United States in terms of contributing to U.S. domestic investment for new jobs and production. Balancing the outflow of investment from the United States against the inflow last year, foreign residents financed a net volume of $102 billion in U.S. domestic investment. Some of this was direct investment of type recently made by Japan's auto producers in the United States. Much of it, however, was portfolio type investment which, by raising the real credit available in the United States last year, simply allowed Americans to invest more domestically than they otherwise would have been able to do.

Investment, in part made possible by foreign borrowing, has been so strong that for the first time in many years the United States now has a newer and presumably, on average, more modern stock of plant and equipment than Japan.

The trade deficit is not draining investment from America, on the contrary, low saving levels and booming investment have put our country in a position of needing to borrow foreign resources—both financial resources through capital inflows and real resources through the trade deficit. Within this general context, some U.S. firms whose business is highly sensitive to the dollar exchange rate may be more likely to consider reverse investment abroad. The answer to this problem is, however, clear. If we want to maintain the current high level of U.S. investment and to ease the value of the dollar and the pressures it is generating on some firms, we must increase the level of U.S. domestic saving. As I have stated before, reductions in Federal deficits and spending and tax reform are I believe our most promising opportunities for achieving these desirable ends.

Question 6. How can you claim any successes vis-a-vis Japan if our trade deficit could be cut almost in half if they did what we're asking?

Answer. I think it's nearly impossible to say just what impact a full opening of Japan's market would have on our bilateral trade balance. If Japan's market was truly open, and could be expected to stay that way, U.S. exporting companies could plan investments with the Japanese market in mind. One can't be certain what the long-term impact of such investments would be, but I wouldn't want to underestimate them.

We have had some successes in Japan. Within the past two weeks, for example, the Japanese Government has advised us that it has abandoned a proposal which would have sharply reduced protection for computer software. Japan has now decided to use copyright law to protect software, a step we have been strongly urging. This is a decision of major importance for our software producers. Japan has also reduced some tariffs of importance to us, including semiconductor tariffs, which we mutually agreed to eliminate.

What has been done is not enough, and more must be done to give our exporters an equitable opportunity to compete in Japan.

Question 7. The bilaterial trade deficit is $36 billion. Can you say it would have been worse without Administration trade liberalizing efforts?

Answer. I believe there is no doubt that Japan's market is more open to U.S.exporters now than it would have been had we not pressed the Japanse as we have done over the past five years to remove trade barriers. The bilateral deficit arises from a variety of factors, and lack of market access is prominent among them. I am not suggesting that removal of all the barriers would eliminate that deficit. What I would say is that Japan's import restrictions cannot be justified in light of the trade surplus it is experiencing not only with the United States, but with the world.

Question 8. What is the Administration doing to rectify problems in these areas? (Computer software protection, not buying U.S. satellites, single tendering, small NTT purchases of telecommunications equipment from the United States.)

Answer. Japan has recently advised us that it will use copyright law, as we had urged, to protect computer software. This is a welcome and important decision.

Japan's policy on satellite purchases has not changed: purchases by government agencies are not being allowed; it is not entirely clear whether a private purchase, e.g., by a consortium, is possible. We've told the Japanese the ban on imports of satellites by government agencies is not acceptable, and we'll continue to press for a change in the policy.

We are engaged in dispute settlement consultations with Japan concerning the use of single-tendering procurement procedures. In the course of these discussions, the Japanese have made some moves toward improving their performance in this area. We are not yet satisfied that these steps are adequate. At this point we are focusing our efforts on gaining additional information about Japanese practices. We have given the Japanese a number of written questions and are now awaiting their reply. If the reponses, and our consultations, do not yield satisfactory results in a reasonable time, we are prepared to take the next step, that is to use Code procedures to convene a panel of experts to examine Japan's practices. Assuming the panel found the Japanese to be acting inconsistently with the Code, they would have the option of modifying their practices or accepting retaliatory action by the United States.

We have made known to the Japanese our disappointment with the low level of purchases under the NTT Agreement and have called for consultations to review the status of that Agreement and Japanese purchasing performance.

Question 9. How is our current approach any different from past efforts?

Answer. In a January 2 meeting with the President, Prime Minister Nakasone made a personal commitment to address our market access problems in Japan. As a result of that meeting, intensive negotiations have begun in four initial sectors: telecommunications, electronics, forest products, and medical equipment/pharmaceuticals. This approach differs from past efforts in that it is intended to attack all barriers in each sector under discussion, to avoid getting mired down in a "peeling the onion" approach. We want to avoid piecemeal approaches in which we gain removal of one barrier only to face new, previously unknown obstacles. Furthermore, these negotiations are being led by senior officials, all at the Undersecretary level, and will be followed closely by the U.S. and Japanese Cabinets, as well as by the President and the Prime Minister.

Question 10. What indication is there that we'll have any success this time?

Answer. It is too early to judge the results of the new approach. As a matter of fact, the signals so far are mixed. In the first meeting on forest products, Japan refused to consider tariff cuts, which are seen by our industry as the principal barrier it faces in the Japanese market. There are some signs the Japanese may be reconsidering their stand. Time will tell.

The major part of our effort to date has been in the telecommunications sector, because Japan will implement a new telecommunications law April 1 which will have a major impact on the competitive opportunities available to our companies in the Japanese market. While our concerns are not limited to the areas covered by the new law, its provisions will provide an indication of the depth of Japan's commitment to opening its telecommunications market.

Talks in the electronics and medical equipment/pharmaceuticals sectors are at very preliminary stages, and it is too soon to judge their results. However, Japan has taken a highly important step in the electronics area by deciding to use copyright law to protect computer software. This is a course we had long been urging. It's an action we and our software industry welcome.

Question 11. Mr. Brock, do you think that we're really going to make headway with Japan given their cultural and societal differences? Are we beating our heads against a wall for nothing?

Answer. From the standpoint of overall United States trade policy, it does not make sense for us to accept that cultural and societal differences are in themselves a justification for depriving our exporters of opportunities to compete. Certainly we recognize that these factors are important in shaping the domestic policies of our trading partners, just as they influence our own policies. Nevertheless, we and our partners share an interest in supporting certain "rules of the game" for international trade. These rules, best summarized in the General Agreement on Tariffs and Trade (GATT), reflect a consensus that despite national differences, our interests are best served by following some internationally-agreed norms for trade conduct. Those norms are squarely based on the notion of balanced competitive opportunities.

In dealing with Japan or our other trade partners we must insist on mutually beneficial opportunities to trade. Neither cultural differences nor other factors ought to be accepted as a justification for abandoning our right to a balance of advantages in our trade relationship.

Question 12. I think that we've established that we're creating some real "losers" in this economy because of the too strong dollar. As I mentioned in my opening statement, I'm particularly concerned about stripping Ex-Im Bank of its ability to finance exports. It strikes me that we've not only made losers out of winners, but then we're withdrawing their "safety net." Did you participate in the decision to strip Ex-Im Bank of its financing capability? Was this a decision you supported? How are you going to go over to the OECD and tell our allies that we insist that they stop subsidizing exports, when we can't even threaten them with subsidies of our own?

Answer. I agree, in general, with the points that you and others have made with reference to the past importance of the Export-Import Bank in promoting U.S. jobs through exports and blocking the adverse effects of foreign official subsidized credits on the competitive position of our exporters into third country markets. However, the current record U.S. trade deficit, as I know you recognize, was not caused by lack of subsidized export financing and cannot be cured simply by the maintenance of the Bank's direct credit program. Certainly, the strong dollar, in part resulting from relatively high domestic interest rates, and the upswing in economic growth have had a much more powerful impact upon our trade balance.

In order to reduce the federal budget deficit, the President has proposed that access to government loans be sharply curtailed across the board, and not just by exporters using the direct credit facility of the Bank. The proposal which has been made would also not affect the Bank's loan guarantee and insurance programs which would be expanded, nor would the changes go into effect before fiscal year 1986 with the approval of the Congress. During the remaining nine months of fiscal year 1985, $3.8 billion will remain authorized for the Bank's use. In addition, it has been proposed as a supplement to guarantees and insurance that the Bank also subsidize interest rates on some loans originating from private financial entities by setting aside $136 million of "I-MATCH", an interest buy-down program. This program, if authorized by the Congress, would help keep U.S. exporters competitive with foreign sellers, who have access to export financing in accordance with minimum rates established by the existing arrangement on official export financing under the auspices of the Organization for Economic Cooperation and Development.

Since this program, as currently envisioned, could not be used to match mixed credits or tied aid, alternatives that would allow the United States to compete in this area are also under consideration. In my view, the U.S. threat to compete or retaliate against mixed credits and tied aid must be credible to produce improved discipline in the OECD arrangement.

Response of Hon. William E. Brock to Additional Written Questions Posed by Representative Hamilton

Question 1. U.S. rhetoric continues to place a great deal of emphasis on the GATT as a set of rules and system for governing multilateral trade. Yet, the United States is as big an offender as anyone in terms of violating, or at least sidestepping, GATT rules to protect certain domestic industries. The auto VRA is an obvious case in point.

What is the continued relevance of the GATT system to the current trade environment and practices?

Answer. The international trading system has evolved considerably since the GATT's inception in 1948. The problems which confront the trading system today are far more complex and far more difficult to resolve. The number of GATT member countries has grown from 23 to 90, and their respective trade interests have become increasingly diverse. Despite these changes in the international trading system, the fundamental precepts embodied in the GATT—nondiscriminatory treatment and liberal access to foreign markets—remain relevant today.

The GATT continues to provide the basic set of rules for the conduct of international trade. However, this set of rules needs to be strengthened and expanded in order for the GATT to continue to provide an effective framework for trade in the coming decades. No other alternative framework for trade exists; if the GATT system is allowed to deteriorate, the considerable degree of trade liberalization which has been achieved over the past thirty five years will quickly unravel.

Question 2. Does the U.S., like other countries, pay lip service to the GATT but go its own way when it feels domestic economic interests are threatened?

Answer. No. I think that the record of the United States in safeguarding the legitimate economic interests of its domestic industries while keeping within the bounds of its GATT obligations is quite good. The GATT allows contracting parties to impose import restrictions on an emergency basis, in those relatively few instances in which import competition presents a serious threat to the continued viability of a domestic industry. The Administration has sought to limit the provision of import relief to domestic industries in such circumstances. In those instances, the domestic procedures used have been highly transparent and, with only a few exceptions, the measures selected have been imposed on a nondiscriminatory basis and phased out over a set time period. These measures have been notified to GATT and subject to review and consultation.

Considerable concern has been expressed about the debilitating impact on the GATT system of the increased reliance on so-called grey area measures, such as voluntary restraint arrangements. Although this concern is well founded, it has not always been possible to avoid the use of such measures. However, in those relatively few instances in which they have been used, the United States has complied with its obligation under GATT to notify them promptly.

Question 3. If the Administration still believes in the GATT, what is it proposing in terms of fundamental reforms to make it a more effective governing body for global trade?

Answer. The Administration is convinced that the most effective way of improving and strengthening the GATT system is through the initiation of a new round of multilateral trade negotiations. For more than a year, we have been working to develop a domestic and international consensus in support of a new round of negotiations. Most of our developed trading partners, and some developing ones now favor this idea. It is our hope that agreement soon will be reached to launch negotiations in the coming year.

The United States has proposed that several key areas be included in a new round of negotiations. These include strengthening the current rules for trade in agriculture, existing discipline over safeguards actions, and improving the functioning of the GATT's dispute settlement mechanism. In addition, the United State has suggested that rules be negotiated to cover new areas of increasing importance, such as trade in services, trade in high technology goods, and the problems presented by inadequate protection of intellectual property rights.

It is important to keep in mind that the GATT is a contractual agreement among states; it is a set of rules and obligations which are assumed voluntarily by contracting parties. We can work with our trading partners to imporve and strengthen the GATT's rules, but our collective efforts will not produce the desired results—a more effective GATT trading system—unless all GATT members, including the United States, agree to abide by those rules.

Question 4. What elements of our domestic trade policymaking authority are we willing to foresake in the interest of a stronger, more effective multilateral body?

Answer. I do not believe that it is necessary for us to sacrifice any particular element of our existing domestic trade policymaking authority in order to bring about a stronger, more effective multilateral trading system. What we must do is ensure that we use our existing trade policymaking authority in a manner which is consistent with our obligations under GATT. In recent years, this has not always been an easy task. Nevertheless, despite the difficult economic and political context in which our trade policy has been formulated, we have been largely successful in resisting the temptation to impose protective measures, such as domestic content legislation, which are both inconsistent with our GATT obligations and self-defeating in purpose. The coming months will bring new pressures for the imposition of protectionist measures—an import surcharge, more stringent quotas on textiles, etc. We must resist these pressures and encourage our trading partners to resist them as well.

THE 1985 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 26, 1985

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

The committee met, pursuant to recess, at 10 a.m., in room 2257, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Hamilton, and Snowe.

Also present: Charles H. Bradford, assistant director; and William R. Buechner, Christopher J. Frenze, Kent Hughes, and Paul Manchester, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. If we could begin this morning I'm very pleased to have with us two of the Nation's eminent economists, Mr. Alan Greenspan and Mr. George Perry.

Mr. Greenspan, as everyone knows, served as Chairman of President Ford's Council of Economic Advisers and he's currently head of Townsend-Greenspan, an economic consultant firm in New York.

Mr. Perry is a much-published senior fellow at the Brookings Institution.

Both Mr. Greenspan and Mr. Perry are well known for their economic forecasts. As I think is generally recognized, 1984 has been a pretty good economic year for most of the economy and the outlook for 1985 also appears to be bright. I understand that both of you are in basic agreement with the administration's 4 percent growth forecast for 1985.

It's been a strong recovery so far and we are hoping and looking forward to more in 1985 but there are still many short- and long-term concerns about the direction of the economy.

The continuing rise of the dollar in the international exchange markets is especially troubling. The dollar has been pushing steadily upward as we see every day in the news accounts, pushed up by inflow of foreign capital needed to offset the Federal deficit. The overvalued dollar is creating a new kind of industrial policy, albeit an inadvertent one. Instead of consciously picking winners and losers, the overvalued dollar seems to be turning many of our industrial winners into economic losers.

Some economic experts estimate that the dollar may be overvalued by as much as 30 percent, in effect acting like a 30-percent tax on every product that we compete to sell overseas. Few products that I know of can withstand that kind of handicap long term, especially when competition is strong and getting stronger.

Our growing dependence on foreign capital clearly comes at a serious economic cost both present and future and, on the other hand, if foreign investors were to sharply reduce the amount of capital they invest in the United States the dollar could fall and the cost of imports could rise with the cost of domestic goods to compete with those imports.

The flow of savings for domestic investment would shrink and interest rates would rise and investment in new plant and equipment could fall.

It seems to me at least that our unwillingness to pay for today's spending with today's revenues has forced us into a serious dilemma. If we do without the foreign savings, we risk more inflation and less investment. If we continue to rely on foreign investment, we are risking the loss of markets on a long-term basis which really ought to be ours. There are other potential problems as well.

In your prepared statement, Mr. Perry, you spell out the economic cost of escalating interest payments. You made a similar point, Mr. Greenspan, in your testimony before the Senate Budget Committee in the last week. In your separate forecasts, as I understand them, while basically agreeing with the administration's projections short term, you both raise some questions about the optimism of longer range projections of the administration.

Mr. Greenspan, I understand according to Business Week that you have beaten Gerry Ferraro to the airways with your commercials on the Apple II computer. There are no television cameras here this morning but maybe you can exercise that same magic with the pencil media. Why don't you lead off and we can have Mr. Perry follow.

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

Mr. GREENSPAN. Thank you, Mr. Chairman. I prefer to answer that by saying we assume that she was a copycat.

While the preponderance of evidence suggests a fairly buoyant pattern of economic activity in the months immediately ahead, deep shadows hover over the longer term outlook. The recent pause in economic growth was a seemingly natural aftermath of the solid pattern of expansion during the first 2 years of recovery. This slowdown appears to be over, and a quickening pace of activity apparently is developing.

The improving outlook continues in the face of extraordinary strength of the U.S. dollar on foreign exchange markets. By creating price advantages for foreign-produced goods, the strong dollar has significantly increased the average share of imports to domestic demand in recent quarters. It has also diverted U.S. purchasing power to foreign producers and, at least in the simple first approximation, cost American production and jobs. But that first approximation is far from the whole story, however. The heavy demand for U.S. dollars has also left interest rates lower than they otherwise would have been and has clearly contributed to a lower rate of inflation. These in turn have lowered the sense of instability and risk associated with capital investment. It is thus unclear, on balance, how much of a job loss, if any, the strong dollar has produced.

What it has produced, without question, is a pattern of economic activity which is unique to the post World War II period and, perhaps, for a good deal of U.S. history before that. For the first time in many generations, our domestic output and employment are being significantly impacted by events which originate outside our borders.

The impact of international trends was particularly pronounced last year. The tremendous expansion in consumer expenditures, which was triggered by pent-up demand in the summer of 1983, was finally exhausted by the summer of 1984. This inevitably brought with it a slowdown in economic growth. Growth in domestic purchases in real terms, that is gross national product minus net exports, slowed from a near 9 percent annual rate for the first six quarters of this recovery to a less than 6 percent annual rate in the third quarter of 1984. But the growth rate in domestic production, that is the gross national product, fell from 7 percent to less than 2 percent annually over the comparable periods. The additional slowing of GNP growth was a reflection of a greater volume share of imported goods presumably ordered earlier in 1984—arriving on our shores in time to displace a significant amount of domestic supply, production, and employment last summer.

The marked slowing in production, coupled with the weakness in dollar-denominated international commodity prices, also created a major squeeze on profit margins which, in conjunction with the dollar translation of foreign affiliate earnings of U.S. corporations, brought the rapid acceleration of profits in the first half of 1984 to an abrupt halt by the summer. Whereas after tax corporate profits during the first quarter of 1984 were a staggering 47 percent over the first quarter of 1983, it looks as though the current quarter's level of earnings will come in below those of a year ago.

All of this created a tendency on the part of American business to adopt a somewhat defensive posture. The result was a dramatic contraction in purchases for inventory, and a sharp decline in the average lead time on the deliveries of materials from basic suppliers. In fact, with production materials being quoted with a lead time of only 50 days in December 1984, purchasing patterns were back to their levels of the beginning of the 1983 recovery. This is an extraordinary phenomenon since a more typical pattern is one of considerable tightening of supply 2 years into a business recovery, prompting slowed deliveries, spot shortages, and rising commodity prices. Whatever one may say about the end of 1984, it was characteristic more of the beginning of a business recovery than its later stages.

The reason why the late 1984 pause in economic activity did not degenerate into another recession is that inventories remained exceptionally low by historical standards and capital investment was expanding. The period was scarcely describable in terms of an unsustainable boom, nor were there the clear credit stringencies which typically predate the beginnings of a recession. Thus it was just a matter of time before the reduction of commitments—the fall in new orders, the weakness in commodity prices, and the general compression in the timeframe of business decisionmaking—would run out of room to contract. The normal forces of economic expansion would then reassert themselves and, indeed, this appears to be what is currently in progress. Real GNP growth through the first half of the current quarter seems to be tracking at something in excess of a 4 percent annual growth rate. This implies continuation of the moderate inventory accumulation rate which is now apparently underway. If the inventory pace should accelerate, it is quite possible to get a much higher, say 6 percent, GNP growth rate for the current quarter.

Accordingly, the near-term outlook is fairly optimistic. The lack of imbalances suggests that normal economic growth will take hold and carry us until imbalances are created. While the next 12 to 18 months seem reasonably secure, a number of unexpected events could derail the recovery. The first is the possibility of an excessive surge of demand built on large inventory accumulation leading to credit stringency and, eventually, a recession produced by a standard financial crunch. This does not seem particularly likely at the moment, especially since the tremendous pulling back of commitments to a near hand-to-mouth basis is reflective of a virtual elimination of inflationary expectations in the short term. There is apparently little reason to accumulate inventories for potential capital gains.

More likely is an eventual weakening of the dollar, which could develop into a speculative downturn in the exchange rate. This would, in turn, push short-term interest rates higher and stifle further economic growth. It is difficult to assess the probability of this occurring in the short term, despite the indications that the current exchange rate, now probably close to 30 percent over purchasing power parities, is being driven by dollar demands which are unlikely to be sustained indefinitely.

What this implies is that there is a very significant amount of capital flowing into the United States net on balance and if one endeavors to track the reasons why the capital flow is so strong, it is necessary to look at the various segments of capital flow demand which in effect is what is keeping the exchange rate so much above the so-called transaction purchasing power parity levels. It is not significant shifts in the balances of U.S. dollars in the Eurocurrency market. That did occur through the early 1980's when the dollar continued to rise adjusted for exchange rate changes as a share of total holdings of currencies in the Euromarkets.

Neither is it the extraordinarily large flow of capital directly into the United States currently underway. It is certainly the case that these numbers have mounted up very significantly, but since 1982 the rate of flow of moneys into the United States from abroad have remained relatively constant. The numbers are very large but they have not increased from the $80 to $90 billion annual rate level.

The major force of capital flow which is affecting the exchange rate in a positive direction currently is the result of the portfolio adjustments not of foreigners but of U.S. residents.

In 1982, actual accumulation of foreign assets by U.S. residents was in excess of $110 billion, largely the result of U.S. commercial banks extending loans abroad either directly to lenders, mainly in

Latin America, but also substantially to Europe through their branches.

With the unfortunate debacle in the international credit markets following the near default of Mexico, there was a major pulling back of extensions of credit in the commercial banking system, and what this did was to create a major decline in effect in American purchases of foreign currencies with U.S. dollars because ultimately when we lend money abroad in dollars it is converted into the local currencies and used. That quantity fell very dramatically and by mid-1984 it was virtually unchanged, meaning the rate of flow was zero, and as far as we can judge in the second half of 1984 there has actually been a net liquidation of commercial bank loans of U.S. banks abroad. That is, I might add, a contraction both of loans to the less developed nations and a significant retrenchment of the flow of parent company capital to branches and affiliates of American banks abroad.

There is very little that one can say with respect to when the dollar will eventually peak out. That it must is fairly clear from the evidence. At some point, the rate of demand for U.S. dollars must fall if for no other reason than it has to be maintained at this very large rate consistent with the net capital inflow, a little over $100 billion, to keep the exchange rate where it is. If the capital flow falls from say $100 billion to $70 billion, which is still a very large amount of moneys flowing in, in principle, the exchange rate must fall back toward purchasing power parities.

At the moment, there is no evidence in the markets to suggest that we are looking at the termination of the rise, but eventually it must occur and the key question really relates to the issue of what happens when that process of adjustment occurs because it's fairly obvious that one of the reasons why we have this very large Federal budget deficit out there and a seeming tranquility in the financial markets is that to a substantial extent the pressures that would ordinarily occur in these markets as a consequence of very heavy Treasury borrowings are in effect being absorbed by the dramatic increase in the amount of foreign savings flowing into the United States.

Another factor which has not been well advertised is that even though private capital investment is very large in this country as a percent of the GNP, the net investment is not. By that, I mean we have a very large amount of depreciation occurring concurrently with this capital investment and so the net increase in our capital stock is only modest by any historical measure.

What this in effect is saying is that the very high cost of capital has tended to suppress the average economic life of the types of things we're investing in and as a consequence of that we are looking at very large depreciation charges, not because of the change in the Tax Code so much but mainly because of the shift in composition of the types of assets in which we are investing. Both of these factors are temporary.

The more important question, however, is on the international side.

Mr. Chairman, I have a good deal to say on the Federal budget deficit and the like, but having glanced through George Perry's paper, there's probably more duplication than supplement, so I will just terminate my remarks and comment on George's remarks, if any.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF ALAN GREENSPAN*

While the preponderance of evidence suggests a fairly buoyant pattern of economic activity in the months immediately ahead, deep shadows hover over the longer term outlook. The recent pause in economic growth was a seemingly natural aftermath of the solid pattern of expansion during the first two years of recovery. This slowdown appears to be over, and a quickening pace of activity apparently is developing.

The improving outlook continues in the face of extraordinary strength of the U.S. dollar on foreign exchange markets. By creating price advantages for foreign-produced goods, the strong dollar has significantly increased the average share of imports to domestic demand in recent quarters. It has also diverted U.S. purchasing power to foreign producers and, at least in the simple first approximation, cost American production and jobs. But that first approximation is far from the whole story, however. The heavy demand for U.S. dollars has also left interest rates lower than they otherwise would have been and has clearly contributed to a lower rate of inflation. These in turn have lowered the sense of instability and risk associated with capital investment. It is thus unclear, on balance, how much of a job loss, if any, the strong dollar has produced.

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*Dr. Greenspan is President of Townsend-Greenspan & Co., Inc.

being significantly impacted by events which originate outside our borders.

The impact of international trends was particularly pronounced last year. The tremendous expansion in consumer expenditures, which was triggered by pent-up demand in the summer of 1983, was finally exhausted by the summer of 1984. This inevitably brought with it a slowdown in economic growth. Growth in domestic purchases in real terms, that is gross national product minus net exports, slowed from a near 9% annual rate for the first six quarters of this recovery to a less than 6% annual rate in the third quarter of 1984. But the growth rate in domestic production, that is the gross national product, fell from 7% to less than 2% annually over the comparable periods. The additional slowing of GNP growth was a reflection of a greater volume share of imported goods -- presumably ordered earlier in 1984 -- arriving on our shores in time to displace a significant amount of domestic supply, production, and employment last summer.

The marked slowing in production, coupled with the weakness in dollar-denominated international commodity prices, also created a major squeeze on profit margins which, in conjunction with the dollar translation of foreign affiliate earnings of U.S. corporations, brought the rapid acceleration of profits in the first half of 1984 to an abrupt halt by the summer. Whereas after tax corporate profits during the first quarter of 1984 were a staggering 47% over the first quarter of 1983 it looks as though the current quarter's level of earnings will come in below those of a year ago. All of this created a tendency on the part of American business to adopt a somewhat defensive posture. The result was a dramatic contraction in purchases for inventory, and a sharp decline in the average lead time on the deliveries of materials from basic suppliers. In fact, with production materials being quoted with a lead time of only 50 days in December of 1984, purchasing patterns were back to their levels of the beginning of the 1983 recovery. This is an extraordinary phenomenon since a more typical pattern is one of considerable tightening of supply two years into a business recovery, prompting slowed deliveries, spot shortages, and rising commodity prices. Whatever one may say about the end of 1984, it was characteristic more of the beginning of a business recovery than its later stages.

The reason why the late 1984 pause in economic activity did not degenerate into another recession is that inventories remained exceptionally low by historical standards and capital investment was expanding. The period was scarcely describable in terms of an unsustainable boom, nor were there the clear credit stringencies which typically predate the beginnings of a recession. Thus it was just a matter of time before the reduction of commitments -- the fall in new orders, the weakness in commodity prices, and the general compression in the timeframe of business decision-making -- would run out of room to contract. The normal forces of economic expansion would then reassert themselves and, indeed, this appears to be what is currently in progress. Real GNP growth through the first half of the current quarter seems to be tracking at something in excess of a 4% annual growth rate. This implies continuation of the moderate inventory accumulation rate which is now apparently underway. If the inventory pace should accelerate, it is quite possible to get a much higher, say 6%, GNP growth rate for the current quarter.

Accordingly, the near-term outlook is fairly optimistic. The lack of imbalances suggests that normal economic growth will take hold and carry us until imbalances are created. While the next 12 to 18 months seem reasonably secure, a number of unexpected events could derail the recovery. The first is the possibility of an excessive surge of demand built on large inventory accumulation leading to credit stringency and, eventually, a recession produced by a standard financial crunch. This does not seem particularly likely at the moment, especially since the tremendous pulling back of commitments to a near hand-to-mouth basis is reflective of a virtual elimination of inflationary expectations in the short term. There is apparently little reason to accumulate inventories for potential capital gains.

More likely is an eventual weakening of the dollar, which could develop into a speculative downturn in the exchange rate. This would, in turn, push short-term interest rates higher and stifle further economic growth. It is difficult to assess the probability of this occurring in the short-term, despite the indications that the current exchange rate, now probably close to 30% over purchasing power parities, is being driven by dollar demands which are unlikely to be sustained indefinitely.

The deepest shadow which crosses our otherwise benevolent economic scenario is cast by the structural budget deficit. Unless the laws of arithmetic are repealed, interest cost accumulation on top of $200 billion plus deficits must inevitably crowd out private investment and economic growth. However, it is not a short-term problem. Temporary market adjustments might fend it off for several years, but the process of deterioration is inexorable.

While the strategic purpose of reducing the deficit is to prevent long-term excessive absorption of private savings and a crowding out of private investment, the short-term tactical purpose is to create, in law, a fiscal policy which the financial markets perceive as sufficiently credible to drive long-term interest rates down. There is no need for a pact with the Federal Reserve stipulating that, if Congress reduces the deficit, the Fed will ease money supply. The markets work very efficiently by themselves. If the average cynical bond trader begins to perceive that indeed a budget reduction package is not phoney, the desire to turn a profit can be counted on to drive bond prices sharply higher and long-term interest rates correspondingly lower.

There is clearly a difference, however, in the way bond traders and other participants in the world markets view a reduction in the deficit. A deficit reduction package which is heavily weighted toward tax increases is less likely to induce a marked decline in interest rates than one heavily or solely weighted in the direction of expenditure cuts. There is the strong presumption in the financial community that an increase in tax rates could just as easily become the base for increased expenditure programs, as for reducing the deficit. The argument that the Congress has not in the past employed tax increases to finance increased expenditures is apparently unpersuasive to the financial community. The past is likely to tell us little about the future behavior of the Congress when confronted with pressures from constituencies.

It is true that Presidents and the Congress continuously cut tax rates through the 1970s as inflation pushed most taxpayers into progressively higher tax brackets. Hence, federal receipts as a percent of the GNP or of taxable incomes has remained relatively steady during the past couple of decades. It is argued, therefore, that increased tax receipts have not been the basis for financing new outlay programs. The critical consideration, however, is spending, which rose as a ratio to GNP, increasing the structural deficit. Unless the upward pressure on spending is reduced, tax increases will eventually be triggered, since deficits can't increase indefinitely. In that event, taxes are supporting increased spending programs, albeit with a time lag.

There is also clearly a difference in the way markets will react to the mix of federal budget cuts between defense and entitlement programs. Leaving the politics of entitlements and the very serious question of defense adequacy aside, so far as the economy is concerned, does it make any difference where the cuts are made?

The short answer is that it does. Entitlements: social security, Medicare, civil service, military retirement, etc., depend to a significant extent on population growth, especially among the elderly. As the base of expenditures expands, reflecting the growth in population, changes in the law today have a much larger impact on outlays ten years from now than they do, say, three years from now.

Defense, however, is another matter. A goodly part of defense expenditures are involved in building up our military asset base. Once we reach the requisite number of F-16 wings, carrier task forces, ammunition stores, etc., procurement outlays will fall back to maintainance levels, which are significantly lower in real terms than the huge budget outlays required during the period of military build-up. Hence, cuts in defense over the next three years are not translatable, as they are in entitlement programs, into very much larger cuts in the years 1990 and beyond.

Accordingly, the financial markets are surely likely to credit, on a dollar for dollar basis, short run cuts in entitlement programs with far more long-term anti-inflation impact than equivalent cuts in defense outlays.

There can be little doubt that the markets do not expect expenditure cuts ranging up to $100 billion or more annually by fiscal 1988. Should they actually occur, or of more relevance should they be enacted into law currently, in a manner which is credible to the financial community, long-term interest rates are likely to fall by at least 2 full percentage points with short-term rates falling even more. Thus, even the sharp reduction in purchasing power implied by such a major contraction of the federal deficits, i.e. so-called fiscal drag, would surely be overridden by increases in effective demand generated by the marked decline in interest rates, and cost of capital.

Most immediately, homebuilding would rise quite significantly, increasing from recent levels of 1.7 million housing starts annually to well in excess of 2 million and perhaps as high as 2.2 million units annually, at least for awhile. But the more important and lasting impact would occur in the capital goods markets. The exceptionally high cost of capital which has prevailed in recent years has led to a disproportionate emphasis in investment in short-lived assets, i.e., those with quick cash payoffs. Lowered long-term interest rates would surely propel stock prices higher, and lower the cost of equity capital. The combination of lowered costs of equity and debt would increase the incentive to invest in plant and other long-lived goods. Considering the pent-up demand for long lived investments at lower costs of capital, the expansion could go on for years. This would be especially helpful to those depressed areas of the American economy which build long-lived facilities or the materials which go into them -- steel, heavy equipment, etc.

The reason it is important to address the budget deficit issue now rather than await the accumulation of interest, larger deficits, and more difficult periods of political and economic adjustment is that there is an underlying bias in our political system toward higher spending. Faced with nothing more than rhetorical concern, structural deficits would creep progressively higher.

It may be a cliche, but it is also an important political principle. A particular subsidy or tax preference may be something which the nation has gotten along without for a couple of hundred years and, seemingly, could do without for another couple of hundred years. Once a subsidy or preference becomes part of our budget and Internal Revenue code, however, a constituency forms around it, nurturing it, supporting it, and implicitly threatening dire electoral consequences to the nonsupportive. Most importantly, the combined cost to the rest of the electorate is sufficiently diffuse and unfocused that the value placed on the benefit by the select few appears to exceed in units of political pressure, the cost to the remainder of the electorate. This is especially the case when the benefits or tax preferences are funded through borrowing where the cost, i.e., the potential inflationary consequences, is delayed, while the benefit is perceived as being received immediately.

I am, of course, merely describing the political process of which we have all become acutely aware in the last couple of generations. We take it for granted and perceive it as an intergral part of our democratic process. It is, in fact, a dangerous underlying bias in our system which threatens our democratic processes if not appropriately addressed. It was not an issue in the first 150 years of our republic because government was not perceived of as a redistributer of income and a creator of benefits through the fiscal system. Activist, redistributive, fiscal policy, has been with us only for the past half century but its effect has been cumulative.

Thus, while it is crucial to address the current budget problems and restore fiscal balance to our system, we should remember that we are only fighting the symptoms of a far more deep seated problem. It is essential to look beyond the short-term and into the structure of the system which created the problem, and which has been endemic in a world where central banks' money creation capacity is no longer even constrained by the supply of paper.

While I subscribe to the principal of a balanced budget amendment with tax increase constraints, I believe that the expenditure process cannot be effectively stopped after constituencies have been formed and the corrosive effect of a whole series of seemingly costless benefits control the budget.

I believe as I have previously testified before this body, that to offset the bias in our political system, it is necessary to place in the constitution a super-majority requirement for the passage of any money bill or authorization or entitlement to a claim on federal revenues. If, for example, we required a three fifths majority of both Houses to pass any claim on federal tax revenues we would surely screen out a number of those programs perceived to be marginally desirable by the Congress and allow through only those which are of unquestioned priority to the nation. I suspect that even though such a change does not directly relate to balancing the budget, it will surely do so. This is especially likely if, appended to a three fifths majority vote requirement, is mandatory sunset legislation which requires all programs with a claim on federal finances to undergo reauthorization every five to ten years.

Sunset legislation stresses the importance of completely eliminating programs and, hence, their constituencies. Although sharp reductions in individual programs might seem to create large long-term fiscal savings, it is usually tantamount to cutting off a weed at the root. The weed seems to be gone, but it is merely awaiting a more favorable environment to sprout and grow even larger.

In summary, the payoff in economic well being for this nation from defusing our chronic budgetary problems is so large relative to the short-term welfare and political costs, that it is inconceivable we will choose to trace a different course.

Representative OBEY. Thank you, Mr. Greenspan. Mr. Perry, please proceed.

STATEMENT OF GEORGE L. PERRY,[1] SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. PERRY. Well, Mr. Chairman and members of the committee, I have arranged my remarks to address the economic outlook and several issues relating to our budget deficit.

THE NEAR-TERM ECONOMIC OUTLOOK

The outlook for overall economic developments in 1985 is good. I expect real GNP will expand a little more than 4 percent for the year and inflation will remain under 4 percent. This rate of expansion will be fast enough to push the unemployment rate below 7 percent in the second half of 1985 and overall profits will rise by about 10 percent. Thus the year will see generally improving prosperity for most firms and employees. In this regard, the forecasts from the administration appear to me, if anything, to be a shade too pessimistic about near-term prospects for the economy. With the chairman's permission, I would like to submit for the printed record a copy of a bank letter prepared by myself and Walter W. Heller for the National City Bank of Minneapolis which spells out my view of the near-term econmic outlook in considerably more detail.

NEAR- AND MEDIUM-TERM PROBLEMS

The deep and protracted recession that ended in the fourth quarter of 1982 provided the basis for both the substantial ratcheting down of inflation and the extended economic expansion that we are now experiencing. But these good near-term prospects hardly mean that all is right with our economy or our economic policies. The historically large and rising structural budget deficit with which we came out of the recession has created imbalances, costs and risks that detract from the near-term overall prosperity we are enjoying.

Even as overall economic expansion continues in 1985, the depression in agriculture deepens. The overvalued dollar that our deficits have helped create are causing a vast erosion in our normal markets for agricultural goods. The problems of farmers, in turn, are jeopardizing the banks that have been lending to them, and those problems are crippling production and employment in the industries that supply them with equipment.

While the plight of the agricultural sector in the face of today's dollar is the most visible, many manufacturing firms are in a similar position because of competition from abroad. As an example, nearly two-thirds of last year's big increase in business purchases of nonautomotive capital goods was supplied by rising imports rather than by domestic suppliers.

The distortions between present and future financial burdens are also serious. Whatever levels of budget spending and deficit or sur-

[1] The views set forth here are solely those of the author and do not necessarily represent the opinions of the trustees, officers, or other staff members of the Brookings Institution.

plus we ultimately operate with in future years, the burden on taxpayers will be substantially larger because of the oversize deficits we have been running during the past few years. Compared to what they would have been if interest expenses in the budget had stayed at their 1980 fraction of GNP, tax revenues will have to be $112 billion higher in 1990 to cover interest expenses projected for the current services budget by CBO.

Federal budget deficits reduce the amount of domestic saving available for private investment. In a closed economy, historically large deficits would lead to historically high real interest rates in order for total saving and investment to balance. In our open economy, because net foreign investment into the United States has risen rapidly, interest rates are not nearly as high today as they would otherwise be. This development, in turn, has defused the deficit issue politically. But although net foreign investment, which is projected to be about $100 billion in 1985, may have made it easier to live with our deficits in the short run, it has costs and dangers that should be recognized.

The obvious cost is that net foreign investment earns a return that must be paid for out of our national income. Our international trade and service deficit is not a gift of consumption from foreigners; it is a loan out of which we are presently consuming more than we produce. To put this in perspective, I estimate that net U.S. fixed business investment will total $233 billion in 1984 and 1985. In these same 2 years, net investment by foreigners will total $166 billion, or 71 percent as much as our net fixed business investment. Because the returns earned by foreign investment should not be expected to differ by much from the returns to investment in plant and equipment, the earnings on the net foreign investment in these years will also be about 70 percent of the earnings from our total plant and equipment investment.

The present reliance on foreign investment also carries the danger of being potentially destabilizing. If at some point investors' decisions about holding foreign assets versus dollar assets should move away from adding dollar assets at the present rate, it would put downward pressure on the dollar's exchange rate and upward pressure on our interest rates. A more competitively priced dollar would reduce the trade deficit and expand total demand here. If all this occurred with our budget deficit still very large, it would require a major increase in our interest rates and would pose a serious stabilization challenge to monetary and fiscal policy. How smoothly such a transition could be accomplished is hard to say. But the risks of recession, inflation and financial problems would all increase.

An abrupt change in exchange rates could pose a stabilization challenge even if the budget deficit has been reduced beforehand. But the transition is likely to be easier in that case because interest rates will not need to be as high; they may not have to rise at all if the exchange rate simply moves in response to changes in budgetary policy.

ON HOPING THE PROBLEM WILL VANISH

Budget projections for the middle run are necessarily uncertain. But I see no basis for using uncertainty as a reason to ignore or delay action to reduce today's projected deficits. Uncertainty means that deficits could turn out either larger or smaller than present baseline projections. Decisions should be based on likely rather than unlikely outcomes, and on consideration of the costs of being wrong in either direction.

The OMB current services projections anticipate a deficit of $224 billion in fiscal year 1990, or 3.9 percent of that year's GNP. The CBO projections have much higher deficits. Although they still leave deficits too high, the OMB projections are based on what appear to be unduly optimistic assumptions about economic performance over this interval.

Real GNP is projected to grow by 4 percent a year indefinitely. Real GNP can grow that fast or faster at present because there is still ample slack in labor and project markets. However, present evidence suggests potential GNP is growing at a rate of only 2.5 percent a year. If so, the administration's projected growth path would push the unemployment rate to 4 percent by 1990.

Lower unemployment is an important goal. But we do not know whether that unemployment rate is achievable over the next several years without reigniting inflation. If monetary policy needs to hold average real growth to 3.5 percent a year between 1984 and 1990 in order to avoid inflation, the 1990 deficit will be greater than OMB projects by $60 billion. If real growth can average only 3 percent a year, the deficit will be greater by over $120 billion.

The OMB projections assume interest rates decline steadily, to about 5 percent on Treasury bills in 1989 and 1990. There is every reason to believe that current services budget would produce interest rates much higher than this. Indeed, if the exchange value of the dollar falls in this period and the budget deficits have not been greatly reduced, interest rates are likely to rise sharply from present levels. If rates simply stay at around 8 percent, near where they are now, the 1990 deficit will be about $65 billion higher than OMB projects. If they rise well above 8 percent, the deficit will be correspondingly larger.

We can all bet on long shots and hope for unexpectedly good economic outcomes. But that is a reckless and irresponsible basis for designing budget policy. We should not hope to "grow out of" the budget problem. If we try to, we are far more likely to find the budget problem growing.

GENERAL ISSUES IN DEFICIT REDUCTION

If there is emerging agreement that structural deficits should be reduced sharply, there is apparently still no political agreement about how to do so and over what period of time. I would like to close with a few observations on these issues.

How deficit reduction should divide between cuts in different expenditure categories and increases in revenues depends mainly on social priorities rather than on any differences in economic performance that would result. The economy's inflation and growth performance will not be affected by whether we are at the low or high end of the range of Federal expenditures that might be contemplated. Public expenditures are not intrinsically more or less useful than private expenditures. Rather, they address different issues and needs of our society and economy. Therefore, individual expenditure programs should be considered on their individual merits, not on the basis of any superficial view that total spending should be above or below some arbitrary level. I know of no basis for picking such a level.

To the extent we want to encourage investment and make it more productive, we should look to reducing the overall budget deficit and to tax reforms that more nearly equalize the pretax returns on different kinds of investment. And to the extent that we prefer lower to higher marginal tax rates, which for a variety of reasons I believe we should, we should examine base-broadening tax reforms such as the Bradley-Gephardt or Treasury proposals, both of which would reduce marginal tax rates substantially.

As to when to reduce deficits, the sooner the better. The lasting legacy from the budgetary battles that started in 1981 is going to be the higher taxes needed to meet interest payments on the national debt. Under CBO's current services budget projections, by 1990 interest payments on the debt will total 3.8 percent of GNP while the primary deficit—defined as the total deficit less interest payments—will total 1.5 percent of GNP. For the 1975–79 period and in all previous decades since 1950, interest payments ranged between 1.1 and 1.3 percent of GNP, only one-third of their projected size for 1990.

This explosion in interest costs results from a combination of factors; the deep and prolonged recession, a budgetary policy that has forced interest rates to historically high levels, and a political stalemate in reducing those structural deficits. Because they are based on the current services budget, the CBO projections implicitly assume that stalemate continues. The sooner the deficits are reduced, the more benefits we will reap in lower interest costs through a combination of lower interest rates and a smaller national debt on which interest must be paid.

The main argument offered against prompt and decisive action to reduce structural deficits is that such an abrupt swing in fiscal policy could lead to recession. That fear ignores the fact that monetary policy at present has enormous scope for offsetting the loss of fiscal stimulus through lower interest rates. Both Federal Reserve policy and financial and foreign exchange markets could be expected to react to deficit reduction in a way that encouraged U.S. investment and a move toward surplus in our foreign trade balance. Thank you.

[The bank letter referred to in Mr. Perry's statement follows:]

FOR RELEASE A.M.'S, FEBRUARY 15, 1985

NATIONAL CITY BANK OF MINNEAPOLIS

February 15, 1985

U.S. ECONOMIC POLICY AND OUTLOOK

by

WALTER W. HELLER AND GEORGE L. PERRY

In our October letter, we forecast "solid expansion" for 1985, at a pace of about 3½% real growth in GNP. Since then, most of the forecasters of little faith who feared that expansion would top out this year have recanted and now see continuing growth. Still, noting that the leading indicators are lackluster, unemployment is up, new orders are down, farmers are reeling, and our trade deficit is still growing, many economists consider the White House forecast of 4.0% real growth this year as too optimistic.

We don't. On the contrary, we think it is too low. First, though the still-rising federal deficit is far too big and is piling up deep trouble for the future, the economy has enough idle labor and unused productive capacity to welcome its stimulus in 1985. Second, the likelihood of low inflation, plus concern over the pressures that high U.S. interest rates exert on foreign economies, will tend to stay the hand of the Federal Reserve. Third, our trade deficit, while setting new records, will grow more slowly this year than last, thus exerting less drag on GNP. And fourth, both consumer confidence and business confidence are still high.

True, we share the growing alarm of most economists and members of Congress over the corrosive effects of mountainous budget deficits. They leech away too much of our private savings, keep interest rates high, undermine long-term growth, and heavily mortgage our future. But most of these chickens won't come home to roost this year.

And true, we agree with the Congressional Budget Office that for the later 1980s, the White House is once again projecting too rosy a scenario, especially for 1988–90. But for 1985, we once again foresee more growth and less inflation than the Administration, just as we did in these Letters for both 1983 (by a large margin) and for 1984 (by a hair). For the third year running, then, we believe that the Administration is not optimistic enough for the current year, and overly optimistic, progressively, for the years ahead.

THE ECONOMY IN 1985

For 1985 as a whole, we expect real GNP to rise 4.2%, with current-dollar GNP totalling $3940 billion. From 4th-quarter-to-4th-quarter, this implies a rise of 4.3% in real GNP, compared with 5.6% last year.

This rate of expansion will be fast enough to push the unemployment rate below 7% in the second half of 1985. But it is not so fast that it will reignite inflation, which we expect to average about the same as in 1984, roughly 3½%, in contrast with the White House forecast of about 4%.

An analysis of expected developments in the main GNP sectors follows.

Consumption

Several things will be working against a banner year for consumers in 1985. With slower GNP growth and with tax cuts coming to an end, personal disposable income will rise about 3 points less than the spectacular 10.2% advance of 1984. Also, consumer debt has been rising relative to income. Nonetheless, dwindling fears of both recession and inflation, coupled with prospects of falling unemployment and a rising stock market, will serve to bolster consumer buying attitudes.

Lower interest rates will boost automobile sales, which should total between 11 and 11½ million units in 1985, up from 10.4 million units last year (with both figures including auto sales to business, which are counted in business investment). The overall consumer saving rate is not likely to change much from last year's 6.1%. All in all, though consumer buying won't lead the expansion this year, it should about keep pace with the rise in total GNP.

Residential Construction

Although housing starts in 1984, at nearly 1.8 million units, were somewhat above 1983, rising interest rates kept them on a declining path until late in the year:

- After reaching nearly 2 million units (annual rate) in the first quarter, housing starts slid to just over 1½ million units in the 4th quarter under the impact of rising mortgage rates, which reached a high of over 14½% on conventional mortgages last summer.
- This contributed to the economic slowdown in the second half of the year, which in turn pulled mortgage interest rates down to nearly 13% by year-end.
- This arrested the decline in housing starts late in the year.

Starts should now rise substantially above the 1½ million level, though for the year as a whole, total housing starts may not quite reach last year's level. Yet, beginning from this winter's lower levels, rising construction activity will contribute to a faster pace of overall expansion in the spring and summer months.

Business Fixed Investment

Business spending on new plant and equipment in 1985 will fall considerably short of the 21% increase of 1984. But the surge in investment, which started from levels that had been severely depressed by two consecutive years of decline, is not over. Near-term indicators suggest modest increases in investment:

- New orders for non-defense capital goods, which presage equipment purchases from domestic suppliers, ended 1984 on a weak note. Orders in the 4th quarter were the lowest of the year.
- The Commerce Department's survey of plant and equipment spending plans, taken last fall, projects a rise of 8.4% for this year, with a more rapid increase during the first half.

We believe that these indicators understate the prospects for 1985. First, because imports are accounting for a sharply rising share of capital equipment purchases, new orders have become a less reliable indicator of future spending than they were in the past. Second, such fundamentals as continued expansion of sales, lower interest rates, and an improving stock market are favorable to business investment and should lead to some step-up from the plans reflected in the fall Commerce survey. This leads us to expect a 12½% rise in business-fixed investment for all of 1985, with increases occurring steadily throughout the year.

Inventories

Inventory investment, which averaged $70 billion more in 1984 than in 1983, led to some inventory overhang by last fall. Working down that excess held down output gains in recent months. We expect less inventory building this year than last. But the working off of the inventory overhang should be largely completed this winter and should not impede the growth of output during the rest of the year.

Government Purchases

Spurred by the stepup in defense spending, federal purchases will rise about 12½% this year after a 9½% rise in 1984. State and local purchases will also rise somewhat faster than last year, advancing about 9½% against 8.8% in 1984.

Loose talk about $55 billion to $87 billion state-local surpluses over the next few years has led some observers to expect bigger advances in state-local spending. The plain fact is that the great bulk of these "surpluses" consists of monies collected from state-local employees to finance their pensions. It is distinctly not operating money to pay for local services. Recent studies show that state-local operating surpluses are running at an annual rate of less than $5 billion.

IMPORTS, EXPORTS, AND THE DOLLAR

During 1984 the dollar continued to strengthen and the trade balance continued to worsen:

- Between the end of 1983 and the end of 1984, the dollar rose 12% against the currencies of our major trading partners (weighted by their shares in world trade) to a level 71% above 1980 (not corrected for inflation).
- Last year the merchandise trade deficit grew to $107.6 billion. This covers the same trade as the widely publicized $123 billion figures but excludes such items as military sales and the cost of shipping and insurance.

- Merchandise exports rose by $20 billion, or 10%, to $220 billion (after falling nearly twice that much in the preceding three years). This rise was dwarfed by the $67 billion, or 25%, jump in imports, to $328 billion. On net balance, the trade deficit grew by $47 billion in 1984.
- When services (mainly earnings on foreign investments) are included, the rise in the trade deficit from 1983 to 1984 was even greater.

Although discussions of the ballooning U.S. trade deficit often center on Japan, Table 1 shows that it is only part, and not the biggest part, of our problem.

- Between 1980 and 1984 the U.S. trade balance worsened sharply with all major trading partners except OPEC.
- OPEC aside, trade with Japan accounted for only 23% of the total rise in the trade deficit between 1980 and 1984 and 33% between 1983 and 1984.
- Over either interval, the deterioration of our trade deficit with Western Europe was greater than that with Japan.

Table 1. Changes in U.S. Merchandise Trade by Geographic Region
(in billions)

	Imports from		Exports to		Balance	
	1980–84	1983–84	1980–84	1983–84	1980–84	1983–84
Western Europe	$ 23.7	$17.1	$ −10.7	$ 2.0	$ −34.4	$ −15.1
Japan	26.1	16.0	2.4	1.5	−23.7	−14.5
OPEC	−29.0	1.4	−7.2	−1.2	21.8	−2.6
Canada	25.8	14.3	11.9	9.7	−13.9	−4.6
Mexico	5.4	1.2	−3.2	2.9	−8.6	1.7
Other Western Hemisphere[a]	3.4	2.8	−4.8	−0.4	−8.2	−3.2
Other	22.7	13.8	7.6	5.5	−15.1	−8.3
Total	78.1	66.6	−4.0	20.0	−82.1	−46.6

a. Excluding estimated Venezuela, which is in OPEC.

Despite the overvalued dollar and our reduced competitiveness, U.S. exports to most regions leveled off or grew last year because of improving economic conditions abroad. Strong U.S. expansion, coupled with the strong dollar, accounted for the greater surge in imports from all regions.

As we turn to 1985, we can expect new records in both imports and the net export deficit, but as noted earlier, the drag on GNP will be "less worse" than it was last year:

- Because the exchange value of the dollar climbed another 12% last year and the effects on trade flows occur with a lag, we expect a further $15 billion increase in the trade deficit for 1985.
- Including services, the deficit will grow by $25 billion, primarily because of growing outflows of interest and dividends payable on last year's huge inflow of foreign investments.
- In other words, the net increase in the export deficit (which is the number that enters the GNP accounts) will be much smaller than in 1984. This will reflect both the narrowing of the differential in rates of expansion between U.S. and foreign economies and the fact that the change in U.S. inventory investment, which has a large import component, will be down rather than up this year.

The powerful impact of movements in the exchange value of the dollar is well illustrated by the history of the 1973–84 period:

- For the 10 years between 1973 and 1983 (the last year for which accurate cost comparisons are available), unit labor costs in U.S. manufacturing, after adjusting for exchange rate changes, rose 11% relative to a trade-weighted average of other major industrial nations.
- Reflecting a pronounced net drop in the value of the dollar, U.S. unit labor costs fell 14% between 1973 and 1980 but then jumped by 31% between 1980 and 1983 as the dollar's value surged.
- In 1984, as the dollar kept forging ahead, U.S. relative labor costs rose still further, worsening all these cost comparisons.

The resulting damage to American producers hit by the huge influx of low-cost imports and by the big crimp put on our exports has been extensive:

- The blow to agricultural exports ranges from substantial to devastating.
- Many manufacturing firms have also been hit hard. In particular, the 21% jump in business fixed investment in 1984 brought a lot less cheer to U.S. capital goods producers than one might think because, aside from autos and trucks, imports accounted for over 60% of the increase in capital goods investment.
- Even high-tech firms dependent on sophisticated engineering are losing markets.

Unless the dollar returns to a level more nearly consistent with relative production costs here and abroad, protectionist pressures will continue to mount. A bold attack on the federal deficit and a reduction in interest rates would be a far better way to bring the dollar back in line and improve the competitive position of U.S. agriculture and manufacturing.

PRICES, PRODUCTIVITY, AND PROFITS

The outlook for continued quiet on the inflation front remains very favorable in spite of the likelihood of declining productivity gains. As for profits, the prospect of solid expansion in sales coupled with continuing moderation in cost increases leads us to expect respectable gains in business earnings.

Prices

Prices behaved well in 1984: from year-end to year-end, consumer prices (CPI) rose 3.9%; producer prices (PPI) for finished goods rose 1.8%; the GNP deflator rose 3.5%. Continued softness in energy and food prices contributed materially to low inflation rates in 1984. As Table 2 shows, even when the more volatile factors like food and energy are removed from the inflation indexes and when wage trends are measured, we also find encouraging signs of a declining inflation trend.

Table 2. Measures of Underlying Inflation Rate

	Year ending				
	1980:4	1981:4	1982:4	1983:4	1984:4
CPI less food, energy, shelter and used cars	9.6%	8.7%	6.1%	4.1%	4.2%
PCE deflator[a] less food and energy	9.7	8.8	6.4	4.5	4.6
PPI less food and energy	10.8	7.6	4.9	2.1	2.2
Average hourly earnings index[b]	9.6	8.4	6.0	3.9	3.0
Employment cost index[c]	9.8	9.8	6.4	5.7	4.9

a. The GNP deflator for personal consumption expenditures
b. Earnings, production workers
c. Average hourly compensation, all private workers

The table brings out several major characteristics of basic price behavior in the 1980–84 period:

- The inflation slowdown since 1980 ranges from 5 to 6½ percentage points in all measures except the volatile producer price index, which dropped 8½ points.
- After falling sharply from 1980 to 1982, the 3 price measures in the table changed very little from 1983 to 1984.
- However, the two measures of hourly labor costs decelerated further, by nearly one percentage point, in 1984.
- From 1983 to 1984, the employment cost index rose noticeably faster than the hourly earnings index, for two major reasons: first, white collar wages and salaries rose faster than blue collar wages; second, fringe costs rose faster than earnings for both groups.

The ratcheting down of inflation that occurred in 1982 as the great recession deepened and lengthened is still being felt in the economy, especially in labor markets. Weak energy prices, slow recoveries abroad, and intense pressures from imports are also holding prices down. With these forces still effective throughout most of 1985, we expect price inflation, by most measures, to average about 3½% for the year.

Productivity

Although productivity growth has improved briskly during this expansion, there is still no convincing evidence that the improvement is more than cyclical. Surprisingly, a comparison of the last three expansions through their first 8 quarters reveals that productivity advances in the non-farm business sector are lagging this time around:

Trough quarter	GNP gain	Productivity gain
1970:4	12.0%	8.7%
1975:1	11.4	7.5
1982:4	12.3	6.2

Productivity gains always outstrip their trend increase in the early stages of recovery as fuller use is made of relatively fixed-cost factors like plant, equipment, and the white collar labor force. Also, generally speaking, the faster the expansion in output, the faster the rise in productivity growth. Therefore, the difference between a 6.2% productivity gain in this expansion and the larger gains in the two previous ones probably reflects an even larger difference in the underlying productivity trends. This is especially disappointing in light of expectations that a maturing labor force coupled with an apparent high rate of innovation, technological advance, and new investment, would boost productivity faster than in the late-70s. While such improvement may yet appear, there is little or no sign of it today. So in 1985, with expansion maturing and output growth slowing down, a productivity advance of more than 2% does not seem to be in the cards.

Profits

Last year's rise in aggregate profits was held down by foreign competition, weakness in the oil and financial industries, and the adverse impact of the strong dollar on earnings from foreign operations. This year, these negatives will be less important. But at the same time, output gains will be smaller. Netting out these opposing forces, we expect continued expansion in 1985 to boost after-tax profits by approximately 9%.

However, as pointed out in our October letter, when we adjust profits for the excess of book (accelerated) depreciation over economic (replacement-cost) depreciation and remove capital gains or losses on inventories (the "inventory valuation adjustment"), the picture is a good deal brighter. The resulting "economic profits"—a better measure of the underlying strength of business profits—will rise nearly 15%. The recent rise in the stock market seems to reflect a growing recognition that on the basis of expected economic profits, price-earnings ratios are still very low.

MONETARY POLICY

Last year, the Federal Reserve leaned against the rapid economic expansion in the first half of the year and then as the economy slowed, permitted and perhaps encouraged interest rates to fall in the second half. The Fed's main concern has been to stabilize the rate of GNP growth rather than to keep various measures of the money supply rigidly within their target bands. This year again, one should expect that controlling the monetary aggregates, which are already above their presumed target ranges, will not be allowed to dominate Fed policy making.

In addition to its concern for domestic economic performance, the Federal Reserve is likely to put increased weight on holding interest rates in check to help keep the dollar out of the stratosphere, to ease somewhat the burdens of Third World debtors, and to promote expansion abroad by facilitating lower interest rates in other countries. These considerations should moderate any tendency for rates to rise even if the expansion quickens in coming months as we project. Nonetheless, by next summer, especially if resolute action on the federal deficit is not forthcoming, short-term interest rates may well rise.

Bond markets will parallel these developments in short-term rates until the budget picture is clarified. If substantial progress is made toward cutting the deficits in fiscal 1986 and beyond, the interest rate outlook will brighten and bonds will rally further.

BUDGET POLICY

In these Letters, we have underscored the dangers and damages to our economic future inherent in the mountainous deficits generated by coupling the biggest tax cut in history with the biggest peacetime defense buildup in our history. To be sure, we have noted that the deficits during the recent deep recession and early stages of recovery had more positive than negative effects, especially in propelling a vigorous demand-side recovery. But as recovery progresses and puts private borrowers—for business plant and equipment, for housing and for durable goods—into ever-greater conflict with the rapacious demands of the federal government, that deficit becomes more and more corrosive. Indeed, the greatest single downside risk to our favorable forecast for 1985 is the possibility that the collision between public and private demands on the credit markets will intensify enough later this year to boost interest rates and curb expansion.

This can be averted if Congress and the White House break their deadlock on deficit-cutting and seem safely on the way to meaningful deficit cuts by mid-year. Mr. Reagan has once again tossed the ball (or better, the hot potato) to Congress by excluding defense (except for token cuts) and Social Security from his budget cuts and by proposing unacceptably harsh cuts for many of the civilian programs that remain in his sights.

So again, as in the past three years, Congress will have to take the initiative—and the onus—for hammering out a compromise that accepts some of the Reagan cuts, opens the political gates to realistic cutbacks in defense and entitlements, and perhaps seasons this unappetizing stew with modest tax increases.

Looking at conflicting voting blocs in Congress, many observers see gridlock and failure. But they forget that Congress fears and loathes the deficit and that 22 members of the Senate and all members of the House must face their political makers next year. Will members of Congress endanger their political future and the country's economic future by tolerating deficits that eat up over half of U.S. net saving, that will boost the federal debt to $2.8 trillion and annual interest costs on it to $230 billion by 1990, that will keep interest rates high and undermine economic growth, and that are putting us deeper and deeper into debt to creditors abroad? We doubt it. One way or another, we believe that Congress will find a way to chop perhaps $40 billion off the 1986 deficit, the President will sign on, and the country will say, "See, he's done it again."

Walter W. Heller

George L. Perry

Representative OBEY. Thank you both. Let me ask a few questions around the edges before I get to the subject I'd really like to talk about this morning.

For the last 4 or 5 years we have really had a debate in this country about exactly what is happening to productivity, how do you measure it, where do we really stand on it. We have had political claims on both sides on what's happening in terms of productivity.

Let me ask basically two questions and I'd like both of you to comment on it.

In your judgment, how does the recent growth of productivity compare with growth in comparable stages of previous recoveries? Second, do you believe that the record over the past 2 years in productivity growth indicates there is any significant underlying long-term trend that would indicate an increase in productivity?

Mr. PERRY. In the bank letter appended to my remarks, there is a small table that compares productivity gains in the first 2 years of this expansion with the 2 years previous and the record is very disappointing. Productivity always grows much faster than its normal trend in the early stages of an expansion. So the fact that we have had some good quarters of productivity growth in the past 2 years is not surprising and, unfortunately, is not indicative that the trend has quickened.

If we compare the first 2 years in this expansion with the two previous ones—and the story would be very similar if we took all previous expansions, indeed, the story would look somewhat worse—we see the productivity gain over the eight-quarter period this time was 6.2 percent. It was 7.5 percent coming out of the 1975 recession and 8.7 percent coming out of the 1970 recession.

So over that eight-quarter interval, the record this time has been 1.25 to 2.5 percent less gain in productivity.

That is so despite that the GNP gain this time has been somewhat larger than in the two previous expansions. Since we would expect faster GNP gain to give us a faster cyclical productivity rise, the fact that the worst productivity gain accompanies the fastest expansion here suggests that the underlying trend is indeed slower, significantly slower than in these previous cases.

Being slower than what we had coming out of 1975 is bad news indeed because we were beginning to worry about the productivity slowdown in the last half of the 1970's. If we are in fact behind that, the productivity problem is rather deep.

I confess to being puzzled. It's hard to think of reasons why the productivity trend shouldn't be improving a bit at this stage, but the facts suggest that's only a wish, that it hasn't really happened. Once we abstract from that initial euphoria in productivity that comes early in an expansion, productivity gains have been decidedly disappointing.

Representative OBEY. Mr. Greenspan, would you care to comment on that?

Mr. GREENSPAN. Well, I basically subscribe to what George Perry has been saying. The problem, however, I would amend to this discussion is that our data in the nongoods area on productivity are really rather dubious. And one of the characteristics of the current period, as I think we are all acutely aware, is that because of the strong dollar and the significant increase in import shares of manufactured goods we have had a suppression on the manufacturing sector in many areas where productivity would otherwise have been advancing fairly significantly.

So that it's possible that one of the reasons we're looking at these data in a way which is less than encouraging is that we are dealing with very significant internal shifts within the structure of American output and our ability to measure nonmanufacturing productivity is in such a questionable state that any conclusions we come to with respect to these aggregate productivity figures have to be tempered. Until we go through this cycle and are able to look back at it in full detail, industry by industry, I'm not sure exactly what we should glean from what is obviously a less than encouraging set of aggregate numbers in this recovery.

Representative OBEY. Let me ask another question on that. As you know, a lot of the debates surrounding the whole question of productivity has centered upon the role of capital investment in affecting our rate of productivity. I recall holding a series of hearings on that subject about 4 years ago. I think it would be useful if both of you would respond, so that we have it in the record here today and we don't get into that argument again because we have it all memorized by now. In addition to adequacy of capital investment, what would you pick as being the next three main factors of importance in providing the ability for this country to increase its productivity or to sustain a healthy rate of productivity growth over the next 5 or 10 years?

Mr. GREENSPAN. It's hard to define that except in terms of either measures which directly contribute to productivity or are we talking largely about an improved economic environment which leads to general advances in productivity?

Let me rephrase the question in a way which may not address your question immediately. When we think in terms of productivity we tend to be too narrowly focused on physical output or its comparable services component and sort inputs, dividing them in terms of capital, labor, technological know-how, education of the population, and a variety of other different things.

One of the things that is crucial that we may well be learning in this period is that if there are sufficient incentives in the system for people to move forward with innovative ideas, whether that entails actual use of plant and equipment or whether it's an education question, whether it's an entrepreneurial question, is less important because I'm not certain that we fully capture the productivity trends solely by looking at the so-called input factors.

One of the problems that productivity statisticians have had in recent years is in endeavoring to conceptually allocate the causes of productivity. Obviously, we know that capital investment is important. We know that the state of knowledge is important. We know that the quality of labor input is important. But nonetheless, we always end up with a very large residual which is the unexplained changes in productivity. We need to be cognizant of the fact that a lot of growth, a lot of activity, occurs in areas which are very difficult to measure such as in the high technology area where we have very little in the way of physical equipment. All we have is somebody's idea and it's tough to measure that. But we know what's going on and I would suspect that the most important question is to maintain a level of incentives of all types so that we have an entrepreneurial cutting edge which gives us the type of growth that we need.

Representative OBEY. Mr. Perry.

Mr. PERRY. As Alan's remarks suggest, there are a lot of murky mysteries in this business. For one thing, it may be that the normal pace of productivity advance isn't very fast, or as fast as we became accustomed to in the early postwar years. That may have been a unique period in which a tremendous backlog of new ideas and new capital investments were put in place and we reaped the benefits of backlogged productivity gains from the depression and the war.

So maybe our notion of what is achievable became exaggerated from what was happening in that period; perhaps this is the normal period and that was the exceptional one. The implication is maybe we shouldn't wring our hands and twist the economy all out of shape trying to find a little faster productivity growth somewhere.

America has always been an entrepreneurial nation and that characteristic has always served us very well. The main secret of our economic success is the freedom and encouragement that people have to pursue new lines of activity and research ideas. We should never want to turn our back on that.

There are some general things which common sense as well as economic analysis suggest we ought to encourage and pursue. Obviously, for the longer run, education is one. It's a major aim for its own sake, and it also serves our economy well. Our Nation's infrastructure is very important, and it may be that neglecting it would do us more harm than anything else that we might deliberately do as far as productivity and economic growth is concerned.

I do think that we went overboard a few years ago. It was possible to sell almost anything in the tax system if you could link it to productivity and in so doing, we may have gone too far. The important thing is not simply to get investment. The important thing is to get efficient investment, to get investment in the right places. The total amount of investment we get as a country is limited by the total amount of saving that takes place.

What's important is that this investment be high productivity stuff. The current interest in reform in the tax system is a recognition that we have been taking scarce savings dollars and putting them in the wrong places.

As far as the Nation as a whole goes, we want our investment where the pretax return is the highest. If we have a tax system that tilts the after-tax return on some investments far away from the pretax return, that skews it so that we are investing in "a" rather than "b" because the after-tax return is attractive, even though the pretax return is more attractive in "b" than in "a." We certainly will have damaged any efforts we may be making toward improving productivity—I don't care how you measure it—but more generally toward a growing economy.

Since total investment is limited by our total saving, we should think much more seriously about the efficiency of investment, and think hard about whether the tax system is now channeling investment dollars into low priority rather than high-priority places. That's a decision the market should make. The tax system should get out of the way of distorting that decision.

Representative OBEY. Before I turn it over to Congresswoman Snowe, let me just followup on your last remarks.

When you talked in your statement about methods by which we could encourage investment, you indicated that if we want to do that we ought to examine Bradley-Gephardt or Treasury proposals.

Did you mean those two? Did you purposefully point to those two as opposed to Kemp-Kasten? If you did, is there any reason why you singled out those two as opposed to the third proposal?

Mr. PERRY. In terms of the equity of the tax system, the Treasury proposal and Bradley-Gephardt more closely maintain the present distribution of tax burdens than does Kemp-Kasten which attempts a flat tax across the board. I'm not prepared to compare those bills in detail at this time.

Representative OBEY. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

I, too, want to welcome both of you here this morning.

My first question is with respect to the exchange rate. As the Vice Chairman of the Federal Reserve Board, Preston Martin, said, a major risk for 1985 is some possible sharp change in the dollar exchange rate. Some are very concerned about a sharp rise in the exchange rate; others are concerned about a precipitous drop in the exchange rate.

How likely is either scenario to occur and to what extent has the exchange rate contributed to the decline in inflation and if the exchange rate changes to the extent that it could affect the budget, how much; and could we continue to reduce inflation if the exchange rate changes downward?

Mr. GREENSPAN. Well, it's obvious that if the dollar continues to rise we are probably observing an increase in the rate of flow for investment into the dollar relative to other currencies.

I think there's been some confusion in the press and elsewhere which fails to distinguish between the level of the dollar relative to its purchasing power parity which is probably 30 percent lower, and the rate of increase in the dollar. In other words, if you're going to maintain the exchange rate above its purchasing power parity, you need a flow of capital into investment to keep the exchange rate up at that level. If the exchange rate relative to the dollar is going to rise relative to its purchasing power parity, you need an increase in the rate of investment flow.

We have been looking at an increase in the rate of flow, part of which may be of a speculative nature and hence unsustainable.

The basic concern that most people have with respect to the dollar is not that it will continue to rise indefinitely. There are, I must admit, some people who do believe that. I think they are mistaken. The danger is that these recent sharp increases because they are ultimately unsustainable could create a speculative level in the exchange rate which when reversed creates an abnormal decline in the dollar.

The reason why that is a major problem is that it is not the decline in the dollar per se, but the causes of it, meaning a withdrawal of the desire to invest in dollars. It affects the United States by reducing the supply of savings in our system without changing demand at any given interest rate. Unless the Federal Reserve intervenes fairly significantly interest rates would then rise.

If it intervenes, it then creates a growth in the money supply which is probably inflationary, at least so far as the markets are concerned.

So the major concern at the moment is a decline in the dollar. But ironically, one of the concerns many people have is that the dollar will rise too much and therefore create an overvaluation which will have to be corrected. It is probably at the moment the major threat to the recovery in the short term. There's no question that there has been a significant deflationary effect from the exchange rate change. It is not simple to measure. There are those who would argue that the effects were remarkably small. That is, most of the effect of the exchange rate is merely being reflected in profits of importers in the United States. There's no question that it has had some effect. It may be as large as 1 or 2 percentage points in the inflation rate and certainly if we go from a plus to a minus effect you're doubling up on those numbers.

Our analysis suggests that if the exchange rate now turns and declines and falls at a 10 or 15 percent rate, that that in and of itself would add somewhere between 2 and 2½ percentage points to the inflation rate.

Representative SNOWE. Mr. Perry.

Mr. PERRY. The question of what the dollar is going to do is a murky one; Alan's remarks cover the waterfront pretty well.

We have to accept what will be very modest proinflationary—adding a little to inflation — consequences of the dollar falling. We have gained a bit of a free ride from the dollar's big rise in this respect and we have to give a little of it back.

I do think the amounts aren't very large. Obviously, how much the effect is on our price level depends on how quickly the decline occurs. It doesn't necessarily add to the inflation rate permanently. It adds to the price level. Should the dollar fall 20 percent in a year's time, that would add, depending on whose estimates you believe, a half a percent, 1 percent, 2 percent to our price level. So, for that year, the inflation rate would be that much higher. But if the dollar then stabilizes at that new level, 20 percent lower, there need not be any major further effect on the inflation rate. Whether there is depends a great deal on the dynamics of inflation, on whether wages start to rise faster because prices rose faster. However I think those secondary effects would be rather small, at least if the dollar declined at this time with lots of space capacity available.

Despite the fact the dollar has risen, many important prices have not been held because they are not very sensitive to the value of the dollar. The most commonly observed case is automobile prices: partly because of the Japanese quota, partly because of pricing policies on the part of foreign carmakers, you're hard pressed to find much effect on car prices from the very, very large change in the dollar's value. Should the car market become more competitive in the next few years, we could see the dollar depreciating and still see car prices declining.

Certainly, the steel market is somewhat insulated from price changes and it might be insulated in the other direction as well. Oil prices are a major item and I would not expect oil prices in dollars to rise corresponding to a decline in the dollar's exchange rate.

Few major commodities are going to be very sensitive to what happens to the dollar. The bottom line is to not be afraid of the dollar falling because of inflationary consequences. The effect would be modest and in any case the effect is inevitable.

Representative SNOWE. Well, could a precipitous drop in the decline of the dollar create massive withdrawal of foreign investment from our banks and would that have an effect on our banking system? And second, do you anticipate major withdrawal of foreign investments in this country at any time?

Mr. GREENSPAN. Actual net withdrawal per se is unlikely. The real danger that we're concerned about is a much more limited issue; namely, that the rate of increase in holdings of dollars slows down. We are implying in this conversation that the accumulation of dollars continues relative to other currencies. If we were to run into a real actual across-the-board liquidation, then the effects would be far greater than either George Perry or I have mentioned. There is no evidence of that occurring because the move into dollars in certain respects is mandatory. That is, even though we talk in terms of purchasing power parity as the appropriate level for the dollar, because the dollar is in effect the unquestioned world currency, so long as the nominal values of world GNP, assets, and incomes rise, the aggregate holdings of dollars should be presumed to continue to rise.

Where the problems lie are in the rates of change. However, if there is a significant change in attitudes toward the United States and toward the dollar to a point where actual liquidations of significant dimensions occur, over a protracted period of time, then you could have a lot of important effects in the money markets on inflation, with savings, investment, and the like.

I would not, however, be terribly concerned about that creating a problem for our banking system because unlike our savings and loans in this country who have a major mismatch between the maturities of the assets and of the liabilities—that is long-term mortgages and short-term deposits—most of our commitments abroad are largely matched with respect to maturities. So were there a withdrawal of deposits, we would immediately liquidate the asset side of the balance sheet. It would cause a shrinking in the size of our international exposure bringing down both the liabilities and the asset side of the U.S. commercial banking balance sheet with respect to foreign commitments, but it could be done. It would liquidate the system without creating a crisis. We always assume a run on the bank is a disaster. A run on the bank is only a disaster if the assets are not sufficiently liquid to pay off the funds.

Mr. PERRY. Let me add to that. There are two issues which aren't quite the same thing. One is, if the desire to hold dollars, if the desire to make net investments in the United States were to change, what would that do to the value of the dollar? The other is, if the value of the dollar changed, what would that do to the desire to hold dollars in the United States?

Markets work reasonably well with respect to the second question. If some event or opinions changed unilaterally about prospects for the exchange rate, the exchange rate could change overnight. It could change 20 percent in a month—probably break all records—but it could happen without a great deal of money flowing in or out, just as the price of a stock can change 20 percent overnight because of an announcement that simply makes people decide it's worth more or less, and an enormous amount of stock need not be traded for that to happen.

The same thing is true of the value of the dollar. We could see the exchange rate move a great deal without necessarily having any large effect on foreign investment.

What presumably would motivate foreign investment would be a consensus expectation about what the dollar was going to do over the next year or over the next 6 months or over the next 3 months. The trick is that markets aren't ever going to let that happen: if there's consensus that we'd better get out of dollars because over the next year they are going to do this or that. They will do this or that immediately and it will be too late to do much about it if you have your dollars in dollars, so why bother to take them out? It's now 20 percent lower and the party's over. It's just like when your stock falls 10 points, it's too late to get out; you wanted to get out yesterday. Thus, a change in the exchange value of the dollar has no predictable consequences for what happens immediately to investments in this country.

There is another route by which it eventually affects the rate of investment. If the dollar falls a great deal, our trade balance will gradually improve. That means less foreign investment will take place and that has to equilibrate with the new exchange rate. So,we do not need to equate some change that might occur to the dollar with serious investment flow problem.

There is another way in which a big change in the dollar's value can have important financial consequences. In responding to a big change, the markets and the Federal Reserve could bring about a very sharp change in interest rates which would have financial consequences, partly for the reasons that Alan alluded to though not all financial intermediaries have a good match between liabilities and assets. I would not like to see interest rates go back to 15 percent in a short period of time because that would have major consequences in many directions. You don't want that to happen if you can avoid it. Not the least of these consequences would be the LDC debt problems would be back on the front page and, I suspect, a lot of other financial institutions would have problems.

Representative SNOWE. Thank you. I'll ask one final question. You both referred to the budget deficit but neither of you really indicated what bottom line figure Congress should reduce the deficit by for 1986 and beyond. Do you have any opinions on that level? Probably as much as possible?

Mr. GREENSPAN. The probabilities that Congress will overdo it are zero, so it's not a concern. We have to ask ourselves what is it that determines in today's context the appropriate levels? We start with the fact that we know that the deficit has to be financed and that financing adds to the Federal debt which in turn increases interest costs at a given interest rate.

We can also postulate that there is a budget deficit which, leaving out interest costs, is sufficiently large that it will create such a cumulative increase in interest costs over a period of years that the aggregate impact on money markets would be to drive interest rates higher. It is very easy to simulate, as indeed we've seen in some less developed countries, an explosive deficit process occurring as a consequence of the interest costs on outstanding debt. This adds to the deficit which in turn increases the debt which increases interest rates, and consequently what we have to look for is where is this explosive point.

Now, clearly, we are not there or even close in that respect. But we now see some estimates beginning to reflect very large interest costs in the outyears. Projections of the current services budget in terms of a more realistic outlook, not only with respect to growth but with respect to projected periodic recessions, possibilities of $350 or $450 billion deficits emerge. This would occur under extraordinary recessionary conditions. Not bizarre ones but ones we've had in the past. We tend not to realize that while we are not at the explosive point, we are beginning to get that odd feeling that the numbers are growing in ways which should make one uncomfortable.

Moreover, the Congress is being confronted at all times in these budget evaluations with current services budgets. We will surely add to the existing spending through emergency programs—for example, the farm credit for farmers that you're all confronted with now—and *x* 3 months from now. I dont know what *x* is, but believe me, it will be here. There is no contingency fund in the current services budget which picks up either the real contingencies or political contingencies and therefore tends to underestimate what you're actually confronted with.

At an absolute minimum, we have to suppress the move toward deficits that escalate to a crisis point. Therefore, if you could reduce the deficit by $50 billion in fiscal 1986 and a $120 billion in fiscal 1988, that would be a lot better than doing nothing. If you could do more than that that would be even better. That is not to say that if you can do neither of those that you should do nothing, because $10 billion and $50 billion is a lot better than zero and zero. Hopefully, we can fend off the cumulative effect of the deficit until we have the ability to come to grips with it in a fundamental way.

The danger is that we will look at it as though it's some nonserious economic phenomenon and come to grips with it only when it becomes exceptionally difficult politically to deal with.

Representative SNOWE. Mr. Perry.

Mr. PERRY. Well, I don't disagree with anything Alan said. I let him go first so I could see whether this time I would be more fiscally conservative than he. I think I am. He hasn't emphasized enough why we ought to do a lot and do it fast.

The problem does mount. Interest costs mount. In this budget, there is nothing more wasteful, fraudulent, and abusive than collecting taxes simply to pay interest costs. The idea that we can't quite do it now but maybe we will be able to do it some time is kind of laughable. I don't know why it's going to be easier then than it is now, and it is not the case that there's very little cost in putting it off. There is cost. The rising interest cost is a main manifestation, but in a general sense, each year that the economy doesn't disintegrate makes at least some politicians believe that everyone has been crying wolf. So in terms of numbers, you should do it now. In terms of numbers, they should be big. For starters, over $100 billion in deficit reduction. If you can do more than that, that's fine, but that would be a good start for the first year.

It's very hard to find analysis that says just what the optimal number is—whether it is a deficit of 1 or 2 percent of GNP or balance. But we are very far from any such number. The projections call for deficits much larger than you can make a case for, so they require over $100 billion in deficit reduction right now.

Maybe the thing we can do to start this process off right is to pass a small law that says no one is allowed to talk about how much budget reduction is being accomplished over 5 years. Nothing undermines the seriousness of this business more than that new tradition. You have to talk about what you're doing to the deficit per year and I propose that as a small step toward serious thought on this topic.

Mr. GREENSPAN. Could I put an amendment on your law, that when people say we must reduce the deficit, they designate that provided they are in the Congress that their districts will presumably take part in the deficit reduction.

Representative OBEY. That's unconstitutional. [Laughter.]

Mr. GREENSPAN. So we'll change the constitution and make George's law an amendment.

The problem that is really disturbing to those of us who are on the outside of this process is that everybody wants to reduce the defense budget in somebody else's district. They want to reduce the deficit in general on the backs of constituents somewhere else. And I know that in Congress, especially in the House, that if you were to take a vote, "Would you cut the defense budget by say 10 percent or 20 percent," there would be a large majority in favor. If everybody went at it line by line, however, that majority would dissolve in midair because I know of no one who would pass John Tower's test. When, somewhat cynically, he sent around a note to all his colleagues in the other body asking, "Give me your recommendations of where we could cut the defense budget in your State?", his mail was not overwhelming.

Representative OBEY. Let me suggest, however, that while he indicated he had not received any letters indicating reductions, he did get several from the Wisconsin delegation for letting go of Project Elf, that we would gladly get rid of.

Mr. GREENSPAN. I remember that.

Representative OBEY. Let me pursue that because frankly in all the hearings we have, as a practicing politician I get frustrated because we are talking to economist after economist, both over the table and elsewhere, and yet I really don't think our problem is economic. There are lots of things we don't know. We don't know exactly, as you indicated this morning, how to measure productivity. We don't know exactly how to get more of it. We have some general ideas but we're not really sure. Even Mr. Brock the other day indicated that he was mystified because he couldn't figure out why the tax cuts had not generated the kind of increase in personal savings that had been expected. So there are some things we don't know. We don't really know what we can expect out of the dollar and we don't know exactly what percentage of the increase in the dollar on world markets is related to what specific causes, but again we have some general ideas.

The problem I see is simply political. I appeared at a very interesting forum last week and a fellow by the name of Alan Schick, who's well known as an analyst of the congressional budget process and the political process as well. He made the observation that in the end the greatest role that the President can perform is to provide some insulation on the wiring in the political system in Congress and that if he doesn't do that, the wires won't work because the political wires get too hot and then the substance get screwed up.

I really think we're facing that. It is my own view that we could meet every dime of budget reduction that the President has suggested and still not in any way significantly decrease the deficit over the next 5 years. In fact, I would bet it would increase, even if we accomplished every single budget cut the President is recommending because I think there will be other contingencies down the line, as Mr. Greenspan indicated.

I also think that there will be policy contingencies. I also think there will be interruptions in the evenness of the economic recovery and so we will get big additions to the national debt, and I think we're going to wind up with an ever-ascending portion of the Federal budget and Federal revenues being devoted to paying interest.

I get lots of people who don't want to pay taxes. They don't even want to pay taxes to support education or health care or military budgets. They sure as hell don't want to pay taxes to pay for interest. But yet, the country really decided that that's what we were going to do and I think the political system decided that. I don't think you have the votes on either side of the aisle for anything adjusting revenues in any way, whether it's adjusting in the individual tax rates or other revenue raising devices that don't relate to the individual tax rate, and I think that means that we are going to all wind up seeing the edges nibbled at but nothing really effectively done.

Let me ask the question I wanted to get to. Mr. Perry, in your statement, you indicated that the economy's inflation and growth performance will not be affected by whether we are at the low or high end of the range of Federal expenditures that might be contemplated. And you said that in the context of a statement urging that we take a look at both the spending side and the revenue side.

I take it from your statement that you're assuming that even if we were able to meet the President's budget reductions this year in total on the spending side, that the interest problem would still be serious enough long term that we ought to consider doing something on the revenue side as well.

Mr. PERRY. Oh, I do. The main point is that the deficit is the problem. The problem is not confined to the revenue or expenditure side of the budget. If one could get agreement to close the deficit to a tolerable number entirely through revenue increase, that would be a perfectly good solution. If one could get agreement to close the deficit entirely through expenditure reduction, that would be an acceptable solution. Within the range of the numbers that we would be contemplating, there is no presumption as to what the right levels of revenues or expenditures are. It depends on social choices and on questions of what needs to be done in the economy and society. Therefore, we realistically have to look to higher revenues for an important part of deficit reduction. If we don't, if instead the President insists that we look exclusively at his proposals on the expenditure side—and in looking at them Congress can, after good analysis, conclude that only some of those expenditures should be reduced and others should not be reduced because they have important functions to perform—we're going to find that we have done very little to the deficit and that interest costs will have risen because of the delay.

Another year will have gone by and nothing will have happened because interest costs will have risen by more than you succeeded in cutting expenditures. You really have to look at the revenue side and you have to look at it promptly. It's not a last resort. The logic of budgeting and the logic of what you ought to be doing doesn't tell you that it should be the last resort. It says you should look at the whole thing and do what has to be done; that includes finding additional revenue.

Representative OBEY. Let me ask, because of your statement, you know the argument is made that if you have an increase on the revenue side that therefore weakens the ability of the country to grow because it makes it tougher for the country to invest. I've certainly heard Members of Congress make that argument on a regular basis.

Mr. PERRY. I don't think that's true.

Representative OBEY. What's your response to that?

Mr. PERRY. I don't think that's true. There's nothing in the record that says that's true. We can look at periods when investment was very high and productivity was growing rapidly and corporate taxes were substantially higher than they are today. We can look across the world and find examples of higher investment with higher taxes. You can find almost any combination you want.

What determines the total amount of investment is the total amount of saving and that is governed—in our economy in which private saving is quite insensitive to anything—primarily by the size of the budget deficit. Anyone who's serious about investment should be serious about reducing the budget deficit; reducing it by raising taxes would still generate more saving therefore making room for more investment.

On the investment issue itself, the main open question is whether we're making the most productive investments or investments which are not sufficiently productive to the country as a whole. That gets back to the question of seeing that investments are made where the pretax return is the highest and not distorting it by taxes that tilt investment in other directions.

Representative OBEY. Mr. Greenspan, I know that you would prefer that we not raise revenues and deal with it on the spending side, but if we were to meet the President's total numbers for budget reduction from the current services budget, would you think it would be economically preferable then to let it go at that or do you think it would be preferable to do more than that by also taking a look at the revenue side and adjusting that upward?

Mr. GREENSPAN. Mr. Chairman, let me just first state what it is that concerns me about the revenue side with respect to the deficit.

The underlying momentum of our political system, especially in recent years, is exhibiting clear evidence that despite the tendencies of concerns about the deficit we have an upward bias in our political system toward creating increasingly larger expenditures even in an environment such as today.

What I am most concerned about is not the issue that increased taxes in and of themselves need affect investment. I'm concerned that if we endeavor to move the tax side as a significant factor in reducing the deficit that we will find very large leakages. There are two types of leakages. One is that a reduction in expenditures could induce reductions in taxes which would therefore offset the deficit reduction. Or an increase in the taxes would increase expenditures by bringing revenues in to finance other programs which would also create a leakage in the deficit reduction program.

While it is very difficult to come up with data defending either position historically, I think that the nature of our political system has gradually evolved into a form which clearly in recent decades creates much more of a problem on the tax side than on the expenditure side. So if our purpose is to get the deficit down, the more we cut on the expenditure side, the greater is the probability that we will solve the deficit problem.

I might also add that I do think there are differences in what you cut on the expenditure side, largely because of the consequences of the outyear effects. Defense expenditures, for example, include a large proportion of asset accumulation. Military asset accumulation implies that at some point you build up to the number of F-16 wings we need or navy ships we need and when we get there the net additions to the stock falls to a maintenance level, so that cuts in defense expenditures don't lead to cuts necessarily in the outyears, whereas any entitlement program, especially those tied to population, has a very big wedge effect in the outyears. So there are compositional effects on the expenditure side.

But having said all of that, assuming large outlay cuts were made, would I ask that we move on revenues to reduce the deficit further, the answer at that point would be yes. I would consider that in the President's terms, the last resort, because I do not consider that the budget deficit that is currently contemplated either by OMB or any that is likely to come out of the budget committees of the House or the Senate adequate to reduce the risk that this process is creating for the economy.

Representative OBEY. Thank you. What bothers me is I think that we have an insiders' game going on in this town. What happens is that you get resistance on the part of traditional liberals because they're concerned about preserving social programs, many of which I think are very important; and you get resistance from conservatives to raising the revenue base. And I understand the concern about increasing the revenues in terms of what it might do to release pressures for different spending. I frankly don't sense those pressures that much in this Congress any more. I think you have, even if you take the agriculture thing which we have all been going through this week and last week and the week before and we'll be going through it for the next months—if you add up that and two or three of the other items that are likely to hit us on the spending side this year, you're still talking about a very small adjustment in spending. But I do see many people in Congress beginning to understand that if they want the Government to be able to do anything at all 10 years out except pay for retirement and pay for military and pay for interest, that it's in everybody's interest to squeeze everything on all sides right now. What I don't see is the system being given the insulation to accomplish this.

Mr. GREENSPAN. Mr. Chairman, I'm not sure that the President is in and of himself capable of creating that insulation. We learned something very important in the Social Security process whereby you may recall prior to the Social Security Commission there had been votes on a number of things such as should we tax Social Security benefits. The votes were overwhelming in the House and the Senate. That, as you may remember, was a recommendation ultimately by the Social Security Commission as part of a package which was accomplished with great trepidation. Because both the President and the Speaker supported it and created an odd bipartisan set of insulators, so to speak, it went through the committees and both Houses like a hot knife through butter. It's telling us that there's something about this insulation question which is very crucial to the processes of government in this country and unless we come to grips and can somehow resolve it, we're in very serious difficulty on this whole budget process.

I don't think that the budget act can function in this type of environment unless we can resolve the issue which you raise, and I frankly am not sufficiently confident that the President alone can create that sort of insulation. I think it has to be some grouping which protects both sides, both flanks of the political process.

Representative OBEY. I would agree with that, but I hate to see a situation where the President is tearing the insulation off, as he has on two of the three pieces of the equation. I'll grant you that Congress has torn the insulation off the third piece.

Mr. PERRY. I don't think you can work this thing with the asymmetry that's being proposed. Revenue as the last resort presupposes that the expenditures are somehow not desirable in and of themselves. There's disagreement about that. Obviously if there were agreement about that, there wouldn't be any problem: the expenditures would have been cut and we would see what's left over. There's obviously disagreement about that and compromise is needed. If so, you can only get past this issue if the President has the leadership to say, "Let's put it all together and do revenues and expenditures at the same time." It seems that would be an effort a lot of people could get behind even if particular concerns had to be compromised.

Short of that, I disagree with Alan's formula that says you can somehow do it by not providing the revenues and that will force you to do it. I think the record of the last few years says that's not the way the world works.

The fact that there are disagreements about what we ought to be doing is the reason why that order of things won't work and why a compromise means doing at once. I don't see what else a compromise could mean.

Representative OBEY. I thought that's what a compromise would mean, but I honestly don't think that that's going to happen. I don't think you have sufficient willingness on my side of the aisle to do that frankly because the President and his party felt that they got burned on Social Security 2 years ago and we feel that we got burned on taxes this time around. Let us assume that we don't know what Congress and the President will finally reach agreement on the spending side, but it looks to me in the end that some time this year we are going to make a decision, whether it comes on increasing the silly process called the budget process which really is a promissory note stipulating things to come half of which might and half of which might not. But some time this year we're going to reach agreement. By the time we have to pass a continuing resolution, if nothing else, we will reach agreement between the parties, if not long term at least for the year, on what can in fact be accomplished on the spending side on either domestic or military or both. It would seem at that point that unless we want to continue this for another year that that is the time at which we will have to ask the simple question, in addition to what's been reached on the spending side, it will be necessary to look at the revenue side. I would guess there's only one way to answer that and I'd like you to respond.

I would think the only way to answer that would be to take a look at what everybody thinks is going to happen on the numbers on the interest payments and if we think that is an unacceptable legacy to leave our kids, then we ought to move.

I'm concerned that we have a generational transfer going on on two sides. One, because of changing demographics, 20 or 25 years from now we're going to be leaving a very large responsibility for the younger generation to be financing the retirement of the older generation. That's one problem. That's one legacy that we're leaving the younger generation.

We're also leaving a second legacy, which is in addition to financing the retirement of anybody 45 or 50 or above at that time, we are also going to be leaving them the glorious ability not only to pay for our retirement but to pay for our enjoyment along the way in terms of the services that we are demanding the Government to give.

So it would seem to me that the only way to decide whether you go at revenues or not is to take a look at what the interest amount shows. Much as I would like to think we could do it together, I don't think—because of the decisions that have to be made—that that's going to happen and I think if it happens at all it's going to happen at the end of the cycle this year and we see what the interest numbers show.

Without beating the horse to death, do either of you want to comment on that?

Mr. PERRY. Well, it makes good sense. My suspicion is that you can cut expenditures more—and here I disagree with Alan's view of how the game is played—if you simultaneously agreed to raise revenues than you could if you tried to do it sequentially. The degree of trust required to do it in a sequential order, for good reason, strains the trust that's available. If you see how far you can go and then see how much you still need to do, my guess is you will find you still need to do an awful lot and what gets done in total won't be very much.

Mr. GREENSPAN. I don't want to shock George but I don't necessarily disagree with that. I'm saying as a general political thrust that there is a bias in our system toward expenditures, toward eventually increasing taxes to finance them, and a growing ratio of expenditures and taxes to GNP biased into our political system. I would not disagree with George in this respect, that in some form of bipartisan, perhaps even smoke-filled room environment senior political figures that have the capacity to insulate the others could meet. They, in combination with higher taxes, could get lower expenditures than otherwise would be the case. Perhaps it's that environment which offers us the greatest cut in the deficit itself.

We are dealing with a very complex problem which our system at the moment is clearly ill equipped to handle. Any ad hoc procedure which defuses the extraordinary political sensitivities which we're able to engender would be all to the good. In this very serious problem because we tend to focus too much on the short term and not recognize the issue which you, Mr. Chairman, pointed out, that at the extreme, leaving out retirements and everything else, you can envisage a situation in which a very large chunk of the total Federal outlays are interest and a very large chunk of our tax receipts are going literally just to finance the interest costs on the debt. That will create some extraordinary political problems.

Representative OBEY. Congresswoman Snowe.

Representative SNOWE. I might just say that with respect to raising taxes, one of the other problems has been the fact that had taxes been raised there's a great deal of feeling in Congress that the revenue would only go toward more spending rather than reducing the deficit.

There is one question I've had in the back of my mind. Do you have any concerns about the rising consumer debt that has developed in the more recent months and that the percentage of consumer debt as a percent of their total income has risen substantially?

Mr. GREENSPAN. Congresswoman, you're raising a very interesting question. One of the things that has been puzzling me is the aggregate net funds raised in the economy, which is our best measure of aggregated borrowing. It's shown us a significant rise relative to any measure which we can employ, including gross national product, including the elements within the gross national product which tend to get financed. Stripping out from the debt the effects of financing capital gains or changes in the asset side of America's balance sheets, you still get that element of excess. And when you track it down, it tends to be to a substantial extent consumer credit.

When you're looking to the internal structure of the data, it's hard to find the reasons. It's clear that auto credits have eased, that maturities have increased, the interest rates have declined. There's been increased turnover and so-called revolving credit. But there's nothing that stands out as the fundamental cause. That it has all of a sudden become a much larger element in our economy than before is clear.

I had superficially thought that the huge amount of credit card operations have merely created a meaningless increase in credit because instead of paying in currency you delay it through a credit card for a few days. That has no economic implications. But apparently it's more than that. There's something else going on that I don't fully understand.

Representative SNOWE. Mr. Perry.

Mr. PERRY. I have no reason to think it's a source of concern. I haven't tried to take the numbers apart as carefully as Alan has, but things like rising housing, rising purchase of durables, certainly rising automobile sales, always produce a big rise in consumer credit. That's just the other side of the coin.

I don't know how much you can or can't get out of the growing use of credit for a very short term basis but I always learn something from Alan and he says that's not an important part of the answer. I'm a little surprised those things have proliferated so much. My mailbox is full and I assume everybody else's is; it can make a big difference when you make an adjustment to the new system from the old system, even though once everybody is doing credit card business it will grow much more slowly.

It's always a hard question to answer. Should we be worried about this or that, because a lot of odd things pop up from time to time. I can see no particular reason to be worried. We would be worried if we thought that lenders were becoming increasingly reckless. I don't know any reason to believe that.

Representative SNOWE. Finally, there was a study that was recently released that indicated that there was no correlation between business investment and tax incentives. Do you believe that there is a link between businesses decision to make an investment contingent upon the kind of tax credits and tax incentives that Congress enacts?

Mr. PERRY. I think there's a very strong link between what kinds of investments get made and where the incentives lie. The total investment is relatively insensitive. It is sensitive to total savings availability; if availability is low, interest rates will be driven up as people try to invest more and more which will ration some investors out of the market. So, there's a major effect on what kinds of investments get made, but I don't think that total investment is affected much by specifics in the tax law. It is affected by the total of saving in the economy.

Representative SNOWE. Mr. Greenspan.

Mr. GREENSPAN. I think George is making too strong a point on the basis of the evidence. I think that you can find statistical analyses which come to different conclusions. Unambiguous is the issue of whether it affects the internal structure of investment. It clearly does and I would subscribe to what George Perry says about that in his last remarks and earlier. But it's very difficult not to read into some of the data some significant net lowering of capital costs as a consequence of tax incentives. Since we know that the cost of capital is a crucial element in determination of investment levels within companies and in general, and since the Tax Code can simulate the reduction in capital costs, we do see evidence of increased investments.

Whether that is desirable is yet another question. In other words, I think George raised the issue early on about is investment per se an end in itself, and the answer is clearly it is not. But I would be more inclined to argue that in aggregate investment does rise. I should say gross investment does rise with reductions in corporate costs and specifically corporate tax costs.

Mr. PERRY. Well, just one last remark. The cost of capital is a determinant of investment. My point was if you provide an investment break and do it by enlarging the deficit, you're not changing from raising $10 billion of revenue in one way to raising $10 billion in another. The question becomes a little murkier: if you drive interest rates up as a consequence of this, interest rates also enter into the cost of capital. The firm contemplating investment will see the cost of capital falling because the tax incentive was there and at the same time rising because he faces higher interest rates; he will come out closer to where he started than if he just looked at the tax incentive part alone.

I may have overstated what I said earlier. For instance, if we do something which is specifically a business tax incentive and does not affect housing, on balance you probably have an effect on business investment because whatever rise occurs in interest rates, a part will choke off housing therefore not all of it acts to choke off business investment. I didn't mean to overstate the point, but I think the effect from everything we've observed, is not dramatic on total investment. We haven't seen total investment respond that sharply to tax changes. The one place we have a handle on total saving, and therefore total investment, is the debt. That would have a more predictable effect.

Representative SNOWE. Again, I thank you both for your respective viewpoints.

Representative OBEY. Thank you both. We appreciate you coming.

[Whereupon, at 11:50 a.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 28, 1985.]

THE 1985 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 28, 1985

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

The committee met, pursuant to recess, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Mitchell, and Scheuer.

Also present: Charles H. Bradford, assistant director; and William R. Buechner, Christopher J. Frenze, Kent Hughes, and Paul Manchester, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. Before we begin Mr. Penner, let me apologize for what will probably have to be an abbreviated nature of the hearing. We are going to be having the African aid bill on the floor and I will have to be there for that. But I don't want you to feel rushed.

I'm very pleased to welcome Mr. Rudolph Penner, Director of the Congressional Budget Office, to this morning's hearing. Mr. Penner, I think, has maintained CBO's well deserved reputation for providing objectivity and timely analysis to the Congress. CBO recently forecast that under current policies, without change, the budget deficit could rise to approximately $300 billion by 1990 even if we have steady economic growth, and could go as high as $400 billion under a more traditional historical path if there's a recession in the next 3 years.

Mr. Penner, as you've testified, under current policy spending national defense, social security, Medicare, and net interest could equal 94 percent of total revenues by 1990.

What concerns me is that sets up a far more brutal generation gap than we have seen in past years, even though it received a lot of discussion about 10 or 15 years ago sociologically in this country. Then we could very well be facing a situation in which the younger generation not only would be forking over a substantial portion of its income to help support the retirement of the older generation, but in addition, they could be paying large amounts of their taxes simply to pay interest because that same generation had neglected to pay its own bills along its way to retirement.

In your report on the economic and budget outlook you raise the possibility that interest on the debt could lead to an explosive situation if we got into an uncontrollable situation with deficits. We know that's happened in a number of less developed countries. We don't expect that that would happen here, but it is nonetheless a possibility.

I think it would be helpful if you could, in addition to your statement, give us some further development of that concern.

Another issue of concern is the high value of the dollar which isn't quite as high today as it was yesterday but nonetheless is pretty high in recent historical terms, and in fact it places a 30-percent tax on everything we try to ship outside of the country for sale.

Yesterday you released an analysis of the President's budget. My understanding is that you estimate that even if all of the budget cuts proposed by the President are enacted, the budget deficit could still be virtually unchanged through 1990, and that Federal debt could increase 40 to 44 percent during that same period. I think that projection ought to sober up anybody in the Congress looking at the problems at this time.

Let me simply welcome you and ask you to proceed with your statement.

STATEMENT OF HON. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Penner. Thank you very much, Mr. Chairman. With your permission, I will summarize my prepared statement fairly briefly to give time for questions.

I am very pleased to testify today before this committee on the outlook for the economy and on fiscal policy. Thus far in the recovery the performance of the economy has exceeded expectations. Last year, the rate of economic growth was 6.9 percent, the highest since 1951. The inflation rate was down to about 4 percent in both 1983 and 1984, the lowest rate in a decade.

The budget deficit, however, remains a serious problem. Despite the vigor of the recovery, the deficit-to-GNP ratio in fiscal year 1984 was, at 5.2 percent, the second highest in our postwar history, clearly indicating the extreme imbalance in our fiscal policies. If budget policies are not changed, record budget deficits are likely for the remainder of this decade. Current law implies a steadily rising total deficit reaching $300 billion by 1990, assuming average historical rates of economic growth. The deficit-to-GNP ratio, while projected to remain constant, is nearly 5.5 percent. This does, however, represent an improvement over last February's projection of a steadily rising deficit-to-GNP ratio. The improvement results from the enactment of the "downpayment" on the deficit during calendar year 1984.

The high deficits imply rapid growth of the outstanding debt. In turn, this rapidly growing debt implies a steadily growing interest burden that is itself a major component of our budget problem. As you noted, Mr. Chairman, it is theoretically possible for deficits to get so high that the debt grows so fast, and interest payments on it start to grow so fast, that there is little hope of countering it either with spending cuts or tax increases. We feel we are a long way from that situation. The downpayment really helped, I think, to make the path that we are on more stable. As you say, however, the implications of being on such a path are severe. Even if the probability is low that we should get on such a path, we have to keep in the back of our minds that there is an ultimate risk of deficits. When countries get into such a situation, they have little choice but to repudiate the debt. Very often, unfortunately, countries choose to do just that through hyperinflation rather than through an explicit declaration of bankruptcy. By the way, that has happened in developed as well as underdeveloped countries. I think the prewar hyperinflation in Europe was budget related. I think Israel's present difficulties are very definitely budget related and, as you suggested, financing government through the creation of money is quite common in some less developed countries.

As I say, however, we would attach low probability right now to that risk. As we see it, the more important point was made in your opening statement; namely, that the current fiscal policy suggests that the living standards of future generations of Americans will be gradually lowered compared with what they could be if fiscal policy were more prudent. The Congressional Budget Office's (CBO's) projections assume that the economy will continue to expand in the face of a steadily growing debt burden. In fact, in the very short run, the growing deficit may even add slightly to the rate of expansion. The combination of growing deficits and relative economic prosperity is without precedent in peacetime history, however, and CBO's relatively optimistic economic projections must be put forward with considerable uncertainty because of that. We are just outside of the range of peacetime historial experience.

The remainder of my prepared statement goes into all of these matters in considerably more detail. It also compares our economic assumptions with those of the administration and elaborates on the connection that we see between budget deficits and the trade deficit. We believe that cumulative deficits do exert upward pressure on real U.S. interest rates and that the high real interest rates are, in turn, partially responsible for large capital inflows and the resulting high value of the dollar. This has led to our trade deficit and naturally depressed our export and import competing industries.

The adjustment problems have been severe, but we have also benefited greatly from the large capital inflow. It has kept real interest rates lower than they would be otherwise and has allowed capital formation to proceed at high levels in the face of the budget deficit.

The high value of the dollar has also kept inflation lower than it would be otherwise. Of course, we are going to have to pay for the large capital inflow in the future in the form of higher interest and dividend payments abroad, and that will reduce the standards of living of future generations as well.

I think I will just stop there and take your questions, Mr. Chairman.

[The prepared statement of Mr. Penner follows:]

PREPARED STATEMENT OF HON. RUDOLPH G. PENNER

Mr. Chairman, I am pleased to testify today before this Committee on the outlook for the economy and on fiscal policy. Thus far in this recovery the performance of the economy has exceeded expectations. Last year, the rate of economic growth was 6.9 percent, the highest since 1951. The inflation rate was down to about 4 percent in both 1983 and 1984, the lowest rate in a decade.

The budget deficit, however, remains a serious problem. Despite the vigor of the recovery, the deficit-to-GNP ratio in fiscal year 1984 was, at 5.2 percent, the second highest in our postwar history, clearly illustrating the extreme imbalance in our fiscal policies. If budget policies are not changed, record budget deficits are likely for the remainder of this decade. Current law implies a steadily rising total deficit reaching $300 billion by 1990, assuming average historical rates of economic growth. The deficit-to-GNP ratio, while projected to remain constant, is near 5½ percent. This does, however, represent an improvement over last February's projection of a steadily rising deficit-to-GNP ratio. The improvement results from the enactment of the "down payment" on the deficit during calendar year 1984.

The high deficits imply rapid growth of the outstanding debt. In turn, this rapidly growing debt implies a steadily growing interest burden that is itself a major component of our budget problem. More important, current fiscal policy suggests that the living standards of future generations of Americans will be gradually lowered compared with what they could be if fiscal policy were more prudent. CBO's projections assume that the economy will continue to expand in the face of a steadily growing debt burden. In fact, in the very short run, the growing deficit may even add slightly to the rate of expansion. The combination of growing deficits and relative economic prosperity is without precedent in peacetime history, however, and CBO's relatively optimistic economic projections must be put forward with considerable uncertainty.

RECENT ECONOMIC DEVELOPMENTS

Real GNP grew at a rapid 5.9 percent rate between the last quarters of 1983 and 1984, only slightly less than in the first year of recovery, and the unemployment rate declined to 7.2 percent by the fourth quarter of the year. Despite the sharp drop in unemployment, the inflation rate averaged about 4 percent during 1984, little changed from the moderate pace achieved in the previous year. Economic growth was led by rapid growth in consumer spending and a surge in business investment spending, both of which continued to benefit from the tax cuts enacted earlier. The lagging trade sector, however, remained a serious drag on the economy.

Economic growth was particularly strong in the first half of 1984, then slowed sharply at mid-year, and returned to a more sustainable pace in the last quarter. Interest rates declined and inflation remained moderate at the end of 1984. At year-end, business firms also had some success in reducing excess inventories. Thus, conditions now appear to be set for continued economic expansion with little increase in inflationary pressure.

THE CBO ECONOMIC PROJECTIONS

CBO's baseline economic projections are composed of two parts: a two-year forecast, conditional on specific policy assumptions; and medium-term projections, which show a smooth growth trend derived from average historical experience.

The Short-Run Economic Forecast

As in the past, CBO's economic forecast for the next two years incorporates an assumption of unchanged federal budget policies. In regard to monetary policy, the forecast assumes that the growth in the money aggregate M1 will be 5.5 percent from the end of 1984 to the end of 1985--the midpoint of the target range recently announced by Federal Reserve Chairman Volcker--and 5.0 percent in 1986. In addition to these policy assumptions, the price of imported oil is projected to average about $1.50 per barrel below last year's price and the value of the dollar in international exchange markets is assumed to decline moderately from current levels, so that its average value this calendar year will be about the same as last year.

Based on these assumptions, real growth is now forecast to be about 3½ percent over the four quarters of 1985 and slightly less during 1986. The unemployment rate is projected to decline gradually to 6.9 percent in 1986. Inflation is expected to rise only fractionally from about 4.0 percent last year to 4.6 percent by 1986. The three-month Treasury Bill rate in calendar year 1985 is about one percentage point below last year and rises only slightly in 1986.

The Medium-Term Projections

In its medium-term projections, CBO assumes that from the fourth quarter of 1982 (the recession trough) to the fourth quarter of 1990, the growth of GNP and of labor productivity will match the average growth rate in the eight-year periods following earlier postwar recessions. As a result, real GNP growth averages about 3.4 percent a year in the 1987-1990 period, and productivity growth in the nonfarm business sector averages about 2.2 percent. With these growth rates, the unemployment rate declines slowly to 6.2 percent in calendar year 1990. Inflation, as measured by the GNP deflator, averages 4.2 percent in the 1987-1990 period while the three-month Treasury bill rate averages 8.2 percent, or 4.0 percent after adjustment for inflation (see Table 1 and Figure 1).

Uncertainties in the Economic Outlook

The economy's performance could easily turn out to be much better or worse than CBO's projections indicate. At present, the major uncertainties in the short run are related to oil prices, exchange rates, and interest rates. Some analysts expect that oil prices will decline more sharply than projected by CBO, a development that could have beneficial effects on both inflation and real growth. On the negative side, the economy may be

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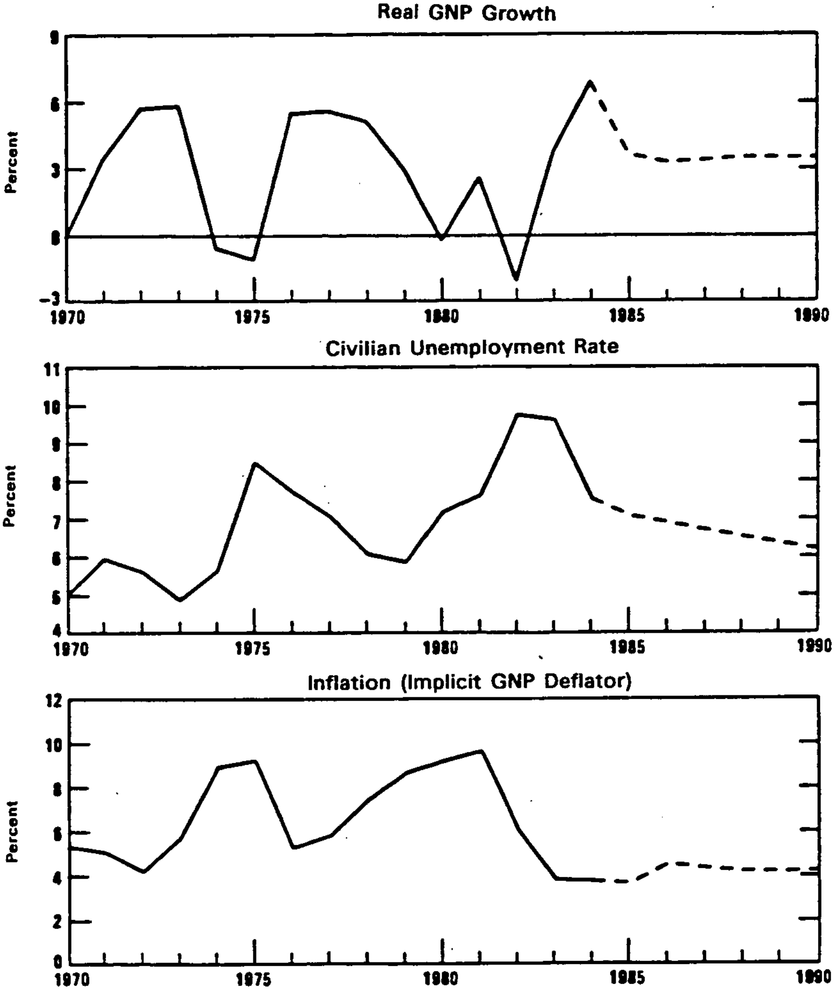
vulnerable to a drop in capital inflows from abroad. While CBO does not forecast such an occurrence, a sharp drop in capital inflows would lead to a decline in the dollar, a rise in domestic inflation, and increased pressure on interest rates. Other risks relate to the financial stress being experienced in agriculture and other sectors. CBO assumes that these problems will be

TABLE 1. CBO'S MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1987-1990

	Actual	Forecast a/		Projection			
	1984	1985	1986	1987	1988	1989	1990
GNP (billions of current dollars)	3664	3927	4238	4567	4921	5301	5711
Nominal GNP Growth Rate (percent change, year over year)	10.9	7.3	7.9	7.8	7.7	7.7	7.7
Real GNP (percent change, year over year)	6.9	3.5	3.2	3.3	3.4	3.4	3.4
GNP Implicit Price Deflator (percent change, year over year)	3.8	3.6	4.6	4.4	4.2	4.2	4.2
CPI-U (percent change, year over year)	4.3	3.7	4.5	4.2	4.2	4.2	4.2
Civilian Unemployment Rate (percent, annual average)	7.5	7.1	6.9	6.7	6.6	6.4	6.2
Three-Month Treasury Bill Rate (percent, annual average)	9.5	8.3	8.7	8.2	8.2	8.2	8.2

a. Does not reflect revised GNP estimates for 1984.

FIGURE 1.
MAJOR ECONOMIC ASSUMPTIONS



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

confined to the sectors directly affected and will not spread in any significant way to the rest of the economy.

Although the baseline projection for the out-years does not explicitly incorporate a recession or an inflationary shock of any kind, it also does not imply that such events will not occur. Because the timing of such events is impossible to forecast so far in advance, our projections simply smooth out real growth and inflation rates over the period.

COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS

The near-term economic forecasts by the Administration and CBO are quite similar, though the Administration is somewhat more optimistic about economic growth. Both forecasts indicate that the expansion is likely to continue at a healthy rate at least through 1986 without a major acceleration of inflation.

Unlike the CBO baseline forecast, which assumes a continuation of current law, the Administration's forecast assumes the implementation of its proposed deficit reductions over three years, and therefore the forecasts are not directly comparable. (These budget proposals are analyzed in a recent CBO report entitled An Analysis of the President's Budgetary Proposals for Fiscal Year 1986.) In the Administration's medium-term economic projections, growth rates of productivity and real output exceed the postwar averages assumed by CBO. The Administration's projection of real growth is, however, well within the bounds of historical experience. As

TABLE 2. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS, 1985-1990 (By calendar year)

	1985	1986	1987	1988	1989	1990
Nominal GNP (in billions of dollars)						
Administration	3948	4285	4642	5017	5399	5780
CBO	3927	4238	4567	4921	5301	5711
Difference	21	47	75	96	98	69
Real GNP (percent change, year over year)						
Administration	3.9	4.0	4.0	4.0	3.9	3.6
CBO	3.5	3.2	3.3	3.4	3.4	3.4
Difference	0.4	0.8	0.7	0.6	0.5	0.2
Consumer Price Index (percent change, year over year) a/						
Administration	4.1	4.3	4.2	3.9	3.6	3.3
CBO	3.8	4.5	4.2	4.2	4.2	4.2
Difference	0.3	-0.2	0	-0.3	-0.6	-0.9
3-Month Treasury Bill Rate (percent)						
Administration	8.1	7.9	7.2	5.9	5.1	5.0
CBO	8.3	8.7	8.2	8.2	8.2	8.2
Difference	-0.2	-0.8	-1.0	-2.3	-3.1	-3.2
Civilian Unemployment Rate (percent)						
Administration b/	7.0	6.9	6.6	6.3	6.1	5.8
CBO	7.1	6.9	6.7	6.6	6.4	6.2
Difference	-0.1	0	-0.1	-0.3	-0.3	-0.4

SOURCE: Congressional Budget Office.

a. Urban wage earners and clerical workers.

b. The Administration's projection is for the total labor force including armed forces residing in the United States, while CBO's is for the civilian labor force excluding armed forces. In recent years, the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force.

shown in Table 2, economic growth in the Administration's projection is less than 4 percent, which is significantly below that experienced in the strongest postwar expansion (1961-1969). The Administration also assumes a larger decline in the unemployment rate than does CBO, and a slowing of inflation. The major difference, however, is the decline in real and nominal interest rates in the Administration's projection. Some decline in interest rates appears to be consistent with the proposed measures for deficit reduction.

THE BUDGET OUTLOOK

Given baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the total federal deficit--including off-budget spending--will rise from \$215 billion in 1985 to over \$300 billion by 1990 (see Table 3). Except for the current fiscal year, the projected total deficits for the 1986-1989 period are very close to those calculated in our August report. The 1985 total deficit estimate, however, has been raised by \$24 billion--from \$191 billion to \$215 billion--largely because of lower anticipated revenues and a one-time increase of \$13 billion in spending for purchases of federally guaranteed notes issued by local public housing authorities.

Under current law and budget policies, projected total deficits are stabilized at around 5.4 percent of GNP through 1990--in contrast to our projections of a year ago, when the deficit was rising as a percentage of

TABLE 3. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1984 Actual	1985 Base	Projections 1986	1987	1988	1989	1990
			In Billions of Dollars				
Baseline with Budget Resolution Defense Authority a/							
Revenues	666	735	788	855	934	1,005	1,088
Total Outlays b/	852	950	1,008	1,095	1,191	1,284	1,390
Total Deficit b/	185	215	220	240	257	280	302
Debt Held by the Public	1,313	1,526	1,745	1,984	2,240	2,519	2,820
Baseline with No Real Growth in Defense c/							
Revenues	666	735	788	855	934	1,005	1,088
Total Outlays b/	852	950	1,002	1,075	1,150	1,218	1,292
Total Deficit b/	185	215	213	219	216	213	204
Debt Held by the Public	1,313	1,526	1,739	1,957	2,172	2,384	2,587
			As a Percent of GNP				
Baseline with Budget Resolution for Defense a/							
Revenues	18.6	19.1	19.0	19.1	19.3	19.3	19.4
Total Outlays b/	23.8	24.6	24.2	24.4	24.7	24.7	24.8
Total Deficit b/	5.2	5.6	5.3	5.4	5.3	5.4	5.4
Debt Held by the Public	36.7	39.6	42.0	44.3	46.4	48.4	50.3
Baseline with No Real Growth in Defense c/							
Revenues	18.6	19.1	19.0	19.1	19.3	19.3	19.4
Total Outlays b/	23.8	24.6	24.1	24.0	23.8	23.4	23.0
Total Deficit b/	5.2	5.6	5.1	4.9	4.5	4.1	3.6
Debt Held by the Public	36.7	39.6	41.8	43.7	45.0	45.8	46.1
Reference: GNP (in billions of dollars)	3,581	3,855	4,158	4,483	4,830	5,204	5,606

SOURCE: Congressional Budget Office.

a. Defense budget authority for 1986 and 1987 is assumed to be the amounts specified in the most recent Congressional budget resolution. Defense budget authority for 1988-1990 is an extrapolation of the budget resolution prepared for the staffs of the House and Senate Budget Committees. Outlays are estimated consistently with the assumed budget authority using CBO technical estimating methods.

b. Includes off-budget spending, primarily by the Federal Financing Bank.

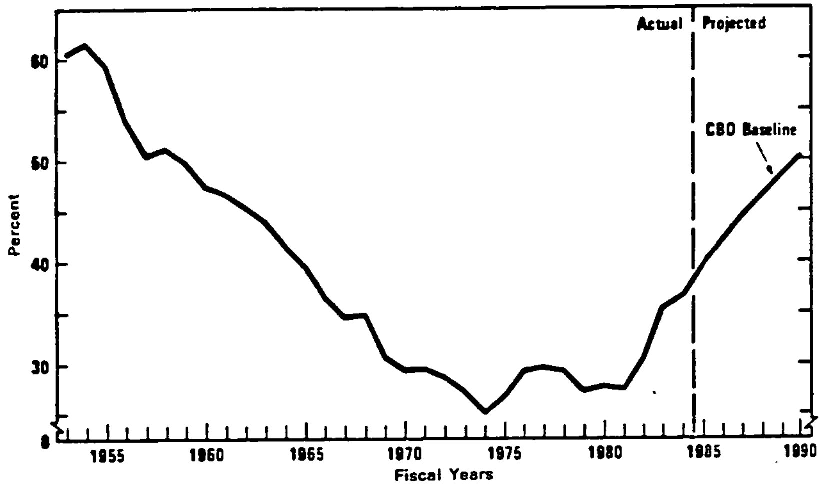
c. Defense budget authority for 1986 through 1990 is the amount that would provide no real growth under CBO economic assumptions.

GNP. This improvement results from policy changes in the Deficit Reduction Act and other measures.

With current policies, these deficit projections imply that federal debt held by the public would grow from $1.3 trillion at the end of fiscal year 1984 to $2.8 trillion by the end of 1990, an accumulation that outpaces the growth in the economy by a wide margin. The debt held by the public would grow from under 30 percent of GNP during the 1970s to 50 percent by 1990 (see Figure 2).

I would like to emphasize that our projections are not meant to be forecasts of future budget outcomes, but merely what would happen to the budget if current laws and policies were continued unchanged. In that sense, they provide a useful benchmark or baseline against which proposed policy changes can be measured. In preparing our baseline projections, it is necessary to adopt a number of conventions or assumptions as to what constitutes current budgetary policies. In some cases, the choice of assumptions can have a substantial effect on the projections. For example, for defense spending we use an extrapolation of the most recent Congressional budget resolution as the best approximation of current policy. An alternative approach would be to assume no real growth in defense budget authority, essentially the same assumption as that used for nondefense discretionary spending programs. The effect of this alternative assumption is to hold the budget deficit at about the present level for the next several years. As shown in Table 3, under a zero real-growth assumption for

FIGURE 2.
FEDERAL DEBT HELD BY THE PUBLIC AS A PERCENTAGE OF GNP



SOURCE: Congressional Budget Office.

defense spending, the baseline deficit in 1990 is projected at $204 billion. This amount is almost $100 billion lower than the deficit projected under an extrapolation of defense spending implied by last year's budget resolution.

Finally, in terms of the budgetary outlook, I must underscore the sensitivity of the specific numbers to the actual state of the economy. If the economy performs better than projected, deficits will be less than projected. But the opposite also holds: a weaker economy implies a bleaker budgetary picture.

We have provided two alternative sets of economic assumptions that are very likely to bracket the range of possibilities. 1/ In one set of assumptions, the economy duplicates the extraordinary growth performance of the 1960s. Even in this scenario, under current policy, the budget remains far from balanced. The implied 1990 deficit is about $130 billion or about 2 percent of the GNP--a ratio exceeded only once in the 1960s. In the other set of economic assumptions, we assume a severe recession in 1987 and as a result the 1990 deficit soars to about $430 billion or nearly 9 percent of a much lower GNP.

THE ECONOMIC EFFECTS OF DEFICITS

What are the economic effects of the deficits implied by the CBO projections? Economists cannot answer this question precisely. It seems unlikely that deficits would have a sudden destructive impact on the economy. In fact, under some circumstances, temporary deficits--even large ones--can have beneficial effects on the economy. But persistant large deficits, such as those that would be realized with current policies, are almost certain to have detrimental effects on the growth of the economy in the long run.

In the remainder of my testimony, I will discuss five aspects of the deficits: their size in relation to historical savings trends; deficits and international capital flows; the costs associated with financing such deficits;

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1. See The Economic and Budget Outlook: Fiscal Years 1986-1990, pp. 44-46.

the impact of the buildup in government debt on the living standards of future generations; and the short-run effects of corrective measures.

Savings and Deficits

The unique nature of the recent experience with deficits, and the potential for damaging productive investment, can be seen by looking at historical magnitudes of flows of savings and investment. Since 1950, net private savings in the U.S. economy have averaged about 7.2 percent of GNP. State and local governments registered an additional small surplus that averaged 0.4 percent of GNP during this period, while net foreign investment was negligible. Federal deficits absorbed about 1.1 percent of GNP, on a national income accounts basis, leaving total private and public saving available for net domestic investment equal to about 6.5 percent of GNP (see Table 4).

Thus far in the 1980s, the federal sector deficit has averaged 3.9 percent of GNP despite the fact that net private savings was only 6.0 percent, well below the historical average. The financing of these large budget deficits was made possible by above average savings by the state and local sector (1.3 percent of GNP) and an increase in net foreign investment. Private investment also was weak (4.1 percent of GNP), largely as a result of the recession.

While it is difficult to forecast future savings flows, it is clear that the federal government will stake a major claim to these funds during the

TABLE 4. NET SAVINGS AND INVESTMENT FLOWS AS PERCENTS OF GNP (NIPA Basis)

Period	(1) Net Private Domestic Savings	(2) State and Local Surplus	(3) Federal Deficit	(4) Net Domestic Savings Available for Domestic investment: (1)+(2)-(3)	(5) Net Private Domestic Investment	(6) Net Domestic Savings Shortfalls (5)-(4) = Net Foreign Investment
1950-1959	7.2	-0.2	-0.1	7.1	7.1	-0.1
1960-1969	7.8	0	0.3	7.5	7.0	-0.5
1970-1979	7.2	0.8	1.8	6.2	6.4	-0.1
1980-1984 a/	6.0	1.3	3.9	3.4	4.1	0.7
Average						
1950-1984	7.2	0.4	1.1	6.5	6.4	-0.1
1985-1990 b/	7.2	1.4	4.6 c/	4.0	6.4	2.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

a. BEA estimates are used for 1984 state and local surplus and 1984 federal deficit.

b. Only the federal deficit is a CBO projection. Net private domestic savings and net private domestic investment shares of GNP are assumed for illustrative purposes to be at their averages of the 1970s, while the state and local surplus is assumed to maintain its high estimated share of GNP in 1984. Columns 4 and 6 are calculated from the other figures.

Details may not appear consistent with totals because of rounding.

c. The NIPA federal deficit projection is based on unified budget deficit projections from The Economic and Budget Outlook: Fiscal Years 1985-1990, CBO, February 1985.

next several years if budget policies are not changed. CBO's baseline budget projection for the 1985-1990 period indicates that the federal deficit-to-GNP ratio will average over 4½ percent of GNP, on the same national income accounts basis. Thus, the share of net domestic savings absorbed by deficits would be many times higher than the average of the past. Moreover, funds available for domestic investment would be well below average, if savings behavior follows historical trends. Even if net private savings were restored to its historical average of 7.2 percent and state and local surpluses were to near their record high, domestic savings available for investment would be only about 4 percent of GNP, given the budget deficits. Therefore, if investment spending merely matched its historical average--6.4 percent of GNP--the shortfall of domestic saving would be about 2½ percent of GNP. This large gap between domestic savings and investment could be filled only by (1) reducing federal budget deficits, (2) raising domestic savings sharply above U.S. experience, or (3) attracting inflows of foreign capital of record proportions. Otherwise, investment spending is bound to suffer.

While the behavior of savings rates is not well understood, experience in the United States indicates that this large shortfall is not likely to be filled by increased private domestic saving. Instead, if budget policies are not changed, total domestic savings are likely to remain scarce relative to planned investment. The competition for funds would be intense, leading to high real-interest rates, because interest rates are the mechanism for allocating scarce funds to alternative uses. In its baseline economic projections, CBO assumes that large capital inflows are maintained and that growth in domestic investment remains strong. For this to happen, investors must be willing to see their holding of dollar-denominated assets rise rapidly.

The Deficit and International Capital Flows

Net capital inflows have already become very large, amounting to 2.5 percent of GNP in 1984, a postwar record. Foreigners have been lending more to the United States, but equally important, U.S. residents have been lending and investing less abroad. The result has been a soaring dollar. It is up about 20 percent since January 1984, and on average, nearly double its value at its low point in 1980.

The strength of the dollar, which continues to surprise economists, has had some good results: higher availability of capital means that interest rates are not as high as they would otherwise be, and lower costs for imported goods have helped to achieve the significant reductions of inflation in recent years. But there have also been severe costs. Some sectors of the economy have suffered losses of profits and employment--for example, farming and other industries for which exports are important, as well as many industries that directly compete with imports. The direct counterpart of the record net capital inflow is a record merchandise trade deficit, which reached 3.4 percent of GNP last year.

In CBO's view, a significant portion of the massive capital inflows is linked to the federal deficit. When there are few impediments to international capital flows, relatively small changes in interest rates can move large amounts of capital from one country to another. Therefore, the deficit, which increases domestic demands for credit and thus increases interest rates, can be financed to a large extent in the international capital market rather than in the domestic market alone. Economists also point to other reasons for the changes in capital flows:

- Investors may be attracted to the relative political stability of the United States; and

- Real rates of return on investment in the United States have been raised by the tax reforms of the ERTA, and possibly by the regulatory reforms undertaken in recent years.

The stability of current capital inflows, whatever their source, cannot be relied on indefinitely. Investment prospects may improve abroad. Foreigners who acquire U.S. assets could eventually face the risk of unfavorable changes in the return on their dollar holdings--for example, a fall in the value of the dollar or capital loss as a result of rising interest rates. At some point, which cannot be determined in advance, the net capital inflow must slow or stop. At that point, the prop that has supported the dollar will be removed. CBO has assumed in its projections that dollar accumulation by foreigners will continue at least through 1990, but the risk of an earlier end must be recognized.

What would happen if foreigners decide to acquire fewer dollar assets? First, the dollar would fall. Since the strength of the dollar is an important part of the attractiveness of holding dollar assets, a fall in the dollar would presumably further reduce capital inflows. Second, lower credit supplies on the domestic market would raise interest rates in the United States. Third, the falling exchange rate would add to inflation--a big change from the current situation, in which the rising dollar is holding down inflation. Fourth, one pleasant result would be that those industries that have been most severely hurt by the rising dollar would get relief.

Outlays for Interest on the Debt

As indicated earlier, if budget policies are not changed, the outstanding federal debt will rise dramatically. Federal spending for interest payments would also rise sharply. How fast interest payments will rise depends on the rate of growth of the outstanding debt and the level of interest rates. In CBO's baseline, net interest costs are the fastest growing category of spending, rising from $111 billion in fiscal year 1984 to $234 billion in fiscal year 1990. One consequence of the rapid rise in interest costs is that it would limit resources available for other spending programs, given a constant deficit-to-GNP ratio.

If deficits were to become sufficiently high in the long run or interest rates were to rise significantly, interest costs might rise so rapidly that it would no longer be politically feasible to offset their growth by raising taxes or cutting programs. At that point, there is a danger that the deficit and the associated debt outstanding would explode relative to GNP. Under these circumstances, there would be a strong temptation to finance government by creating money rather than by further borrowing. The result would be, of course, highly inflationary. Fortunately, under current policies, the projected growth of non-interest spending, relative to the growth in receipts, is sufficiently low to offset the growth in interest costs and to stabilize the deficit/GNP ratio at somewhat more than 5 percent of GNP.

Long-Run Effects of Deficits

One consequence of persistent large deficits about which there seems to be little disagreement is their adverse effect on future generations. If deficits were financed entirely through domestic savings, rising federal debt would begin supplanting more and more private debt and equity in the portfolios of private investors. Slower growth of the private capital stock would result in lower productivity than would occur with smaller deficits, and the income of future generations would be lower. If the deficits were partly financed by inflows of foreign savings, those inflows would imply a growing debt owed to foreigners. While investment could be maintained at higher levels than would be possible without the inflows, U.S. residents would enjoy a shrinking proportion of the production generated here because of rising interest and dividend payments abroad.

Thus, while reducing deficits may be painful for our generation, failure to reduce them will affect future generations. Of course, to what extent one chooses to benefit the current generation at the expense of future ones call for a value judgment rather than an economic one.

Short-Run Considerations

Although a vast majority of the economics profession argues that deficits should be cut, some economists worry that large and abrupt spending cuts or tax increases might weaken the economy in the short run. Most options now being considered, however, would phase in deficit-reduction measures, thus ameliorating any shocks to the economy. But without such cuts federal fiscal policy will become even more expansionary at a time when the economy may be approaching high rates of capacity utilization.

The potential adverse economic impact of deficit reduction measures would also be limited by the following factors:

- A reduction in budget deficits could reduce foreign capital inflows and thus put downward pressure on the dollar in international exchange markets. If the dollar declined, the U.S. net export position would improve over time, thereby at least partially offsetting the contractionary effects of deficit-reduction measures on domestic demand. There is a small chance that more prudent fiscal policy would so enhance the confidence of foreign investors in the United States that capital inflows would rise and the dollar would appreciate further. Under these circumstances, the enhanced savings inflow could reduce interest rates dramatically.

- With a given monetary policy, the curtailment of the Treasury's borrowing needs would reduce upward pressure on interest rates and stimulate interest-sensitive domestic expenditures. According to some economic theories, the reduced pressures on interest rates would quickly offset the contractionary effects of deficit-reduction measures.

- The financial community has expressed so much concern over the high deficits that any effort to correct them should have a salutary effect on investors' confidence in the long-run health of the economy, and thereby stimulate long-term investment.

In theory, monetary policy could largely offset short-run effects of deficit-reduction measures, at least on nominal GNP. Indeed, if falling deficits showed clear signs of reducing the velocity of money, a somewhat faster rate of money growth may be appropriate. But such fine tuning is fraught with difficulties. There is also a risk of overcompensation and the inflation that goes with it.

Thus, while there is a chance that a large and abrupt change in budgetary policies would temporarily have an adverse effect on the economy, that effect could be ameliorated by a number of factors, including phasing in the program changes, monetary policy, or an exchange-rate decline. Moreover, because of its long-run consequences, the deficit situation must be dealt with, and the sooner the better. Indeed, postponing action on the deficit may entail costs beyond the direct costs of higher interest outlays on the budget. For example, delay may have serious consequences for business investment even in the short run. Businesses and individuals have to plan knowing that there is growing pressure to reduce deficits, but without knowing what specifically will be done. The uncertainty of this situation could cause firms to postpone investment or to make inefficient decisions, with adverse consequences both for individuals and for the economy.

Representative OBEY. Thank you. First of all, you indicated in your report yesterday you expected that deficits could pretty much stay the same between now and 1990. You also indicated in your estimates that one of the major components in the difference between your estimates and the administration's was the interest rate forecast.

Would you expand on that and explain why you come to different conclusions than the administration and others might not have?

Mr. PENNER. We have traditionally recomputed the administration's budget estimates on the basis of our own economic assumptions, which are based on the continuation of current law. Under those circumstances, we think that it's reasonable to project more or less constant real interest rates.

The administration's budget this year does involve really more major moves toward lower deficits than is typically the case. In that sense the two economic forecasts are not exactly comparable. That is to say, CBO projects on the basis of current policy and the administration does so on the basis of its own policy. So, it is not surprising that it projects lower interest rates than CBO.

Representative OBEY. Well, let me interrupt at that point and ask for a point of clarification. These are the numbers that as far as I'm concerned would be legitimate numbers. If you assume that the administration does get the deficit reductions which it has requested, under those circumstances, accepting their estimate of what the political process ought to produce—maybe not but ought to produce as they see the world—what are your projections for deficits under those circumstances?

Mr. PENNER. We start with a deficit of $215 billion in 1985 and then, projecting according to our economic assumptions, there is a big drop in the deficit to $186 billion in 1986, and it varies around that level through 1990.

Representative OBEY. So you are still saying that even if we do accept the administration's budget cuts you expect the deficits would remain equal?

Mr. PENNER. That is before one takes account of any indirect economic impacts that the administration's cuts might have. We estimate the effects of the administrations policy proposals on the basis of a given set of economic assumptions. We think that's a convenient way to compare them with current policies and compare them with other proposals that are around—for example, budget freezes and so forth. But our estimates are static. That is to say, we don't go on and try to predict exactly what those policy changes will do to the economy.

Representative OBEY. Well, if I could play devil's advocate on the part of the administration for a moment, I would assume they would argue that if something happens that they recommend then something else will happen in the economy producing some different numbers.

Mr. PENNER. I think that is exactly right.

Representative OBEY. What I'm looking for is if I'm going to give a dead level honest estimate of what happens on deficits, assuming the administration's package prevails, we have to make some assumptions about what happens to other indicators in the economy.

Mr. PENNER. That's right, sir. The problem is that there is probably no issue that is more controversial in the economic profession right now.

Representative OBEY. So I guess what we would simply say then is that—and if I'm wrong correct me—you still feel comfortable in at least asserting that regardless of the changes that might occur in the economy you still think we are likely to face higher deficits than the administration thinks we would face, even if you were looking at the situation in an unstatic way?

Mr. PENNER. It's even difficult to reach that definite a conclusion because of two factors. First of all, even given a certain set of policies, there is a lot of forecast uncertainty; then there is the added uncertainty, which I just mentioned, of what any particular policy change would do to the economy.

Now the biggest difference between what the administration is assuming and what we assume is on the matter of interest rates. That is what really drives the biggest wedge between our estimates and theirs. They are assuming that if they got their policies you would see real interest rates driven back down to their historical levels; that is, to average levels we experienced in the 1960's and so on.

I can't blatantly rule out that possibility, obviously. I think the real question that you all face, given the uncertainty, is would you be satisfied with a deficit of $180 billion or so assuming that in essence history repeated itself with the exception of real interest rates which would remain unusually high—and that is the basis of our assumption; or, conversely, would you be satisfied with a deficit that is up at $82 billion if things worked out very much more optimistically than is implied by our baseline.

It's a difficult choice. I think what it really reflects is that very small changes in the economic assumptions have very large effects on deficits, and we try to help you through that whole process by laying out all of these various scenarios.

As you suggested, we could even have a worse scenario, a recessionary scenario; we can't rule that out either. Things could be much worse than our baseline.

In the testimony I gave yesterday, there are four different combinations of scenarios. But, unfortunately, the art of forecasting and the state of macroeconomic analysis is such that there are just extraordinary uncertainties that we have to lay out on your table.

Representative OBEY. Let me ask you, because I don't know what your procedures are or how you do this, could you give us an estimate of the effects of the administration's program on the economy using DRI or the Chase Econometric models?

Mr. PENNER. We can run such simulations. We're very nervous, however, about their accuracy.

Representative OBEY. We're nervous about the accuracy of everybody.

Mr. PENNER. Yes. But we can and have run different policy simulations on such models. It's very important, of course, when you do that to have the requester specify what else is being assumed, particularly about monetary policy, which is crucial to all of this. But we do that, although we do it with great nervousness.

Representative OBEY. Sure. I appreciate that. Well, I would frankly like to see that done and I'll get back to you on it.

Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Mr. Penner, you mentioned the possibility of increasing taxes on alcohol, tobacco, gasoline, and other luxury items. I'd like to have your opinion on whether we could reinstate a luxury tax and what its potential would be. It seems a little anomalous to me that we would continue on with a scheduled reduction in the cigarette tax from 16 cents a pack to 8 cents a pack when we are in the midst of this dire deficit crunch. I'm told that for every one penny that we would reduce that tax we would lose $112 million. So when you talk about reducing it by 8 cents, you talk about almost $1 billion.

What do you think about the whole proposition of reversing that scheduled reduction in the cigarette tax and increasing the cigarette taxes and gasoline taxes, more nearly to the level that Europeans have become used to being taxed on their gasoline per liter or per gallon, and perhaps reinstituting a luxury tax. I take it there would be several billion dollars a year eventually added income enhancement, to quote a phrase, and in a way that wouldn't penalize the average person because all of these taxes would be avoidable. And I assume it wouldn't offend the administration as much as a broad across-the-board income enhancement measure would.

What would your reaction be to such a broad scale increase in alcohol, tobacco, gasoline, and luxury taxes?

Mr. PENNER. Well, sir, they are clearly consumption taxes, which implies a certain distributional effect. They are also taxes on particular items, at least those on alcoholic beverages and cigarettes, that people do believe have health costs. That is to say, they increase our health costs.

Representative SCHEUER. I am sorry. Could you repeat that, please?

Mr. PENNER. What I'm saying is that there is a general presumption that cigarettes and alcohol are bad for your health.

Representative SCHEUER. And if you increase the tax, presumably that would have a tendency to reduce consumption.

Mr. PENNER. Yes, sir, that was my point. It would reduce both public and private health costs if the presumption is correct.

I think it's clearly a political and value judgment for the Congress to make as to whether that is a more equitable and efficient approach than perhaps some other sorts of taxes—for example, broadening the base of our existing income and corporate taxes.

Just to give you the numbers on the various options, if you were to extend the increase in the cigarette excise tax that was in TEFRA, which involves keeping it at 16 cents a pack, that would add about $1.7 billion per year to revenues in the period 1987 through 1990. Were you to double the excise taxes on beer and wine, that starts out providing $0.8 billion in 1986 and rises to $1.2 billion in 1990.

As you know, right now the taxes on cigarettes and alcohol are fixed at a certain number of cents per unit. You could think of indexing that number of cents for inflation, or you could even think of converting to a tax that's based on a percentage of the good's value. We have an option to index the tax rate in our annual report, that would raise about $1.5 billion in 1990. As an aside, it's a little difficult to levy a percentage tax in these areas because it would usually be thought of at the manufacturer's level and there are a lot of integrated firms, so there is a valuation problem. Most tax experts would favor indexing the tax to inflation rather than a percentage tax. But those examples give you the sort of orders of magnitude that we're talking about.

You also asked about increasing gasoline taxes. A motor fuel excise tax increase of 12 cents a gallon would raise $10 billion by 1990.

Representative SCHEUER. What is it now?

Mr. PENNER. It is now 9 cents per gallon.

Representative SCHEUER. So every penny a gallon on the gasoline tax produces——

Mr. PENNER. It would be $3 billion in 1990. In 1986 the amount would only be a little over $2 billion.

Representative SCHEUER. If you went to a substantial tax there, 50 cents a gallon tax, it would produce——

Mr. PENNER. I'm sorry. I misspoke, Congressman Scheuer. I was referring to a tax of an additional 12 cents. Therefore, the amount is a lot lower than I suggested. It would be a little less than $1 billion in 1990 and probably about $600 million in 1986. So it's lower than I said .

Representative SCHEUER. Well, even there, if we have as a national goal achieving some kind of energy independence, at least to the extent that the tax didn't unfairly discriminate against poor people who needed it to go to work and so forth, it would be consistent with clearly established long held national goals, would it not?

Mr. PENNER. That is correct, yes.

Representative SCHEUER. Do you have any policy advice to give us?

Mr. PENNER. That is something I'm not supposed to do, sir. I think in this book that I've been reading from—our report on the deficit spending and revenue options—we do try our best to state what we see as both the advantages and disadvantages of these various options.

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

Thank you, Mr. Chairman.

Representative OBEY. Congressman Mitchell.

Representative MITCHELL. Thank you, Mr. Chairman.

Mr. Penner, I have just one or two points I want to get clarified. In your prepared statement you refer to the money supply M1 and you pointed out that your projections for short term would be around 5.5 percent and then added that that's about midway of the range of Mr. Volcker's projections from floor to ceiling. But I thought the last time Mr. Volcker appeared before us he said that his range, the top, would be about 8 percent not 10 percent.

Mr. PENNER. No, the new range that he announced very recently for M1 is between 4 percent and 7 percent, so we've just gone right down the middle range in terms of making our own forecast.

Representative MITCHELL. Well, 5.5 percent is not really midrange even if it's 7 percent. I'm not being picayune, but a one point shift in money supply either up or down can have a significant impact.

Mr. PENNER. Absolutely. That's one of our problems in forecasting. But we have little alternative other than to use something in the middle somewhere.

Representative MITCHELL. Then another point of clarification. Somewhere in your prepared statement you made a statement to this effect—even temporary high deficits can have beneficial effects on the economy. That's an absolutely sharp contradistinction to the Reagan position that any large deficit has an immediate effect on the economy. So I wanted you to explain for me the rationale behind that statement that even a large temporary deficit can have a beneficial effect on the economy.

Mr. PENNER. Yes, we really want to differentiate between the short run and the long run. In the short run, according to traditional Keynesian theory which, of course, is being attacked from all sides these days, an increase in the deficit would be expansionary. It would increase aggregate demand in the economy and could move us toward the full-capacity path of the economy. So it was that element that we were referring to.

We think that in this modern day that element is considerably muted by the interrelationship to the trade deficit, which I spoke of before. That is to say, as soon as you start to push up the Federal budget deficit, it starts to pressure up interest rates, thus drawing in capital from abroad, sending the value of the dollar up, and raising the trade deficit, which, of course, counteracts this shortrun stimulative effect of the budget deficit.

Representative MITCHELL. By short run you're talking about a year?

Mr. PENNER. Yes, something like that. In the longer run the effects are negative as far as future generations are concerned.

Representative MITCHELL. Thank you. I'm beginning to sound more and more like a broken record in terms of the foreign capital investment in this country. Every time I raise the issue with Mr. Volcker or Treasury or anybody else, they say it's really not a problem. And I feel somewhat rebuffed, but I continue to raise it.

Let me talk just a little bit about the foreign capital inflow. It seems to me that we find ourselves in a totally impossible situation. If on the one hand we're going to rely on foreign investments which help finance our budget deficit and keep the exchange rate high and do all sorts of good things, but yet hurt our own export industries—if we do that it has a bad effect; or if we reduce our reliance on foreign investment it has the same effect. And if we do that, we will increase interest rates, according to your testimony. This will bring about more inflation and will hurt domestic investment. These are two absolutely opposing positions.

How do you get out of this dilemma?

Mr. PENNER. Again, our whole analysis is based on the presumption that one way out of the dilemma is to reduce the budget deficit. Now some people disagree with that. There are people who would argue that if we reduce the budget deficit, then foreigners will be so taken with our move toward prudence that they will invest even more in this country and the dollar will go up further and there will be even more negative effects on our trading industries.

We don't think that is likely. But we can't rule out that possibility. But I would argue that if that occurs, there would be a great increase in the supply of savings to our economy. You would have that increase because you're reducing the budget deficit, you would have the increase from more foreign savings coming in, and that would cause interest rates to absolutely plummet in this country, which would have a very good effect.

Moreover, according to that sort of scenario, capital inflow would be more like what we experienced in the 19th century. I don't think there is any denying that the big imports of capital we had in the 19th century greatly aided our long-term economic growth. The big difference, though, was that then we were using foreign savings to finance railroads and canals and other very productive investments. Currently, while the inflows of foreign capital have been extremely useful in keeping our level of investment high—and even slightly higher than we would otherwise expect at this time of the business cycle—I think it fair to say, at least by our analysis, that most of it has just gone into financing the budget deficit indirectly.

So the situation is analogous to that of a household. You don't object to a household borrowing to finance real assets such as a house, for example, but you do begin to worry if it borrows a lot to finance consumption. And I think that is more similar to the state that we are currently in.

But to reiterate, we think that the most direct way to reduce foreign capital inflow is to reduce the Federal budget deficit.

Representative MITCHELL. All right. I'm more inclined to take the position that if we reduce the deficit in any significant fashion that would have the effect of lowering interest rates, and from our vantage point the only reason we have high foreign investment in this country is because of our interest rates.

Mr. PENNER. That's exactly our analysis.

Representative MITCHELL. And if we accomplish what you think is the desideratum of reducing the deficit, then those who have invested in this country are likely to pull out? The only attraction here for them is the high interest rates.

Mr. PENNER. That is exactly the way we see it, sir, just the way you're describing it.

Representative SCHEUER. Would my colleague yield?

Representative MITCHELL. Yes, I would be delighted.

Representative SCHEUER. Isn't there another attraction, and that is the whole safe haven business? Even if interest rates go down, a lot of investors around the world will still say that the U.S.A. is still the best place on this globe to have their money.

Mr. PENNER. I didn't mean to imply that the only reason people are investing here is the budget deficit. I think that is just one factor. Another important factor is the fact that the European economies have been so sluggish recently and not a very attractive place to invest money. So I do think there are three things going on—the high real interest rates, and we attribute much of that to the budget deficit; the political stability argument that you just made; and the difference in growth rates between us and other countries that might compete for this pool of capital.

Representative SCHEUER. I yield back.

Representative MITCHELL. I didn't discount the safe haven theory, but that is more applicable I think in terms of the European countries. When I look at the—and I'll use the word—volatility of some of the Arab States, I'm not at all sure that their investments are essentially predicated on a safe haven. This is where there's the biggest return. If that's right, then they would pull out. Then you raise the question of what percent of foreign investment is there other than from the European countries. I agree that it's not a simplistic, one-dimensional answer.

Mr. PENNER. Though we often refer to foreign investment in this country and much of it is owned by foreigners, it should also be pointed out that another important thing that has been going on recently is that American capital that would have otherwise gone abroad is staying here—capital owned by the big multinational corporations that's usually labeled American capital. That's another element of the picture.

Representative MITCHELL. My time is up.

Representative OBEY. Just following up on that point, I'd simply like to observe that we may have significant investment going on in this country from foreign sources. But in one sense at least we have a disinvestment going on in our own country. If you take everything that we were spending in 1980 for any possible program that goes to anybody that's retired—and if I include in that veterans' retirement programs, and if you include programs for which people who will retire are eligible—you see an increase in the percentage of the dollar going to that portion from 1980 and on out. You see an increase in the portion of the budget dollar going for military expenditures. You see an increase in that portion of the budget dollar going for interest, well over a 50 percent increase.

So if you take a look at the 1986 request, vis-a-vis the 1980 after expenditures, you see a 20 percent reduction from 6 cents to 5 cents in the subsidies that go to the nonelderly poor which are not retirement related or medically related for the retired.

And if you look at the remainder of what Government does, everything, whether it is maintaining the prisons, running the IRS, all of the environmental programs in the country, all of the highway programs, all of the transit programs, all of the other health programs, all of the research programs, everything else the Government finances—and certainly it is in that portion of the budget in which you find our own public investments in kids, in infrastructure, you name it—that portion of the budget has really decreased by almost half from 1980 through the budget request for 1986. And while that certainly isn't under the jurisdiction of this committee, it nonetheless relates to the work we do.

I'm very frustrated by the whole idea of how both parties rely from time to time on magical wondrous things that will happen in the outyears that really divert our attention from the necessity to face the real choices now, this year and next year.

I noted—well, to be honest about it, the staff did—but in 1981, you evidently wrote an article in which you pointed out that rosy projections dull us into being too complacent regarding future budget trends. To overcome that problem you advocated accepting the administration's forecast for current year and subsequent year but proposed that extrapolations for the 4 succeeding years be based on the record of the economy over the preceding 5 years. I hope that's a correct description of what you said.

Mr. PENNER. That was a correct description of what I said. I think it was wrong.

Representative OBEY. That's what I wanted to ask you. You're the first man I've ever met that's admitting that you did anything wrong. Why do you disagree with yourself?

Mr. PENNER. Well, I wrote that article while inflation was plummeting to a much greater degree than expected and to apply that process in the subsequent years after I wrote that article would have given really very misleading inflation numbers.

What we are doing now, though, is a variant on the theme in that article, and so far at least I'm quite satisfied with it. The main point of the article was to suggest that budget projections be based on historical trends and relationships in the economy and not on goals. While obviously we as a nation should have economic goals, those goals should be ambitious and that in turn means that you're not going to meet all of them. So basing projections on goals, which I think both the administration and CBO were guilty of early on, really does give an optimistically biased result.

So now, instead of putting in goals, CBO bases its long-term projections on historical evidence. Our actual process is not the one that I recommended in my article, which I think would be flawed. Taking this year as an example, we are projecting out to 1990; 1990 is exactly 8 years after the trough of the business cycle in 1982. What we now do is to assume that the average growth over those 8 years will be equal to the average growth in 8 year periods following other business-cycle troughs in the postwar period. Then having that real growth amount, and again basing our analysis on historical evidence, we try and come up with an inflation rate that looks consistent with that kind of rate of growth and whatever slack or tightness it implies for labor markets, and so on.

Because we smooth it all out after our forecast period from 1987 to 1990, a lot of people misinterpret us and say that we are still too optimistic because we're assuming that there will be no recession in the period. That's not quite right because we're averaging 6 of these 8 year periods, only 1 of which had no recession in that long a period. Some of those periods had one recession; others had two. So that is all wrapped up in our average. But the implication would be that we could tolerate a mild recession and still come out with the kind of economic growth that we are projecting.

I think that we have moved a long way in the spirit of that article, and I should say that process started before I came to CBO—a move away from putting in goals for the economy. So I hope that our projections are now more realistic. If you go over our projections through time, the optimistic bias is really quite incredible.

Representative OBEY. What I'm concerned about is that—when we started to require people to look at things in 3 year and 5 year timeframes, the purpose was to avoid funny business short term, and to get an honest view of what you were doing short term if it were carried out long term. Instead, I think what has often happened is that people have used ethereal assumptions about outyears to in fact make our actions in the short term appear more significant than they are.

I recall after the House passed the budget resolution last year we went home after it finally happened and I recall turning on NBC News one evening to hear that the Treasury itself had estimated that approximately half of the deficit savings or more which had taken place had been wiped out simply by changes in estimates. So we had gone through one hell of a lot of struggle and produced something less than a gnat. And I guess we'll probably walk into the same problem again.

Mr. PENNER. I really hope not. I think we really have changed the way we're looking at the process.

Representative OBEY. Maybe you have. I'm not talking about you. I'm talking about us.

One other question. On military expenditures, it's my understanding that the administration in its budget says that current services estimate "reflect the anticipated cost of continuing ongoing Federal programs and activities at present levels without policy changes. That is, ignoring all new initiatives, Presidential and congressional, that are not yet law."

Then my understanding is that they proceed not to use their own guideline in the case of military expenditures by using as a current service baseline their own policies as reflected by the midsession review of the 1985 budget, not policies which were enacted. But you use as a deficit baseline an extrapolation from the most recent congressional budget resolution.

We've gone over this before, but why do you do that? Obviously I have less argument with your numbers than with the administration's definition, but why do you do that rather than simply defining current policy as current military budget projected on a no-growth basis?

Mr. PENNER. I think in any account where you have a big——

Representative OBEY. No real growth.

Mr. PENNER. I think in any account where there are large-scale capital expenditures and where there are plans, even though those plans are not ratified in terms of an actual appropriation, it is really difficult to know what current policy should be. This is a problem that afflicts defense and nondefense accounts. While in most nondefense discretionary accounts we do assume zero real growth, there are exceptions to that. For example, we had a debate at CBO about whether the space station should be included in NASA current policy. In that case, we decided it should not be. But that is the sort of a conceptual problem that occurs again and again in defense. Although you appropriate year by year, there is a multiyear plan to acquire a certain number of F–15's, to acquire a battleship, or to acquire a nuclear carrier that won't even be seen until the 1990's.

So it's hard to know how to reflect all of these commitments which, as I say, are not necessarily ratified by a particular appropriation, after much discussion among us and the budget committees, we have resorted to the budget resolution as an indicator of congressional plans and strategies.

Now, because of this problem, we do put in our reports a zero real-growth number for defense as well. In fact, I've repeated it in my prepared statement today in table 3. So if people really feel strongly that they don't want to use the budget resolution as a definition of current policy, you can turn to this other path.

Representative OBEY. My concern is simply this—and I congratulate you for at least using or listing other methods of computing it, but the problem is simply this—I believe the problem is one of public conception and I believe when the public hears current policy they don't think of things in the technical insider way that we usually do here. And you're talking about some huge numbers because, as I understand it, if you assume the administration's current services estimate procedure, you get to a figure of $442 billion in 1990 for what would be a current services military budget. Under yours, we get a small favor—we assume that it's $424 billion rather than $442 billion. But if you assume that current policy means, as we generally think of current policy for domestic programs, which is zero real growth in programs, you get a military expenditure in 1990 on a current policy basis of $344 billion, which is one hell of a difference.

And I think that if we do not at least give coequal emphasis to the latter number, we do take people like Cap Weinberger off the hook because they can pose for political holy pictures on reducing deficits by significant amounts when in fact they've reduced them by peanuts. It means if I'm sitting in a poker game and I throw in a quarter and he thows in a penny, he's got a hell of an advantage. That's what I think he's done and I recognize that reflects my own bias on the issue obviously, but I've discovered nobody is really objective.

Mr. PENNER. Although it is probably a hopeless cause, I personally think that the discussion would be advanced a great deal if instead of discussing cuts from something—we so seldom say what the cuts are from—we were to talk in terms of the target deficit that we are after or the target outlays or the target receipts. I think that would help clarify the discussion a little bit. Of course, then you immediately run into the problem that the deficit itself is very sensitive to economic assumptions. But I couldn't agree with you more that discussing the issue in terms of cuts is just very, very confusing. It's confusing even to me: I'll be the first to confess. I can't imagine how the public sorts its way through this.

Representative OBEY. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Let me ask a question about productivity. Apparently it's gone up somewhat by 2 or 3 percent in the last couple years. It didn't go up much in the last half of the 1970's, as I recall, and the early 1980's.

How do you view our national productivity as compared with prior years, prior recoveries, and with what's going on in other countries; and how do you view trends in our productivity? How do you view the way in which trends in productivity will posture us in terms of our competitiveness and our ability to sell our goods and services to the global economy, assuming that somehow or other we solve the problem of this mind-boggling outsized dollar we have on our hands that in itself is a tremendous impediment to our selling goods and services in this global economy?

Mr. PENNER. Well, I see you have volume I of our Annual Report in front of you. On page 6 of that volume, there is a chart that shows how productivity has behaved in this current recovery as opposed to an average of previous recoveries. And what the chart shows is that right at this moment we're just about average, which is a significant improvement over the 1970's when we were running far below average.

Representative SCHEUER. What are the implications of our current rate of productivity growth on the growth of the economy, real income growth, our budget deficit, inflation and the like?

Mr. PENNER. The real importance of productivity is that it determines how fast our full capacity economic path is growing. That is obviously crucially important. We're not near that path at this moment. But as we approach it, needless to say, the higher that path, the better we will do in terms of inflation as we expand upward. Obviously, the higher the ceiling imposed by that path, the higher the standards of living will be in the future.

I should also add that I think it's very difficult to know exactly how to change productivity. Many scholars have looked at the stagnation of productivity in the 1970's and have not really come up with any very good answers as to why productivity was so much lower. Some of the gap has been explained. It's much lower in the 1970's, however, than anyone can explain satisfactorily. So it's very hard to say where it's going to go in the rest of the 1980's. Again, our particular economic forecast is based on the assumption that we stay with this historical average. We're right about on the line now. And that that will continue for the rest of the decade.

You also asked about the implications of productivity for the budget deficit. I guess I would reverse that and really again say that the budget deficit has implications for productivity. To the extent we have to finance the growing Federal budget deficit domestically, it does eat into our capital stock.

In my prepared statement, table 4 is an interesting table that looks at savings trends and investment trends over different periods. It illustrates the quantitative importance of the Federal deficit today relative to net savings and essentially asks, how on earth are we going to finance that? Well, to the extent it is financed out of domestic capital formation, obviously productivity will be lower in the future.

With regard to the effect of productivity changes on trade, that is a very tricky question. In terms of the composition of trade, what kind of relative growths of productivity you have in different sectors is more important. The average rate of productivity growth may not tell you very much.

Representative OBEY. Would the gentleman yield for a question?

Representative SCHEUER. Surely.

Representative OBEY. When Mr. Brock was before our committee, he expressed confusion at the inability of the individual tax cuts that were provided over the past few years to provide a greater stimulus to the personal savings rate. He said he didn't know why it hadn't done what had been hoped for and expected.

Do you have any views on that as to why they did not stimulate a greater amount of personal savings?

Mr. PENNER. The one problem that economists have, of course, is that we can't say for sure that savings wouldn't have gone down even more, for other reasons, in the absence of those tax cuts.

The empirical evidence on the savings rate, however, does show remarkable constancy. Even the most bullish estimates in terms of trying to affect the savings rate with well-designed tax changes show a fairly modest response.

I think, however, that it has to be said that our various special devices for trying to increase savings are not very well designed. I'm thinking primarily of IRA's and Keogh's and the various things we've done with pension accounts. While the effect of those plans is to essentially eliminate the taxation of a particular amount of the return of the savings, that amount is first of all limited. Obviously, if an individual would ordinarily save more than the IRA or the Keogh limits, there is no extra reward for the additional amount that he or she might put into savings in that plan. So the plan is really irrelevant for those people. In the jargon of the economist, it just provides a windfall because it doesn't affect that extra dollar of savings that they're interested in.

Conversely, for those people who ordinarily would save less than the limit, we have created an opportunity for arbitrage in the tax law where they can go out and borrow. Now they'll normally say it's money borrowed to finance a car or borrowed to finance a house or something similar. But to the extent that money finds its way into a Keogh or IRA account, what you have is essentially a tax-free rate of return and in the case of the interest paid on a loan, you have interest deductibility. What that does, of course, is not change savings behavior but, rather, just creates a revenue loss for the Treasury.

Now I don't want to claim that either of those things are completely worthless in terms of savings, in fact, I do think they probably stimulate savings somewhat. But my main point is that they are very poorly designed in terms of maximizing the savings impact per dollar of revenue lost and I think that there are other techniques. I mean, on the one hand, our whole tax system today encourages borrowing through interest deductibility. On the other hand, it encourages raising your assets. So we're telling people to raise both their liabilities and their assets, and the net effect of that is not very powerful.

Representative OBEY. The gentleman still has some time.

Representative SCHEUER. That's OK. I just have one very brief question.

What do you think are the fiscal and tax and monetary measures that we can take to increase the rate of savings for investment? It's a fraction of what the rate of saving is, for example, in Japan where I think it's 18 or 20 percent of GNP as compared to 3 to 7 percent.

Mr. PENNER. That is a very difficult question to answer because there's some argument, frankly, as to whether increases in the net aftertax rate of return to savings increase or decrease savings. I rather think they increase savings, but the point is that it does not appear to be a form of behavior that's extremely susceptible to influence from various government instruments.

But the usual economist's answer to your question would be that, to the extent the tax system is reformed, reform it by putting a heavier tax burden on consumption as opposed to putting a heavier burden on the income from capital and savings. But, of course, there are all sorts of value judgments inherent in that kind of swap.

Representative SCHEUER. Does that imply some kind of a consumption tax of 1 percent tax across the board on all consumer items?

Mr. PENNER. Not necessarily. There have been all sorts of proposals.

Representative SCHEUER. Value added tax?

Mr. PENNER. Value-added taxes or retail sales taxes are generally designed to be consumption taxes, but there are other approaches as well. Under Secretary Simon, the Treasury put out a proposal for something they called a cash-flow tax. That would be a progressive consumption tax. To oversimplify somewhat, what you would do with that sort of tax is to total up your income as you do today, deduct your net savings, and that would be the amount that would be taxed. That amount would be, by definition, equal to your consumption and you would have an exemption. There could be a progressive rate schedule and so forth. That is a way of making a consumption tax, which many people think of as being regressive and converting it into a progressive sort of tax.

Representative SCHEUER. In effect, you would get a tax credit on anything that you saved?

Mr. PENNER. I wouldn't put it that way, sir. A tax"exemption" would be a better way to put it. In essence, all savings would be treated as we now treat IRA and Keogh accounts. That is to say, you would get a deduction when you put the savings in and you would pay a tax when you took it out because it would be presumed that if you didn't reinvest it somewhere that it would go for consumption purposes.

Another variant on the theme has recently been proposed by the Brookings Institution. The proposal runs just as I've described it except that because some people worry that you will get heavy concentrations of wealth if you just tax consumption, their proposal would not only tax consumption as I've described, but it would then levy, in addition, very heavy taxes on gifts and inheritances. They call it a tax on lifetime command over resources because, you tax income during a person's lifetime, though in any single year you largely just tax consumption.

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

Representative OBEY. Thank you.

Mr. Penner, I apologize for having to end the hearing, but we're having one of our daily rituals over there and we will shortly get into the African bill so I just won't be able to get back. I do thank you for your most thoughtful testimony and we'll be seeing each other again.

Mr. PENNER. Thank you very much.

[Whereupon, at 11:10 a.m., the committee adjourned, subject to the call of the Chair.]