U.S. INTERNATIONAL TRADE STRATEGY

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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U.S. INTERNATIONAL TRADE STRATEGY

MONDAY, JULY 28, 1980

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:34 p.m. in room 2221, Dirksen Senate Office Building, Hon. Bill Bradley, presiding.

Present: Senators Bradley, Roth, Dole, Heinz, Danforth, and Chafee.

[The press releases announcing these hearings follow:]

[Press release of Thursday, July 3, 1980]

FINANCE SUBCOMMITTEE ON INTERNATIONAL TRADE ANNOUNCES HEARING ON U.S. INTERNATIONAL TRADE STRATEGY

The Honorable Abraham Ribicoff (D., Ct.), Chairman of the Subcommittee on International Trade of the Senate Committee on Finance, announced today that the Honorable Bill Bradley (D., N.J.) will chair the hearings in July, August, and September on the trade and economic issues confronting the United States and on an international trade strategy for the United States.

The hearings are designed to develop information on the international economic and trade challenges facing the United States and on the trade policies of other countries, and to serve as a basis for Congress developing an international trade strategy for the United States. Senator Bradley said in connection with the announcement of these hearings that he expects further hearings would be held in 1981 on formulating such an international trade strategy.

Senator Bradley also said: "Powerful changes in the world economy now challenge the United States. Unless American business, labor and government quickly join to respond to the increased competitiveness of overseas industries and to recurring energy and monetary shocks, the United States will suffer serious economic decline, lose influence in international economic events, and find its ability to protect its vital security interests abroad dangerously weakened. Americans can meet the international challenges by creating a modern trade strategy. To be effective, this strategy must grow out of a more competitive economy and a better capacity to integrate American domestic and foreign economic policies. My purpose in chairing these hearings is to develop a framework and an agenda for successfully responding to international challenges in the coming years."

The hearings in July, August and September will be divided into two parts. The first part would consist of examining the economic and political structure of the world trading system and trends therein. Particular attention would be focused in this phase on the trade and economic impact of the energy crisis and of developing countries' economies, as well as pressures on the international monetary system and its institutions.

The second part of the hearings would elicit testimony on the trade policies of major U.S. trading partners. Here the Subcommittee's interest is to gather information on the policies of successful Western countries, such as Japan and Germany, as well as to identify the impact of the policies of other countries and groups of countries on the United States, such as the European Communities and developing countries.

Exact dates and topics for each of the hearings will be announced shortly.

[Press release of Friday, July 18, 1980]

FINANCE SUBCOMMITTEE ON INTERNATIONAL TRADE ANNOUNCES INITIAL HEARING ON U.S. INTERNATIONAL TRADE STRATEGY

The Honorable Abraham Ribicoff (D., Ct.), Chairman of the Subcommittee on International Trade of the Senate Committee on Finance, announced today that the Honorable Bill Bradley (D., N.J.) will chair the first of a series of hearings on the trade and economic issues confronting the United States and on an international trade strategy for the United States. The series of hearings was described in Finance Committee Press Release No. H-35 of July 3, 1980. The initial hearing will be held on Monday, July 28, 1980, in Room 2221 of the Dirksen Senate Office Building beginning at 2:30 p.m.

This hearing will focus on changes which have occurred in the structure of international trade and investment and their implications for the United States. Senator Bradley indicated that the hearing will explore:

(1) Sources of the change in the structure of international trade and investment, including the political and economic factors which affect the distribution and composition of trade and investment, growth levels, and productivity gains in the world economy;

(2) Sources of the change in the position of the United States in international trade and investment and key determinants of the future composition and performance of U.S. trade, including determinants of the general competitiveness of U.S. industries;

(3) The prospects for escalation in the number and severity of trade disputes in the coming years and the prospects for the positive management of international economic interdependence; and

(4) Implications of these changes and prospects for U.S. economic welfare and for world political conditions, particularly the impact of a redistribution of global economic power on U.S. political leadership and national security.

The witnesses who will testify at the hearing include:

(1) The Honorable Robert D. Hormats, Deputy U.S. Trade Representative, Office of the U.S. Trade Representative, Executive Office of the President;

(2) Mr. Harold B. Malmgren, President, Malmgren, Inc. (Former Deputy Special Trade Representative, 1972-75);

(3) Mr. Howard D. Samuels, President, Industrial Union Department, AFL-CIO;

(4) Professor Robert G. Gilpin, Jr., Eisenhower Professor of International Affairs, Woodrow Wilson School of Public and International Affairs, Princeton University; and

(5) Professor William H. Branson, Professor of Economics and International Affairs, Woodrow Wilson School of Public and International Affairs, Princeton University.

Written statements.—Persons who desire to present their views to the Subcommittee are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be submitted to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510 not later than Monday, September 8, 1980.

[Press release of Monday, July 28, 1980]

FINANCE SUBCOMMITTEE ON INTERNATIONAL TRADE ANNOUNCES SECOND HEARING ON U.S. INTERNATIONAL TRADE STRATEGY

The Honorable Abraham Ribicoff (D., Ct.), Chairman of the Subcommittee on International Trade of the Senate Committee on Finance, announced today that the Honorable Bill Bradley (D., N.J.) will chair the second in a series of hearings on the trade and economic issues confronting the United States and on an international trade strategy for the United States. The series of hearings was described in Finance Committee Press Release No. H-35 of July 3, 1980. The second hearing will be held on Friday, August 1, 1980, in Room 2221 of the Dirksen Senate Office Building, beginning at 10 a.m.

This hearing will focus on the impact of energy price increases and disruptions in energy supplies on international trade and finance, as well as the present and future circumstances of the international monetary system and international financial institutions. Senator Bradley indicated that some of the matters that the hearing will explore include:

(1) The effect of, and responses to, escalating energy costs and supply disruptions on growth in developed and developing countries, investment, the terms of international trade and trade patterns, and balances of payments.

(2) The role of private banks and the multilateral financial institutions and other mechanisms in the past and future in dealing with payments imbalances and their effects arising from the movement of financial resources from oil-deficit countries to oil-surplus countries.

(3) The role of the U.S. dollar as a reserve currency and its effects on U.S. trade and domestic policies, as well as the role and impact of Eurocurrencies.

The witness who will testify at the hearing is: Mr. Roger M. Kubarych, Vice President and Assistant Director of Research, Federal Reserve Bank of New York.

Written statements.—Persons who desire to present their views to the Subcommittee are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be submitted to Michael Stern, Staff Director, Committee on Finance, Room 2227 of the Dirksen Senate Office Building, Washington, D.C., not later than Friday, September 12, 1980.

Senator BRADLEY. The subcommittee will come to order.

Today's hearing is the first in a series that will focus on U.S. international trade strategy and U.S. competitiveness. I think that we have some outstanding witnesses today.

The first witnesses will testify on a panel, and Ambassador Robert Hormats, who is the Deputy U.S. Trade Representative, will follow them. For protocol purposes it should be explained that he is testifying today not as an administration official but as an expert in the field to help us focus on these very critical issues.

I might say at the outset that I believe Senator Roth and most members of the Senate Finance Committee think that we are at a time of real choice in this country. We were at a time of real choice after the Second World War. We made the right choices then, and we enjoyed an unparalleled period of prosperity.

Today we are at another period of choice. American domestic economic objectives are intertwined with our foreign objectives. In this context we have to consider the rate of growth of productivity, our research and development expenditures, our nonresidential fixed business investment, how they have declined over the years, and how, indeed, they can be improved.

The message, the figures, give us cause for grave concern. But we need to know more about the dynamics behind the decline in productivity, research and development and fixed business investment: What are the sources of change in productivity and research and development and investment; how do the figures vary by sector and why; what is their relationship to the competitiveness and composition of U.S. exports; and we need to know answers to a whole series of other questions. We hope that this hearing and those that follow will give us an opportunity to address them. I ask that the full text of my opening remarks be placed in the record.

At this time I would like to call the first panel and ask each of you to summarize your statements. I have read your statements in detail. I find them excellent. However, if you read them in full there would be no opportunity for questions, and I know we would like to ask questions.

So can we have the panel of Mr. Harald Malmgren, trade consultant and former Deputy Special Trade Representative from 1972 to 1975; Mr. Howard Samuel, president of the industrial union department of the AFL-CIO; and Prof. William H. Branson, professor of economics and international affairs at Princeton University.

Would you please come forward and take your positions?

[The prepared opening remarks of Senator Bradley and Senator Heinz follow:]

[Press release of Monday, July 28, 1980]

WASHINGTON.—With Sen. Bill Bradley, D-N.J., serving as chairman, the Senate Finance subcommittee on international trade began a series of hearings today to analyze changing world economic conditions and develop a new strategy for improving America's ability to compete.

The text of Bradley's opening statement follows:

During the 1930's, the loose system of rules that had guided nations in their trade, monetary and financial conduct collapsed under the pressure of escalating national efforts to gain short-term advantages. The devastation spread widely and the reverberations of economic collapse fractured the fragile political order a short time after.

The Western leadership that came to power after World War II recognized the necessity of carefully managing economic interdependence among nations. Accordingly, they conceived a new, more formal system to moderate and contain conflict in the economic arena. There was a basic principle underlying these new rules and it was reflected in the GATT arrangement governing trade, in the Bretton Woods arrangement governing monetary interactions, and even in the aid operations of the new International Bank for Reconstruction and Development. That principle was that the rules governing the economic conduct of nations must balance self-interest with self-restraint.

The task of reconstructing a shattered world made the post-war period a time of historic choices for the United States. Our country emerged from the war not only victorious, but with the only strong economy in the free world. Fortunately, American leaders had the wisdom to use America's immediate advantage to speed the recovery of nations that subsequently became our partners in trade and defense. By making farsighted choices, they served America's long-term national interests by paving the way for a generation of economic peace. Through the Marshall Plan, the Point Four program, the IBRD and the GATT/Bretton Woods frameworks, the United States provided the defeated powers and the disabled democracies of the West alike with the material resources to create a stable economic order.

The flow of capital and technology from the United States to these countries opened markets for American products and fostered American economic power in the long term. But such efforts entailed, and were widely perceived to entail, sacrifices for Americans in the short term. We were willing to make these sacrifices because the disorder of the preceding 15 years made clear to us the possible consequences of refusing to make them. Americans thereby made a critical choice, and established an impressive precedent of deliberation and strategic thinking in U.S. foreign economic policy.

Once again, this nation and the world are at a major crossroads of choice. The world is not as bleak as it was 35 years ago, and this is largely owing to the farsighted choices made then. But the system created as a result of these choices could not last forever. Indeed, the system intended to create precisely the economic dynamism in Europe and Japan which in recent years has upset the balance of economic power upon which the original system rested. The changed configuration of power has made parts of the system unworkable, and thereby made its functioning unreliable. The fact that the system lasted so long and performed so well should create satisfaction rather than dispair. The lesson is not that we failed in maintaining the system, but that reconstruction was a condition of continuing prosperity for all.

We must take care not to lock ourselves into crisis-born solutions. Crisis management is not adequate for achieving the enduring stabilization of the world economic order.

We must have a trade strategy that grows out of a more competitive economy and a better capacity to integrate American domestic and foreign economic policies.

The shocks and setbacks to the world economy which Americans have experienced personally as job dislocation, explosive prices, tight credit, and long gas lines are indeed urgent warnings. But they do not herald the imminent collapse of international economic order, nor the fall of the United States from economic preeminence.

The United States has not been overcome or reduced to a second-rate economic power. The United States still has the strongest, most dynamic economy in the world. What has happened is that profound, complex changes are taking place in international economic affairs and powerful rivals are increasingly challenging our long-standing preeminence—in automotives, steel, textiles, electronics and numerous other industries. Our future prosperity and security will depend in large part on

how well we respond to the competition at home and overseas. The challenges facing us are serious and must be confronted. But the implications go far beyond the immediate impact of today's news headlines. We cannot afford to panic. This is a time for clear-headed, critical and informed analysis of the situation and the options available. These hearings will provide an opportunity to do that and formulate an appropriate strategy.

Formulating a strategy entails reasoned choice. If we do not have a strategy by which we choose deliberately, change will impose adjustment upon us. Instead, we should take the initiative, set our own terms of adjustment and thereby shape, rather than react to, the future.

In making our choices, complacency is an option only if we agree to become a victim of powerful world events. Isolation can be chosen only at great expense to our future prosperity and opportunity. Virtually all sectors of the U.S. economy rely heavily on international transactions, either for production inputs, profits, services, financing, technology or investment. Interdependence has become a condition of U.S. growth.

The wise, farsighted choice for the United States at this time of great challenge is to strengthen the international competitiveness of our industries at the same time that we strengthen our commitment to leadership in maintaining harmony, stability and equity in international economic affairs. The requirements for strengthening our domestic economy and strengthening our commitment to international economic leadership are compatible. Both ends require that American business, labor and government join in measures to increase real growth in the U.S. economy. This is necessary to restore the confidence of Americans in our proven ability to make economic progress at home and second to defend the collective interest in a sound international economic order, even when that defense entails short-term material sacrifice.

American domestic economic objectives are intertwined with our foreign economic objectives. In this context, we should consider the course of action available to resume a healthy rate of productivity growth in our industries. The troubling statistics are now well known. Productivity growth has slipped from an average of 3.2 percent during most of the 1950s and 1960s to about 1 percent during the 1970s, and became negative last year at minus 2 percent. Research and development spending has dropped from 3 percent of Gross National Product in 1964 to just over 2 percent in 1977, and the U.S. share of world R. & D. spending has dropped from about 50 percent in the early 1950s to about 23 percent in the last four years. Our nonresidential, fixed investment to GNP ratio has averaged only 10 percent in the last few years—less than any major industrial nation.

The message the figures deliver is cause for grave concern. But we need to know more about the dynamics behind them. What are the sources of change in productivity, R. & D. and investment? How do the figures vary sector by sector, and why? What is their relationship to the competitiveness and composition of U.S. exports? Are there income-producing positive developments in some sectors that compensate for loss in others? What are the choices available to Americans in their efforts to improve competitiveness in the short-term, and to set the basis for a strongly competitive economy in the future? What are the social consequences of choosing to emphasize capital formation over consumption, of choosing tax reduction over social spending? What are the political consequences of undertaking industrial planning, or of taking a sectoral approach to government regulation, taxation and provision of services? How do social and political consequences weigh against the economic benefits?

These are the urgent questions of the day and they are questions critical to both our domestic and foreign economic policy, to both our national welfare and our national security.

There are many ways of making choices, many ways of trying to achieve our broader objectives. The different choices have different interim consequences for different Americans, even though we all ultimately share the benefits of a more dynamic economy and a stable world. A democracy differs from other systems of government in its commitment to try to distribute fairly the benefits and burdens of achieving national objectives. Democracy is in essence a system that takes pains to weigh the consequences of competing choices. Meeting that democratic commitment in a complex world is perhaps the greatest challenge posed by international economic events to our political system.

The changes in the international economy, particularly during this past decade, have been widespread and profound. They include:

The economic resurgence of the European Community and Japan, entailing a redistribution of economic power in the world.

Shifting structures of international trade, particularly concerning trade between the developed and developing world.

Widespread balance of payments disequilibria.

Destabilizing pressures on the world's central currency.

The demonetization of gold followed by partially floating, partially managed exchange rates.

Shocks in the price of a commodity—oil—that literally fuels the world's industry, which were delivered by an unprecedented cartel of oil-blessed countries.

The attendant accumulation of petro-dollar reserves by these countries, many of whom could not spend them, matched by the draining of resources for development and growth from other countries, particularly developing ones.

The unprecedented phenomenon of worldwide stagflation.

Increasing interdependence among national economies at the same time that there have been increasing popular demands that require government to exercise control over key factors affecting national economic performance.

In addition, new actors have entered the system, bringing with them different world views and modes of conduct. New, proudly independent nations found their voice, and when OPEC caught the developed world's attention by holding its energy supplies hostage, the new nations used the opportunity to loudly dissent from many of the existing economic norms. Principles of reciprocity and open borders meant little to nations whose economies did not have the overseas reach to profit from reciprocity or to penetrate open borders. Principles of redistribution and strong national control over transnational forces meant more to them. As the ability of many of these nations to penetrate Western markets improves, and the developed world's appreciation of the use of national controls consequently deepens, there may be an opportunity to reconcile views on such principles.

In thinking about U.S. trade relations with the developing world, we should remember interdependence means that market growth is a stimulant to exports in both directions. Some of these countries have made great strides in penetrating U.S. markets, but it's worth also noting that U.S. industrial exports to Third World countries have grown to more than a third of total industrial exports—more than to the European Community and Japan combined.

The architects of the post-war economic system tries to anticipate the entry of these newly independent nations. What they grappled with, but never fully came to grips with, was the entry of a second class of actors into that system—the Communist countries. Yet that revolutionary development has now come about, bringing with it the risks and opportunities, and raising fundamental questions about security, peace and equity that will take great foresight to resolve.

Finally, a third class of new actors anticipated by very few post-war thinkers has entered the system, and indeed has become intrinsic to it. These are the non-government actors, commonly referred to as "transnational" because their realm of activity transcends national jurisdictions. The best known transnational actor, of course, is the multinational corporation. But the class includes others such as multinational financial institutions, stock and commodity dealers, international labor organizations, and international groups with a range of purposes from science and culture to religion and ecology.

Although there is little doubt transnational activities can transmit benefits across borders, for example, by bringing financial resources to a nation suffering a payments deficit, by bringing investment to a country seeking development, or by taking from a country exports that help correct the depreciation of a nation's currency, transnational activities often elude national controls.

Activities subjected to new taxation in one jurisdiction can elude them by moving to a jurisdiction abroad, perhaps to a tax-free haven. Export sanctions can lose effect through the substitution of overseas sales. Capital controls or monetary austerity is avoided by recourse to Euromarkets.

The elusiveness of private transnational activities creates a general sense that governments have lost control. This weakens the confidence of the people in government and in the workings of the markets. Also, rapid transnational transactions can produce volatility in economic indicators, which in turn erodes confidence in long-term business investment. Diminished investment reduces prospects for real growth, higher productivity and raising living standards.

Shifts in economic power, shocks to international markets, pressure on international institutions, volatility in exchange rates and the entry of new actors—these are all powerful changes which have tested and altered the GATT-Bretton Woods system. But the system has not yet adjusted to these powerful changes, nor have the policies of the system's members.

My guess is that effective adjustment requires more than tinkering and more than one or two simple remedies for our economy. We need a comprehensive

strategy to prepare the way for adjustment that is effective, brings greater prosperity and preserves economic peace.

For the United States and its major allies, the risk of economic war may be more imminent than that of military battle. Forces are developing which could fragment the international economic order. Alternatively, they can be turned to the task of establishing new, more secure bindings on it. Which way they go depends in large part on our ability, and that of our economic partners, to control them.

Control will be very difficult. At minimum, it will require understanding the sources of change in the international economy and the forces that spring from them; knowing our purpose, as we try to shape these forces; and having a strategy to achieve that purpose.

The hearings today and in the coming weeks provide an important opportunity to build our understanding, crystallize our purpose and evolve a positive strategy. I thank our witnesses today for making their expertise available to us in this effort.

Opening Statement of Senator John Heinz

Mr. Chairman, the first thing I want to do is to express my appreciation to you for developing and arranging these hearings. It is all too infrequent that Members of Congress have a chance to engage in some real dialog with experts—and between themselves—on broad policy issues rather than the specific crises of the week. Congress is notoriously poor at both regular oversight and policy planning. Members and staff seem to focus only on those issues that are imminent, and they always seem to fill all the available time.

I have also found, somewhat to my frustration, that on trade issues in particular, it is often impossible to consider a policy question outside the context of a specific case or a specific industry's concern. Every issue has its affected group, and every witness has his client. Getting "uninvolved" advice on trade policy issues has proven very difficult.

That is why I welcome this series of hearings—they provide a chance to step back a bit and examine trade policy issues outside the context of specific interests and cases.

These hearings are timely for another reason—the serious and continuing erosion in our economic position in the world. Today or tomorrow the Commerce Department will announce the 50th consecutive monthly trade deficit. Last week the Government said publicly what most of us have known for some time—this year's trade deficit will likely be even larger than last year's.

This decline in the strength of the American position has created a number of new issues and questions which I hope these hearings will examine:

(1) In studying the causes of these changes, we should discuss the extent to which they are due to other countries changing the "rules of the game" and embarking on what one might call neo-mercantilist "beggar-thy-neighbor" policies at our expense, rather than classic free trade policies.

Bad economic times always encourage protectionism: And it is popular, though a gross oversimplification, to blame all our trade problems on dumping and subsidization by others. Only yesterday, Robert Samuelson had devoted his column in the Washington Post to this subject. While we must not simply accept that easy explanation as the whole story, as Samuelson cautions against, neither should we reject it as totally irrelevant. There have been and will continue to be efforts to take economic advantage of our policies, and we should not hesitate to examine that part of the overall problem, understand how it contributes to the larger picture, and as a matter of policy aggressively insist on our rights internationally.

(2) We should also consider changes in the world that make irrelevant the traditional post-war division of the world into advanced industrialized countries, the Communist Bloc, and the Underdeveloped Third World. We are now beginning to take note of the complexity of the economic and political world and the multiplicity of stages of development that make generalizations much more difficult—and inaccurate—than before. In particular we should study the so-called newly industrializing countries (NICs), and discuss how they fit into a complex world economic structure and how they can assume both the benefits and obligations of their new status.

(3) We should also remember that a relevant trade policy is one which recognizes and attempts to cope with change. Change inevitably means bad news for some industries, and bad news means adjustment to new competitive conditions. Historically, our Government has been very poor at pursuing intelligent adjustment policies, a fact which has not deterred us from pursuing trade policies which create new victims in need of adjustment. These hearings should examine the problem of adjustment and the difficulty of developing coherent programs to provide for it.

(4) Of particular interest to me, as many of you may know, is the problem of development of expanded trade relations with non-market economies, primarily Communist Nations. I support such trade expansion in principle but recognize that it brings with it some problems that are unique to non-market economies and which we are ill-prepared to deal with in a free-market context. This is particularly true of how we respond to allegations that a non-market economy has engaged in unfair trade practices according to our laws. Senator Roth and I have introduced legislation on that subject for discussion purposes, and I would welcome the witnesses' comments on the problems of trade with non-market economies.

(5) Finally, in terms of solutions, we should also look at export policy—this year's bright idea. Obviously, increasing exports will help our trade deficit. The question is whether any of the proposals currently circulating in the Congress would achieve the intended result, or whether export expansion, as some believe, is more a captive of larger economic movements than responsive to specific incentives. This is probably a question which can only be finally settled empirically. We shall simply have to enact some suggested incentives and see what happens. At the same time however, it would be useful to examine this question and gain a better understanding of the economic forces contributing to our overall trade problems.

Mr. Chairman, these are some of the personal priorities and interests that I have in the trade field. I am looking forward to hearing today's witnesses and those scheduled to appear in the future, and I hope that some of our dialog during these meetings will touch on the concerns I have raised.

Thank you.

Senator ROTH. Mr. Chairman, I notice we have a vote.

Senator BRADLEY. Why don't you go, and then when you come back, I will go.

I might tell the witnesses that is one of the disadvantages of afternoon hearings, but we will make the best of it.

I would like the three witnesses to testify as a panel.

So could we have Harald Malmgren, Howard Samuel, and William Branson?

Why don't we go down the line? Mr. Branson?

STATEMENT OF PROF. WILLIAM H. BRANSON, PROFESSOR OF ECONOMICS AND INTERNATIONAL AFFAIRS, WOODROW WILSON SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS, PRINCETON UNIVERSITY

Mr. BRANSON. It is a pleasure to be here, to be able to discuss with you developments in U.S. trade and investment. I sent a paper, which is a working paper from the National Bureau of Economic Research, to your staff, and what I will do is discuss some of the data and findings that are in that longer paper.

I think the message that I got out of studying the trade and investment data over the period since World War II was that at the end of World War II, the United States was clearly a dominant industrial power in the world, and what we have seen since then could be interpreted as the natural growth of industrial competitors, first the recovery of Europe in the 1950's, the emergence of Japan in the 1960's, and the growth of manufacturing capacity in the developing countries in the 1970's. This could be, I think, interpreted as a natural development in which manufacturing capacity grew around the world, new competition appeared for the United States, and the U.S. share of manufacturing output and trade declined.

The result, I think, was that a devaluation of the dollar was needed to stabilize the U.S. share of manufacturing and trade, and that more or less brings us to the position we are at now.

I have distributed a few of these tables that are in the paper which I will summarize.

The first one that you have shows an index of output per man-hour in manufacturing for a number of important countries over the period 1950 to 1978. What we see there is that the growth rate of manufacturing productivity in the United States has been below that of the other major industrial countries. The only other country in that little table that has as slow a productivity growth record is the United Kingdom.

In looking at the table, you can focus on the year 1967, to which all the time series are indexed, and then you can see that since 1967-equals 100, U.S. productivity grew to 128.9 by 1978 where the other numbers are numbers like 162 for Canada, 215 for Japan, et cetera.

The next table shows average annual growth rates. It summarizes the first table, and you see there the United States is generally at the bottom of that league.

The consequence of that is shown on the next table which shows the shares of total manufacturing output in ten major industrial countries from 1950 to 1977, and there you see that in 1950, the United States was producing 62 percent of this group's total output in manufacturing. By 1977 that number was down to 44 percent. That simply reflects the fact that the others were growing a lot faster than the United States.

The next table shows an index of relative unit labor costs, the United States versus its major competitors, and the numbers there are an index of the ratio of U.S. unit labor costs to the other countries' unit labor costs. What you see there is from 1961 to 1969 things stayed about even; in other words, U.S. price developments, and unit labor cost developments were about the same as the average of these other countries. Since 1970 with the dollar devaluation, foreign costs have risen significantly relative to U.S. costs. In other words, the index has gone down.

Basically what that is saying is that the devaluation of the dollar has improved the U.S. competitive position a lot.

The next table shows distribution of exports of manufactures across countries. The numbers in the table are each country or each area's share, percentage of world total manufactures, and there again you see in 1953 the United States had 29.4 percent of total world exports of manufactures. That share of world exports of manufactures shrank to 1971 where it was 13.4 percent, and it stabilized around 13 percent through the 1970's.

Senator BRADLEY. Which table is this?

Mr. BRANSON. This is the table that says table 13 at the top. There you see in the middle of the table, opposite the United States, you see the number 29.4 in 1953, which says that the United States was exporting 30 percent of total world exports of manufactures in 1953. That number runs down to 13 percent by 1971 and then stays there. The way I would interpret that is that with output growing in the other parts of the world, the U.S. share of exports was shrinking for given comparative price behavior, and it took the devaluation of the 1970's to stabilize that share at 13 percent.

Let me pass on to the changing distribution of U.S. exports. I will skip a couple of pages and go to the page that is numbered 49 at the top which shows a time series of U.S. exports and imports of

chemicals, and the next page which shows a time series of U.S. exports and imports of capital goods.

There you see the two categories of manufactured goods in which the U.S. trade position is strongest. There has been a large and rising trade surplus in both chemicals and capital goods.

If you turn the page to page 51, which says table 20 on the top, you see a little table that shows where the growth in capital goods exports was in the 1970's, and what we see is that a major market for U.S. capital goods that developed in the 1970's was the developing countries, Latin America, and the other category Asia and Africa, where we had a significant increase in sales of capital goods.

The next chart, which is on page 53, shows the category in which the United States has had the biggest trade deficit. That is consumer goods, and you can see a rising trade deficit in that category. That has been a traditional position in the United States. One of the things that we see when we take a long look at trade data is that the United States has generally been a net importer of consumer goods. Before World War II it was, and it is just during a short period after World War II when we were a net exporter of consumer goods.

The next chart on page 54 shows trade in automotive products. There you see the United States was a net exporter of automotive products up to around 196——

Senator BRADLEY. Mr. Branson, would you excuse me? I thought Senator Roth would be back. I have 4½ minutes to vote. If we break for 5 minutes, I will be back and we can continue.

Mr. BRANSON. OK.

[A brief recess was taken.]

Senator ROTH [presiding]. Gentlemen, it appears as if we may have more than one vote, although your guess is as good as mine. But I think in the interest of moving forward, we will proceed with the testimony.

Mr. BRANSON. Well, I was discussing the changing composition of U.S. trade, and we see that in one of the figures that I have handed out that there has been a very rapid growth in the U.S. trade surplus in capital goods, a very rapid growth in the U.S. trade deficit in goods such as consumer goods and automotive products, and of course in fuels with the price of oil moving.

To summarize the picture of the current trade situation, it is that the United States has moved from being the dominant manufacturing producer in the world to being one of a number of fairly competitive centers, and the composition of U.S. trade has moved very rapidly toward concentration on capital goods and chemicals, importing consumer goods and automotive products. I would interpret that as a movement in the direction of specialization in areas of comparative advantage. It makes the economy more open, in a sense, and more vulnerable to external disturbances. At the same time, it gives us the gains we get from specializing along lines of comparative advantage.

I think that the problem now for U.S. trade is to maintain a competitive position in this kind of multipolar trading world, and that means that we have to be concerned essentially about productivity growth in order to maintain our competitiveness, especially

in the areas of our comparative advantage, which are the production of capital goods and other products that use skilled labor intensively in production.

I will stop there and turn the floor over to the next panelist.

Senator ROTH. All right, Mr. Malmgren.

STATEMENT OF HARALD B. MALMGREN, PRESIDENT, MALMGREN, INC., AND FORMER DEPUTY SPECIAL TRADE REPRESENTATIVE, 1972-75

Mr. MALMGREN. Senator, I have made a long statement in writing which I have made available for the record, and I won't read that. The reason it is a little bit long is that I was asked by the staff on behalf of the committee to try to paint a backdrop for this series of hearings.

Senator ROTH. Could you speak into the microphone? It is a little bit hard to hear you.

Mr. MALMGREN. As I said, the long statement is there as a backdrop to some of the hearings that you will be having not only today but in the future.

What I start with here really is a point of departure with which you are familiar, and that is the crisis of confidence and competitiveness in the American economy. What I am pointing out to start with is that at a time when global forces, which I will describe, require faster adjustment of our economy than in the past, we are in fact adjusting more slowly than at any time since World War II, that we have talked ourselves into slow growth and slow capital formation. Yet, to deal with the forces that we have to cope with in this coming decade, we should be doing rather the opposite. It is inevitable in the present circumstances that our productivity performance is weakening; that there are inflationary consequences of utilizing an increasingly inefficient industrial base that is not being modernized; and that we are having serious troubles in basic industries, so basic as autos and steel, which we would never would have foreseen in, let's say, the autos case 10 years ago.

Now, there are a series of reasons, that we have to take into account that caused this problem, the first of which is the growing interdependence of the U.S. economy with the rest of the world.

Now, our automobile drivers, all of us, when we had to wait in line a couple of times, realized we are interdependent as regards fuel, and there have been cases where our farmers have been awakening to the fact that international markets determine the well-being of their own farms and farm incomes at home. But apart from that, we really don't recognize in policy very much the tremendous interaction.

I give some figures in this testimony relating trade not to GNP, which is so popular, but rather to something else. In our economy we have a lot of services, dentists, lawyers—of course, many lawyers—and doctors and people who drive buses, and these people in the service sector are not dealing with tradable goods. They are dealing with things that are kept at home essentially. So trade should really be compared with what do we produce that is tradable, that is food and industrial production.

The Commerce Department offers a couple of series for that, but I use the upper figures to compare them with other countries. But

in any event, looking at trade as a percentage of our production of goods, exports are a little short of 23 percent and imports about 29 percent. These are big numbers and they explain why when we have an exchange rate adjustment or trade problem it passes right through into the economy, much faster than it did 10 years ago. Indeed, these ratios are more than double what they were in 1970. That curve is going up. I believe that 10 years from now that interdependence will be greater.

Now, the comparable ratios for other countries are much higher, although Japan is not as high as most people think. The highest country is Canada, and then next highest is the United Kingdom. The United Kingdom, about 75 percent of its industrial production and food production is trade.

Now, that is one area. The second area is the interaction of our monetary system at home with the international monetary system, to such an extent that it is no longer possible for us to separate out the management of the money supply and the interest rate at home without taking into account the international circumstances and vice versa. We saw this recently with having to drive up the interest rate a couple of times in the last 2 years in order to defend the dollar in world markets.

Related to this is the enormous increase in what some people talk about as the Eurocurrency market, but which I would generally describe as a pool of dollars and other assets somewhat detached from national market behavior and available for international lending.

There are disagreements about the scale of that. I give some figures that are much larger than the typical press accounts. In any event, it is my view that the scale of this pool is so large as to create all by itself a source of potential volatility for the dollar and other hard currencies.

Now, in addition to this, because of the volatility of asset holdings throughout the world, people are more concerned with their expectations about what is happening in each economy than they are about the current economy or the current figures, the current statistics. And those expectations have to do not only with the trade account of a country but also its political behavior, its stability, its order, whether its economic policy seems coherent or not. These factors do affect the judgment about where you want to park your assets.

And that creates yet again a source of instability because you may today want them in D marks and tomorrow in sterling, and the dollar looks relatively not as attractive as it once did.

This means that currencies can move around quite a bit in short periods of time without necessarily a connection with the trade account, as is happening with sterling right now, which is way too high relatively to its trade account. It has a terrible trade account.

Now, this puts the United States in a quandary. Do you relate the dollar to domestic considerations or to these international considerations? If the dollar does decline this has two effects right away at home because of this interdependence. One, you get inflation at home from that dollar exchange rate effect; and second, it encourages the OPEC producers to either raise prices or slow down

the supply of oil. So you can't just write it off and say, well, let the dollar run. It is not possible.

In addition to these factors, we are facing new sources of competition in the world marketplace. Not only the traditional competitors, Japan, a few other countries, but newly emerging countries are coming onstream very fast, and Korea, for example, is one of the examples I would use. Korea now is world class competition in steel, shipbuilding, engineering in the Middle East against our companies, and in electronics.

The Japanese were a problem for us in certain sectors, and are now moving up the ladder, and we see them converging with us in competition in the areas of computers, office machines, automated machine tools, areas where we thought we were more or less ahead 10 years ago and would stay so.

But the new competitors, the developing countries that are growing very fast, are also being chased by centrally planned economies of Eastern Europe. These two groups have to pay their debts. They have enormous debts, and so therefore they must export as fast as possible. And they are tending to export more or less the same products, so that intensity of competition, not only to the United States but to the world market, is going to grow in the 1980's.

Now, traditional markets for the United States, in my view, will be changing. Our European orientation will gradually phase down and the Asian Pacific will gradually phase up. Developing countries will probably become more important for the simple reason that they grow faster than the average industrial country. So they are growth markets. It is pretty inevitable.

The United States, however, is going to be in a bind in this category of countries because to sell to countries that have debt problems, you have to finance. And in my view—I have gone through this—there are some problems for the United States. First of all—you can look at the numbers later—American banks in the 1980's will also be in a declining competitive position. I think this is absolutely inevitable unless we change the capital structure, which we are not likely to do, of our banks, change our regulatory policies. Banks of other countries will be able to take smaller spreads, and therefore they can go out and hustle more trade business than we can.

It is now—I didn't mention it in my statement—the case that a number of our banks are financing trade out of European sources rather than financing them from here because they can cut a better deal. They can also get cooperation with governments of the other countries on better terms.

The regulatory environment and country risk considerations are factors also, but they are not the only ones. I mentioned that the way in which we handled the Iranian asset seizure has also had a very bad effect on the syndication market.

Throughout the western world, because of this financing problem—and that is where the trade is—governments have been increasingly involving themselves in not only export finance but guarantees, local cost financing, inflation and exchange risk insurance, and even use of AID funds. I believe this process will grow. It is inevitable because countries that want to export and have the

capability to pull together their private and public funds and guarantees will do so.

Now, on the developing country side, for those countries that have some leverage, they will be also bargaining harder. An example was Mexico in the last 2 months asking, in exchange for oil, for comprehensive assistance in building ports, transportation facilities, basic industries, and finance, and aid, all as a sort of a package. We are going to see more of that in the 1980's. The interaction of private and public effort, in that regard, will be easier for France, Germany, and Japan and difficult for the United States because we are not used to thinking in terms of public-private cooperation in that way.

Another fact of life which we face is that there is excess capacity and heavy Government intervention in a number of other countries in some of our basic industries such as steel, chemicals, petrochemicals, nonferrous metals, so that the world market is conditioned very much by heavy Government intervention, particularly in Europe and the developing countries, but not so much in Japan as is thought.

We do have, though, in some of these key industries, world overcapacity in the 1980's. So when you say let's do something about steel alone in the United States, it is very difficult to see that except in a world context because there is just too much capacity there.

We have some problems of adjustment in the 1980's that may be shocking to our economic system. Energy you know about, except that I would add that the Persian Gulf is, in my view, highly unstable politically so that we could have additional shocks we are not anticipating at this time. In my opinion in the 1980's we will have a tight fit in food supplies. Any back-to-back 2-year period of tight markets or tight supply will be quite disruptive. This year we will have a so-so production picture globally. If we have another one back-to-back with it, we would have big trouble.

There will be a tight fit for raw materials in the 1980's because there has been very slow investment in minerals and mining for at least 15 years. If we stepped up to a little bit higher rate of growth, we would get bottlenecks by 1985.

Now, another factor is that all of the markets are becoming—and economists have difficulty with this—are becoming interactive, so that the commodities, and as you know, the silver market and the exchange markets, and markets for anyplace where you can put your money and protect it from inflation are all becoming one fungible market. Portfolio analysts can handle that as a thought process, but economists tend to like to keep these markets separated.

But what that means is that even the Federal Reserve has trouble controlling the handling of funds and the movement of capital in the economy, and the short-term and long-term forms of assets. It was clear that in the latest credit crunch, the Fed had to ask for restraint in the speculative area in order to get control of the money supply in general, and the asset positions of people.

These interactions make a lot of our economics obsolete. The possibility for lurches from one market to another is greater than ever. People are, let's say, staying more liquid than they were 10

years ago when they were willing to invest long term, but now staying much more short term, make the stability of the overall system very difficult to assess, but it is volatile.

Other countries have been investing slowly also, but they have been doing better, let's say, in terms of keeping their productivity up and investing in the industrial sectors, in the job creating sectors.

R. & D. has slowed down. Other countries have done better in that area.

So we then face some fundamental issues. How do we catch up and then get up to speed once again to be a leader? I cover some of the issues, but my theme in the concluding part of the statement is that quick fixes aren't going to work. We have to think this through in a more methodical way, and we have to try to relate all these fields and understand what it is that trade has to do with our domestic growth and capital formation and vice versa, and that you can't separate these pieces out and deal with them one at a time, We need to rethink the interaction of our international and domestic policies. We need to rethink our troubled industries.

In this area, I have spent a lot of years, as you know, in handling trade disputes and trade problems at home in this country in the Government, and I have thought a lot about what happens when a company or a group of companies comes in for help. Do you just give the help and walk away from the problem and hope that something happens during 5 or 7 years, or do you somehow oversee that change? What is the quid pro quo for the public sector, to defend the workers, the consumers, the broader range of interests, the suppliers, the buyers, so that you know that something happens while you give the help. What is that critical bridge between public and private interests when somebody comes into the Government for relief?

I try in my statement to touch on this in a number of ways. Boiled down I suggest that Rohatyn's idea about a reconstruction finance corporation is another porkbarrel. But I think something intermediate between bankruptcy and telling people to rely on their own devices, some conditional situation intermediate is what we need to define. We need to think through how we deal with that, what kind of overseeing we want to have, and whether it should be private or public.

In my own opinion, probably the oversight should be on the financial community side in the private sector because they can do it better than Government. My own view of Government is that Government can carry out official policies reasonably well, with its many good people, but in terms of watching over company behavior, Government people are not very experienced in that and usually make a hash of it.

This area is related, of course, to the issues of industrial policy that are so faddish right now, and I mentioned that in public debate this is not well thought through as to what we are talking about.

I conclude with comments both on the international and the domestic institutions, pointing out that each has problems of bureaucratic turf and compartmentalization, that this is part of our problem, and that we need somehow to create means by which they

can interrelate the different areas of policy, so that for example the capital formation work that the World Bank does and the monetary management work that the Fund does and the trade work is somehow thought through in a coherent way, and that within our Government we begin to pull together these issues of trade, trade finance recycling, aid, and the domestic adjustment process that goes with it.

This is not easy to do. The recent executive branch trade reorganization was, in my view, a turning of the wheel a few more notches of the ratchet, but it is a wheel that was started turning by this committee and the Ways and Means Committee in 1962, and I think it has some way to go further.

If you take, in summary, all of the points that I made in my prepared statement, and walk through some of the numbers, you might walk away with the impression that it is pretty gloomy for the 1980's for the United States, and I think it is, unless we get hold of these issues and think about them.

But I also believe that if we were to really get a handle on the issues, we have the capacity, we have the people, we have a Government big enough to think through, we have people that you can bring here to this committee from around the country with enough brainpower. It isn't as though we are short of ideas. It is just that we are having trouble pulling them together, and we are showing no vision, in my view, in the public policy area about the 1980's as a whole, more or less dealing with the problems as they arise as we are in autos and steel, problems that have to be dealt with, but problems that should have been anticipated, and problems that cannot be solved in a year or two.

Thank you.

Senator BRADLEY [presiding]. Thank you very much, Mr. Malmgren.

Mr. Samuel, before we begin, perhaps we should pause. There are five bells up there, I will go to the floor to vote, and then we will be right back to continue this process and hope that we will get to questions sooner or later.

[A brief recess was taken.]

Senator ROTH [presiding]. Again, I would like to apologize to those of you who are good enough to come before us this afternoon, but it appears that it is going to be one of those afternoons in which we have to run back and forth.

I am not sure where we left off, but I would ask that we proceed.

STATEMENT OF HOWARD D. SAMUEL, PRESIDENT, INDUSTRIAL UNION DEPARTMENT, AFL-CIO

Mr. SAMUEL. Senator, I am Howard Samuel, and I am here as your third witness of this first panel.

Senator ROTH. Thank you, and welcome.

Mr. SAMUEL. I am very pleased to have been called to testify before this committee. I do want to make it clear that my comments emerge from my own experience and judgment and should not be construed to represent the policy of the AFL-CIO in some of these matters.

Like the others, I have submitted testimony for the record and I am going to cut through it fairly rapidly, omitting as much as I actually give.

The issue which was raised with me as one which would be of most interest to the committee, is the effect of the decline of American productivity on our international competitiveness, particularly, of course, dealing with the American worker. I think that question has been answered to a large extent by the figures that have been presented by Professor Branson. He points out that although obviously productivity in the United States has not been increasing, and in the last year has actually been going down. Yet in terms of international competitiveness, the U.S. productivity rate is only half the story. The other half is the growth of wage costs, and as Professor Branson's figures pointed out, the fact is that the modesty of our wage gains more than offset our relatively poor productivity performance. The result has been a very strong U.S. position over the years in respect to relative costs.

I have submitted some supporting material, but what it comes down to is that unit costs, measured in dollars, have increased only half as much in the United States as in other industrialized countries in the last 13 years. For example, U.S. unit labor costs were up 79 percent from 1967 to 1978. In the United Kingdom the costs were up 149 percent; West Germany costs were up 259 percent; and Japanese 309 percent. Again, let me repeat, the United States has only gone up 79 percent.

So the decline in U.S. trade competitiveness has to be laid to other causes than slowed productivity growth or American labor pricing itself out of the market.

Let me suggest a couple of other problems affecting our trade position which in our eyes are more significant.

One of the causes is imports which worm their way into our market on the basis of irregular pricing or special privilege bestowed by their home governments, and the closing of other markets to our exports through the use of various tricks of trade practiced by the same governments. Such trade practices are based not on ancient principles of comparative advantage but on violation of comparative advantage. In effect, these governments have given up on it and instead are resorting to cheating on it.

There is good reason to fear that unfair trade practices, the new GATT codes notwithstanding, will be on the rise during the decade ahead. Tariffs are no longer the major barrier to trade they once were. Successive tariff reductions since the Smoot-Hawley rates of 1930 have largely accomplished their intended goal. Nontariff practices, less visible and more difficult to circumvent, have become the weapons of choice for governments and firms seeking to beggar their neighbors by observing neither the spirit nor the letter of the law of comparative advantage.

The expanding use of dumping and subsidies can take place because of increasing government involvement in industry in almost every industrialized nation other than the United States. While a Chrysler loan guarantee is very much the exception on the American scene, even more profound government involvement in industry is the rule in Japan, Germany and our other key trading partners, especially the developing countries. In many countries, at

all stages of development, government ownership of firms in the private sector has become the customary final stage in any rescue effort. Meanwhile the frequency of dumping violations is rising. Although carried out by private firms, the chronic dumping apparent in industries like steel is indicative of government support, that is, either direct or indirect subsidies.

The economic impact of dumped or subsidized imports on the U.S. economy and U.S. productivity growth are unfortunately clear. Highly productive American producers can be undermined by dumped imports whose price advantage results only from illegal pricing practices. While some consumers may draw a temporary gain from dumping, disruption of profitability, output, employment and investment in competing domestic firms will not help improve our national productivity track record.

A new species of unfair trade practices has recently emerged with enormous potential for damaging U.S. investment and productivity growth. Performance requirements imposed on international investors have an almost unlimited potential to pull investment and jobs and new productivity growth from the United States because of the absence of any international rules limiting such government intervention. These trade-distorting performance requirements are becoming a major factor in international commerce generally, particularly from countries like Brazil, Australia, New Zealand, Canada, and Mexico.

Performance requirements which distort trade are a matter of great concern because of their negative economic effects. They result in a direct transfer of jobs and production to the country which imposes them. The international changes in employment, production and trade which they cause are not a response to market forces. These changes are the result of government fiat. The purpose is to increase the imposing country's economic welfare directly at the expense of other countries. Such government-directed economic decisions not only injure other countries, they also result in the misallocation of resources internationally, with predictable consequences for efficiency and inflation.

Performance requirements which artificially expand exports threaten to grow into the most important distortions of global investment, production and trade because they are not disciplined by any present international agreements.

Because the United States is the source for approximately 50 percent of international direct investment, a large share of the trade effects of these measures will be experienced in the U.S. economy. This distortion of economic resource allocation will appropriate U.S. jobs and production and push down productivity growth.

The other aspect of trade which deserves your attention is the fact that some proportion of products crossing national boundaries is made under exploitive labor conditions. I think I have already made it clear I am not advocating repeal of the law of comparative advantage. We know that there will be differences in wages and conditions between developing and developed countries, even in comparable industries making the same products with the same capital. But comparative advantage should not serve as camouflage to hide aggravated exploitation such as child labor in factories,

forced labor, or the uncontrolled use in the workplace of toxic substances or dangerous conditions. The standards of humanity accepted by all of civilization do not bestow a license on anyone to damage young children or kill adult workers, even those working in the least developed of nations. Products which are designed for sale to other nations should be required to have been made under minimally reasonable standards.

It would to be difficult logically to protest against the imposition of minimum labor standards for international trade. After all, a principal rationale for increasing international trade is that it is supposed to enhance the living and working conditions of all parties, for both those who sell and those who buy. But when a building supply manufacturer in a developed country moves his asbestos plant to an LDC in order to avoid health regulations, neither the workers in his old plant who have lost their jobs, nor the workers in his new plant who are doomed to lung cancer, can boast of any particular benefit from the resulting flow of trade.

There are other issues related to international trade which concern America's workers. We are dissatisfied, for example, with both the policy and practice of adjustment programs. We question the Government's so-called neutrality toward outward investment. We are dismayed by the mad competition among nations to finance the export of capital goods, even when no economic purpose is served, a competition which ensnares our own Export-Import Bank with all the rest. We are not optimistic about the implementation of the new MTN codes, particularly when we examine the very first subsidy agreement signed with Pakistan.

The list could be lengthened, but your time is limited. Let me sum up simply by assuring you that by and large, as I see it, American labor, of any segment of the country, is the least burdened with doctrine, whether free trade or protectionist. We view the problem in most pragmatic terms. We know we cannot repeal the law of comparative advantage. We are convinced that what is needed, in fact, is more of it, not less. But comparative advantage should not be diluted by unfair trade practices or exploitation of labor or special deals for special trading partners. And we know that given a climate of fair trade, the American worker can compete with anyone on Earth and win.

Thank you.

[The prepared statements of the preceding panel follow:]

TRENDS IN U.S. INTERNATIONAL TRADE AND INVESTMENT SINCE WW II

I. Introduction and Summary

At the end of World War II the U.S. was by far the dominant industrial economy in the world. With industrial capacity largely destroyed in Europe and Japan, the U.S. produced more than 60 percent of the world's output of manufactures in the late 1940s. As a result, the U.S. was a net exporter of manufactured goods of all kinds; historically the U.S. was a net importer of consumer goods, but in 1947 there was a net export surplus of $1 billion in that category. Thus in the immediate post-war years, the pattern of U.S. trade was distorted by a relative strength in manufacturing that was transitory. The recovery of the European and Japanese economies in the 1950s and 1960s, and the growth of manufacturing capacity in the developing countries in the 1960s and 1970s inevitably reduced the U.S. share of world output, and of world exports. The evolution of U.S. trade patterns since World War II has been strongly influenced by these initial post-war conditions. By the 1970s, trade patterns reflecting underlying comparative advantage had been restored, and the U.S. was once again an importer of consumer goods.

The U.S. international investment position just after World War II was miniscule. In 1950, U.S. private long-term assets abroad totalled $17.5 billion; foreign investment in the U.S. was $8 billion. Thus while the U.S. was very open to trade at that point, there was little international ownership of assets. The U.S. long-term foreign asset and liability positions have both grown steadily at about 10 percent per year since 1950. This has resulted in an internationalization of investment over the same period in which the U.S. lost its dominant position in trade.

In this paper we lay out and analyze the data on the trends in U.S. international trade and investment since World War II. We see the shrinking

U.S. fraction of manufacturing output and exports, a return to and strengthening of lines of comparative advantage, and balanced and rapid growth in long-term investment. We also see increasing volatility of trade and long-term investment in the 1970s, along with a real depreciation of 25 percent in the weighted U.S. exchange rate.

The outline of the paper is as follows. In section II we set the framework by studying trends in the U.S. position in the world economy since 1950. The U.S. trend real growth rate has been the lowest in the industrial world, as the European and Japanese economies recovered. The U.S. share of manufacturing output shrank from 1950 to the 1970s, while the share of manufactured exports has stabilized at about 13 percent since 1970. U.S. costs have risen at a rate that is about average for the industrial countries, and the dollar devaluation of the 1970s has resulted in a significant real depreciation.

In section III we study the trends in U.S. trade and comparative advantage since World War II against the background of data going back to 1925. The post-war export bulge was eliminated by the mid-1950s, and a stable pattern of trade emerged. It shows export surpluses in capital goods, chemicals, and agriculture and deficits in consumer goods and non-agricultural industrial inputs. Trade in automotive products switched from surplus to deficit in 1968, and of course energy imports have soared in the 1970s. At the four-digit end-use code level one can also discern patterns of trade that are consistent with the internationalization of investment and production.

Trends in long-term investment position are summarized in section IV. There we see a picture of remarkably steady and balanced growth, with international assets and liabilities both growing at 10 percent or so a year. The data on direct investment are disaggregated by country and industry—

There we see that U.S. investment abroad has been increasingly directed toward Europe, whose share of total U.S. direct investment rose from 15 percent in 1950 to over 40 percent in 1977. To a large extent, direct investment has gone to the industrial economies, rather than to the developing countries. Foreign investment in the U.S. has been mainly European throughout, with a share of 66 percent in the 1950s and the 1970s.

Developments in the balance of payments, reserves, and exchange rates are discussed in section V. There we see the trend from surplus to deficit in the U.S. basic balance (current account plus long-term capital), and the marked increase in the volatility of the basic balance (as measured by time series variance) from the 1960s to the 1970s. This increase in volatility has raised significantly the size of variation in reserves that would be needed to fix exchange rates. The result has been more movement in reserves with "floating" rates in the 1970s than with "fixed" rates in the 1960s.

It is difficult to summarize briefly the impression created by this intensive review of the data, but perhaps it is worth a try. At the end of World War II the U.S. dominated an industrial world that was tied together economically mainly by trade. This was clearly a temporary position, at least in hindsight. Gradually, over 35 years, the other industrial countries have caught up with the U.S., restoring a kind of economic balance to the world picture. At the same time, international investment has thickened the connections of the U.S. to the world economy. My impression is that from a position of dominance, the U.S. has become much more one of several roughly equal centers, with increasingly tight economic interconnections among them.

Table 6: Index of Output per Hour in Manufacturing, 1950-78, 1967=100

YEAR	UNITED STATES	CANADA	JAPAN	FRANCE	GERMANY	ITALY	UNITED KINGDOM
1950	65.0	51.6	21.5	43.9	37.3	35.8	62.5
1951	67.1	53.7	26.8	46.2	38.5	39.0	62.6
1952	68.3	55.2	28.2	47.7	42.1	40.6	60.8
1953	69.5	57.1	32.1	50.2	45.1	42.6	62.4
1954	70.6	59.6	34.3	51.6	47.0	44.9	64.9
1955	74.1	63.4	36.0	54.2	50.0	46.8	66.9
1956	73.5	66.1	38.4	57.7	51.3	51.5	67.8
1957	75.1	66.5	41.9	58.6	55.8	52.5	68.6
1958	74.7	68.8	39.2	60.9	58.6	53.4	69.8
1959	78.0	72.5	45.6	65.3	63.3	57.5	72.7
1960	78.9	75.1	52.6	68.7	67.8	61.2	77.0
1961	80.8	79.2	59.5	71.9	71.4	66.1	77.7
1962	84.5	83.3	61.7	75.2	75.8	73.2	79.6
1963	90.5	86.5	67.1	79.7	79.3	75.2	83.9
1964	95.2	90.3	75.9	83.7	85.2	74.6	89.8
1965	98.3	93.7	79.1	88.5	90.7	88.5	92.5
1966	99.7	96.9	87.1	94.7	93.9	94.8	95.8
1967	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1968	103.6	106.8	112.6	111.4	106.9	107.9	107.3
1969	104.8	113.1	130.0	115.0	113.4	116.1	108.6
1970	104.5	114.7	146.5	121.2	116.1	121.7	108.8
1971	110.1	122.9	151.0	127.6	121.4	125.2	113.2
1972	115.7	128.5	162.3	135.1	128.7	135.3	121.5
1973	119.8	134.3	181.2	142.5	136.6	151.7	127.6
1974	112.6	136.6	181.7	146.6	145.0	159.7	127.7
1975	118.2	133.5	179.6	150.7	151.5	152.9	128.2
1976	123.4	137.4	198.7	163.6	160.3	165.9	127.9
1977	127.5	146.1	199.2	171.7	169.0	167.8	126.5
1978	128.9	152.2	215.7	180.2	175.3	172.7	126.6

SOURCE: Department of Labor

Table 7: Average Annual Growth Rate of Output per Hour in Manufacturing

COUNTRY	1950-55	1955-60	1960-65	1965-70	1970-75	1975-78
U.S.	2.62	1.26	4.40	1.22	2.46	2.89
Canada	4.12	3.39	4.43	4.04	3.01	4.42
Japan	10.31	7.58	8.16	12.33	3.51	7.05
France	4.21	4.74	5.06	6.29	4.36	5.96
Germany	5.86	6.09	5.82	4.94	5.30	4.91
Italy	6.65	4.53	7.38	6.37	4.56	4.06
U.K.	1.36	2.81	3.67	3.25	2.65	1.16

Table 8: Shares of Total Manufacturing Output in Ten Industrial Countries, 1950-77

COUNTRIES	Share of Total, %						
	1950	1955	1960	1965	1970	1975	1977
U.S.	61.9	58.1	50.5	50.1	43.6	42.5	44.0
Canada	3.5	3.4	3.3	3.5	3.4	3.7	3.6
Japan	2.1	3.5	6.3	8.0	13.1	13.2	13.4
Denmark	0.7	0.5	0.6	0.6	0.7	0.7	0.7
France	7.6	7.1	8.1	8.1	8.9	9.8	9.6
Germany	10.1	14.1	17.2	16.7	17.2	16.5	16.0
Italy	2.2	2.5	3.1	3.1	3.7	4.3	4.3
Netherlands	1.8	1.9	2.2	2.1	2.3	2.3	2.2
Sweden	2.0	1.7	1.9	1.9	1.9	2.0	1.6
U.K.	8.2	7.2	6.9	5.9	5.3	4.9	4.5

SOURCE: Department of Labor

Table 12: Index of U.S. Weighted Relative Unit Labor Cost, 1975=100

YEAR	RELATIVE COST INDEX
1961	152.6
1962	151.8
1963	151.0
1964	151.2
1965	148.1
1966	147.5
1967	148.1
1968	151.4
1969	151.2
1970	144.8
1971	137.0
1972	123.9
1973	110.1
1974	105.8
1975	100.0
1976	105.1
1977	104.2
1978	96.5

SOURCE: International Monetary Fund

Table 13
Distribution of Exports of Manufactures (SITC 5-8)

	1953	1956	1959	1962	1965	1968	1971	1974	1976
Total (million $)	37,738	51,721	61,400	79,330	109,730	150,070	226,670	483,070	585,260
Country	% of Total								
Developed	88.0	83.5	82.1	81.6	82.0	83.1	83.9	83.7	83.1
LDCs[2/]	7.0	6.6	5.3	5.3	5.8	5.8	5.5	7.8	8.0
CPEs[3/]	5.0	9.9	12.6	13.1	12.1	11.0	10.4	8.4	8.9
Developed									
W.Europe	49.0	50.1	53.7	54.4	54.7	53.0	54.7	54.9	54.0
EEC	-	-	31.9	33.5	34.4	34.4	35.8	*44.9	44.0
EFTA	-	-	20.3	19.2	18.4	17.2	17.2	* 8.2	8.0
Germany	9.7	12.2	15.6	14.8	15.4	14.8	15.4	16.3	15.5
U.S.	29.4	23.0	18.7	17.6	15.8	15.8	13.4	13.2	13.2
Canada	5.0	4.3	3.9	3.5	3.7	4.9	4.6	3.4	3.5
Japan	2.8	4.2	4.9	5.5	7.1	8.1	10.0	10.9	10.9
Other	1.9	2.0	1.2	0.6	0.8	1.4	1.3	1.4	1.5
LDC									
Africa[4/]	1.6	1.4	1.3	1.2	1.3	1.3	0.9	0.9	0.6
Lat.Amer.	1.6	1.6	1.2	1.1	1.2	1.6	1.4	1.9	1.6
M.East	0.3	0.4	0.4	0.3	0.4	0.2	0.2	0.5	0.4
Asia[5/]	3.5	3.2	2.4	2.6	2.8	2.7	2.9	4.5	5.4
NIC3[6/]	0.9	0.9	0.8	0.9	1.2	1.5	1.8	2.4	3.0

[1/] Developed Market Economies: U.S., Canada, Japan, West Europe, Australia, N. Zealand, South Africa

[2/] All countries excluding Developed & CPEs

[3/] East Europe, U.S.S.R., PRC, Mongolia, N. Korea, N. Vietnam

[4/] Excludes S. Africa & Rhodesia

[5/] Excludes Developed countries & CPEs

[6/] Republic of Korea, Hong Kong, Singapore (Data for Taiwan was not available for the entire period)

Table 18: U.S. Effective Exchange Rates, 1961-78,

1975 = 100

YEAR	(1) Effective Exchange Rate[a]	(2) U.S. WPI Relative to Competitors	(3) Exchange Rate Adjusted for Relative WPI (3)=(1)÷(2)x100
1961	85.0	102.6	82.9
1962	84.3	101.7	82.9
1963	84.2	99.7	84.4
1964	84.2	98.2	85.7
1965	84.2	98.0	85.9
1966	84.2	98.4	85.6
1967	84.0	98.7	85.1
1968	82.6	99.0	83.5
1969	82.4	99.3	83.0
1970	83.2	98.4	84.5
1971	85.5	98.3	86.9
1972	92.3	98.4	93.8
1973	100.3	98.3	102.0
1974	98.1	97.9	100.2
1975	100.0	100.0	100.0
1976	94.4	97.3	97.0
1977	95.6	96.4	99.2
1978	105.3	98.9	106.4

[a] This is the inverse of an index of the weigthed average of the foreign exchange prices of the U.S. dollar.

SOURCE: International Monetary Fund

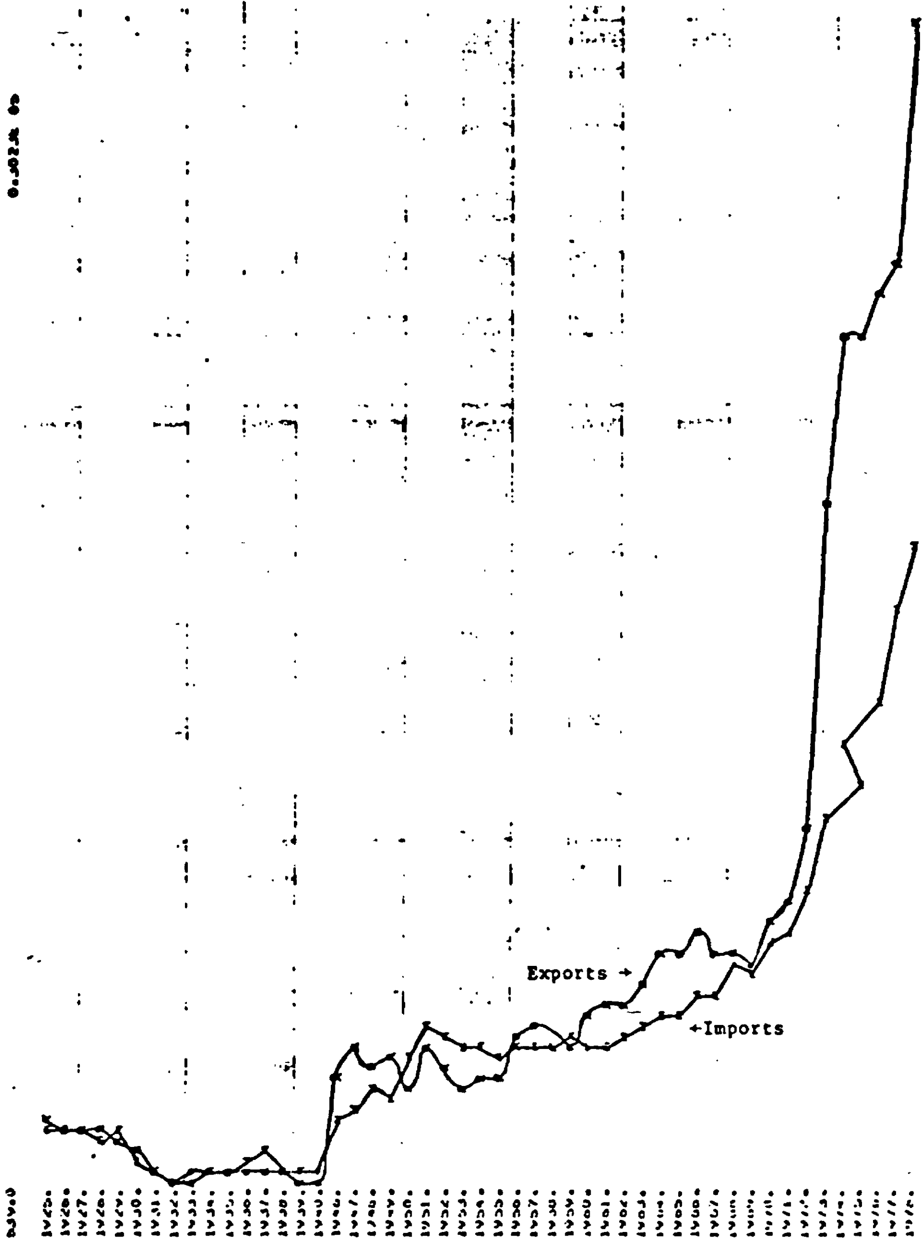

Figure 2: U.S. Exports and Imports of Agricultural Goods, 1925-78

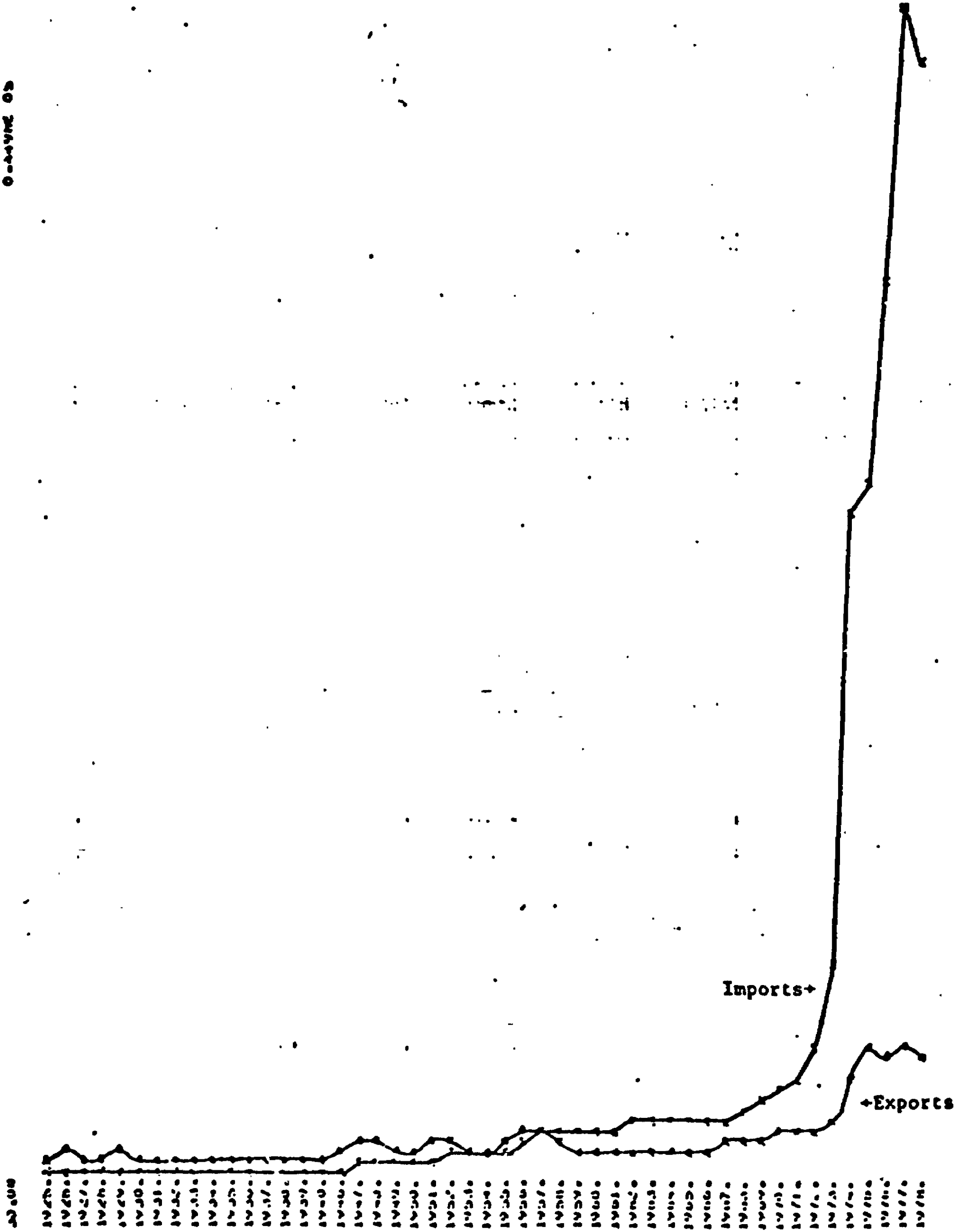

Figure 3: U.S. Exports and Imports of Fuels and Lubricants, 1925-1978

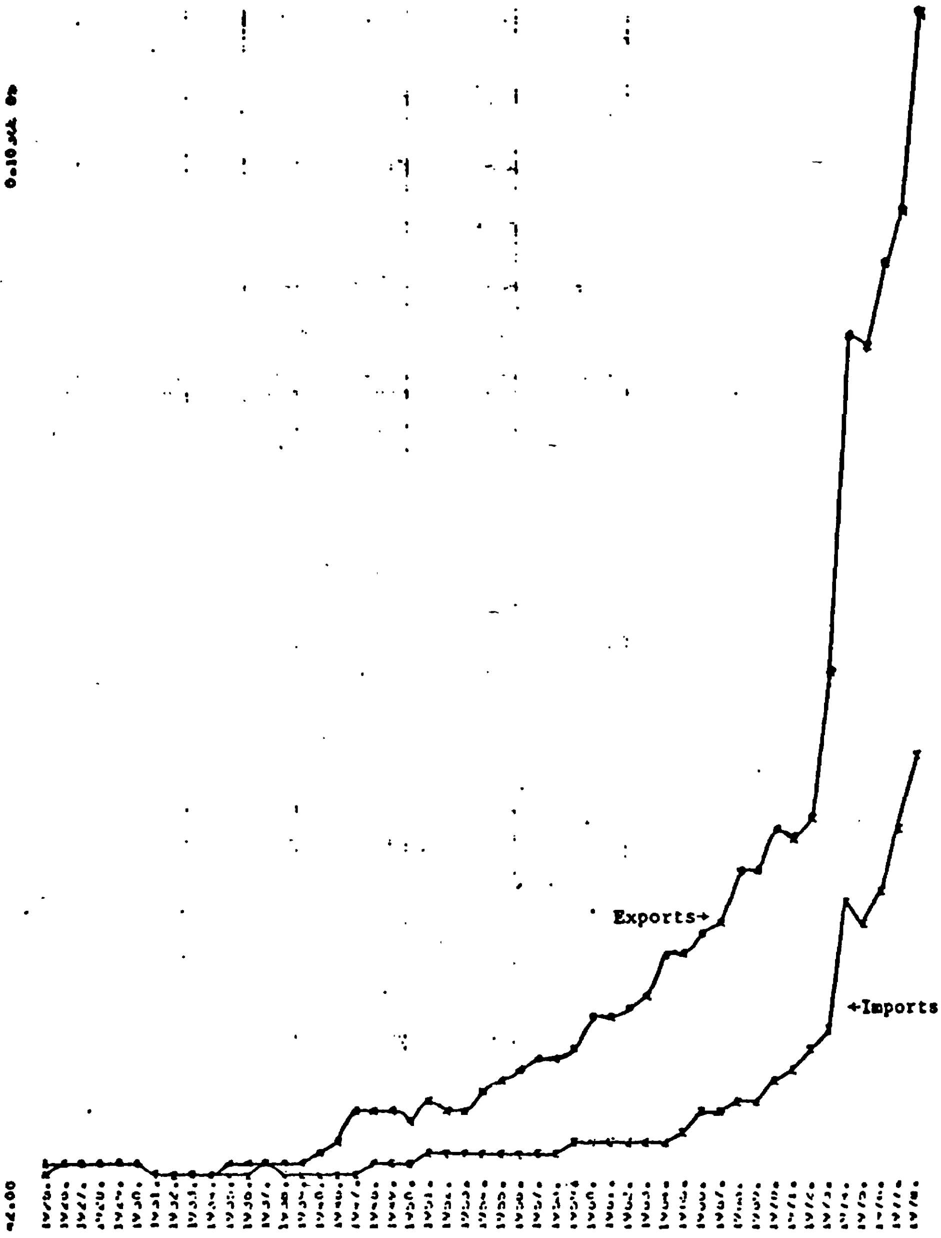

Figure 4: U.S. Exports and Imports of Chemicals
1925-1978

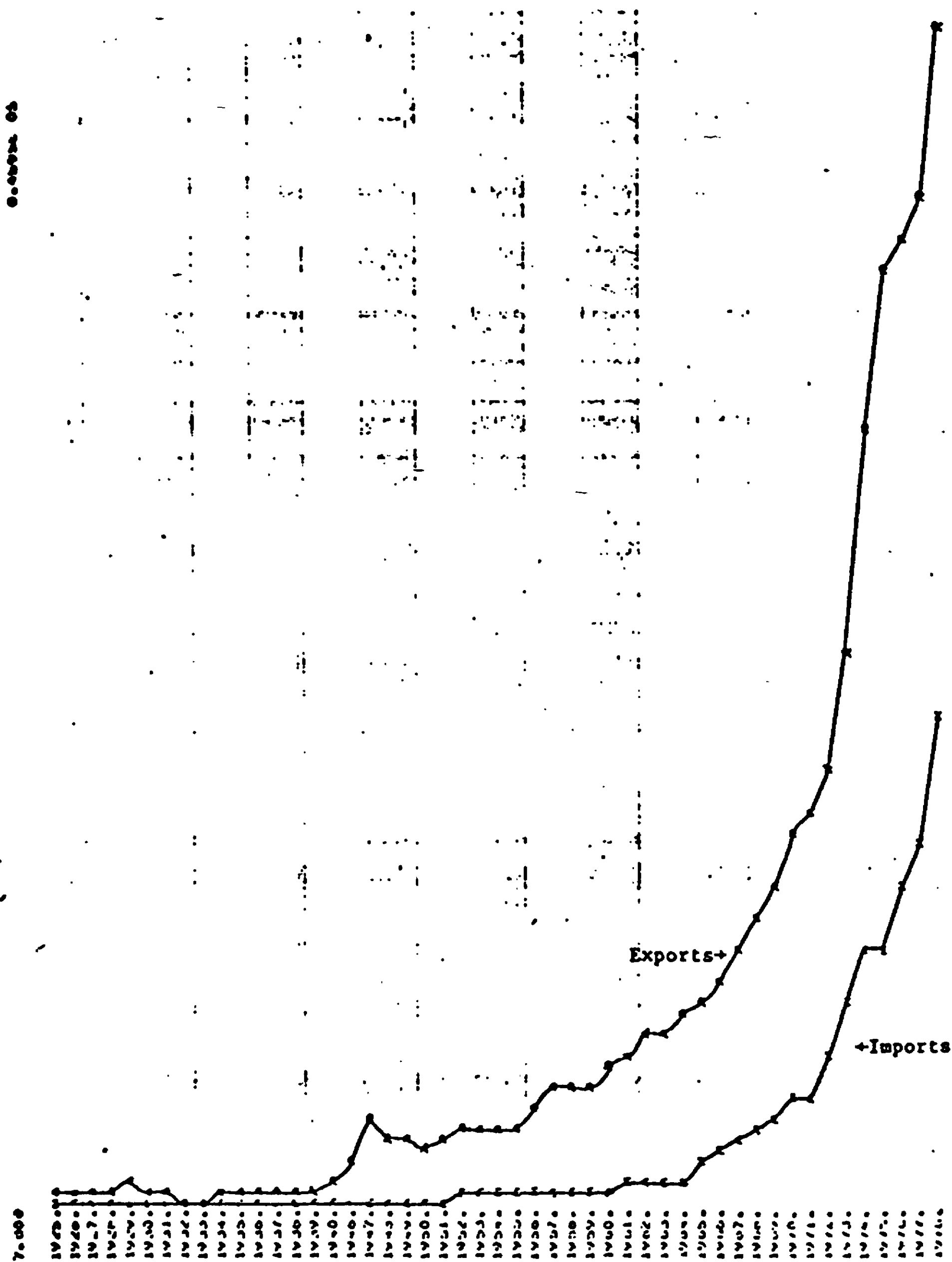

Figure 5: U.S. Exports and Imports of Capital Goods, 1925-1978

Table 20: Change in Capital Goods Exports, 1972-75
($ billion)

Area	Increase in Exports
Western Europe	$4.9
Eastern Europe	0.7
Canada	2.7
Japan	0.5
Latin America	3.6
Australia, N.Z., S.A.	1.1
Other Asia and Africa	5.5
TOTAL	$19.0

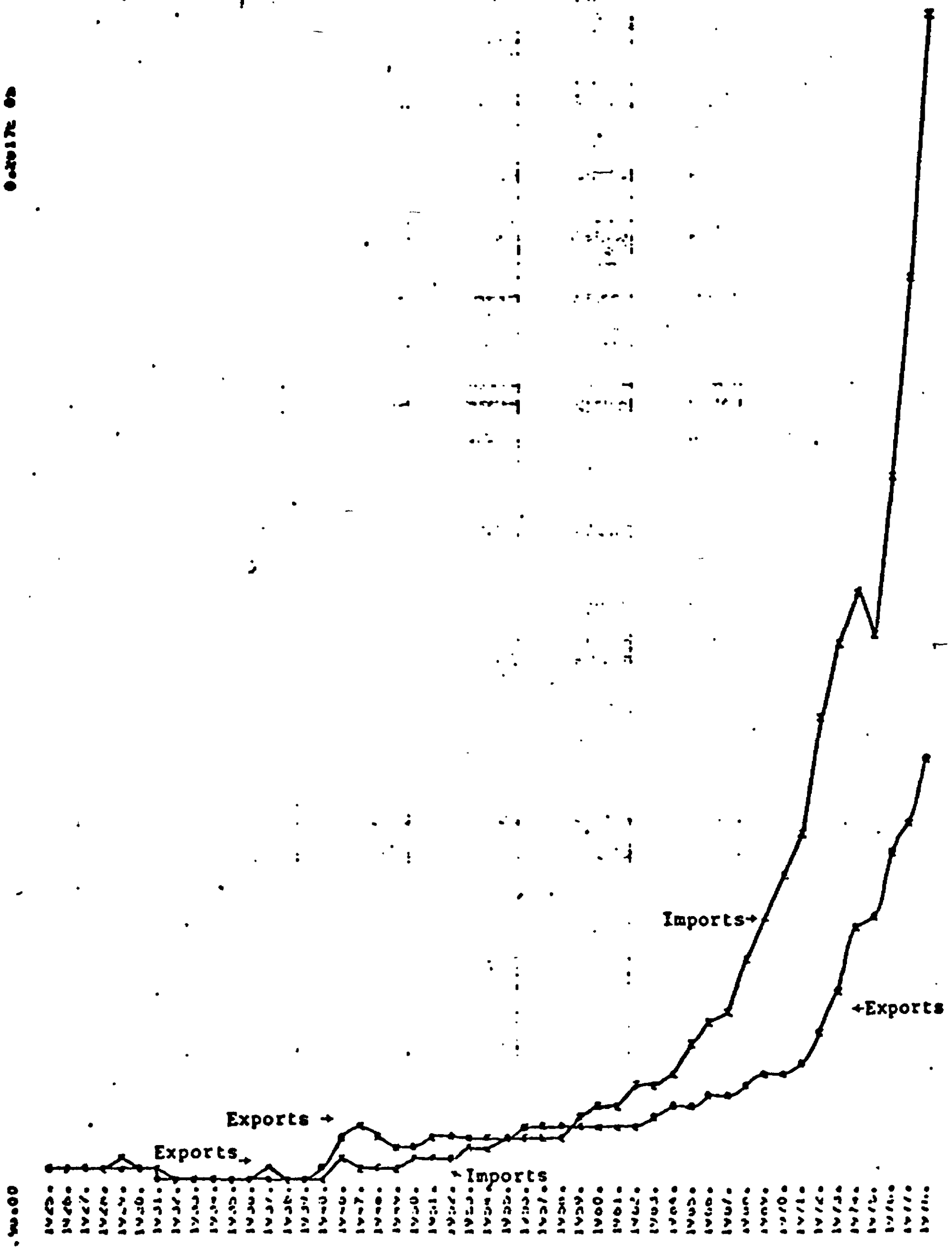

Figure 6: U.S. Exports and Imports of Consumer Goods,

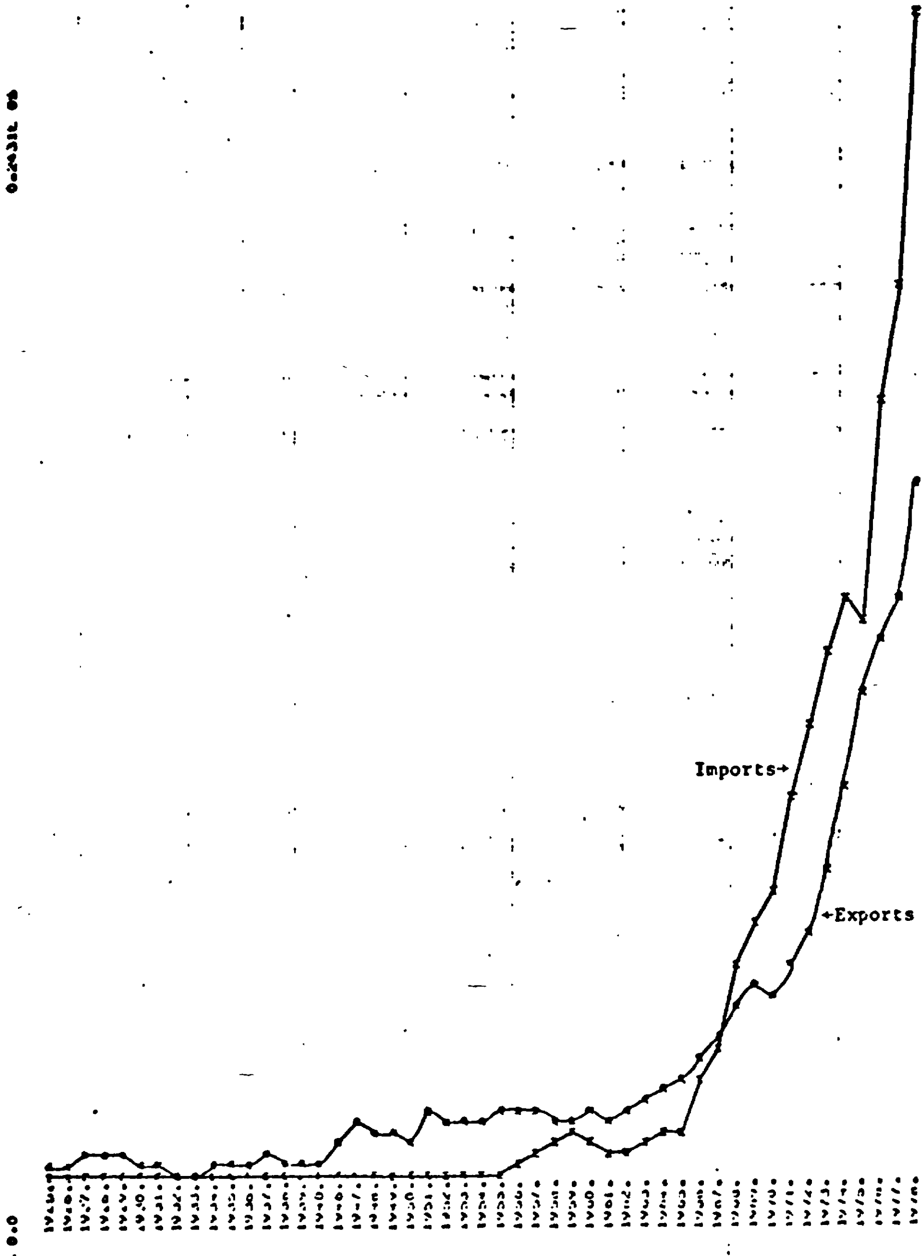

Figure 7: U.S. Exports and Imports of Automotive Products, 1925–1978

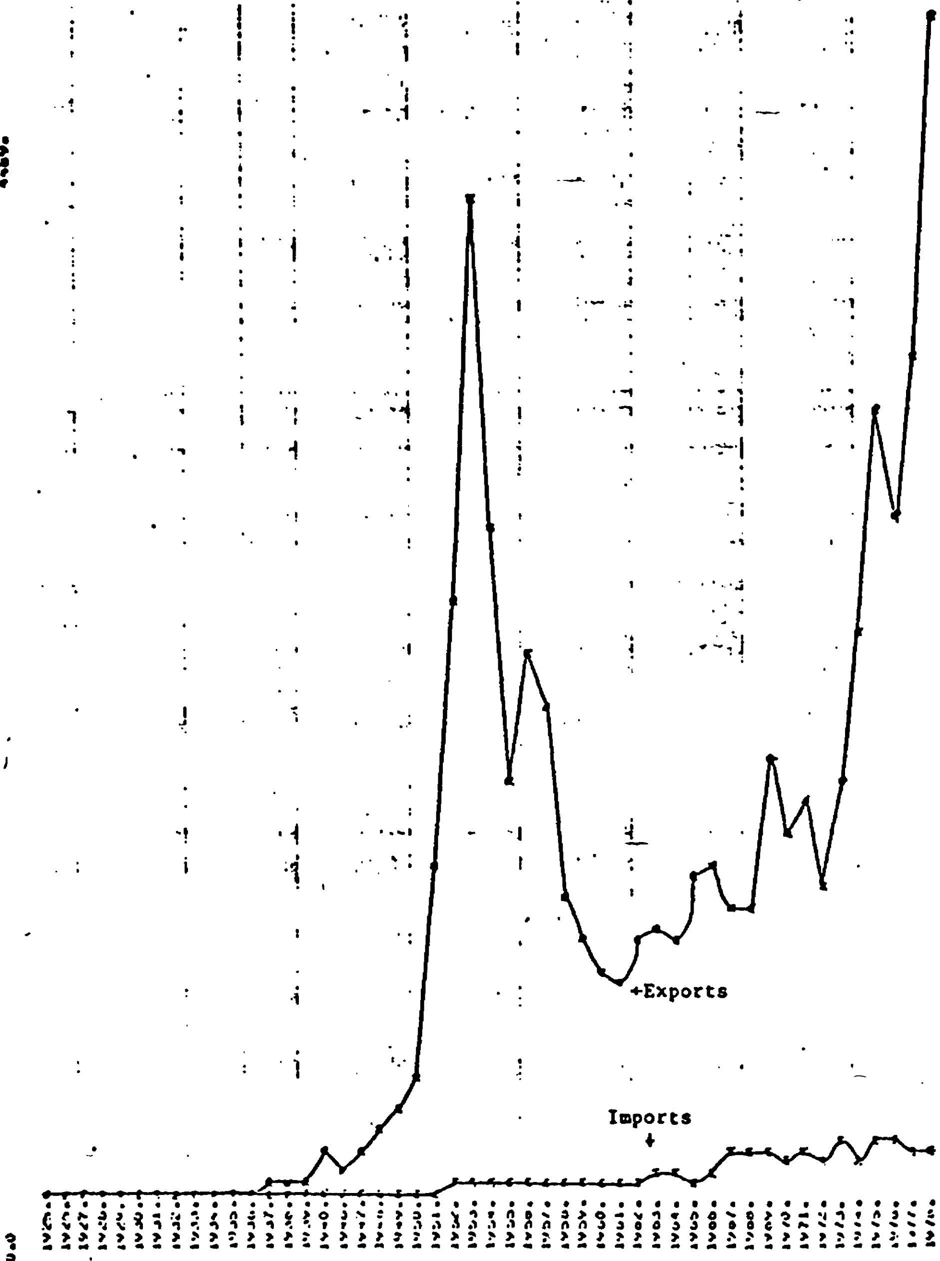

Figure 8: U.S. Exports and Imports in Military Goods, 1925-1978

Table 25: U.S. Long-term Assets and Liabilities, 1950-77 ($ billion)

YEAR	U.S. Private Long-Term Assets (1)	U.S. Gov't. Long-Term Credits (2)	U.S. Long-Term Liabilities (3)	Balance (1)+(2)-(3)
1950	17.5	10.8	8.0	20.3
1955	26.8	12.4	13.4	25.8
1960	44.4	14.1	18.4	40.1
1965	71.0	20.3	26.4	64.9
1970	105.0	29.6	44.7	89.9
1975	174.4	39.8	80.7	133.1
1977	216.6	47.8	93.9	170.5

Table 26: U.S. Private Long-Term Foreign Assets

($ billion)

YEAR	Total	Direct	Foreign Bonds	Foreign Stocks	Other
1950	17.5	11.8	3.2	1.2	1.4
1955	26.7	19.4	3.0	2.4	1.9
1960	44.4	31.9	5.5	4.0	3.1
1965	71.0	49.5	10.2	5.0	6.4
1970	105.0	78.2	13.2	6.4	7.2
1971	114.5	83.0	15.9	7.6	8.1
1972	127.8	90.5	17.1	10.5	9.7
1973	139.8	101.3	17.4	10.0	11.1
1974	151.0	110.1	19.2	9.0	12.7
1975	174.4	124.0	25.3	9.6	15.4
1976	198.3	136.4	34.7	9.5	17.8
1977	216.6	148.8	39.2	10.1	18.5

Table 28: U.S. Long-Term Liabilities to Foreigners

($ billion)

YEAR	Total	Direct	Bonds	Corporate Stock	Other
1950	8.0	3.4	0.2	2.9	1.5
1955	13.4	5.1	0.3	6.6	1.5
1960	18.4	6.9	0.6	9.3	1.6
1965	26.4	8.8	0.9	14.6	2.1
1970	44.8	13.3	6.9	18.7	5.9
1971	50.1	13.9	8.6	21.4	6.1
1972	60.8	14.9	10.9	27.8	7.1
1973	74.3	20.6	12.6	33.5	7.7
1974	67.6	25.1	10.7	24.2	7.6
1975	80.7	27.7	10.0	35.3	7.7
1976	92.6	30.8	12.0	42.9	7.0
1977	93.9	34.1	13.4	39.7	6.7

SOURCE: Survey of Current Business

STATEMENT BY HARALD B. MALMGREN
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL TRADE,
COMMITTEE ON FINANCE, U.S. SENATE
July 28, 1980

THE GLOBAL CHALLENGE OF THE 1980'S

At the beginning of the 1980's in this nation we find ourselves at a time of pervasive loss of confidence. Growth and capital spending for the future have fallen off. Building for tomorrow has given way to consolidation and cost-cutting today. Commitments of our economic resources to long-term modernization and development of new products and new sources of supply are being made at an historically slow rate. Inflation seems to have become chronic, a universal corrosive. Even economic downturns do not offer much hope of squeezing out inflation. Research and development expenditures are falling off. Existing plant and equipment have not only been aging and becoming obsolete according to underlying trends, with which we do have experience, but also as a result of erratic shocks in the world

market structure, particularly the enormous leap in the price of energy. These shocks have had the effect of making inefficient all at once vast amounts of our existing capacity.

Our markets seem to our businesses and workers to be buffeted by international forces beyond our control, causing domestic adjustment difficulties which had not been anticipated a decade ago: gyrations of exchange rates, surges in imports, unexpected rise in the number and quality of international competitors as the developing countries emerge in world markets, interest rates which seem driven externally rather than by home monetary conditions, energy constraints, to name a few. Domestically, too, our national economy is subject to almost universal complaints about inflation, unemployment, problems of structural adjustment, poor productivity, quality of life, social injustices, and unfairness to particular sectors or interest groups.

Calls for government action, to put the situation right, have resulted in more and more public, official efforts to manipulate particular elements of the economic environment, but swollen budgets have been one result. Expanded, costly regulation of the private sector has been another consequence, as government has increasingly sought to meet its objectives by off-budget actions. Fiscal policies have become less flexible, owing to the political need to maintain programs, once they have

started, and monetary policies are now leaned on more and more. But the monetary side of our economy has become so complex domestically and so internationally interactive that we cannot even measure what it is we are trying to control, we cannot readily channel the flows of capital because of the explosion of alternative financing techniques, and we cannot avoid exchange rate implications of interest rate adjustments.

In the face of awesome problems, we increasingly call for new leadership, blaming our predicament on the quality of our present leadership. Yet potential new leaders offer no magic or convincing alternatives, and the lesson gradually being learned is that government may not be capable of gaining command of the present forces of change.

What has happened to our confidence and our competitiveness? What are the challenges facing the United States, and how are we dealing with them? What are the implications for our relative global economic power, and our capacity to influence other nations and the workings of the international economic system?

We are in a serious predicament. At a time when global forces require even faster adjustment of our economy than in the past, we are adjusting more slowly than at any time since World

War II. We talked ourselves into slow growth. We lost confidence in our economic future, and slowed down the pace of our long-term capital commitments. Yet, to deal with the forces of change we should be growing faster and spending more on rebuilding our capital structure than ever before. Without rapid adjustment, it is inevitable that our productivity performance would weaken. It is inevitable that we would suffer inflationary consequences of utilizing an increasingly inefficient industrial base. It is inevitable that we would have serious troubles in such basic industries as autos and steel.

What are the forces we as a nation have to reckon with in the 1980's?

First, we have to deal with growing interdependence of our economy with that of the rest of the world.

Our economy has become far more interactive with the economies of other nations than most Americans realize. Our farmers do know that half our total grain production goes into world trade, and that world markets are therefore a major determinant of domestic farm prices and farmer incomes. As drivers and home owners, we all have recognized our extraordinary dependence on foreign oil producers for generating our gasoline supplies and fuel oil. But beyond a few such

dramatically obvious examples our recognition of global interdependence is minimal.

Yet the interaction of our economy with that of the world has been growing markedly in recent years. For example, we usually think of trade as a relatively small part of our economy, by comparing our trade with our GNP. In 1970, U.S. exports and U.S. imports each accounted for about 4.3 percent of GNP. In 1979, exports were about 7.5 percent of GNP, and imports about 9.2 percent. The impact had more than doubled in the 1970's. Yet this does not tell the whole story. The balance of our economy is increasingly shifting towards a greater share for services, and a declining share for industrial activity. Much of our services are not traded -- dry cleaning, dentists, most of our lawyering, local transportation, etc. A true comparison would be trade in relation to the domestic production of goods -- food and manufacturing production -- of goods which are tradable. The Commerce Department has developed such a series. In 1970, exports represented 14.4 percent of the U.S. production of goods, and imports 14.3 percent. In 1978, the export ratio was 22.4 percent and the import figure 29 percent.

If that seems surprisingly high, the comparable ratios for France and Germany are around 50 percent; for the UK, 70 percent for exports and about 80 percent for imports -- and Canada is

even higher, in the 80 percent range.

In recent years, the ease of transportation, the speed of communication, the spread of capital and technology, the mobility of multinational enterprises, the relentless growth of trade at a rate faster than national GNP growth of most nations, have all led to greater and greater interweaving of national economies.

Even the management of our domestic monetary system is greatly affected by international considerations, with our interest policy periodically driven by external considerations.

In the financial area, the intertwining of our capital markets with rest of the world has grown increasingly intricate. Banks not only lend globally, they also source funds throughout the international capital markets. The range of financing options to a corporation are now so wide that the Federal Reserve felt it had to ask non-U.S. banks, and their respective national monetary authorities, to discourage lending to U.S. enterprises outside the guidelines imposed on U.S. banks in the recent squeeze. The monetary authorities of other nations did not agree, and the problem would no doubt have become serious had the U.S. credit squeeze continued.

The Eurocurrency market has given rise to considerable

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controversy and worry, not just because of its relatively unregulated character, but also because of its scale. According to the BIS statistics on this market, it has by the end of last year grown to about one trillion dollars gross or about 650 billion dollars net of interbank deposits. While it is popular to rely on the net figure, one should remember that a lending institution is driven by its gross deposits, and not by some statistician's abstraction described as net. However, there are now new figures emerging in the work of the IMF and in recent research by an American banker, Jay F. Sterling, Jr., which suggest that the real gross figure at the end of the 1970's may have approached 1.8 trillion dollars. This pool, primarily dollars, is sufficiently large and liquid that its potential volatility and cross-border flow threatens national monetary management, and has a direct effect on the level of exchange rates. Large holders of various kinds of dollar positions throughout the world must increasingly concern themselves with the potential volatility of the dollar, and other currencies as well.

It used to be easier, theorizing about exchange rate determination. One could focus on the current account of a nation and draw conclusions about the transactions demand for that currency. Then one might make allowances for capital flows. When capital outflows or inflows became large relative to trade balances, some economists found their theories about

purchasing power and comparative advantage slipping a little, but still the transaction motives for currency exchange seemed to be most prominent. Now, at the beginning of the 1980's, at a time of persistent high inflation, the dollar holders, and other asset holders, are concerned as well with preserving and enhancing their assets at a time when inflation corrodes asset value.

The asset motivations may often overwhelm the transactions motivations, in which case the primary determinants of exchange rates are expectations about future values and yields. These expectations may be partially based on recent current account experience of a nation, but they will also reflect expectations about inflation, productivity, political safety, national politics and economic policies, and especially monetary (interest rate) policy. As with equity markets, expectations are also conditioned by what you think other buyers and sellers expect.

Under these circumstances, it is quite possible for a currency to rise to undesired heights, as is the case for sterling, or to illogical depths, as happened to the yen a few months ago, on the basis of many factors other than the current account outlook. The recent high British interest rates and the existence of a sophisticated banking center in London have helped sterling up much more than North Sea oil, to which the

press has given great credit. The British trade account not only is not the driving force; but now the British trade account and the process of industrial adjustment are suffering extreme pains of a high exchange rate.

Consequently, with asset managers in the U.S. and throughout the world ever alert to the changes in tides of expectations, strong currencies can move great distances in relatively short periods, as we have seen for the DM, yen, Swiss franc, Canadian dollar, and U.S. dollar. My own judgment is that the volatility may become greater in the 1980's, as domestic asset managers increasingly learn that they too can manage their portfolios on an international scale, and as the markets become even more interlinked by technological advances in communications and information processing.

It has been estimated that 150 to 200 billion dollars of foreign exchange transactions go through the New York clearing banks each business day. The scale of the activity is awesome. The potential scale of dollar diversification, out of dollars, or out of more liquid positions to more fixed positions (equity, bonds, property) is also awesome.

Let me note here that it has been conventional wisdom that the dollar's role or share in international finance has remained steady in recent years, especially in national reserves. The

gross figures have however masked a reduction of relative dollar positions by many countries, while the Germans, Japanese, Swiss, French, and British intervened heavily to purchase dollars in defense of their own currencies. Now the more basic trends are becoming visible. Many countries have cut the proportion of dollars in their reserves, and even the absolute amounts in some cases. While the overall average share of dollars in total national reserves of currencies has been about 80 percent in the 1970's, it seems now to be receding. If we set aside the five reserve currencies I have listed, the share has fallen under two-thirds, and is probably continuing to fall back.

The dollar still represents a relatively politically safe position, compared with other currencies. But even this safety factor was recently diminished, psychologically at least, by the methods employed by the U.S. in seizing Iranian assets. The dollar still stands on a strong economic foundation, the U.S. economy. But world trade patterns are changing. Debt and recycling needs are shifting. Alternatives do exist to dollar positions. The dollar is therefore becoming acutely sensitive to interest rate differentials and inflation differentials. The recent weakening of the dollar is directly related to the rapid decline in U.S. interest rates.

In such a world, even a mighty country like the U.S. is caught in a quandary -- whether to focus monetary policy on

domestic economic conditions or on defense of the dollar. It is not an easy choice, for if the dollar declines much, there is a strong inflationary effect within the U.S., and the OPEC producers are encouraged to raise oil prices even faster, or else reduce supplies, which in turn sets loose new inflationary forces.

The interdependence of markets of which I have been speaking is quite vital to the effectiveness of national economic policies, both sectoral and general. The competitive rise in interest rates around the world in recent months, and subsequent collapse of the U.S. credit restraints brought many forces to work -- in great swings in exchange rates, in gyrations of commodities, in altered export competitiveness positions among traditional trading partners.

We are facing new, additional sources of competition in the world marketplace, as well as at home. Where once we worried about high labor-intensity imports from Japan, like textiles, today we face new competitors from among the developing countries. The number of countries capable of exporting manufactured goods is growing fast -- and these are not simply textiles, apparel, and footwear. Korea is already a global competitor in electronics, steel, shipbuilding, and even big-ticket engineering and construction projects. Brazil is already exporting several types of aircraft, including executive

jets. World car concepts will enable many countries to be part of the automotive workshop that produces our vehicles. As for Japan, we no longer worry about imports of textiles and labor-intensive products. Now we worry about Japanese computers, office machines, and sophisticated, automated machine tools, and we worry about the high quality of Japanese consumer products generated from capital-intensive production systems which minimize the scope for human error.

The newly emerging industrial competitors must export more to service their debts, and pay for imported food, oil, and capital equipment. These newly emerging competitors are being chased by other nations who also have growing need to export. In particular, the centrally planned economies in Eastern Europe have an urgent need to service their growing debt and to pay for food and oil purchases on the world market. They too will be intensifying their export efforts.

<u>Traditional markets may in the 1980's have a relatively less important role in U.S. trade than the OPEC countries, the non-oil developing countries, and the centrally planned economies.</u> The EC will be digesting a broadened membership. Greece will soon be a full member. Spain, Portugal, and possibly Turkey will have gradually more intimate arrangements with the EC, with Spain likely to become a member reasonably

soon. These countries can supply labor-intensive products, as well as labor, for the EC. They, and the associated countries, especially in Africa, can supply many raw materials as well. The EC will have all it can do to assimilate the growing economic role of these countries in the Community, and will be reluctant to involve itself in further global liberalization. Japan and Canada will remain big buyers, but their markets will not grow fast for U.S. products. OPEC countries, in the Middle East especially, can sustain high purchases of capital goods, food, luxury goods, and weapons but even they are becoming conscious of rising construction costs and the political dangers of too much weaponry or conspicuous consumption. They will not be buying on the scale that they did in the 1975-79 period. The developing countries and the centrally planned economies thus turn out to be very important markets for the U.S. The non-oil producing LDC's now take about one quarter of U.S. total exports. These countries have been growing about half again as fast as the rich, Western industrialized countries, and as such they are the true growth markets for the 80's. But they can only buy imports where financing of the imports is available. Commercial bank lending, official export credits and guarantees, and aid transfers are essential in selling to these nations.

The U.S. is likely to slip behind in this area of financing exports, for several reasons. One problem, and this is not widely recognized, is that U.S. commercial banks are losing

<u>ground in global banking competition.</u> In global international lending to non-banks, i.e., to corporations and governments, the American bank market share dropped from 1976 to 1978, from 33 percent to under 7 percent. It is highly unlikely that the American bank's share will rebound to the share held in the 1960's and 1970's, in the 25 to 40 percent range at that time. Most American banks experienced net repayments on Eurocurrency loans in 1978, and in 1979 preliminary data suggest that this falling back is continuing. Among the reason is a structural problem: The capital-assets ratio for U.S. banks requires a pre-tax spread of 100 basis points (one percentage point) or more on lending, in order to obtain a satisfactory rate of return on capital. A French bank can accept a pre-tax spread of about 45 basis points, a German bank 55 basis points, a Swiss bank 60 basis points, and a Japanese bank about 65 basis points. Moreover, a German bank can fatten its return by buying into a deal (taking a position in the project) and drawing dividends and fees, since involvement of banks in operating enterprises is not proscribed by German law or regulations. <u>The regulatory environment and the capital structure of U.S. banks means that the profit dynamics of the 1980's work against U.S. banks in global comptition</u>. On top of this, U.S. banks already have high exposure in many countries, and are cautious about exceeding their country lending limits. Our regulators are also sensitive on this point. The international loan syndication market has also been made more uncertain by recent shocks --

notably the U.S. seizure of Iranian assets and the subsequent scramble of U.S. banks to cover themselves by essentially unilateral actions. Our regional banks are falling out of the international market, and risk diversification is becoming more difficult within the U.S. context.

The international commercial lending climate is now also less bright for banks of other nations, even though they can accept smaller spreads and still make satisfactory profits on their capital. Therefore, increasing attention is being given throughout the Western world to official help to exporters and to banks -- to clinch deals in countries where financing is crucial and the borrowing capacity limited. The array of aids -- official export finance, guarantees, local cost financing, inflation and exchange risk insurance, and even use of aid funds -- is growing. Governments and banks and sellers of big-ticket projects are working more and more closely.

The U.S. has not had great success in halting this official competition in export finance. While the Venice Summiteers did declare their intention to find by December 1 this year a new formula for containing this type of competition, I doubt whether the negotiations will succeed. And even if they do, the orientation and objectives of the U.S. negotiating approaches are too narrow to stop this explosion of government aids. In addition, development assistance money is becoming harder to

obtain from Congress and other Parliamentary bodies at a time of budget austerity. Aid money is much easier to justify if it can be viewed as trade promotion money. The use of official export credits and aid funds to assist poor nations to buy one's own goods seems to be an attractive solution. This tendency can only grow.

Moreover as far as the buying countries are concerned, if they are in a fast developing phase they are in most cases borrowing heavily on world capital markets to sustain their purchases of food, oil, steel, chemicals, and industrial equipment. Many of them are increasingly looking for complex deals by which they can move beyond simple financing of imports. To develop their resources, they are increasingly asking not only for soft lending terms but for comprehensive project assistance -- building projects, supplying technology, providing management services, developing local supplies, improving local ports and transportation facilities, and even guaranteeing world sales of the output of these projects. Mexico's recent discussions with Japan, Germany, France, Sweden, and Canada exemplify the new push. If there is oil to dangle as an incentive, as Mexico can do, then the bargaining position is strong indeed.

Needless to say, complex deals involving private capital, aid, official credits, construction services, and capital goods

in exchange for resources would seem to require close government-private cooperation in making the deals. This trend is likely to enhance the government role in relative competitiveness. France, Germany, and Japan will find this easier than, say, the U.S. The temptation will be great for some governments to secure export deals and assured supplies of resources in exchange for official financial help, especially during a period of weak domestic economic activity. Development of bilateralism, based on such package deals, would be all too plausible and even attractive.

Another fact of life which affects the outlook for U.S. basic industries in the 1980's is excess capacity and heavy government intervention in a number of other nations. The industrial problems of Europe have generated excess capacity and heavy government intervention in European industry. Key industries such as iron and steel, shipbuilding, non-ferrous metals, chemicals, and others have all turned to European governments for help, and those governments have responded not only by various forms of financial support but also by keeping open obsolete facilities. When European iron and steel capacity should have been cut back in the 1970's, European Community capacity actually expanded. Japan's capacity is so efficient that it can only be run at low levels of capacity utilization. In addition, developing countries are building their own steel mills, hoping to reduce their imports and even perhaps begin

exporting. Consequently, throughout the 1980's we face worldwide overcapacity in steel. Such basic industry problems on a world scale make the job of domestic adjustment and modernization very difficult -- especially in a context where governments are heavily involved in many other nations. The slowdown in world growth is a major contributing factor to the present overcapacity. The problems of the 1980's for U.S. basic industries extend through iron and steel, nonferrous metals, petrochemicals, and chemicals -- all of which are capital-intensive and major energy users. To respond, our own capital needs are commensurately large -- but it is difficult to generate capital when profits are low, imports high, and the market prospects for new capacity poor.

On the other hand, where governments are prepared to participate, in Europe, Canada to some extent, and very much in the LDC's, the outlook is different. However inefficient, basic industries in those countries are better placed to compete at home and abroad.

Looking at the 1980's, there are numerous possibilities for disruptive shocks and greater tension. We obviously face a vital problem of energy adjustment. We have as a nation been adjusting since 1974. At that time, a one percent rise in GNP required a one percent rise in energy consumption. Today, a one percent rise in our GNP requires only about one-half of one

percent increase in energy use. But the easy solutions, like turning down heat and slowing driving speed, are coming to an end. Now we have to make massive changes in our automotive industry, and we have to restructure our basic industries to use different processes of production. We have to convert old facilities, and build new ones to use new types of energy.

In the 1980's, the world faces a tight fit in global energy supplies, and this means that any unhappy political developments in oil-supplying nations can dramatically damage the U.S. domestic adjustment process as well as that of a number of other industrialized countries. The Persian Gulf region cannot be considered stable, for planning purposes.

In the 1980's we face a tight fit in global food supplies also. This may be good for U.S. farmers, and even good for U.S. exports, but it could be bad for our own inflationary pressures. With bad weather in Northern Europe, including Eastern Europe, as well as bad weather in the U.S. and Canada, this year's crop will be so-so, while world demand is rising fast. World stocks will probably be drawn down and prices will rise, perhaps by 15 percent in the 1980-81 crop year. But then what happens in 1982, 83, 84 and afterwards? With low stocks globally, just a little bad luck could lead to escalating food prices. World developments could dramatically alter our domestic economic perspective, and give rise to new wage-push pressures. Some of

the developing countries that buy our exports may also have to cut their imports of manufactures from us sharply in order to enable them to acquire vitally needed food and oil.

And then there is the tight fit for raw materials. In the basic resources, we are a well endowed country, but there is much we must import from the rest of the world, and world prices determine our domestic prices. Global investment in basic resources, especially mining, has slowed to a trickle in the 1970's, so if we do manage to get the Western world on a faster growth, faster adjustment path, we and other nations are likely to find great bottlenecks in raw materials in the mid-1980's. We shall also discover that the main sources of many raw materials are in politically volatile areas, such as Southern Africa, or in the hands of the Soviet Union. This cannot be quickly corrected. Lead times for new mining and processing facilities run 5 to 7 years. This is another source of potential shock in the 80's.

Another set of forces which can prove very disruptive, and which we have not yet recognized in our policy thinking, is the interaction among financial markets, commodity markets, property markets; bond and equity markets, and other asset markets.

The 1972-75 global commodity boom was typical of the new forces at work, which even experienced observers could not

readily explain at that time. Coinciding with an acceleration of inflation, this boom saw a doubling of overall commodity price indices, with a quintupling of some individual commodities such as sugar and urea. Some analysts saw the upward leap as the beginning signs of the limits to growth, but as matters turned out, the commodity markets dropped nearly as fast and as far as they had risen. What had happened was that parties interested in capital gains joined in frantic speculative competition with commodity producers, users, and traders, as other forms of assets were turned towards the commodity markets. We have again vividly seen this crossover in recent months, to an extent that the U.S. Federal Reserve, as part of its recent credit squeeze, made explicit admonitions about credit granted to support speculative activity. The silver market crunch was but a symptom.

Now, we have to view the commodity markets and the financial and currency markets as inextricably intertwined. Given the inadequate world sugar supply conditions for the next two or three years, for example, an asset manager could not help notice in recent months that sugar would be on a rising tide, and indeed the tide is still rising. Non-sugar related funds must inevitably flow into the market, driving the price up further. National authorities have valiantly tried to control the gyrations of some of the precious metals recently, but it was a credit squeeze more than anything else which brought order

back into the markets. The lessons having been learned, and the squeeze behind us, the speculation will inevitably resume -- perhaps in a more orderly way, but who can say?

These interactions are making many of our economic theories and concepts obsolete. Much of economics is built around an approach which considers a specific change in one market sector while all other conditions are assumed to hold steady. We analyze supply and demand for copper, or for sugar, or for bonds, as if they were separate. Financial portfolio theorists in recent years have widened their perspective to look at the greater interaction among different financial markets, but this thinking is not well integrated into the mainstream of academic economics. In the meantime, an asset manager in the real world must try to protect his assets from the corrosion of inflation as well as try to find a place, however temporary, to put the assets which might provide an overall positive yield. With tremendous variations in inflation rates and interest rates among currencies, with varying degrees of political safety, with variations in the near-term outlook and marketability of various forms of assets, and with growing risks as one looks further and further into the future, it is no wonder that asset managers are reluctant to commit long-term and instead prefer to stay relatively liquid. It is also no wonder that a wider range of asset holdings is being considered for parking capital.

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In such a volatile environment in the 1980's, lurches from one asset or market to another can be expected. The possibilities for great swings and disruptions are pervasive. It is not at all surprising in this climate that OPEC countries are looking for new ways to protect their assets and re-examining the tradeoffs of holding the oil in the ground.

The potential for a global swing into the dollar, and into the U.S., is great, in the next year or so; but the potential for a massive swing out of the dollar, towards wider global asset diversification, is also great.

Very much at the heart of our present predicament is slow economic growth and slow capital formation. We were not alone in this slowdown, of course. Most of the industrialized free world economies had the same experience.

How did our principal competitors fare? Improvements in manufacturing productivity fell in the 1970's everywhere, compared with the 1960's. However, over the past two decades, U.S. manufacturing productivity growth has been only one-third to one-half that of Japan and Germany. The U.S. has invested in manufacturing industry at a far lower rate than its principal competitors. Even the UK, which is a very sick economy indeed, did better. Not surprisingly then, our annual growth in manufacturing productivity has been lower than most of our

competitors, and our competitive position has been slipping.

Can we rectify this serious problem? Stepping up capital spending and R&D expenditures will not be easy. First of all, we have a fundamental bias in our economy towards consumption, and borrowing for consumption, and against savings and investment, during a period of rapid inflation.

Second, even if we shift our tax incentives somewhat, the expected rates of return on new investments will not necessarily be then sufficient to start a capital boom in our troubled sectors. Indeed capital spending for long lead time projects may still be approached cautiously, because of a pervasive loss of confidence in the workings of our economy, and especially in the management of the economy by the government. The present array of conflicting policies that determine the methods of production, the product composition, and the market behavior of private companies are sufficient by themselves to slow down, or put the brakes to any wishful surge in capital spending plans -- at least domestically. The unwillingness of the government at all levels to bring together and make coherent the range of policies and administrative processes that affect each sector will not be easily corrected.

Third, the growing number of new competitors internationally can well lead to sourcing from a wider range of

marketplaces, further intensifying our domestic adjustment problems, and reducing our willingness to invest at home.

To catch up, and stay competitive, we need to build on what we can do well. Our broad educational base and advanced technological capabilities have to be at the center of what we do. This is true whether we talk about agriculture, natural resources, or industrial production -- it applies to methods of production, to products, and even increasingly to management itself as the interaction of sophisticated memories, improved communications, and managers grows.

Existing technology will have to be transferred if we are to participate in sales to the newly emerging or fast growth markets. If we don't, others will. But that is not at all self-destructive if we continue to innovate ourselves, and stay ahead of the pack. What is required to stay ahead is (1) stepped up technological development and innovation in production methods and in products alike; and (2) greatly accelerated capital spending to apply the technological breakthroughs in our production processes as well as in our products.

What else can be done?

In policymaking, we must try to get away from our

piecemeal, ad hoc, quick-fix approach to our economic shocks. We need to look at the U.S. in a global market context. Economic forces give only a little recognition to borders. In the international area, trade, public and private trade finance, aid, oil dollar recycling, the relative role of the dollar, adjustment policies of the IMF, the new structural adjustment themes of the World Bank, the workings of commodity markets, and so on, all need to be looked at from one, comprehensive perspective. We can no longer afford the high degree of compartmentalization and competition over bureaucratic turf which dominates our present policymaking process.

But we also have to think about the direct interaction of our domestic with our international economic policies. Our domestic concentration policies, for example, desperately require re-thinking. In the 1980's and 1990's we may need to consolidate some of our industries, but this should not give rise to fears of inadequate competition. It is obvious to anyone with open eyes that international competition and its role in the U.S. economy have become fierce -- indeed, many of our workers and leading industrialists are complaining they cannot deal with the intensity of this external competition.

We need to re-think what we should do about our troubled industries. As you well know, there is a rapidly growing debate in this country about the possible need for an "industrial

policy," or a "re-industrialization policy." There is no clear consensus in this public discussion. Some people focus on helping sick industries, especially those adversely affected by imports. Others focus on helping the newly emerging industries. Some people worry about providing retraining of workers and reorientation of our educational objectives; others worry about how to decide what to train people for. In sick industries, some firms are always stronger than others, so there is a problem over who to help. Do you give public assistance to those in difficulty, or to those perceptibly adjusting to the changing marketplace and gearing to the future?

Alternatively, some people argue full reliance on the marketplace. But then we know that capital for modernization and diversification will go to the most profitable firms, and will flow away from the poor performers. To dramatize, there is little doubt in my mind that GM will survive the early 1980's and undertake adequate capital spending between now and 1985 (more than 40 billion dollars) to meet global competition. GM will be able to raise the necessary capital. But Ford, Chrysler, and AMC all have serious problems. Their prospects for generating capital internally are very poor, and their standing in the capital market is weakening fast. Their collective needs approximate another 40 to 60 billion dollars. Do we let GM emerge as the single U.S. firm, or do we try to keep the other U.S. firms in place, and if so, how?

When a sick industry comes to government for help, what should be the conditions? When they ask for trade restrictions, or financial assistance, or regulatory relief, we shall have to learn to ask what will be done by those enterprises during the period of help.

If we do not try to look at the plans for future adaptation, there is no assurance that special help will do anything except shore up badly managed companies. In such cases, the troubles are prolonged, and the taxpayers and consumers pay the price.

In the past, our ad hoc responses have often done just that. We have had adjustment resistance policies, not adjustment assistance policies. In essence, we have treated the symptoms of competitive difficulty with various remedies to ease the pain, but without much attention to the underlying ailments.

In the case of Chrysler, we created the Chrysler Loan Board. But that has not proven to be an adequate overseer. It has threatened and cajoled Chrysler's creditors, and it has asked for some changes in Chrysler's management, but that cannot be enough to protect the wider interests of consumers and taxpayers, if the government is to involve itself at all.

Something more is needed.

In times of trouble, the companies in greatest difficulties need new capital most -- but the companies that are most profitable will get the capital instead, if the market operates correctly. If we decide that we want the troubled firms to survive, or at least the jobs to be preserved, we have to focus on that problem. In Japan, contrary to popular mythology, the government does not routinely bail out companies in trouble. Rather, the banks are called upon to assist, but also to supervise the transition, if any aids are brought to bear. The lead bank will be expected to bring in to management some of its own people; it will be expected to guide the transition in all aspects of management and capital budgeting. Given the close interaction of government and the banks in Japan, this is a feasible approach.

Our system is different. Recently, Felix Rohatyn suggested in an article in the Washington Post that the U.S. needed to rebuild the old Reconstruction Finance Corporation and have it stand ready to deal with the Chryslers and the New York Cities. That may be one way to go.

That in my view would however lead to assistance on the basis of political pressure, making even more political and

bureaucratically sensitive the industrial adjustment predicament. It would tend to become a new pork barrel.

We need to find some other solution, and we need it to be an American solution. We do not have a Japanese economy, nor do we have a European tradition of government directly participating in equity ownership. We cannot rely on bureaucrats with little experience in fin ance or business to oversee industrial change.

But we also must recognize that troubled firms are those that did not foresee their troubles. They did a poor job of anticipating market forces, and that is how they got into trouble. Their strategic planning and capital budgeting were not geared to the international forces of change. They were surprised by technological developments, by commodity and exchange rate gyrations, by newly emerging competitors abroad or by global over-capacity. If such firms are helped, how can we insure that management changes its ways, and adapts to the future? How do we promote or facilitate adjustment, rather than prevent it, or discourage it?

Bankruptcy in our system is one method of forcing consolidation, restructuring, new management, development of new plans and capital budgets. We are seeking something short of that in the case of helping troubled enterprises or industries.

To me, we need gradually to find a new legal framework which might classify a firm or industry as in trouble, if the petitioning firm or firms qualify, and then, if federal help is given, the quid pro quo would be a program of action on the side of the troubled firms. That program of action would involve the strategic plans and the capital budgeting process of the firms. Since government bureaucrats are ill-equipped to evaluate such plans and processes, we should take a page from experience abroad and ask our investment bankers and perhaps the commercial banks to involve themselves in this process, and to report periodically on what the aided companies are doing, and how well they are adjusting.

In other words, to rebuild private sector confidence, to protect the public interest, and to get the capital to where the trouble is and correct the problems, we must devise new public and private procedures, especially when government is called upon to act with trade restrictions, subsidies, or regulatory relief.

On the government side, we must find some drastically different way to address the collective difficulties of an industry -- all the problems have to be looked at together, the trade problems, the regulatory problems, the capital borrowing problems, the tax problems. Other countries may refer to this kind of comprehensive approach as industrial policy. We don't

have such policies, but if government is to play a role then we must learn to think in those terms.

Now let me turn briefly to some other institutional questions. Senators Ribicoff and Roth of this Committee have for a number of years focused on the need for change in our national decision-making structure. The Finance Committee itself has played a major role in redesigning the trade policy and trade negotiating institutions of our government. It has also taken considerable interest in the international rules and institutional structure.

As far as our international economic institutions are concerned, it is increasingly apparent to me that new approaches to the maladjustments and malfunctions of the world economy are needed. Here, too, new ideas are surfacing and old concepts are being modified -- but the orientation in each case tends to be selective, to take a specific set of problems and treat them separately. The World Bank is now focusing on so-called structural adjustment issues in the developing world with a view to improving the industrialization and trade prospects of these countries. Yet one can assume that before long industrialists in the advanced countries will be complaining about the artificial aids given to intensify competition in world markets. The IMF is moving to ease its conditionality requirements, as it should, to cope with the massive and lengthy adjustment

requirements of many of the developing countries, but financial experts in other parts of the world are now worrying about the inflationary consequences of relaxed conditionality. It seems most difficult to establish a sense of common destiny and common purpose, either nationally or internationally.

What we do have in hand to maintain a reasonable degree of order, and a reasonable restraint on special interests and ever-changing political pressures, is a fragile international system of rules and procedures for managing economic affairs among governments. We do at least have the GATT, IMF, BIS, OECD and other managerial bodies, with rights and obligations, and agreed procedures for consultation. These institutions have performed surprisingly well in recent years -- especially at a time when other aspects of international political relations have often been strained.

However, these institutions do reflect artifical separations, of trade from finance, of banking from industrial development, of international economic policy coordination from domestic economic policies focused on specific sectors. They too need an integrative perspective.

Our best experts and our ministers alike found the present framework of cooperation insufficient in the latter 1970's, in the face of traumatic shocks to the world economy, and a variety

of experimental, new institutions were tried. Among these, a new quasi-institutional process evolved at the head-of-government level. These economic summits among Western leaders now seem to be a regular event, superimposed upon the existing system of diplomacy and international institutions.

Heads of government are uniquely qualified to cut across bureaucratic jurisdictions and to develop out of the many views within a nation an overall national perspective. In conversations with other leaders, they can also give recognition to mutual interests on the international level. Potentially, therefore, the summit process could provide the much-needed integrated perspective. The summit process was indeed perceived by the participants as an anti-bureaucratic process, and the summiteers made it clear that they did not want to be in the hands of the technocrats, nor in the hands of the bureaucrats in the international institutions. This adversarial posture can be demoralizing to participants in other forums of international cooperation, and therefore holds its own dangers. But in practice the summit leaders have not stretched far beyond the conventional, segmented proposals developed by the bureaucracies they were trying to overcome. The summit declarations one after another sound like shopping lists of the preoccupations of the technical experts. Where the experts and negotiators have failed to reach agreement, they have passed the issues up to the political leaders, in hopes that these men could force

resolution upon their reluctant ministers and bureaucrats. The summiteers have then at times found themselves in unseemly quarrels about technical questions like oil conservation targets, as happened in Tokyo last year.

The record of the economic summits since 1975 can be viewed with some cynicism. Much of what the leaders said they were doing, or would do, has not been done. Their credibility has been eroded, and this is most unfortunate at a time when we all suffer a crisis of confidence in leadership and in governance.

The existing international institutions therefore need rethinking. We in the U.S. also need to put greater, not less, effort into making them work, because we have global interests, and any system which helps provide global order helps us in protecting our global interests. Indeed, we are one of the very few countries with totally global interests, and we must remember that when dealing with countries whose interests are more regional, and whose stake in global order is far less than ours.

In this regard, I would hope that the new framework of codes and procedures which were worked out in the GATT framework, in the Multilateral Trade Negotiations, and which were reinforced by the Trade Act of 1979, on which this Committee made such a great effort, would now be used actively by the U.S.

However, <u>changes in international institutions can only come slowly, and only if great effort is put into such changes. We cannot wait for problems to blow up, and then respond</u>. The process is too slow for that. There is a very long lead time between the moment when there is recognition of a problem and the subsequent conclusion and implementation of an internationally agreed solution. The lead time for international financial innovations is about three years. In the trade field recent experience has suggested even longer lags. The Kennedy Round took about six years from the idea stage to signing of an agreement. The Multilateral Trade Negotiations completed in Geneva in 1979 took even longer -- from ideas generated in a Ministerial meeting which started a new GATT Work Programme in November, 1967, to a Ministerial meeting in Tokyo in 1973, to a final deal in the early part of 1979, for a total of twelve years.

There is consequently <u>a serious risk that the slow process of national and international consensus-building, which we call negotiation, addresses problems perceived at one moment in time, but long since overtaken by new events.</u> The same can be said for much of our conventional economic methodology and theory.

But governments rarely act except in moments of crisis, and heads of government rarely have the time or the political

strength to allow contemplation of potential future crises. We are caught in a dilemma, and it is becoming more serious as we contemplate the problems ahead. For example, the non-oil producing developing nations can probably handle their balance of payments adjustment problems for the next year or so within the present facilities they have (IMF, World Bank, bilateral aid and credits, commercial loans, and national reserves). But if the oil-related balance of payments deficits continue persistently year in, year out for the next few years, then present facilities are obviously inadequate. If we wait for trouble before we devise new facilities, we shall have a prolonged period of trouble before such new facilities can be put in place. This will affect our own exports, as well as the health of our banks.

If we look ahead at the potential for currency and commodity turbulence as a result of dollar diversification, it would seem imperative to devise a system for minimizing the downside risks. Ideas are indeed moving around involving the SDR and the substitution account and other instruments for meeting the potential dangers, but a collective sense of urgency is not visible. U.S. officials seem, for example, to be so optimistic about the U.S. current account outlook that they feel no urgency. Yet reliance on the current account and balance of payments statistics to put the market right is to hope that the traditional theoretical economic framework for balance of

payments adjustment and foreign exchange determination will work as expected. Will it?

We also need to avoid oversimplifications in policy, and we need to revise our analytical approaches to reflect the intensity and speed of global market interdependence in all its aspects. Purely unilateral, national solutions, whether or not based on protectionism or mercantilist policies, simply cannot work, without collapse of international cooperation, with negative effects on all our national economies. In saying this, I am not precluding trade restrictive action in some cases. What I am saying is that we need to follow the rules, and develop internationally acceptable solutions. Our economic theories and concepts have to be rethought, particularly those which provide the framework, if not always the exact prescription, of economic policy. In this connection, our ideas about the role of trade and current accounts, in the determination of exchange rates need rethinking; the growing interaction or convergence of various types of markets -- domestic and international money markets, commodity markets, markets for goods and services, and other markets -- needs to be reflected in our fiscal, monetary, and general economic thinking; the forces of global interdependence have to be worked into our national economic discussion.

We desperately need in this connection to improve public

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articulation to ourselves about what our problems really are, and try to develop national and international consensus on objectives. We did manage in the Western world in recent years to talk ourselves into slow growth. A combination of loss of confidence in the future, and wistful dreaming that quality of life would be better if we redistributed our present resources without driving so hard toward economic objectives, has left us without adequate resources to renew our economic engine and improve it for the next decade and the next. If we could talk ourselves into our present predicament, we can surely talk outselves out of it too. The "now generation" has already found that quality of life objectives and slow growth are not costless. There is a rethinking taking place throughout our society. It is time for economists, politicians, and the press to reassess and redefine priorities, and especially to focus on the need for committing resources to long-term rebuilding of our economies. Especially, we have to rebuild confidence in the future, so that private as well as public long-term investment will take place.

While it will look tempting from time to time to settle problems bilaterally, sometimes employing coercion and other times official financial bribes, that general approach cannot be practiced by many nations without generating conflict. Rather, we have to increase reliance on the international system of rules, based on rights and obligations, and commitments in

principle. If selective actions are to be taken to ease the pains of structural adjustment in a particular sector, let it be done within the international institutional system, and not in informal side-arrangements based on coercion or threats of retribution. What one nation does teaches lessons to the others, and such lessons spread quickly.

Another pressing need, in light of our growing economic interdependence, is that we have to improve the methods by which we concert internationally our economic policies, or at least avoid conflicts among them. This requires far more intensive efforts to reconcile both instruments of policy and policy objectives on the international level. This cannot readily be done by heads of government at annual summits. It requires far greater effort on the part of ministers and senior officials. Moreover, it requires greater international attention to the specific elements of policy -- including interest rates and industries policies. The summiteers may be able to bless such detailed efforts, but they cannot replace them.

At home, the reorganization of our trade decision-making system last year was half-hearted. The Executive Branch resisted more fundamental changes. I view that reorganization as a turning of the wheel by a few more ratchet notches, a wheel which has been turning since Congress raised this issue in the Trade Expansion Act of 1962. We must do more. The USTR now has

enormous policy responsibilities, with a staff so small that these responsibilities cannot be carried out effectively. The Commerce Department has major new or broadened roles in certain areas, but has tended to live with the approaches and procedures of the past. The USTR can in theory take an integrative approach in all aspects of trade policy, but in practice many parts of poicy are still distributed elsewhere. The Commerce Department can now think through domestic and international interactions affecting our major industrial enterprises, but in practice the responsibilities are dispersed. The automotive tripartite program is over in the Department of Transportation, which makes only a little sense, inasmuch as what is being looked at is regulatory policy, fiscal policy, environmental policy, and trade policy -- with little attention to fundamental transportation policy.

For the time being, we are talking about band-aids and baling wire for the steel and automotive sectors, without a clear conception of where these industries are going in the mid-1980's, how they look in a global market context, and what are their real capital needs. Surely we can do better. A new trade policy is not enough for these sectors, even though it may help.

You may feel that I have pointed a gloomy picture of the decade ahead of us. It could in fact become very unpleasant for

our country. Our present industrial adjustment problems and our job market difficulties could become much worse. The turbulence ahead could prove destabilizing, and our responses to it could potentially give us even greater problems.

But I am optimistic about our ability to deal with the 1980's if we put our minds to it, if we rethink our policies, and if we develop some new strategies that recognize the intertwining of our own economy with the rest of the world. Some of our fundamental ideas may need a new look -- even in such fields as antitrust and competition policy, in the relative roles of merchant banks and commercial banks in relation to industry, in our fundamental economic policy biases against capital spending and savings for the future in favor of consumption now.

The global marketplace will be a turbulent, rough and tumble place in the 1980's. The problems of the 1970's are but precursors of the 1980's. If we don't rethink, we will not adjust, and we will lose further ground to our competitors abroad. If we do open our minds, and re-examine our theories and our policies, and if we modernize our institutional decision-making system, then I believe this country cannot only cope, but it can regain its proper role as the leader of the Western, democratic free market system. Our very way of life, our security, depends on it.

TESTIMONY

of

HOWARD D. SAMUEL, PRESIDENT

INDUSTRIAL UNION DEPARTMENT, AFL-CIO

Before the

SENATE FINANCE COMMITTEE

SENATE SUBCOMMITTEE ON TRADE

International Trade Strategy for the U.S.

July 28, 1980

2221 Dirkson Senate Office Building

Washington, D.C.

It is gratifying to have been invited to discuss before this committee some of the international trade issues of most pressing importance to workers. It should be clear that my comments emerge from my own experience and judgment, and should not be construed to represent the policy of the AFL-CIO or any of its components.

I would like to touch on several subjects today, but let me start with the issue which was suggested would most interest this committee—the effect of the decline in American productivity on our international competitiveness.

First, a word about productivity. We start with the given, that productivity growth in America, after decades of smooth sailing and regular increases, started turning slightly sour in the late sixties, and headed downward starting in 1974 through 1979—with the productivity level actually declining during the past year.

What were the reasons? A number of experts have studied the situation, a larger number of experts have issued judgments, but no consensus has emerged. Let me call your attention particularly to the study by Edward F. Denison, produced by the Brookings Institution. Summarizing his conclusion, Professor Denison examined 17 possible causes of the decline in U.S. productivity, with the following result:[1/]

> I rejected a few suggestions, expressed skepticism about some, had no opinion about others, and characterized the rest as probably correct but individually able to explain only a small part of the slowdown. No single hypothesis seems to provide a probable explanation of the sharp change after 1973.

It is also clear that the drop in our productivity rate is not unique to the United States. The same drop also occurred in six other major industrialized countries; only in West Germany was it smaller. It was about the same in Canada, France and the U.K. It was much larger in Japan and Italy.

1/ Edward F. Denison, Accounting for Slower Growth: The United States in the 1970s, The Brookings Institution, Washington, D.C.

In terms of our international competitiveness, the U.S. productivity rate is only half the story. The other half is the growth of wage costs. During the 1970s and 1960s, the extreme modesty of our wage gains more than offset our relatively poor productivity performance. The result has been a very strong U.S. position over the years in respect to relative costs. More extensive figures are in the attached supporting material. In summary: while U.S. hourly compensation went up 130 percent from 1967 to 1978, German hourly compensation was rising 216 percent (in marks); British, 353 percent (in pounds); and Japanese, 400 percent (in yen). As a result, unit costs, measured in dollars, have increased only half as much in the U.S. as in other industrialized countries since 1967. While U.S. unit labor costs were up 79 percent from 1967 to 1978, U.K. costs were up 149 percent; German costs were up 259 percent and Japanese costs up 309 percent.

The facts show that far from undermining U.S. competitiveness, U.S. labor has contributed tremendously to American trade competitiveness through relative restraint in wage gains.

The decline in U.S. trade competitiveness, then, has to be laid to other causes than slow productivity growth or American labor pricing itself out of the market.

Let me suggest a couple of other problems affecting our trade position which are in our eyes more significant.

One of the causes is imports which worm their way into our market on the basis of irregular pricing or special privilege bestowed by their home governments, and the closing of other markets to our exports through the use of various tricks of trade practiced by the same governments. Such trade practices are based not on the ancient principles of comparative advantage, but in violation of comparative advantage. In effect, these governments have given up on comparative advantage and instead are resorting to cheating on it.

There is good reason to fear that unfair trade practices—the new GATT codes notwithstanding—will be on the rise during the 1980s. Tariffs are no longer the major barrier to trade they once were, at least for most industries in developed countries; successive tariff reductions since the Smoot-Hawley rates of 1930 have largely accomplished their intended goal. Non-tariff practices, less visible and more difficult to circumvent, have become the weapons of choice for governments and firms seeking to beggar their neighbors by observing neither the spirit nor the letter of the law of comparative advantage.

The expanding use of dumping and subsidies can take place because of increasing government involvement in industry in almost every industrialized nation—other than the U.S. While a Chrysler loan guarantee is very much the exception on the American scene, even more profound government involvement in industry is the rule in Japan, Germany, and our other key trading partners—especially the developing countries. In many countries, at all stages of development, government ownership of firms in the private sector has become the customary final stage in any rescue effort. The frequency of dumping violations is rising. Although carried out by private firms, the chronic dumping apparent in industries like steel is indicative of government support—i.e., direct or indirect subsidies. Such government support is needed to allow foreign producers to sell persistently below their costs of production in the large U.S. market.

The economic impact of dumped or subsidized imports on the U.S. economy and U.S. productivity growth are unfortunately clear. Highly productive American producers can be undermined by dumped imports whose price advantage results only from illegal pricing practices. (Discovering and proving illegal dumping, of course, is no easy task.) While some consumers may draw a temporary gain from dumping, disruption of profitability, output, employment, and investment in competing domestic firms will not help improve our national productivity track record.

A new species of unfair trade practices has recently emerged with enormous potential for damaging U.S. investment and productivity growth. "Performance requirements" imposed on international investors have an almost unlimited potential to pull investment and jobs—and new productivity growth—from the United States because of the absence of any international rules limiting such government intervention. These trade-distorting performance requirements are becoming a major factor in international commerce generally, particularly from countries like Brazil, Australia, New Zealand, Canada, and Mexico.

Investment performance requirements are measures that governments impose either as a condition of entry for incoming direct investment or as a condition of continued operation for already established investors. Performance requirements can be explicitly stated legal requirements, like those set forth in the Mexican automotive decree, or they can depend on administrative procedures and be negotiated on a case-by-case basis, as happens with the Canadian Foreign Investment Review Agency.

Performance requirements which distort trade are a matter of great concern because of their negative economic effects. They result in a direct transfer of jobs and production to the country which imposes them. The international changes in employment, production and trade which they cause are not a response to market forces. These changes are the result of government fiat. The purpose is to increase the imposing country's economic welfare directly at the expense of other countries. Such government-directed economic decisions not only injure other countries, they also result in the misallocation of resources internationally, with predictable consequences for efficiency and inflation.

Performance requirements which artificially expand exports threaten to grow into the most important distortions of global, investment, production, and trade because they are not disciplined by any present international agreements.

The recently completed Multilateral Trade Negotiations addressed the issues of subsidies, counterfeiting, dumping and other unfair trade practices. Investment peformance requirements which unfairly force export expansion were not addressed. This gap means that governments who seek to expand their exports will increase their use of these measures because other means are effectively closed off. Because the United States is the source for approximately 50 percent of international direct investment, a large share of the trade effects of these measures will be experienced in the U.S. economy. Mexico and Brazil, two developing countries whch use these measures most extensively, are also the major host countries for U.S. direct investment in the developing world, as is Canada among developed countries. This distortion of economic resource allocation will appropriate U.S. jobs and production and push down productivity growth.

The other aspect of trade which deserves your attention is the fact that some proportion of products crossing national boundaries is made under exploitive labor conditions. I think I have already made it clear that I am not advocating repeal of the law of comparative advantage. We know that there will be differences in wages and conditions between developing and developed countries, even in comparable industries making the same products with the same capital. But comparative advantage should not serve as camouflage to hide aggravated exploitation, such as child labor in factories, forced labor, or the uncontrolled use in the workplace of toxic substances or dangerous conditions. The standards of humanity accepted by all of civilization do not bestow a license on anyone to damage young children or kill adult workers, even those working in the least developed of nations. Products which are designed for sale to other nations should be required to have been made under minimally reasonable standards.

Some commentators, whose principal concern is the improvement of the international trading system, reject such international standards on the basis

that they would be used only to disguise a new kind of protectionism. But, the standards would have to be accepted by a multilateral organ, such as GATT, and implementation would presumably be in full view of all. It might be possible to twist labor standards into a protectionist pretzel, but the process would be neither silent nor invisible, and could be met with the same steps that the community of nations takes against unwarranted restrictions of trade wherever they occur.

In the meantime, it would appear to be difficult logically to protest against the imposition of minimum labor standards for international trade. After all, a principal rationale for increasing international trade is that it is supposed to enhance the living and working conditions of all parties, for both those who sell and those who buy. But when a building supply manufacturer in a developed country moves his asbestos plant to an LDC, in order to avoid health regulations, neither the workers in his old plant—who have lost their jobs—nor the workers in his new plant—who are doomed to lung cancer —can boast of any particular benefit from the resulting flow of trade.

The question is raised, why inflict on international trade the obligation to assure minimum labor standards? Why not leave it to the International Labor Organization? The answer is simple: Because the ILO cannot do the job. Like other elements in the United Nations' system, the ILO depends on voluntary cooperation for implementation of its conventions. The ILO is proud of its record over the years, but it is a record which has depended on exhortation, example, and education. There is no means of effective enforcement. Abused workers suffering exploitation in uncounted shops and factories throughout the world deserve better, a more muscular system of implementation which will remove the profit from intolerable conditions by making it impossible to peddle their fruits on the world market.

There are other issues related to international trade which concern America's workers; we are dissatisfied, for example, with both the policy and practice of adjustment programs; we question the government's so-called neutrality toward outward investment; we are dismayed by the mad competition among nations to finance the export of capital goods, even when no economic purpose is served, a competition which ensnares our own Export Import Bank with all the rest; we are not optimistic about the implementation of the new MTN codes, particularly when we examine the very first subsidy agreement signed with Pakistan.

The list could be lengthened, but your time is limited. Let me sum up simply by assuring you that by and large, as I see it, American labor has a most enlightened view toward our international economic relationships. We are the least burdened with doctrine, whether "free trade" or "protectionist;" we view the problem in most pragmatic terms. We know we cannot repeal the law of comparative advantage; we are convinced that what is needed, in fact, is more comparative advantage, not less. But comparative advantage should not be diluted by unfair trade practices or exploitation of labor or special deals for special trading partners. And we know that given a climate of fair trade, the American worker can compete with anyone on earth—and win.

Appendix:

Productivity, Labor Costs, And International Competitiveness

Lower productivity growth affects U.S. international competitiveness directly by raising our costs relative to production costs in competing countries.

U.S. productivity growth, however, is only half the story of relative costs. The other half is the growth of wage costs, and very low American wage gains have more than offset our poor productivity record to yield a very strong U.S. position in relative costs.

The economic facts and figures show that America's slow productivity growth is wrongly blamed for our declining competitive position in international trade and for the falling value of the dollar. It is important to understand why this increasingly common belief is untrue, because its proponents often blame the bogey-man of "labor" for both our productivity and trade problems. Our productivity track records have been much lower than in the other advanced western economies (see chart I—I). In manufacturing, which is most important for trade and where productivity can be most accurately measured, U.S. annual productivity gains averaged only 2.2 percent during the 1970s. Japan's productivity growth averaged 5.8 percent annually and Germany's 5.9 percent annually during the same decade.

Only the beleaguered United Kingdom had a productivity track record comparable to our own, and they were still ahead of us.

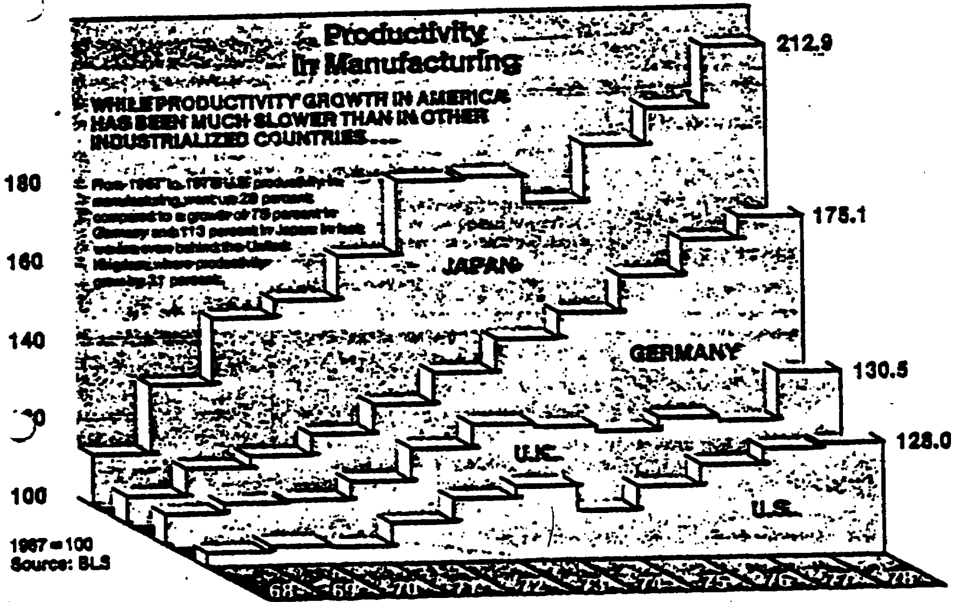
During the 1970s as during the 1960s, the extrme modesty of U.S. wage gains (chart I-2) more than offset our relatively poor productivity performance. The result: a dramatic strengthening of U.S. industry in relative costs of production (chart I-3). While U.S. hourly compensation went up 130 percent from 1967 to 1978, German hourly compensation was rising 216 percent (in marks); British, 353 percent (in pounds); and Japanese, 400 percent (in yen).

The declining value of the dollar against most other currencies further strengthens the American advantage in relative costs (chart I-4).

As a result, unit costs (measured in dollars) have increased only half as much in the U.S. as in other industrialized countries — since 1967. While U.S. unit labor costs were up 79 percent from 1967 to 1978, UK costs were up 149 percent, German costs were up 358 percent and Japanese costs were up 309 percent.

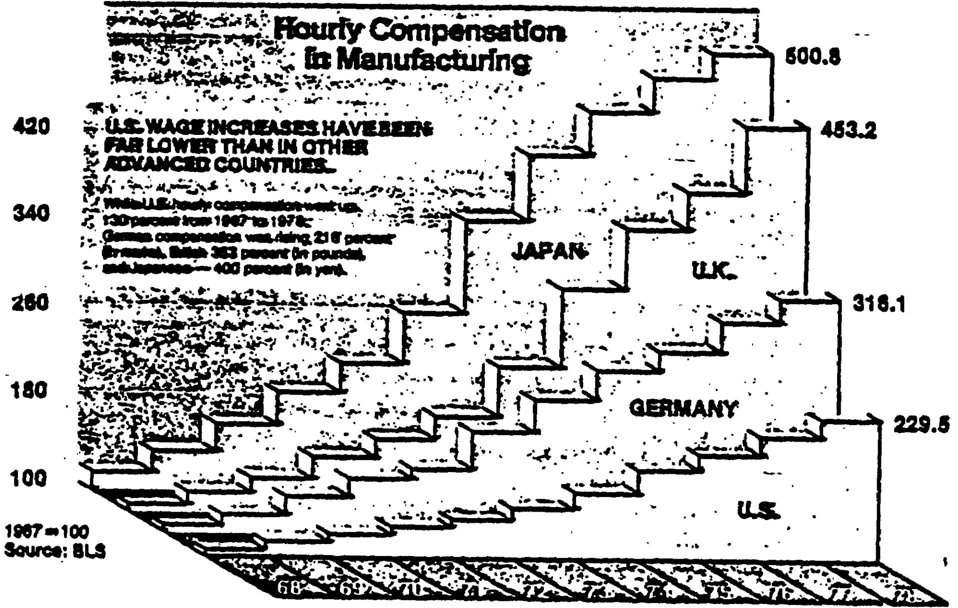
These international comparisons suggest we have to rethink many common misapprehensions about the impact of slow U.S. productivity growth on U.S. trade. Far from undermining U.S. competivieness, U.S. labor has contributed tremendously to American trade competitiveness through relative restraint in wage gains.

Chart I-1



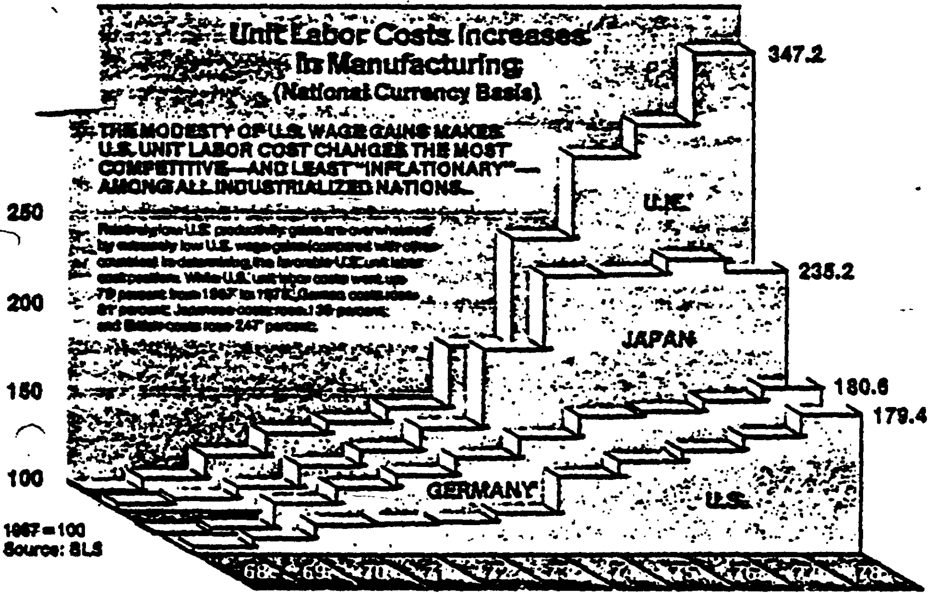
SOURCE: Bureau of Labor Statistics

art I-2



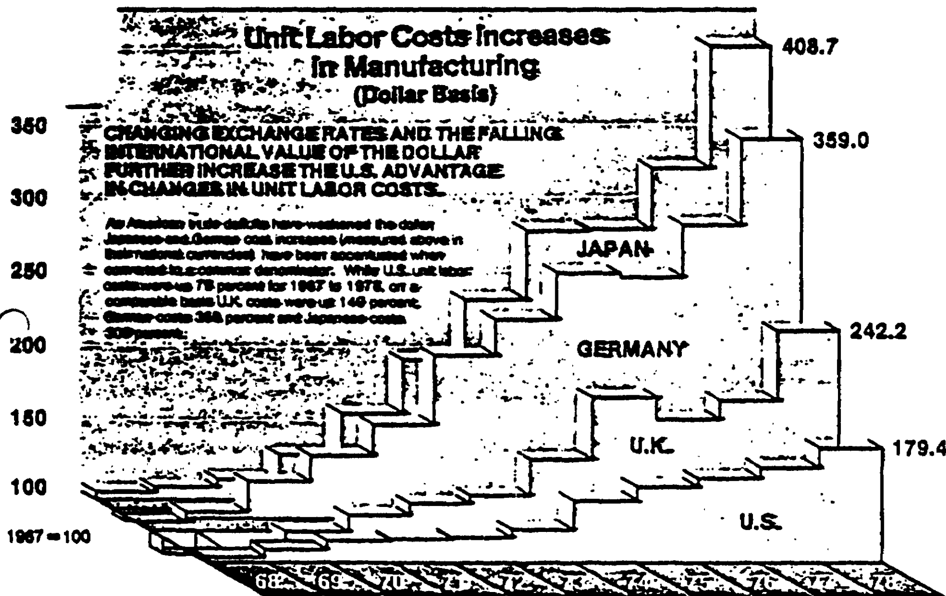
SOURCE: Bureau of Labor Statistics

CHART I-3



SOURCE: Bureau of Labor Statistics

CHART I-4



SOURCE: Bureau of Labor Statistics

Senator BRADLEY [presiding]. Before we get to the questions, I think that what we might do to facilitate this is have Ambassador Hormats come up and give his presentation. Then we will have all four at the table for questions. After that we will have Professor Gilpin testify on geopolitical implications.

Is that acceptable to my colleagues?

STATEMENT OF HON. ROBERT D. HORMATS, DEPUTY U.S. TRADE REPRESENTATIVE, OFFICE OF THE U.S. TRADE REPRESENTATIVE, EXECUTIVE OFFICE OF THE PRESIDENT

Ambassador HORMATS. Thank you, Senator.

First I would like to commend this subcommittee for holding these hearings. It is particularly useful at this time to take a look at the decade ahead—to go beyond the day-to-day considerations of trade policy and develop a strategy for the 1980's. It is going to be a particularly complex period. Trade policy is going to differ in the 1980's from that of the 1970's in that it will have to be more closely interlinked with domestic policy, with financial policy, investment policy, energy policy, environmental policy, and a whole range of other policy considerations. It is useful to take a careful look at trade policy and integrate it with a number of other international domestic considerations.

Let me discuss briefly some of the trends of the 1970's and then move on to some of the specific trade problems that we will have to confront during the period of the 1980's.

The first major trend in trade over the last decade has been the enormous increase in the share of trade in U.S. GNP and the share of trade in total production in the United States. Hal Malmgren mentioned these figures, and they are quite striking. There has been a virtual doubling of exports as a component of U.S. GNP and as a total of U.S. production.

Directly related to this is the fact that trade has become more integrated with overall investment and production decisions. For instance, we are moving toward a world car. Many U.S. auto companies are competitive today because they import components from abroad. The so-called European airbus is one-third American. And virtually every major item you can mention is constructed with components which are imported. This is true in the United States, it is true in most other countries of the world, particularly western Europe. And as a result, you have a more integrated production infrastructure in the world. We are moving toward increasing integration in the area of production and sourcing.

As a result of both of these phenomena, trade policy has become an integral part of domestic economic policy. Disruption in international trade disrupts domestic economies, both in the United States, as we have seen with respect to oil, to food and other materials, and in other countries who are even more dependent on trade than is the United States.

Looking at the American economy, there are two sectors in particular which have demonstrated their ability to compete over the last 10 years. One is high technology. Two-thirds of U.S. manufactured exports today fall within the high technology area, in that they are R. & D. intensive. The other is agriculture, where, in 1979, the United States had an $18 billion surplus. This is also, in part,

the result of high technology, because agriculture has been an increasingly important focal point for new technologies, for new scientific innovations.

There are, of course, a number of sectors in this economy which have not demonstrated the same degree of competitiveness. In my written testimony I go into these. Shoes, some parts of the textile industry, steel, and autos have seen their international competitiveness decline over recent years. Partly the cause of this is that they have had difficulty adjusting to the energy situation. A number of sectors of the American economy, and indeed, in other economies throughout the world, have faced major problems in coping with higher energy prices, either, as in the case of autos, because the product they produce consumes a great deal of energy and therefore is less competitive with cars which consume less energy, or because the equipment that they have bought over the last several years is less energy efficient.

And in this respect, as I will touch on later, the developing countries have a certain advantage because countries that came into the production process later have tended to buy more modern equipment. If they have purchased the equipment after 1973, they have done so with a mind to energy efficiency. And this has given them a certain comparative advantage in a number of areas.

Another interesting trend that has been touched on earlier relates to the developing countries, which are much more dynamic in two ways. They are dynamic in terms of being competitors for the United States. Some produce not only traditional labor intensive goods, but also capital intensive goods. They are able to compete with the United States in construction and in high technology goods. The Koreas and the Brazils and the Mexicos and countries of Southeast Asia have done extremely well in competing across in international trade and services. And I think this is going to be an important phenomenon in the 1980's as well.

The other element to this, however, is that these countries are also extremely important markets for the United States. And while we are concerned about their competitiveness in our market, we should also be extremely pleased by the fact that their growth has helped to buoy the world market for a number of very important products for the United States—airplanes, agricultural products, construction equipment, and other goods.

One last general point is that we are going to be confronting increasing competitive problems over the next decade, in part because countries want to push exports in order to offset the increasing energy bills that they face. This will continue to mean major problems for all of us. Obviously we can't all export enough to overcome our oil-related deficits, in part because the OPEC countries absorbtive capacity is plateauing out. As a result, we are going to be faced with rather large OPEC surpluses, and the converse, rather large, non-OPEC trade deficits. And it is impossible for all the countries in the world to export enough to offset their oil deficits. To the extent they try, they heighten competition and lead to increasing amounts of trade friction. This is true between developed and developing countries, and also among developed countries.

The 1970's also saw some major innovations and improvements in trade policy. The multilateral trade negotiations provide a very useful framework for dealing with the trade problems of the 1980's. In particular, they will help us in our efforts to continue to be competitive in high technology goods. The Government Procurement Code, the Countervailing Duty Subsidies Code, the Standards Codes, all, if properly enforced, should enable the United States to continue to have vigorous exports in high technology goods.

In the area of agriculture we didn't make as much progress as we would have liked, but there have been some improvements. There has also been a framework agreed to for more intensive cooperation in the development of domestic policy, which is a plus. But we are going to need to work hard in order to avoid from time to time countries imposing impediments to our agricultural exports.

We have also made progress in the MTN in bringing the developing countries into the system. This seems to me a critical objective for the 1980's. The developing countries will be more important. To have a two-tiered trade system, with the developed countries playing by one set of rules, the developing countries playing by another is simply unsatisfactory from the point of view of both; it will lead inevitably to fractions in the trading system.

We are making an effort now to bring the developing countries into those codes negotiated in Geneva. We need to do more.

Also, the GATT has been strengthened as a forum for resolving trade differences, and our hope is that countries will use it instead of going around it as they traditionally did.

One problem that was not faced up to as squarely as it might have been was the need for an international safeguards agreement. This is the critical lack in the MTN, and it is one of the major unfinished items on the agenda. I will discuss it later very briefly.

Looking to the environment for the eighties, there are a number of points that I have touched on which I will just go over very briefly.

The developing countries will become more competitive than they are now, and the competition for shares of developed country markets will intensify.

Second, there will be more competition among developed countries, particularly for exports at the high technology end of the spectrum. As developing countries become more competitive in labor-intensive goods and in some goods in the high technology area, products such as airplanes, computers and other high technology goods will be a source of more intensive competition among developed countries, and indeed, there will be efforts by some developed countries' governments to intervene in order to boost that competitiveness. We are already seeing in Europe a move toward a European telematics industry. We see Japanese support for R. & D. in high technology areas such as integrated circuits and microchips, and this is something that is going to be an important phenomenon.

Energy is going to present us with even more problems in the trade area in the eighties than it did in the seventies, in large measure because there is going to be a continued tightening in the energy market, and this is likely to lead, as Hal pointed out, to

efforts by governments to develop bilateral agreements. We already see signs of countries trying to lock up sources of energy through bilateral deals. The pressure is going to intensify because energy exporters are going to realize they have a great deal of leverage and can make these deals, can extract these deals from energy importing countries. Energy importing countries may well, if the situation tightens up, become somewhat more desperate and go out and try to make investment deals or preferential trade deals in order to corner a certain portion of the energy market.

There will be other problems, too, facing the world economy. The recently issued report entitled the "Global 2000" has indicated major problems in the developing countries—population problems, pressures on arable land, pressures on forests, pressures with respect to energy resources, and other types of resources. There will be a major problem. As the developing countries' situation deteriorates, these countries are going to become even more desperate to create employment and obtain resources through exports.

The last point I would make about the environment for the eighties relates to the U.S. economy. While I have not focused on it in my testimony, I think it is fair to say that whatever we do in trade policy, we will not succeed unless the United States can deal with its problems of inflation and productivity more effectively than it has over the last decade.

And it seems to me that the effective management of the U.S. economy in terms of generating more investment over the next decade, generating more R. & D. and providing the right sort of competitive environment, will be critical to our ability to succeed in the international trading arena.

Turning to the specific trade problems of the eighties, I won't go through them all in detail, but let me just tick them off very briefly.

One is the area of continuing to be vigilant about import restrictions imposed by other countries on U.S. high technology exports. This is going to be the single most important area for U.S. exports over the eighties. It will also be an area in which other countries will be trying to establish their competitiveness. It is extremely important that we use such things as the Government Procurement Code and the Subsidies Code to insist that countries keep their markets open so that we can succeed in our major area of comparative advantage.

There may also be some possibilities for negotiating specific sectoral agreements to liberalize trade in an individual sector. The aircraft agreement was negotiated in the MTN, and that might well serve as a prototype for liberalization in other key sectors.

The area of food and feed grains is going to be a major problem. I think there will be a tightening of the market in food over the next decade. Certainly there will be periods in which there will be very tight food markets. It is important that we try to make the world food system more efficient. And that means trying to encourage certain countries which have market distortions as a result of government intervention to reduce those distortions. It requires us to be vigilant about GATT illegal protective acts. It requires us also to establish a much more effective method of coordinating the development of domestic policies which have such a major effect on

trade. It also means that we will have to do considerably more to help the developing countries to increase food production, because it is simply untenable in a world where we have the technology to help increase food production, for developing countries in many instances to face either starvation or major food deficits.

And finally, we need to negotiate what we were unable to negotiate in the 1970's, a system of international food reserves. If there is going to be more food volatility, one of the major methods of dealing with that will be to negotiate a food reserve scheme.

With respect to trade in services, some discussions took place in the MTN, but we need to do a considerable amount more. The United States does very well in the export of services—data processing equipment, software, construction, et cetera. We do very well in these various areas. Yet there are a whole host of restrictions imposed by other countries. It is difficult for American banks to establish themselves in certain places. American insurance companies are constantly faced with discriminatory treatment. Because this is an important area for U.S. exports, it behooves us to make much greater effort internationally to remove or reduce restrictions. This is going to be more important over the next decade because services are a larger and larger part of our domestic economy and will become increasingly important in international trade.

In the area of energy, as I mentioned, trade problems are going to become more intense in the eighties. There will be a great deal more bilateralism as countries try to lock up trade through preferential and investment agreements.

We have now the International Energy Agency, the OECD, and the GATT. All of these, I believe, are going to have to address themselves much more specifically to the potential distortions in international trade and investment which could take place if energy exporters, particularly oil exporters, try to use their leverage to extract certain concessions from energy importing countries.

Nothing could be more detrimental to the trading system or to political and security cooperation than countries falling all over one another to make these bilateral deals.

Structural adjustment is going to be another problem which we are going to have to address more directly. We have, as I said, not reached agreement on a safeguards code. This is a high priority for the eighties because without it countries can make their own little bilateral safeguard arrangements, and that, too, is corrosive to the trading system.

We have developed over the last several years the OECD Steel Committee which may well be a prototype for more intensive exchange of information on adjustment by countries and by national industries to structural problems. This is a committee which doesn't negotiate, but it permits individual countries to identify the particular policies pursued by other countries, and to determine whether those policies are facilitating structural adjustment or standing in the way of structural adjustment. So it is a useful way of exchanging information and putting some pressure on countries not to pursue policies which inhibit necessary structural adjustment.

I think it is also important for us to continue work within the OECD on what has come to be known as positive adjustment.

Positive adjustment is a set of principles by which countries approach industries which are facing difficulties. It provides that countries, in so doing, should only provide support for a temporary period to help industries get on their feet rather than providing prolonged subsidies or protection which in effect distort the allocation of resources.

Further progress in incorporating the developing countries into the international trading system is essential. Bringing them into the codes, making them feel a greater part of the GATT is particularly useful, because these countries, as they become more competitive, also need to assume greater responsibility in the international trading system, both by adhering to the codes themselves and liberalizing further.

It is awfully difficult for us in this country to maintain and argue for open markets for the developing countries if developing countries which have achieved a high level of development are restrictive in terms of their imports from the United States, or engage in the sorts of things Howard was talking about in terms of investment performance requirements.

The North American market is going to demand more attention in the eighties than in the seventies. Congress has mandated that we do a study of opportunities for improved trade in the eighties with Mexico and with Canada. This is particularly important. Both countries have a more nationalistic attitude toward their trade and toward investment policy than does the United States. Their governments intervene to a slightly greater degree in one case, to a much greater degree in another case, and it seems to me that if we don't begin to work out a modus vivendi with these countries, we are going to be constantly subject to disruptions and to frictions in our trade with the two. And because the trade relationship is so intimate, it is particularly important that we move on this very soon and try to work out these differences before they become major points of contention in the eighties.

East-West trade was a very popular item in the early part of the seventies. It has lost its popularity for a number of reasons in the latter part of the seventies, but nonetheless, the U.S.S.R. and China and Eastern Europe are increasingly important actors in the international trading system. We are going to have to figure out a basis for our trade relations with the Soviets in the post-Afghanistan era. The Chinese are interested in broadening their trade relations. They, however, export things which are somewhat sensitive in the American economy, in the European economy. We are going to have to figure out a basis for trading with the Chinese. We also have to figure out how to deal with a potential Chinese request to join the GATT. China, a very large Communist country, works on nonmarket principles. How do we deal with it? It is a major issue, a major issue for the GATT, a major issue for us.

Competition policy is another item we are going to have to address more than in the seventies. A number of questions have been raised about U.S. antitrust enforcement, whether it is attuned to the needs of the eighties, More and more competition comes not internally, but from foreign products into the American economy. Other countries have a different attitude toward antitrust. And

American production has become, in effect, multilateralized, which enhances competition. So one has to look at it in broader terms.

The last point I would touch on is the relationship between trade and investment policy, and here I think Howard's point is exactly right. Trade distortions resulting from investment may well, in many cases, be more serious than trade distortions relating from tariff or nontariff barriers. And there are a few countries who are, shall we say, in the vanguard of the effort to impose performance requirements in order to enhance exports or to enhance local componentry. And unless there is a major international effort to deal with this problem, we can look forward to more and more trade problems that relate to investment performance requirements. That may well undercut a lot of what was done in the multilateral trade negotiations.

In conclusion, let me just underline a point I made in the beginning. Increasingly we are going to have to look at trade policy as it relates to other types of policy: Domestic, energy, aid, finance, and a whole array of issues. It is particularly important that we start out in 1980 to take a look at the decade ahead and figure out just how trade policy does relate to all these other elements of policy. In the final analysis I come away reasonably optimistic that we can manage the difficulties before us, but we can only do so if we have a sense of long-term purpose. We must not react only to day-to-day pressures, but develop a long-term strategy. We need to pull together the various elements of policy domestically and internationally, and then I think we cannot only cope with these problems, but we can develop a system which works even more effectively as a result of our efforts.

Senator BRADLEY. Thank you.

[The prepared statement of Mr. Hormats follows:]

STATEMENT OF

AMBASSADOR ROBERT D. HORMATS

DEPUTY UNITED STATES TRADE REPRESENTATIVE

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE COMMITTEE ON FINANCE

U.S. SENATE

JULY 28, 1980

Mr. Chairman:

I am delighted to have been asked to appear before this Subcommittee in its consideration of the major trade issues that will be facing the United States during the decade of the 80's. I commend Senator Bradley and this Subcommittee for holding these hearings. The beginning of a new decade presents an excellent opportunity to step back from day-to-day pressures and to focus on longer-term priorities and problems.

The first Economic Summit of the 1980's was held in Venice last month. While the problems of energy and inflation dominated the discussions, the participants also recognized that the health of their economies depends on strengthening the world trading system and resisting protectionist pressures. We need to understand where the pressures of the 1980's are likely to come from and identify the elements of the trading system which most need strengthening.

In order to better appreciate what is ahead of us in the 1980's, I should first like to review trade trends of the 1970's. The most important of these was the dramatic growth in the importance of trade relative to overall economic activity in the United States. The share of exports in U.S. GNP grew from 4.3 percent in 1970 to 7.5 percent in 1979, and from 14 percent to over 20 percent of domestic goods production. Production has

become more integrated across borders. For example, we are moving toward a world car. Large airplanes are produced with components from many countries (the "European" Airbus is roughly one-third American), as are computers, televisions, and most other major products. These trends suggest that in the coming decade, policymakers will find it increasingly unrealistic to classify economic issues as purely domestic or strictly international. The international trade and other economic implications of ostensibly domestic policy issues will command growing attention, and developments in international commerce will become matters of ever wider concern within the United States. Put another way, successful management of the U.S. economy will require successful collective management of the global economy.

Much of the domestic attention to trade issues will be directed at individual sectors or industries. It is important, therefore, to appreciate the different experiences of trading sectors during the past decade. The two most dynamic sectors have been high technology and agriculture. During the 1970's, the value of U.S. agricultural exports grew at an average annual rate of approximately 19 percent, compared to an agricultural import growth rate of 12.6 percent. The result has been a substantial increase in the U.S. agricultural trade surplus, from 1.5 billion dollars in 1970 to 18.3 billion dollars in 1979.

The performance of high technology exports (i.e., products relatively intensive in research and development) has been equally dramatic. These sectors, which account for two-thirds of U.S. export sales of manufactures, generated a U.S. trade surplus in 1979 of more than 39 billion dollars. A major objective of U.S. trade policy in the coming years must be to ensure that these highly competitive industries enjoy improved market access and encounter fair treatment by our trading partners.

Declining U.S. competitiveness has been evident in several more traditional manufacturing categories, most notably steel, automotive equipment, textile and metal-working machinery, rubber manufactures and miscellaneous manufactures. These sectors, along with historically sensitive textiles, apparel and footwear, have experienced increasing competition from foreign producers and have faced difficulties in adjusting to their new market situations. In addition, many face the added challenge of adjusting to high-priced energy--which has rendered some of their traditional products and older equipment uneconomic. The challenge for policymakers in the 80's will be to facilitate the necessary trade-related and energy-related structural adjustments in ways that preserve efficiency in the use of our human and capital resources and reflect compassion for the situations of individuals affected by those adjustments.

A final point on recent trade trends is that there has been an increase in the number of developing countries that have become important participants in the world trading system. The growth of these nations has been a major boost to our exports and their exports provide us with a dynamic source of competition--not just in traditional labor-intensive goods, but in capital-intensive goods, high technology goods and services as well. Many of these countries do not share our views on the appropriate conduct of trade, and in particular, on what is justifiable in terms of types and degree of state intervention in trade. These countries will have a significant impact on the trade in the 80's.

The trade trends of the 1970's have affected the competitive position of individual American industries and firms, and indeed of industries and enterprises throughout the world. Two factors just noted stand out in the recent intensification of global competitiveness. First, the developing countries' expansion of industrial capacity, including industrial export capacity means that they are competing in new areas of trading activity and thus challenge our own firms. Because they entered the market later, their equipment tends to be more modern and, because much of it was bought after the rise in energy prices, more energy-efficient.

Second, the sharply increased cost of energy has compelled countries throughout the world to attempt to expand their exports. They are doing so both to earn additional foreign exchange to pay for imported oil and to stimulate their economies in order to compensate for the deflationary effect of transferring national income to the oil-exporting countries. The oil exporters have not been capable of absorbing the rest of the world's additional exports, and as a result, countries have been feeling the effects of heightened global trading pressures.

The challenge will be to adapt to these new trading forces in ways that serve our own national interest which is based to an ever increasing degree on prosperity and international cooperation.

Trade Policies

It is also useful to recall the major trade policy developments over the last several years. International trade policymaking during the 1970's focused heavily on the Multilateral Trade Negotiations (MTN), which were launched by the Tokyo Declaration of September 1973 and completed in April 1979. In addition to substantial cuts in tariff levels, the MTN

produced a series of codes governing the use of non-tariff measures in the regulation of trade. The completion of these codes was an achievement that should significantly improve the conduct of world trade during the 1980's. The increasing inclination of governments to intervene directly in the conduct of trade with a variety of non-tariff measures, and the growing impingement of domestic social, environmental, and health policies upon trade flows, required the international trading system to develop "rules of the game" for situations well beyond traditional trade actions, such as tariffs and quotas. The MTN codes provide a basis for managing trade relations in this more complicated trading environment.

The non-tariff codes negotiated in the Multilateral Trade Negotiations are of particular importance to our exports of high technology products, which tend to face a wide variety of non-tariff barriers.

Each of the MTN Codes and Agreements should, for example, support efforts in the 1980's to ensure that our rapidly growing trade in high-technology products, which is of major importance to the U.S. economy, is conducted in a fair and efficient manner. implementation of the Codes and to negotiate an extension of

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the Codes to areas not adequately covered by the current agreements. Code provisions will not have much meaning unless they can be applied effectively to specific cases.

In agricultural trade, in addition to the exchange of bilateral concessions, the MTN reached agreements covering trade in meat and dairy products. A start was also made on the establishment of a framework for international cooperation on agricultural issues. As a large net exporter of agricultural products, the United States has a keen interest in ensuring that in their management of domestic agricultural programs governments do not raise additional impediments to agricultural trade.

A significant first step was taken in the MTN to induce fuller participation by the developing countries in the GATT system. The issue is of particular importance to the United States because of the increased importance of LDC's to U.S. trade. In the decade of the 1970's, the share of U.S. imports of manufactures from non-OPEC LDC's rose from under 14 percent to over 22 percent. On the export side, LDC's increased their share of total U.S. exports of manufactures from 30 percent to 38 percent, with most of the growth accounted for by OPEC.

Several of the more advanced LDC's have signed various MTN Codes. The MTN also included the "Framework Agreement," which provides the legal basis for differential treatment of

LDC's and includes recognition of the fact that countries should undertake increasing trade obligations as they develop. Developing country adherence to the MTN Codes has been a major priority of USTR during the past year. It must and will continue to receive substantial attention in the future.

The MTN also resulted in institutional reform of the GATT. The non-tariff codes strengthen the GATT's authority to deal with a broad range of trade actions and demonstrate the ability of the institution to adapt its procedures to changes in the world trading environment. The Understanding Regarding Dispute Settlement bolsters the GATT's position as the appropriate place for countries to take commercial disputes. The strengthening of the institution that is made possible by these reforms, however, can be solidified only if the participating members use the new facilities and invest them with genuine operational responsibility.

The major missing ingredient in the MTN was an international agreement on safeguards. The pace and scope of international competition evident in the past decade can be expected to continue or accelerate during the coming decade. This will require further adjustments in the economies of all trading countries. In order to ensure a fair distribution of the adjustment burdens, it is crucial that countries agree upon the rules to be followed when domestic industries are injured by foreign competition.

For this reason, the United States continues to place high priority on the negotiation of a new Safeguards Code.

Several issues that will be of increasing importance in the 1980's were not addressed directly in the MTN. The most important of these are: (1) impediments to international trade in services, (2) trade-related investment issues, (3) the application of competition policy in the international economy, and (4) regional trade issues. I shall discuss these shortly.

The Overall Economic Environment of the 1980's

The way we deal with individual trade issues, depends on the probable environment before us. Factors that contributed to increased global competitiveness during the 70's--the industrialization of the LDC's and the tightness in the world energy market--will continue in the 80's. This situation leads to several considerations which must be taken into account in the formulation of our trade strategy. Specialization between North and South within the manufacturing sector will proceed. The LDC's are determined to develop their industrial bases. They are acquiring the human and physical capital to compete in many manufacturing lines, and they plan to rely heavily on foreign markets. The developed countries will find it

increasingly difficult to compete with LDC's in many areas. In part because of this, one can expect competition among developed countries to intensify in the high technology-, capital-, and skill-intensive range of manufactures. Undoubtedly, this competition will tempt governments to cushion the impact of market forces on weaker industries that appear to count heavily in every nation's perception of their economic vitality, or to strengthen industries in which they believe, with a little governmental assistance, will have a greater competitive advantage.

In the agricultural sector, we face the continuing inclination of governments to use trade barriers, particularly non-tariff measures, to protect farm income. The degree of government intervention in agriculture is matched by no other sector, and there is no sign that such intervention will abate in the near future. Agriculture--mainly for socio-political reasons--has been largely exempt from the disciplines of GATT since its inception. We now face the difficult task of integrating the agricultural sector into the trading system and of holding governments accountable for the trade restrictive policies adopted to protect farmers.

The uncertainty that nations face in meeting their energy needs could stimulate some to seek new commercial or commercial-political arrangements which may not be compatible with the open trading system we desire. For example, pressures could grow for bilateral deals in which nations provide special market access for processed products, such as petro-chemicals, in return for secure supplies of energy. The tighter the energy market, the greater the pressures for bilateral, preferential deals and the greater the potential leverage of energy exporters. The divisive impact of such arrangements, and their corrosive effects on the trading system, not to mention political and security relationships, requires that energy receive high priority both as a trade issue and as a global economic problem which, if not resolved, will make successful domestic and international economic management virtually impossible.

Beyond these are a number of other stresses involving global resources, environment, and population. A report entitled Global 2000 prepared by the Department of State and the Council on Environmental Quality, and released last week by the President, notes that if present trends continue we can expect enormous increases in global population, particularly in developing countries, wider income disparities within and among nations, greater volatility and cost in food production, major gaps between the supply and demand for energy, and the rapid depletion

of forests and arable land. The trading system will not be immune to the effects of these problems. On the contrary, the likely pressures which will result in the developing countries, the instability in trade flows, the growing concerns about supply security, and the attendant pressures to "lock up" secure sources of energy, food and perhaps other scarce raw materials will lead to new sources of trade frictions.

Having sketched a rather harsh global enviroment, and before turning to specific trade issues, I would like to turn to the domestic climate for a moment. So much of our success in trade policy depends upon the ability of the United States to attain relative price stability and higher productivity. Failure to do so risks loss of our competitive edge in our our most dynamic sectors and reduces chances of reinvigorating lagging industries. The principal need is to increase investment. Social goals will need to be attained in ways that do not burden unduly the ability of the economy to direct resources to their most efficient use. Regulations for social and environmental objectives can improve human welfare in ways that are not expressed by traditional measures of GNP growth. Many such regulations, however, inhibit economic adjustment because investment needed to comply with them diverts investment from possible use in increasing productive capacity or developing technology to increase productivity.

Trade Issues for the 1980's

Let me start the discussion of specific trade issues for the 1980's with those relating to this nation's strengths. The great competitiveness of the United States in the area of high-technology exports compels us to place very high priority on the avoidance and reduction of foreign barriers to our exports of R&Dintensive goods and on expanding market opportunities for such products. The implementation of the MTN Code on Government Procurement and the extension of its product coverage are important to supporting U.S. trade in high technology goods. In the case of Japan, we continued to pursue negotiations which are designed to remove such trade restrictions in the area of telecommunications. The Subsidies/Countervailing Measures Code will provide common guidelines for limiting foreign government support for high-technology goods. The Standards Code will similarly reduce the ability of foreign governments to limit entry of high-technology products.

We have succeeded, as I noted, in extending the MTN Codes to encompass high technology trade. In the future, it will be necessary to deal with types of government involvement in high technology trade that were not addressed by the MTN or that will become apparent only as new technologies emerge. The MTN Aircraft Agreement offers an example of a major attempt

to deal with the trade effects of government involvement in technology and industrial innovation at the sectoral level. This agreement could serve as a precedent for possible future agreements in other important trade sectors. To aid in the effort of extending the MTN Codes, we are expanding our research on the problems of trade and technology, with special attention to analyzing domestic and international policies that affect, or are affected by, technological change.

Although we anticipate strong foreign demand for U.S. food and feedgrains over the next decade, we realize fully that tariff and nontariff barriers to trade will continue to limit expansion of U.S. agricultural export opportunities. Governments through the world recognize the special economic, social, and political characteristics of the farm sector that justify government intervention in an effort to stabilize farm prices and income. This intervention is manifest primarily as nontariff barriers including production and export subsidy mechanisms, discriminatory quality standards, and a variety of barriers to imports such as quotas, variable levies, import licensing schemes, and monopoly practices.

We have established a two-track approach for dealing with agricultural non-tariff barriers. On one hand, we intend to use the newly improved codes of conduct negotiated during the Tokyo Round to rectify those practices which are clearly illegal under GATT. On the other hand, we are trying to build on the results of the MTN to develop a framework for cooperation in agriculture through bilateral and multilateral channels. We are using the framework established during the Tokyo Round to resolve specific bilateral trade problems. In addition, we are pressing forward to develop the Multilateral Agricultural Framework, an idea which was initially conceived during the MTN as a forum for high-level agricultural policymakers to consult regularly in order to develop a greater understanding of national agricultural problems. We hope such an improved understanding will deter the adoption of domestic agricultural policies which are self-serving and ignore the interests of other agricultural-producing nations.

We must confront as well the fundamental need to help developing nations increase food production and reverse the deterioration of crop land. We must address the long overdue requirement for a global agreement on food reserves to help offset volatility in supplies and prices.

Trade in services will be of major importance in the 1980's. During the 1970's, services played a growing role in our economy. As this trend continues. There will be a need to pay more attention to the interrelationships between trade in goods and trade in services. As we export more advanced technological equipment, such as sophisticated computers and aircraft, we also will increase exports of services necessary to utilize this equipment--training, management, and repair services, for example. At the same time, as our exports of design and construction services expand, we anticipate expansion of our exports of industrial equipment.

U.S. service industries have become increasingly interested in improved government support for their commercial interests abroad. They also have indicated an interest in developing an international framework for trade in services which would permit negotiation of some discipline for this trade, such as the GATT has provided for trade in goods.

Thus, the primary focus for the 1980's in services will be the development and implementation of multilateral agreements to provide service industries with a body of international principles,

rules, and procedures designed to promote the free flow of service trade. In some cases, it may be most desirable to work out comprehensive agreements for individual service sectors. In other cases, it may be most desirable to negotiate codes of conduct on certain types of problems. For example, it may be possible to extend some of the codes negotiated in the MTN or general rules of the GATT to include trade in services. A study is currently underway in the OECD to determine the possible scope and direction of future negotiations on this issue.

During the past decade we learned how vulnerable our economy can be to shocks in world petroleum markets. However costly we believe energy is today in relation to its historic levels, energy will surely be much more expensive during the 80's. Access to, and prices of, energy resources will be a major source of contention in international economic and political affairs. While a major national and international effort to increase production and use of alternatives to oil, and to accelerate energy conservation, is a high priority objective of many nations, our trade strategy for the 80's will have to recognize that the United States and our more dependent allies and friends will continue to import large amounts of petroleum for years to come.

Key questions will be: whether governments will attempt to work out deals with other countries to "lock up" secure energy supplies, whether their desire to do so will give added leverage to energy exporters desirous of obtaining preferential deals (e.g., major OPEC investment or special market access for, say, petrochemicals), whether this will lead to a proliferation of bilateral arrangements injurious to the trading system, and whether it will also lead to more active interventionist roles for governments in putting such deals together. If, as I suspect, the answer to this set of questions is yes, the trading system, and indeed international political cooperation, will be faced with a whole new series of challenges.

Cooperative planning with oil exporters and importers will be critical if we are to avoid, or withstand the threat of, these types of pressures. We have already created the International Energy Agency. We will want to build on the work of the IEA, the Venice Summit, the GATT, and the OECD to significantly strengthen prospects for a constructive non-divisive response to these problems.

Structural adjustment issues will be extremely important as agenda items for the 80's. There is a pressing need to negotiate a comprehensive Safeguards Code to cover the emergency actions taken by countries to protect domestic industries that are injured or threatened with injury by imports.

During the MTN, progress was achieved in developing a Safeguards Code, but no final agreement was reached. A GATT Committee on Safeguards was established last November to continue negotiations on this topic. The main U.S. objective in these discussions is to concentrate on three key issues: selectivity (the main European objective in the MTN), transparency, and broad coverage. We are seeking a safeguards agreement covering both formal import limits and informal export restraint arrangements. Many such agreements, as they now operate, introduce a degree of bilateralism into the adjustment process and thereby undermine fair and equitable burden sharing. They contain the seeds of increased cartelization of international commerce. Failure to conclude a Safeguards Code in a timely manner will increase the potential for protectionist actions, particularly if the major industrialized countries continue to experience slow real economic growth.

More broadly, there is the difficulty of developing fair and economically sound responses to the global problems of major industrial sectors, such as steel and automobiles. We must face up to the issue of how to help domestic industries regain a competitive standing without undermining the integrity of the market mechanism for allocating resources among alternative uses. The potential for dislocation of labor and capital in these sectors is enormous. However, protection from foreign competition,

or the introduction of domestic subsidies, would generate inefficiency and inflation that would erode economic performance in other sectors as well as in the protected sector. Moreover, protection tends merely to export the adjustment burdens and lead others to take actions which would adversely affect our exports. It will be necessary, therefore, to coordinate with other countries. Because most countries have rather different views on appropriate industrial development policy, it makes such coordination a complex task.

One potential prototype for such coordination is the OECD Steel Committee. Its objective is not to negotiate or to promote negotiations, but to permit the exchange of information on how and the extent to which steel industries in OECD member nations are adjusting, and to enable officials to identify elements of national policies of other countries which unnecessarily prolong, or inhibit, the adjustment process. This type of arrangement might prove useful in monitoring or encouraging adjustment in other sectors, particularly those in which there is global overcapacity or in which major adjustments are needed to deal with dramatically changing energy costs.

To allow for the requisite domestic adjustment to changes in international trade patterns, the United States has in the past relied primarily on the mobility characteristics of our

domestic economy, and secondarily on temporary import restraints in a very limited number of situations. Due to the increased speed and occasional unexpectedness with which imports of some products penetrate our market, the need has arisen, in some cases, for a more sector specific adjustment policy. Efforts have been made to develop a coordinated government policy response to the footwear, steel, auto, and textile sectors. Focused efforts to address regulatory and financial problems of such industries can facilitate their own efforts to improve efficiency and competitiveness. In many cases, trade problems are merely symptoms of more deeply rooted competitive problems in an industry. To the extent these problems can be resolved by other means, import restrictions--which impose a burden on the overall economy--can be minimized.

Effective sectoral adjustment policy at home will strengthen our capacity to encourage sectoral adjustment on a global basis, just as sectoral adjustment abroad can ease adjustment at home. For these reasons, a key trade objective of the 1980's must be to develop further the OECD work on "positive adjustment." This work, which seeks to generate a common effort among industrialized nations to avoid regulations and restrictions which lead to the inefficient use of resources and to promote adjustment consistent with market forces, can make a major contribution to the trading system and to the efforts of national economies to improve productivity and reduce inflation.

The success of the advanced developing countries in using trade as a stimulant to economic growth and diversification is likely to lead to even more widespread use of trade-oriented development strategies. This trend will require that increased efforts and considerable creativity be applied to the task of incorporating the LDCs more fully into the GATT system. It is in the long-term interest of the industrialized countries that the developing countries expand and diversify their trade. In a like manner, our welfare and theirs require trade liberalization as development proceeds. Indeed, our ability to adjust to LDC imports will in large part depend on our ability to export to them more of the products in which we are competitive.

We will need to convince developing countries that the GATT system offers the most practical vehicle for expanding trade in accordance with their respective comparative advantages. Their assumption of the responsibilities of GATT and code membership will strengthen their ability to assert their rights under both. Serious thought and effort must be given to the question of how to maintain a trading system that allows developing countries to earn the foreign exchange necessary to finance their external debt and the imports of capital goods and raw materials needed for their development.

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Similar thought must be given to how to ensure adequate foreign assistance and capital flows--which are essential both on humanitarian grounds and because the growth they help to generate in the LDCs will mean additional exports from, and jobs in, developed nations. In short, there will in the future be a growing relationship between trade and financial issues--particularly in regard to LDCs.

The intimate trade ties on the North American continent always require close attention. Our economy is highly integrated with the Canadian economy, especially in the areas along the border. In trade alone, Canada accounts for roughly 18 percent of both U.S. imports and exports. The United States, on the other hand, takes 65 percent of Canada's total exports and supplies 70 percent of Canada's total imports. Canada, as well as being our major trading partner, is traditionally an important source of energy and raw materials. Increasingly, however, the Canadians are interested in processing their raw materials themselves. There is also strengthened sentiment in some quarters in Canada for a more nationalistic approach to foreign investment --which could also have important trade effects.

Our trade relationship with Mexico also will undergo change in the next decade. As with Canada, well over 70 percent of Mexico's trade, both imports and exports, is with the United States. For the United States, however, Mexico is a substantially

smaller trading partner than Canada; between 5 and 6 percent of U.S. trade is with Mexico. Mexico intends to use its oil and gas wealth in an ambitious industrialization effort which could alter the future composition of U.S-Mexican trade. The energy wealth also gives Mexico a feeling of greater relative strength in its negotiating posture vis-a-vis the United States.

These developments in the trading sectors of our two neighbors require us to examine carefully the premises of our current trade strategy toward these countries. The study of North American trade relations that was mandated by Section 1104 of the Trade Agreements Act of 1979 is providing the vehicle for identifying specific sectoral or functional areas for further liberalization of trade (or investment rules) which would be mutually beneficial. Areas of examination include North American agricultural trade, energy trade, petrochemical trade, broad areas of concern in U.S./Canada trade relations, Mexican industrial development plans and their impact on U.S./Mexican trade in the future, and investment-related trade issues with Canada and Mexico. The report is to be presented to Congress by July 1981.

The global nature of the MTN exercise precluded substantial attention to issues surrounding regional trade arrangements, but these issues will command more attention in the future. We will need to maintain a dialogue with nations in the Pacific Basin as they explore possible regional cooperation arrangements. On the Atlantic side, it will be necessary to work with the European Community as it expands to include Greece, Spain and Portugal to insure that U.S. producers are not adversely affected.

United States trade policy in the 1980's must also focus on the development of East-West trade relations in the post-Afghanistan period. Despite the political issues currently overshadowing East-West trade relations, U.S. trade policy must continue to address the problem of "normalizing" trade between the United States and the centrally-planned economies. To accomplish this, the problems that currently accompany East-West trade--the growing hard currency debt of the Communist countries, their increasing desire for countertrade and the continued need to protect domestic industries from the potentially disruptive effects of trade with centrally-planned economies, to name a few--must be addressed in the context of both bilateral and multilateral trade relations. The United States and its trading partners must determine how best to encourage these countries to assume greater responsibility for the international trading system by accepting and relying

more upon the accepted rules and principles of international trade. The U.S. in particular will have to reevaluate its trading relations with the Soviets in order to determine the basis upon which it will conduct such relations--and their goals and objectives.

With respect to China, the picture is considerably brighter. U.S.-China trade relations have improved greatly. Only a relatively short time elapsed between the decision to normalize relations between the United States and the People's Republic of China in December 1978, and the entry into force of the U.S.-China trade agreement providing for Most-Favored-Nation treatment. The United States will need to develop and implement a strategy for furthering its trade and investment relations with China, including a position on a possible Chinese application to join the GATT.

The increasing prominence of trade in U.S. domestic economic activity requires our taking more explicit account of international factors in our approaches to domestic regulation. A particularly important issue in this regard is competition policy. Questions have been raised as to whether traditional U.S. approaches to antitrust enforcement are sufficiently attuned to the extent to which heightened internationalization of U.S. business and the role of foreign products further our own economic competitiveness. Similar questions are

raised as to whether our firms' ability to compete is unnecessarily encumbered by antitrust concerns or practices. Many of our trading partners have sharply different views of the proper role and procedures of antitrust enforcement, and their practices may give them certain advantages over us. The challenge for U.S. policy will be to develop an international consensus on appropriate guidelines for the application of competition policy in an expanding and increasingly diverse international economy.

In the past decade, we came to recognize the close relationship that can, and often does, exist bewteen trade patterns and investment policy. In many cases, investment policies have a greater effect on trade than tariffs or non-tariff barriers. In this connection, we need to give serious consideration to the trade-distorting effects of certain investment policies and programs, particularly investment incentives and performance requirements offered to or imposed upon foreign investors by host governments.

Many business and labor leaders have expressed growing concern about the increased use of investment incentives and trade-related performance requirements by both developed and developing nations. These leaders support U.S. efforts to reach a multi-lateral agreement limiting the use of such

measures. Until such an agreement is reached, however, they urge the United States Government to take action against them under existing trade statutes (such as Section 301 of the Trade Act of 1974, as amended) and trade agreements (such as the GATT and the Subsidies and Countervailing Measures Agreement).

We anticipate that the 1980's will be marked by two principal developments in this area. First, efforts will continue--with the OECD, the UN, and other groups--to reach an international agreement restricting the use of investment incentives and trade-related performance requirements. Secondly, given the unlikelihood of reaching a comprehensive and legally binding international agreement at an early date, governments as well as private actors may seek to rely upon existing domestic legislation and international agreements to obtain relief from the adverse effects of the use of investment incentives and trade-related performance requirements. Attempts to use trade law to resolve disputes concerning trade-related investment practices would be unprecedented, thereby requiring, as noted earlier, a re-examination of the extent to which trade law is applicable to investment activities. The development of a body of case-law in this area would presumably significantly affect the prospects for attaining an international agreement on these matters.

Conclusion

The 1980's will be a time of both challenge and opportunity Major structural adjustments will be necessary to cope with sharply higher energy prices and increasing developing country competitiveness. Growing pressure on global resources will likely encourage bilateralism, which in turn will increase trade frictions.

At the same time, exports are the most dynamic part of the economies of all regions of the United States. Those countries which are rapidly increasing exports to us are providing the fastest growing markets for our exports.

Our response to the challenges and opportunities must begin at home. We have to reduce inflation and increase productivity. But it will have a strong and growing international component. The growing importance of trade to our economies puts a premium on international cooperation. The improvements negotiated in the Tokyo Round have significantly increased the capacity of the trading system to withstand the stresses of the 1980's. But much work needs to be done in such areas as safeguards, services, and the reduction of barriers to agricultural trade.

Trade strategy for the 1980s will differ from that of past decades. It will need to be closely linked to domestic economic policy considerations. It will need to be integrated with aid, investment, financial, energy and indeed even environmental strategy. In short, it will be an integral part of the management of domestic economies and the world economy.

Based upon the successful cooperation of the 1970's, I am confident that we can prevail over the difficulties of the 1980's. But success will not come easily. And it will, as this hearing underlines, require a strategy geared to U.S. interests, the global environment, and the need for strengthened international cooperation. I very much look forward to working with this Committee on the development of such a strategy.

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Senator BRADLEY. If you haven't learned the system yet, the five buzzers mean I have to go vote. When I come back we will begin the questioning. I am sure that my colleagues will be back and will want to pursue these issues.

[A brief recess was taken.]

Senator ROTH [presiding]. The chairman has asked that we proceed with the questions, which makes it a little difficult, not having been here through all of the testimony.

But one of the first questions I would like to address is this question of productivity. I agree with you, Mr. Samuel, that the American worker, given the proper tools and equipment can, I believe, compete with the best in the world. I don't think there is any question about that.

My question is that with the Japanese replacing their plants, as I understand it, approximately every 10 years, on an average, and the United States, over a much longer period, something like 30 years—at least that figure has been given me—it is pretty impractical to expect the American worker to be able to compete with that kind of a difference in facility.

I wonder if each of you gentlemen would list to me the two or three most important steps you think can and should be taken with respect to this problem of productivity.

Does one of you want to start out with that?

Mr. SAMUEL. I seem to be the sacrificial victim, Senator.

I wish I could wave a magic wand, Senator, and tell you the things we ought to do. In my opening remarks and in my testimony, which I didn't read, I pointed out that although it is true our productivity has not been rising as we would like it to, there is no real agreement on why that has occurred. Obviously it is the result of a mix of a number of factors, including the change in the mix of our industry versus agriculture over the last 15 or 20 years, and I think until we really understand more clearly why it is our productivity did not rise or began to stop rising in 1973, as we were used to, and then began to go down actually in 1979, it is hard to define any remedy.

The one thing I would suggest is if it is a question of investment, that we should approach it on a sectoral basis. There are clearly some of our industries where productivity is very high, and generally speaking, in our manufacturing industries, productivity has not had the same declining rate as it has had in the economy as a whole. As you know, the productivity of our manufacturing industries is still rising quite well. That doesn't seem to be the problem.

So that if we are to change any of the circumstances of investment in our manufacturing industry, it seems to me we should take a very careful look at the individual industry and see, will this really improve productivity? is productivity improvement really called for? or will it, instead, simply end up as a windfall for a particular industry?

Senator ROTH. Could I ask you one further question? In your testimony you pointed out that the increase in the cost of labor has been substantially less than the other countries have experienced. That is based on a percentage, I believe.

In any event, is that true? Are there some industries that have had a greater increase so that it has had an adverse effect on exports?

Mr. SAMUEL. There are differences, of course, Senator, but in all of them we are rising at a much slower rate, and have been rising at a much slower rate since 1965, which is where I go back to—actually, I think since 1960—than most of our foreign competitors, particularly Japan. And I have some figures which I can leave for the record. I won't take time now to go over individual sectors. But all of those figures demonstrate that on an index basis or on an absolute basis, comparing their increases with ours, we have gone up considerably less.

Ambassador HORMATS. Let me——

Senator ROTH. Mr. Ambassador?

Ambassador HORMATS. Yes. Let me just touch on a few. As Howard said, we are not quite sure of all the reasons for the sluggish U.S. productivity. Productivity in U.S. statistics is measured as a residual, and therefore it is very hard to tell exactly what the causes of it are.

But there are a few that are worth noting. One is the amount of capital available per worker. In the United States it has gone up roughly by 2 percent per year over the last decade. In Japan and Korea it has gone up 10 percent per year. In Europe, even in some of the sluggish economies of Europe, it has gone up——

Senator ROTH. The problem with using percentages as we are, is that they depend, of course, on what the base is.

Ambassador HORMATS. No, obviously our base is much higher, but when we talk about productivity, we are talking about increases, and therefore you tend to correlate productivity increases in part with increases in investment.

Surely our base is higher, and in many cases our productivity is higher than many countries. It is just that the growth rate has been more sluggish.

Second, R. & D. as a percentage of U.S. GNP has remained relatively the same while it has increased in countries such as Germany and Japan.

Third, we have had a lot of new workers coming into the U.S. labor force over the last decade, and new workers tend to be less experienced than older workers, and as these new workers gain experience, then their rates of productivity will probably go up substantially.

And the fourth is a point we were talking about earlier, and that is service industries. Services today are over two-thirds of U.S. GNP, and in many cases it is harder to get productivity increases in service industries than it is in the manufacturing sector, and with such a large percentage of our economy in services, we tend, I think, to see a relatively slower growth in productivity in that area.

Those are four reasons. There are others, I am sure.

Senator ROTH. Could I ask you this question? Do you think our steel plants or automobile plants are as modern as the Japanese?

Ambassador HORMATS. No, they are decidedly not as modern as Japanese plants.

Senator ROTH. How about our other basic industries?

Ambassador HORMATS. Well, some certainly are. I mean, in the airplane industry and high technology industries, computers——

Senator ROTH. The basic rubber——

Ambassador HORMATS. Rubber we are not.

Senator ROTH. Copper.

Ambassador HORMATS. Well, copper is a differentiated industry. Some are competitive, some aren't. But in the very basic industries, as a result of relatively sluggish investment over the last decade or so, we are not nearly as competitive as some Japanese plants, or in the area of autos, we are not as competitive in the United States as some American-built plants in Europe. And this is one of the interesting phenomena, that a number of auto plants in the United States built by American companies are simply less modern than their counterparts abroad. It just really depends on the industry.

Mr. SAMUEL. Could I add just a comment to that, Senator, that in two industries which have been most affected by international trade, apparel and shoes, generally speaking, our U.S. industry is at a very high level of technology. This has not been the problem in respect to import impact in those industries.

Senator ROTH. Thank you.

Professor?

Mr. BRANSON. Yes, sir.

I think that I would agree with what has just been said about the fact that we do not understand all the sources of the productivity slowdown. I think that it is clear, though, that the slowdown in investment is bound up with the productivity slowdown. I also think it is useful to think about what one might do about that by looking at the factors that an investor would want to look at, namely, the expected average return on the investment and the expected variability of that return, that is, how uncertain is the investor about the return that he is going to earn. And I think then one can sort out some of the things that have happened to reduce the rate of investment in the United States. It seems to me that in terms of the expected average return, the tax system works against investment. There is the type of well-known problem about inflation and depreciation in the tax law, in the corporate profits tax.

In terms of the variability of the return on investment, one can point to at least three items. One would be the fact that the energy price rises in jumps, and so it increases the riskiness of investment because one doesn't know when the energy price is going to jump. If one could have the same average movement of the energy price over a long period, but smooth it, one could reduce the riskiness of investment.

The second is that the size of macroeconomic fluctuations has gone up enormously in the 1970's relative to the earlier period. We have had two very deep recessions in the 1970's, and that has increased the variability of profits and increased the riskiness of investment.

The third factor I would point to is the variability in exchange rates which causes variation in profits in the traded goods sector.

All of these items, the jumpiness of the energy price, the size of the business cycle fluctuations, and movements in exchange rates have essentially increased the riskiness of investment substantially

in the 1970's, and we can see that in the financial markets by looking at the so-called risk spread that corporate bonds have to give relative to Government debt, which has gone up.

So I think that if one wanted to go after the productivity question, the problem of investment would be on the top of the list, and these kinds of factors are the things that I would look for to start to work on that problem.

Senator ROTH. Dr. Malmgren, could I just ask one additional question?

Can we become competitive again in the basic industries? I think this is a very serious question for this country. I happen to be of a school that as a major or the leading Nation of the free world, with security really depending upon us, can we afford not to have a modern steel, automobile, rubber, you name it, and if so, can we make it competitive in world markets?

Mr. MALMGREN. It's a tough question. I agree with a good deal of what has been said already, that particularly we will have more volatility in the 1980's, and this is going to be another problem of risk in the investment area that has to be somehow dealt with.

Essentially what we have is a lack of confidence in the long term, together with the fact that heavy investment requires long leadtimes. It requires confidence in 5, 10 or 15 years from now, and that lack of confidence has partly to do with the risk phenomena in the market, and the interdependence, and partly to do with the changeability or volatility of our economic policy. Governments keep changing their minds about what they are doing, and an investor can't operate on that basis. An investor taking a long-term position needs to know more or less, this is the rule, however unpleasant, and it will stay that way for *x* period of time. There is this in our time a very strong tendency, especially because of these other factors, inflation, uncertainty about rules, to stay as short term as possible. And that is affecting our trade position and our productivity. There is no question about it.

Now, you asked about what can be done, and I think there are many ideas around, as you well know, including especially your own. In my view, if you are going to compensate for this problem of people having a very short-time horizon, wanting to take care of the risks right away, write off their equipment right away, you are going to have to deal directly with that problem, which is to bring the time horizon of a long-leadtime project up real close, and that means accelerated depreciation, very accelerated for the basic industries that are in trouble.

There are other ideas floating around. The steel people, as you know, want transferable or refundable tax credits for those years in which they don't make a profit but they want to be able to use the tax credits in some fashion or other for capital spending purposes.

In R. & D., actually, our R. & D. is going down as a share of GNP, and that is another area that needs to be looked at from the Senate point of view.

We have some modest R. & D., but it is increasingly energy related, so it is not really productivity related in the mainstream of industry.

But beyond this, can we get competitive again in the basic industries? The industries will change their character, whatever. I mean, the market is going to work in one fashion or another. Can the American automotive industry, for example, be competitive again? Well, it depends on how much they spend in capital commitments. GM has announced that it will spend $40 billion in the next 5 years to retool, redesign, not only the product, but the production process, because we are talking about robotics, about keeping the hands off the vehicle production so you don't have a Monday or a Friday car. There is a lot different going on here than just changing the models.

The world car concept is also coming in. So we don't know now, today, whether our industry will involve all production in one place or whether it will be based on components coming from various parts of the world and then assembled in one place.

I think the industry itself doesn't quite know yet. That is why it is diversifying its risks, and looking to Canada, Mexico, and Spain and other places, covering all bets.

Now, we can be competitive again, but it may not be quite the industry we had, it might be something different. But to be competitive it is going to have to be fast moving on the technology front, and undertake fast capital spending. It has got to have its eye on productivity. If we are not careful, we may find that it won't be an American firm, it will be someody else that is competitive within the American economy.

Now, to get it right, we are also going to have to look at one or two other things that I don't want to dwell on now. Ambassador Hormats touched on it, and I did, too. One of them is concentration policy and competition policy. It may be that we will have to look at the world market as the relevant competitive source, and we may need some consolidation.

In the steel industry, in my view, we need fewer firms, not more. And we may find ourselves in the embarrassing situation that we do have fewer auto firms 5 years from now because nature takes its course and some don't survive. But we shouldn't necessarily automatically think that is a disaster. I think we will have to think through what does it mean in global terms.

Senator BRADLEY [presiding]. Let me rephrase Senator Roth's question, by asking instead of can we become competitive in these basic industries, should we become competitive in these basic industries, given the theory of comparative advantage? Second, how do you factor in our strategic interest in remaining competitive in certain industries?

For example, according to the theory of comparative advantage, maybe the Japanese will outproduce us in electronics, or maybe the Koreans will outproduce us in a particular good.

Now, should we accept that fact and undertake a disinvestment process in this country, and therefore the adjustment process, or should we resist that fact? And which industries do you consider as critical from a strategic sense?

For example, the theory of comparative advantage might say that we don't need an automobile industry, but do we want automobile manufacturing capabilities in this country in the event of a national security emergency, and therefore, what percent of what

industries do you require as baseline level to secure national security?

Mr. MALMGREN. That is a tough question, and many industries come to the Government and argue that their industry is a national security type of industry.

When I came to Washington in 1961 I was in the defense area, and if I haven't forgotten completely about this. It has been the development of thinking about the modern military political situation that we are not going to be fighting massive, land-based wars in the United States or Europe, but that security is something else. Do you have enough to sustain yourself if you are interrupted from supplies in various parts of the world?

It is clear that, for example, in the Korean war the U.S. steel industry was able to meet the military needs, and that was a very small percentage of the total demand in the market at that time, even going full out. It was also true that the automotive industry could respond to the equipment needs, and again, it was a very small percentage of the total automotive output.

So in the kinds of military-political world we are going to see, large-scale capacity is not a dominating consideration but you do want to have some capacity.

Now, would there be in the United States no steel industry if we had a different trade policy? The answer is no. Today, for example, the new small, independent minimills are going all out and making a lot of money. They are different from the big mills, the old type that were put in 10 or 20 or more years ago. But the minimills, in my view, will take over everything west of the Rockies and a good part of the Rocky Mountain area within 4 or 5 years. I think the big companies will be driven out of that market, not by Japan but by our own minimills.

So it is a changing structure of industry. Each industry is, in fact, adapting. We will see survival of some firms in the basic industries for a variety of reasons.

Let's take nonferrous metals. It has been in the 1970's a difficult area for the nonferrous metals companies, but in the 1980's there are going to be world bottlenecks, and my guess is we will have a rebound of our companies in 1985, and they will be doing extremely well. They will then be able to engage in the investment that is required, and we will find that in the North American area we do have a good deal of what is necessary to have for security——

Senator BRADLEY. Let me ask you this another way, and I would like everyone to comment.

Some of you said in answer to Senator Roth that one of the responses we need to make to a lower productivity growth rate is increased investment. I wondered if any of you have done any analysis as to what we do want to encourage investment in and keep as our basic manufacturing capacity in this country, given the threat to them that increasingly is posed by foreign competitors.

My own personal view is that we can not survive as a nation of restauranteurs and security guards, and health care specialists, and I wonder about your views.

Mr. BRANSON. Well, Senator, I think that the answer on the question of do we need basic industry is that maybe the question isn't focused exactly right. I think the right answer comes from the

comments that were made earlier about high-technology industries, that the manufacturing industry that will survive in the world competition in the 1980's in the United States will be and should be the manufacturing industry that is based on high technology and skill, and to the extent that the production processes, or the products, in steel or in rubber or in autos develop with those kinds of technologies, then those will be industries that the United States will focus on rather naturally. If we want to speed that process, doing something about R. & D. spending would make sense.

The second part of your question was how do we factor in strategic considerations, and it seems to me there the question really is what is the probability that one would get cutoff from supply from all sources at the same time.

Taking your example about automobiles, if the concern is security, and if the only automobile manufacturer in the world were in the Soviet Union, then there would be some reason to worry about it. However, if there are auto industries in 30 different countries around the world, there is not much probability that they are all going to stop selling to the United States at some critical moment.

So I would think that most industries would not qualify under those kinds of considerations as being interesting strategic industries.

I am reminded a little bit of the irony of the fact that when a developing country, an India or a Brazil, starts saying that we need to build a steel plant, the people at AID will say, don't be silly, you don't need a steel plant, somebody else is better at making steel than you are. But when we are talking about our steel industry, it sounds suddenly that you can't be a really healthy economy unless you have a steel industry. I think that we ought to use on ourselves the argument that we would use on India or Brazil. The industries that we need are the ones that we are good at, and increasingly we are not so good at running production lines that take semiskilled labor. We are good at doing things that take skilled labor and high technology capital.

Senator BRADLEY. If you could be brief. My 10 minutes were up about 5 minutes ago, and as the chairman, I would like to abide by this.

Ambassador HORMATS. OK.

I think there are a couple of elements to the question. One is I think we are going to have, and indeed probably ought to have, steel, auto and other basic industries. The real question is how large they are going to be, and I think in some measure they are going to be smaller, as those that are less efficient fall by the boards, and those that are more efficient gain a certain amount of strength.

An interesting phenomenon in textiles. Textiles, 4 or 5 years ago, was seen as a dying industry in this country. Now we are very competitive in the European market because a lot of new investment has taken place, and we are able to export, and the Europeans are afraid of our competitiveness, so that industries which have the foresight to develop and use new technologies can compete, and it is very difficult to anticipate which ones are going to die and which ones are going to survive, because in large measure it depends on their own management perhaps more than what

Government can do, although Government can set a good environment.

The second is the question of specialization. What we are likely to have is a steel industry which 5 years from now perhaps is more competitive than today, but perhaps in different types of products. Certain products we may be less able to compete in. Other products, as in synthetic fibers, we may be better at.

So it is very difficult to predict in the aggregate whether an industry will be here or won't be here, but certainly we are going to have in basic industries sectors of those industries which are very competitive, simply because they either, one, specialize in products where they do have a comparative advantage, and two, develop and use high technology more effectively than they have in the past. And this seems to me to be the answer in autos, steel and shoes, textiles, and a number of other lagging industries, more technology and more specialization.

Mr. SAMUEL. Senator, let me first suggest that I certainly support your belief that we need a broadly based economy. To listen to some economists, one would suggest that some years from now we will end up being a nation of McDonald's hamburger stands, which we do very well, and soybean farms. We do very well there. And most of us will be unemployed.

I don't really think that is the answer for the United States. It seems to me there is no single answer for the very difficult question you raise. If you take just three of the industries we have talked about today, the steel industry possibly has been affected the last few years just as seriously by the dumping practices of our trading partners as by its own lack of technology. Certainly it has been a major factor.

The textile and apparel industry, as Bob Hormats has suggested, need some time. I might also suggest to you that that industry employs 2½ million people, many of them of low entry level skills, many women and people from disadvantaged families. The suggestion that that industry be allowed to disappear I don't think is one which we would really like to consider.

The auto industry is the victim of temporary bad management decisions a couple of years ago, and to suggest that we can no longer compete in the international automobile market I think is simply wrong. My guess is, given time, we will be back in the market very strongly, and back employing those, well, 300,000 people in assembly plants and about 600,000 people in parts manufactures, making automobiles for the world market.

What does this lead to as far as policy is concerned? First of all, most important I think is time. When an industry has problems, very often what it needs is time, and very often that time can be provided by import restraints. We have done that. We have done that in shoes and we have done it in textiles, and we have done it in a number of industries recently, in color television and specialty steel, and generally it has worked out fairly well.

Of those industries, specialty steel is an outstanding example. Prices did not go up inordinately. Investment increased, and specialty steel is now able to perform its economic function in this country, without benefit of doctrine or broad philosophical ap-

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proaches to trade. All it needed was a few years of relaxation of pressure.

Senator BRADLEY. Thank you very much.

Senator Heinz?

Senator HEINZ. Thank you, Mr. Chairman.

First I would like to ask that my opening statement be placed in the record at the appropriate point.

Senator BRADLEY. Without objection, so ordered.

Senator HEINZ. First, Mr. Chairman, I want to compliment you on an absolutely outstanding group of leadoff witnesses, on a very far-reaching issue, one that I salute you for addressing, taking what is a turbulent time and yet having the foresight and presence of mind to direct our attention as colleagues to a matter of increasingly vital importance. And I look forward to not only completing today's hearings but to the balance of the hearings that we are going to have.

I listened with great interest to our witnesses this morning. I didn't hear, unfortunately, Mr. Samuel testify, but I will carefully read your testimony, Mr. Samuel. I know it will be good. And I heard them identify a variety of problems. You, Mr. Chairman, have touched on the question of how we should approach the issue of our more mature industries, or, as Mr. Samuel said, you know, do we really want to be nothing but a Nation of hamburger stands? Notwithstanding the fact that I have nothing against hamburger stands, the answer, to my mind, is no, we don't want only to be eating hamburgers.

I would like to address, if I have time, four issues that seem particularly pertinent to me. One that has been mentioned both by Mr. Hormats, by Mr. Malmgren, and perhaps others, is government intervention, and there one of the issues I would like to touch upon is the problem posed by nonmarket economies. We tend to define most of them currently as Communist countries. That is a restrictive definition, in my judgment, that appears in section 406.

Second, the question of international financing of exports, you may be aware that we don't really have an Export-Import Bank as of today. It exists on paper, but it didn't get any additional money; it is out of money. It did not get either the absolutely necessary additional fund to stay in business, as I recollect, but it also does not have the additional funds necessary to show others that we, if we had to, could play their concessionary game.

Third, there is the question of what effect protectionism, particularly that of the Europeans, has on world food supplies. My hunch is that it is terribly destabilizing, not only difficult for our farmers, but when the Europeans, by a variety of means, keep producers of food out of their markets, it just makes it impossible for the LDC's, particularly nonoil LDC's, to ever get their economies oriented toward being self sufficient.

And I see people nodding their heads in agreement. I hope the record will show that.

Senator BRADLEY. Let the record so state.

Senator HEINZ. Thank you, Mr. Chairman.

And finally, I hope we will be able to address in more detail the issue of the overhang of Eurocurrencies, what that does to the stability of the dollar and some other currencies. I hadn't thought

about that issue in a worldwide context, and the uncertainties that must pose for price systems, and therefore investment, and off the top of my head, no easy answers occur to me. It strikes me as ironic that we have been through a period of time in which a lot of people in the 1970's have stressed the crisis of liquidity, and all of a sudden we find ourselves with, in this sense, a certain kind of liquidity that is more than what we ever wanted to have, and then some, recognizing that there is a dichotomy between LDC non-OPEC oil liquidity, and OECD liquidity situations.

Perhaps there is a way of dealing with this issue through some more unique financial transactions. Substitution accounts may pose something of an answer in this area. I am not sure.

I would like to take the remaining amount of my time, having reacted, in a sense, to what you gentlemen have posed to the committee so far, to talk for the moment about the issue of nonmarket economies. I believe that all the comments that dealt with the issue of distorting investment patterns, distorting trade patterns do run contrary to a strict application of the law of comparative advantage. But that works very strongly against us.

And the area where I see us coming into even greater conflict with the world is not just with the Communist countries and China, the People's Republic, but the mixed economies of the non-OPEC LDC's, and I was wondering if I might ask what each of you in turn thinks we ought to do about this issue. I guess you had better keep your comments fairly brief. As you know, I have introduced, along with Senator Roth, legislation amending section 406. S. 1966 is the legislation in question. I would be interested in either your general or specific thoughts on that.

May I ask, going from left to right, Mr. Malmgren, why don't you start off, and we will work our way down.

Mr. MALMGREN. I haven't looked at the particular bill, but the issue of state enterprises as well as nonmarket economies is important. And state enterprises can be found not only in developing countries but, for example, in Europe, many of the basic firms in the basic industries are now owned by state holding companies. We do have different treatment in the dumping laws, as you know, for such enterprises. But there are continuing problems of how quite to deal with this area. When I was in the Government I did recommend that there be separate ground rules brought up gradually over time for the nonmarket systems or the state enterprises. I think in the MTN that was not taken up, but it is to me an issue in the 1980's that should be discussed internationally, and it will be raised, for example, if China decides it wants to come in because it will change drastically the ballgame in the GATT.

Now, China can enter tomorrow morning if it wants to because it does have residual membership in the GATT.

Senator HEINZ. Would you suggest this is a matter on which the committee should place moderate urgency, a great deal of urgency, no urgency?

Mr. MALMGREN. Moderate because it isn't going to change dramatically the trade pattern tomorrow morning, but in the 1980's it is an important issue, and I think that—you have been working on this for a couple of years now—I think in the normal course of events you should keep working on it.

As I say, I haven't read specifically——

Senator HEINZ. For how long? Until we get something done?

Mr. MALMGREN. In the next session of Congress is the time when this begins to get ripe for public discussion, and it is an important issue and will be increasingly so. It does come up even now in the case of industries like steel, which you are interested in, where the steel problems in the U.S. industry are greatly aggravated by market distortions caused by heavy intervention of governments in their steel industries pushing their problems out into the world market, particularly from Europe.

Senator HEINZ. Professor Branson?

Mr. BRANSON. I will try to be brief.

I think the problems of dealing with nonmarket economies are pretty obvious, and I would agree with most of what Hal Malmgren has just said. I think the one proviso I would like to add, though, is there should not be a presumption that simply because an economy is a nonmarket economy that it is going to somehow be behaving disruptively or developing along the wrong kinds of lines as far as world trade patterns go.

I think effectively the directors of most smart nonmarket economies are trying approximately to reproduce the kind of industrial structure that they would have if they were market economies. It is just that they don't like to use the market mechanism to do it.

So I don't think one should presume that they are somehow going to be getting it wrong or doing harm to the international trade structure.

There is, of course, the problem of figuring out how to price their output fairly.

Senator HEINZ. Let me take you up on that assertion, because if they are trying to copy—if one nonmarket country is trying to copy another and they want a steel mill, and they are paying the right price from, for all I know, U.S. steel engineers to build the steel mill, in fact, if enough countries do that, you get the world dramatically overinvested in steel and underinvested in producing food. Steel we are willing to sell them. Food, there is a limit to what we can all produce, and you have people who have got wonderful office buildings but nothing to eat. I mean, I have to challenge your assertion that because a centralized economy goes about imitating what market economies do, that it doesn't have an aggregate effect. It has a very serious aggregate effect.

Mr. BRANSON. Well, I think my point is not that they imitate the particular structure of some particular market economy, but the way they would decide on what industries to go into is by using the signals that are given by the world prices of goods and of factors of production.

Senator HEINZ. Like we did with Chrysler.

Mr. BRANSON. We make mistakes; they make mistakes. I think the initial presumption that somehow nonmarket economies create trouble is the presumption that they are going persistently to make some particular pattern of mistakes, and I don't see any reason to think that. The world oil refinery businesses has built into overcapacity, and this is not a problem necessarily of nonmarket economies. A smart nonmarket economy won't overbuild in steel.

Senator HEINZ. The only reason I get concerned about nonmarket economies is that a lot of market economies are a big problem, you know, France and Great Britain, to name two in the steel industry.

Mr. BRANSON. Sure.

Senator HEINZ. But Great Britain, last I looked, was subsidizing it to the tune of $1 billion a year. They are a market economy. You know, it is not that I am worried about nonmarket economies exclusively. It is just that they are likely to be just as bad as market economies.

I am embarrassed, Mr. Hormats, Mr. Samuel. I have got to go over and vote, and I will give you a choice. You can either answer—you can reply to my question with nobody here, or you can wait.

What would you prefer to do?

Ambassador HORMATS. I think we will wait.

Senator HEINZ. The hearing is recessed until the next Senator shows up.

[A brief recess was taken.]

Senator BRADLEY. I won't ask you to continue now with your answer to Senator Heinz so that when he gets back we can hear your response.

What I would like to know is how to get back to this idea of whether governments should be involved, and if so, how, in trying to allocate capital from less to more productive industries, and away from speculative investments to longer term investments. Also how could we go about doing that so that we get the right level of R. & D. and we don't lose the benefit of what little capital there is around.

So my question to you is what role do you see for Government in facilitating the increased productivity within sectors and among sectors?

Mr. SAMUEL. I'll take the first crack at it, Senator. Everybody else is shy. There is one point I would like to make, I think, because what you are asking, of course, is a very basic question which is now under much discussion under various names—reindustrialization, national industrial policy and so forth. What should the role of Government be in respect to the Nation's ability to compete in the world market? It seems to me that the key; and there are a number of questions that come to mind—but the key question and the key issue that should be resolved is that this must be, as you suggest in your question, a sectoral responsibility. It seems to me that every industry is going to demand or call for a somewhat different answer than another industry, and that possibly the right road is one on which we are already embarked, that is, with the Tripartite Steel Committee, which is set up under the original Solomon plan for the steel industry, and now the administration is in the first stages of setting up the Tripartite Automobile Industry Committee involving labor, management and Government.

It seems to me through this kind of an institutional framework we can look at each industry in turn, make basic decisions as to what is needed to maintain its competitive position, long term, short term, avoid doing things which would be misdirected or

would cause windfalls and which would really be directed at the specific problem faced by that particular industry.

Senator BRADLEY. But the idea that I expressed, that Government should be involved in trying to reallocate capital from less productive to more productive industries, and from speculative to longer term investment is one you accept?

Mr. SAMUEL. My guess is you probably would end up with a Government decision, would end up in a reallocation of capital. I wouldn't like to suggest now which we will find to be industries less worthy of capital or not. It is possible it could happen, yes.

Ambassador HORMATS. I would like to take a slightly different view. The Government has not, over the last several decades, proved itself particularly adept at picking winners, either in this country or any other country that I can name off the top of my head. In fact, given the political system in which democracies operate, the likelihood is that if the Government does have the authority and the mechanisms to allocate capital, it is going to do so in the sectors which are politically potent. Whether or not they are winners in the longrun or competitive in the longrun will, I think, given the political system we operate in, be a secondary consideration. And therefore I would have, just speaking very personally now, have major reservations: One, whether the Government should do this: Two, whether, if the Government were to have the power to do it, it would get at the problem you are trying to address, which is moving capital into industries which are going to be winners, which are going to be the high technology growth industries of the future.

It strikes me that the better way of doing this is to address the problem in a more generalized way with improved treatment for R. & D. and for investment, and then I think you might get some industries which benefit unduly from it, but I think over the long run that will lead to a shift in benefits to industries which are investing more, which are doing more R. & D., and I think that will over time lead to the sort of shift in productivity that you are seeking.

Mr. BRANSON. I think I would like to agree with most of what was just said. It seems to me that the capital markets will allocate capital to its most productive uses probably better than a Government committee or even a tripartite committee. It seems to me that the problem is: One, to remove pieces of the tax structure that impede investment or that reduce prospective returns: Two, to stabilize the economic environment in which firms are investing. Once one does that, I think you will see an increase in the total level of investment and it will flow to the most productive uses.

Beyond that, I don't see the likelihood that we could do well by trying to involve the Government in allocating amongst sectors.

Senator BRADLEY. In your judgment, do firms maximize their profits?

Mr. BRANSON. On average, they come pretty close, yes. Some firms do badly, but I think if you look at——

Senator BRADLEY. Do you think that is a structural problem?

Mr. BRANSON. That some firms make mistakes?

Senator BRADLEY. No, that some firms do badly. Specifically I am referring to these industries that we have come to regard as trou-

bled industries, where because of the incentives to management in our present system, there is a tendency to make short-term investment and to reinvest in your, ones own industry, even though it is declining in productivity growth, rather than putting that investment into a more productive industry. If so, it seems, one solution would be to foster larger, more diversified firms, firms with more ability to move their retained earnings from one subsidiary to another subsidiary, from a less productive industry to a more productive industry. Might that be a way we could address this problem?

Mr. BRANSON. I think yes on that point. I think it would be worth looking carefully at the tax and antitrust codes and treatments to see where the flow of capital between industries is impeded and to remove those barriers. But the point is to try to make the market allocation mechanism work better than to try and substitute for it.

Mr. MALMGREN. Well, Senator Bradley, what does happen now is that in some of these troubled sectors, we are seeing diversification of some of the big companies. It is a well known fact in the market that U.S. Steel makes profits in its nonsteel operations and makes losses in steel, and it has been diversifying quite a bit. The most successful firm in terms of adapting in the steel industry was Armco, which has completely changed its character in the last 15 years. It is now a trader and it is in many other industries as well, an importer and exporter.

So within those sectors there is, in any event, a natural transformation, but that doesn't take care of the job problem or the modernization problem of that sector. Overall in the economy you have one set of problems, and then we have a problem with the troubled sectors. In the general area, it is quite obvious that we have to do something about capital formation, but also something about such areas as speculative activity. You raised that.

But that pretty much can be dealt with, as Mr. Volcker has been doing, by focusing on lending for speculative purposes and I think probably a little bit more attention to the regulation of commodity markets which is pretty loose.

But setting that aside, let's look at the troubled sectors. There is a problem among the firms, how do you allocate assistance? Do you try to pick a firm and say that one we are going to help and this one we won't? Capital will normally flow to those who are making profits and are adapting. If you want to save AMC, Chrysler or Ford relative to GM, it is not so easy to say, well, we will favor those three against GM, which is what it amounts to. It is a very tricky question. But all three of those companies are in trouble, and only GM is really strong right now.

We have had this problem in public policy. In other countries such as, for example, in France, the government and the banks talk it over, and then there is a conscious decision to have the banks lend money to the weaker firms.

In France, and in Japan, the banks are also expected at that point to put new people into management whom they choose, and then the capital budgeting and strategic planning of those companies is reviewed by the banks, and it is changed. They are simply

told, you will no longer do what you were doing because that didn't work. You have to do something new.

Now, we don't have a mechanism for public-private interaction of that type. But——

Senator BRADLEY. Are you suggesting that we should?

Mr. MALMGREN. Yes. I think in my testimony I said between bankruptcy and letting the market run, we have nothing intermediate.

Senator BRADLEY. I know that, but——

Mr. MALMGREN. I myself find that if firms come in for help, not only for trade reasons but regulatory relief in the environmental field, tax relief, or something else, there might be a category that firms get into called troubled industry or troubled enterprise, which is short of bankruptcy. When you are in that category, you get some relief, but you also get something else called oversight, and that oversight might very well be a combination of one of these tripartite committees and a group of the financial institutions that are helping bail out the operation who are expected to get involved in management and who will oversee change. Preferably they are taking a stake in the whole thing, and particularly if you are giving any form of official relief, it is desirable that you ask the people who are in the lending business to get involved with what is happening.

Senator BRADLEY. And you would see this as a Government body?

Mr. MALMGREN. Mr. Rohatyn prefers that type of approach. I am reluctant to see a Government body do this fully because Government people are not very well placed to get inside the capital budgeting process of a company and say this make sense, this doesn't make sense, your management methods are bad. But I——

Senator BRADLEY. Well, now, Mr. Malmgren, if you were on that board, I would have no problem with the Government people who were analyzing the company.

Mr. MALMGREN. I spent a lot of years in Government, and I have sat handholding with many company people, and now I do it from the other point of view, and I am an advisor to many of them. And what I am worried about is to get right some of these international problems, you really have to change the way of thinking of management in many areas.

Quite often the problem arose because the company people didn't see the problem coming and they should have. They didn't have any planning and they had poor capital budgeting. They kept doing what they were doing, and they were overwhelmed.

From a public policy point of view, you have got several issues to cover: The consumer interests, taxpayers interests, especially the labor interest, which is not going to be watched over unless——

Senator BRADLEY. Well, see, the idea of indicating how the marketplace should function I agree with, but I wish someone would tell me how we can successfully, disinvest particularly, in industries where there are serious problems. Everyone talks about the high rate of Japanese investment in sunshine industries and disinvestment in sunset industries. But what they don't talk about is Japanese lifetime employment or payment to workers on the basis of seniority with incentive bonuses at the end of the year. These

practices facilitate the disinvestment and adjustment process. They give everyone a stake in increasing production and competiveness.

So what I want to ask is do you think our adjustment policies are woefully outdated? Do you think we should be emphasizing much more training skills? Do you think there should be a bigger role for workers in the companies? Do you think we should have unions or no unions? Mr. Samuel, you don't have to answer that.

Mr. MALMGREN. Well, just to be brief, I think these tripartite approaches, as Mr. Samuel said, this sectoral approach is a good new development to walk through with all the parties concerned what is at stake. We don't do much on training, as a Government, I mean, really nothing at all to be quite honest. We have not thought through who should do the training and for what purpose. We are not very good at picking things like that.

We do need rethinking about disinvestment, or, let's say, rearrangement of industries' interests. One thing that does happen quite often is that when you put up trade protection people do in that time get themselves out of the industry and leave the workers hanging. So it is a very complicated problem, how to do that with the best overall perspective.

We do need a lot of rethinking, but there is a debate going on in this country now in many quarters on this subject of industrial policy. As a warning, let me say that I have sat in on many different committees, and I find no consensus. They are all over the map and back. It is a very early stage of thinking, and these hearings, that you have called are very timely, and involve investigation of vital problems of our time.

Ambassador HORMATS. Could I just make a couple of points in response to that?

One, I think there is certainly a need for more anticipatory training, and we do have somewhat of a sense as to what directions overall industries are moving in over a period of time. Sometimes we are wrong, sometimes we are right as a Government, but we ought to be doing a lot more training.

Now, people criticize a lot of these training programs because they are very expensive in terms of start-up costs. Once they get going, they can do reasonably well, if you know the right industries to train people for, and the Government has not been perfect at that.

Second, a lot more effort is needed, I think, to focus not so much on the aggregate problems of disinvestment, but the local problems, which is really where the difficulties lie.

Senator BRADLEY. Might another way of saying what you have just said be that instead of focusing on institutions, we should focus on individuals?

Ambassador HORMATS. Individuals and localities, yes.

Senator BRADLEY. So that the idea is not to save Chrysler but to take care of the Chrysler workers and the communities in which they live.

Ambassador HORMATS. Let's take Mahwah, which is a good case in point, where you do get a firm closing, and this leads—without looking at the overall industry you say here is a particular plant which is being closed by whatever industry it happens to be. What can you do to retrain people there? Are there industries in the area

that people could go to? And take a look at it in a more disaggregated way.

There is a group that works now, that the Department of Labor, Department of Commerce, and USTR participate in which takes a look at localities that are impacted by steel plant closings, and my impression is that it has been a fairly effective group, and it works with the unions and it works with the companies, and they meet every month or so to identify plant closings, how the locality is dealing with it, and to focus a lot of particular Government programs on that locality. And that I think is one way of doing it which avoids the overall aggregation problem which I think gets you into difficulty.

The third point I would make, Japan is looked at as sort of the paragon of adjustment. It is for two reasons. One, because adjustment has been relatively easy inasmuch as their economy has grown so rapidly, there are new jobs being created for people who are out of old jobs. And second, the Japanese worker has a sense of security, and therefore is more willing to allow new productivity to go into place because he doesn't feel his job is threatened by new productive investment, including the robotics.

So Japan is an interesting but perhaps not completely relevant model for the United States, although the worker security and the movement of capital and labor into more highly productive industries I think is something that we ought to take note of. If our economy begins to grow again in terms of increased productivity and increased R. & D. and increased investment, then I suspect at least a portion of the overall adjustment problem that you are talking about will be dealt with, not all of it, but a portion of it.

Mr. BRANSON. I would like to pick up on the hint you dropped about workers involved in management. It seems to me that that would be a way to make sure that the labor interest is met in a case of disinvestment. If we had a system of more workers involved with management, but not necessarily Government subsidization of capital, then you might find at least that everybody involved in the difficulty of adjustment has the feeling that their interest is being looked after as well as it can be, given that there is a difficult problem.

Senator BRADLEY. Senator Danforth?

Senator DANFORTH. One of the points that is made in Ezra Vogel's book "Japan Is Number One" is the ability of the Japanese to form a consensus, a truly national policy as to how they become more competitive and more modern, and the consensus is made up of business, labor, and Government.

I am concerned that we have a difficult time in doing just that, and let me give you an immediate example.

Here we are today talking about certainly a major issue for the future of this country. I don't think there is any doubt about that, American trade policy, America's ability to do business abroad. And yet during this hearing we have been interrupted not once or twice but three times, four times—the first was on a motion to instruct the Sergeant at Arms, but three times on the subject of the Zimmerman nomination for the NLRB, and we had to get up, leave the meeting, go over to the floor of the Senate, and cast a

vote, three votes on the question of an appointment to the National Labor Relations Board.

Now, that is a matter which is of intense interest to management and labor and it is a battle, and so many times the floor of the U.S. Senate, since I have been here, has been converted into a battleground between labor and management on subjects such as the Zimmerman nomination, the Lubbers nomination, you name it, and instead of being able to address our attention to the matter of the economic future of this country, we end up rushing over to the floor of the Senate to vote on this kind of subject.

How is a consensus formed? It seems to me that a consensus is formed by discussion, by raising the visibility of the subject, by getting the American people to talk about it. If there was ever a case for a national debate or national discussion on an issue of major importance, it should be in an election year, and yet what is going to be the major issue in the political campaign ahead? Something called Billygate.

Senator BRADLEY. Maybe.

Senator DANFORTH. Now, maybe I am wrong, and Mr. Samuel, maybe you would be the best person to answer this. It would seem to me that if representatives of business, of labor, of government were to get in one room for a few days, and the subject of discussion would be what can we do to regain our competitive position and to rebuild our industrial capacity, and create jobs for the American people and job security and a better standard of living for them, and we are going to talk about what we agree about, not what we disagree about, and when we come to points of disagreement we are just going to lay them aside, and we are going to try to figure out how far we can get in reaching a consensus.

I would imagine that the same thing would happen at that meeting as happened at the meeting at Harvard last April, jointly sponsored by this subcommittee of the Finance Committee, by Harvard University, and by the New York Stock Exchange, which was a broad consensus shared by business people, by labor people, by government people who were present, that we have to get the show on the road, and that getting the show on the road means that we are going to have to do more with respect to research and development, that we are going to have to do more with respect to new plant and equipment, that we have to take another look at extraterritorial enforcement of antitrust laws and the like.

And so my question to you is, do you have any suggestion for us as to how we can build a national consensus which includes business and labor and government, and how we can develop a format for determining wherein we agree?

And I would like you to kick it off, Mr. Samuel, if you would.

Mr. SAMUEL. Well, thank you for the honor, Senator. Your very eloquent remarks are very difficult to reply to. As we have built this country, one of the pillars of our strength has been something we have taken great pride in. That is the adversarial system, and nowhere has this I think been more productive than in labor-management relationships.

We, over the years, I think have produced the kind of industrial relations system in this country that we have, which is to a certain extent the wonder of the world and the envy of much of the world

because it has been based on an honest adversarial system. And to turn that around quickly or suddenly is, first of all, I don't think totally desirable, and secondly, going to be very difficult to do.

I don't think you are really suggesting that. Nevertheless, we are going to get mixed up with that, our feet are going to get mixed up a little bit in that, and I might suggest to you that meeting in April, which unfortunately I couldn't attend, but someone from my office did and came back and did not come back with quite the glowing report of consensus that you did. There were real differences that surfaced, and I think we have got to be sensitive to the fact that different elements in the community do regard our problems through different eyes, and certainly think that the remedies might differ between us.

I mentioned, I think while you were absent voting, the fact that one good sign, I felt, was the existence and the beginning development of the tripartite committee system. I mentioned that the Tripartite Steel Committee has been in existence for I think not quite 2 years, the Automobile Committee is about to get off the ground. There have been a couple of others which were in existence before that, although not well known, one in the construction industry, and the Coal Commission represented a tripartite approach to the problems of that particular industry.

And it seems to me that may be the beginnings of a system whereby retaining the best elements of the adversarial system, nevertheless we could bring the various parties together to look at our problems on a sectoral basis, which I think is important because I think it is on a sectoral basis that we will find answers which are useful and really answer the particular problems that we face.

Ambassador HORMATS. Just a couple of points. I think Howard Samuel put it very well. The tradition in this country differs considerably from that of Europe and Japan. We, as early as our Constitution, had a very clear line drawn between the government and the private sector. Europe and Japan really don't have a very clear line. As a result, there are frequent times in which the government and the private sector are almost interchangeable, act as one frequently. So it is hard to overcome certain of these distinctions.

I think there are two types of approaches which we might think about. One is the general problem of making people recognize that there is a problem, and I think this is where education begins. There is still a feeling in this country today that you can achieve all your objectives all at once, that you can spend a lot for a lot of different things and you will do it without getting a high rate of inflation. The government somehow or the economy somehow can deliver a whole multitude of objectives almost simultaneously.

We are beginning to realize now that we can't, we have got to prioritize, and our economy has not, and our system has not proved terribly adept at prioritizing. Energy, for instance, is a major priority, and yet we still have lots of programs in the environmental and other areas which compromise energy priority. I am not criticizing. I am simply saying it is very hard to set these priorities.

Similarly, anti-inflation objectives are very high priority, yet very frequently things are done which compromise that priority,

not that their motivations are evil, it is just simply that they are done because there are lots of other objectives that move people in different directions.

So we are not really good unless we are hit over the head with a problem, war or a major crisis, at setting the major priorities and developing programs which are focused in a laser type way on achieving those priorities.

So it seems to me, one, we need to articulate the problem of our economy more effectively and more broadly than we have been able to do, and this is a problem executive branch, legislature, business, labor, everyone has to work toward.

The second, I think, is to begin to look at particular sectors. Now, I am very cautious about this, but it seems to me that there have been interesting starts in the areas of steel and autos and shoes, some other issues. I am not as convinced that this is going to lead to major improvements, but it seems to me that there are industries which have particular problems in the financial, environmental, other regulatory areas, and there is some utility in getting business and labor and government together to look at those.

But I would say the major priority is to begin to articulate a set of objectives and goals which have the general consensus behind them and work on that basis because I think unless we do things such as get our energy house in order and get our rate of inflation down, improve investment and productivity, then a lot of other things we want to do in the long run in the area of improved human well being, environmental well being we simply won't have the resources to do. And I think that this committee in holding these hearings, following them up as it is going to, can really begin the effort to set those sorts of priorities.

Mr. BRANSON. Senator, just let me say that I think that when representatives of government, organized labor, and big business come out of that room, Ralph Nader should sue them immediately. You forgot to bring the consumers, the people, as it is, into the negotiations.

Senator DANFORTH. The people's interests and Ralph Nader are two different things, in my point of view, despite the fact that he is a son of old Nassau.

Mr. MALMGREN. We tried, Senator, with the 1974 Trade Act, the 1979 Trade Act with this committee to put together a consensus-building system in trade policy, and in fact, when I was in charge in the Executive of drafting the 1974 act, working in this committee, we spent a lot of time with the advisory committees which involved labor and industry and consumer interests and other people, and that advisory process I think probably had a good effect, together with working with the congressional staff. The Congress was able to deal with that legislation and the Geneva negotiations that wound up last year without an enormous amount of controversy, even though there were a lot of disputes about specific issues, as you were involved yourself.

But the overall thrust of the country was ascertainable through that advisory process. The way you were able to vote the 1979 Trade Act out with a very strong vote in a controversial area shows that you can make consensus in an area which is so heavily lobbied and so delicate as is trade policy.

Now we need to think more about how to do this in other areas so that we pull together as a Nation, and the sectoral approach that has been discussed is the right way to go about these troubled sectors. It isn't going to give us an answer for picking winners because that is an even tougher subject, What are the new industries? I think the market is going to have to do that.

But what we have not been doing, in recent years is focusing on how to build consensus. To me we have had too much of an adversary process and not enough of how we work together to get ourselves back up to speed and to take the lead once again. We need more teamwork. You can't play basketball by arguing all day about who is going to do which thing, and at this point we are going to lose a lot of games if we don't pull together.

So I think I agree with your sentiment, and we have devices, but they can be different types of devices. I will give you an example that goes back even further. The Labor-Management Textile Advisory Committee in the textile field. When that was used well, the Government was able to talk to both labor and management and get a reasonable trade policy while domestic restructuring was taking place at home. It has been sloppy some years and strong other years, but I worked with it for several years in the sixties and it was quite successful at times, and our textile industry did modernize itself.

Senator BRADLEY. Let me interrupt to say that we do want to hear from Professor Gilpin, and time is very short I want to thank all of you for giving us your time this afternoon, and particularly your written statements. I found them outstanding, as I have found Professor Gilpin's statements.

We are anxious to hear from him.

Again I want to thank the panel and ask Professor Gilpin if he could come up at this time.

You might summarize your statement about the two views of the world and then we can get to questions if you would like.

STATEMENT OF PROF. ROBERT G. GILPIN, JR., EISENHOWER PROFESSOR OF INTERNATIONAL AFFAIRS, WOODROW WILSON SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS, PRINCETON UNIVERSITY

Mr. GILPIN. I will pass over my statement. In my paper I made the point that while there was a general consensus that something was wrong with the world economy, there was a disagreement with respect to what had gone wrong, and that there were two basic views, what I call the conjunctural view and the structural view.

Senator DANFORTH. Could you speak a little louder, please?

Mr. GILPIN. The first position holds that we have made a lot of mistakes, and that things will get back to a normal growth path if we pursue the policies of the past.

The other position is that we have a structural problem of some kind. The panel this afternoon has reflected this view that a number of major changes have taken place in the world economy and the American economy's place in it, and that the old policies won't work. One point that was made was the fact that the position of the American economy has changed due to new competition and the rise of the so-called NIC's—underdeveloped countries which are

industrializing. Yet one must appreciate that the American economy is still the most powerful economy in the world and still has a lot of leverage which it can use.

The second major change is that the energy crisis has brought about some major shifts; for example, liquidity problems and the dependence of the United States for the first time, on the world economy. And yet the United States, with respect to its competitors, is a much more self-sufficient entity.

The third problem which has been emphasized, I think, certainly by Professor Branson, is that the world is now more uncertain. This greater uncertainty is due to inflation (what will it be?) due to the price of energy, (what will it be?) due to political instability around the world (what will be the next Iran?). This uncertainty has had a depressing effect on long-term investment and of course on long-term growth, and of course on long-term trade.

So the world is a much more uncertain world and we probably will never go back to the certain world that we had in the 1960's. And what do we do about it? What does the world look like? I would just like to make several points.

One is that I don't think we will go back to the relatively free trade of the 1960's, but I don't think we are going to go way back to the type of protectionism that we had in the 1930's. I think that we don't have to have one or the other. It is going to be much more of a negotiated system of trade shares and so forth. The French have a term for it, organized free trade. It is a lovely term, and I think it is probably going to be something of that nature rather than either the protectionism that some people fear or the free trade that some people would like to go back to.

I think the other thing I want to emphasize is that while the developing countries, or rather the industrialized developing countries, do present a challenge, they also present a new market. The Europeans and Japanese are much more sensitive than we appear to be to the markets that will be opening up in the so-called Third World. Certainly the Germans feel that their future growth prospects with respect to trade will be in those areas and have tied their foreign aid policies much more to their trade policies than we have.

Therefore, although there will be a problem of increasing competition, there also is the question of future markets. The United States shouldn't take the position it can no longer compete. Actually, the goods that we do have to trade, for example, capital goods, as Professor Branson pointed out, are precisely the goods that these countries need if they are going to industrialize.

The other question, I think, that arises is whether we want to create an American, Incorporated to compete against Japan, Incorporated. One senses that this is in the air today, that is, the issue of the role of government intervention in the economy. I think we would make a terrible mistake. I think we would end up creating a United Kingdom, Incorporated rather than a Japan, Incorporated. I think the free market, if it is allowed to operate, is much better at making capital allocations than government bureaucrats.

The government does have a role with respect to the basic research end of the spectrum. When you get over into the commercial sector, government, especially those so-called nationalized in-

dustries in other countries, have not been very good at making the right investment decisions in many cases. Sometime they have; sometimes they haven't.

For these reasons I don't think we ought to move very far into this U.S.A., Incorporated. If you look at Japan and West Germany and why they succeeded, I think they succeeded because they made heavy investments in skilled labor; they have made heavy investments in their own economy and very little foreign investment. They have relied upon the free market, and they also have had a peculiar relationship between industry, government, and banks in those countries. The basic investment decisions have been made much more by banks rather than by government and the government sector. Whether we can move in that direction, as I think Mr. Malmgren has suggested, I don't know, but maybe there are reasons to have new types of institutional structures in the United States.

But certainly I think we should be very careful about moving very far in the direction of having commercial decisions and capital allocation decisions made in Washington.

Another area I would like to stress which has not been stressed by the other members of the panel, and I stress it because it was one of the questions that was given to us by you—and I must say the questions are excellent. I am glad I do not have the opportunity to have to answer them—this is the whole question of economic sanctions.

I do think we have made a serious mistake using economic sanctions as a political weapon. I think that it has hurt us more than it has hurt other countries. It has of course hurt other countries, but I think it has also hurt us. The reason why it has hurt us is because at the same time we are trying to increase our trade we are giving the impression to other countries that we are an unreliable trading partner. This is forcing a number of countries to try to divert their trade from the United States because they do not want to be put in the position of being dependent upon an unreliable United States.

Mr. Malmgren has already made this point when he said that the freezing of Iranian assets by the U.S. Government was probably in the longer term detrimental to the American position.

I think, therefore, if we are going to be more successful in trade in the world, we have to decouple trade much more than we have from our foreign policy and must try to, be much more open to the fact that the United States must trade if it is to import energy and solve its other international problems.

Thank you.

Senator BRADLEY. Thank you very much, Professor Gilpin.

One of the things that intrigued me in your statement was you seem to think that the bedrock of improving our economic circumstance is increasing research and development expenditures.

Is that correct?

Mr. GILPIN. Yes; if you look at the raw figures, the United States has expended a great deal more in R. & D. than other countries. On the other hand, if you look at the way that has broken down we have been putting much more into atomic energy, space and the military relative to the expenditures, for example, of the West

Germans, who put much more in civilian-related industrial technology.

Fortunately there has been a comeback with respect to American R. & D. expenditures in this country, and I think this change will pay off in the long term.

One of the problems, though, at the present time is that given the uncertainty, industry is very reluctant to put funds into long term investments. So you are caught in a vicious cycle. How we get out of it will be a problem until the basic uncertainty caused by energy, inflation and so forth is resolved.

I would like to talk about this whole question of consensus. I have two views on the need for a consensus. If you look at the consensus that developed with respect to the foreign trade policy the United States at the end of the Second World War, it took a long time for that consensus to develop, that is, to move toward an open economy. The financial community, Wall Street, if you will, moved toward this view that we are part of the world economy and must have an open economy in the 1920's. But, then, in 1930 you had the Smoot-Hawley tariff and demands by labor and industry for protection. In the 1930's, you had the move of agriculture, symbolized by Cordell Hull, that the U.S. agricultural community had an interest in the world economy. Then, you had the move of industry toward free trade. And, then, at the end of the Second World War labor began to move in the same direction.

So the four major sectors of our economy—finance, agriculture, industry, and labor—joined behind the so-called Bretton Woods system of liberalized trade.

Now, lots of things have happened. Labor is departing from that consensus. Certain important sectors of industry are departing. Agriculture is still very strong behind free trade though they have their problems with the restrictions of the European common agricultural policy. The financial community is still very much behind free trade. And I think that you cannot forge a new consensus except through the type of debate that your committee is encouraging.

But I would make a last comment about consensus, especially when you bring up the problem, the point of view about the Japanese consensus. It was also a Japanese consensus that took them into war against the United States in 1941, and one of the reasons they did so was because dissent had been suppressed.

I think that the strength of the United States is the fact that we do have all these contending voices. But it does get frustrating, I appreciate, and it will take a long time to sort out what will be the new foreign economic policy of the United States in the future.

I think what I am trying to say is that consensus is good only if it is the right consensus.

Senator BRADLEY. Getting back to my question on research and development, there is an argument made that it is not just that we haven't had enough research and development, but that we haven't had enough process research and development in particular. We have had a lot of basic research and development, though that has declined somewhat in the 1970's. But presently it is not so much the decline in our basic research and development that hurts our

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productivity as it is the decline in our process research and development.

Do you have any ideas about how we could increase our process R. & D.?

Mr. GILPIN. Well, I think that we are talking about a spectrum of activities, which are basic research, done mainly in universities, through developmental research, through process research that you are talking about, through the whole question of actual commercialization of a product.

Government, I think, has a role, a very effective role in financing and supporting research and development as well as process research up to the point of commercialization. Now, as you go from one end of the spectrum to the other, from basic research to commercialization, you also are going from costs of $1 to $10 to $100 to $1,000 so that the basic end of the spectrum is relatively cheap. When you get over to the commercial end of the spectrum, it becomes very expensive.

One of the problems is that in many cases we are putting too much money into commercializing technology before we really have done enough of the basic research. I think it has been one of the real strengths of the United States that in the past we have tried to put more money into the basic and applied end before we went into the commercial side of the thing.

France would be an example of a country which poured a lot of money into commercial developments, most of which turned out to be duds. Great Britain did the same thing.

So that, yes, I would agree with you, government has a role in this type of basic, applied and process type research, but it should shy away from getting into the commercialization side. We are moving much more in that direction, of course, with the synfuel, and I think there are some dangers in that direction.

Senator BRADLEY. Did you read Mr. Malmgren's testimony?

Mr. GILPIN. That was not available to me.

Senator BRADLEY. Were you aware of the facts he gave us on the Eurocurrency market, the size of the market, commonly estimated at a net of $650 billion, including interbank transfers, but his source estimated it at a figure of $1.8 trillion.

Now, that size, whether it is the first or second figure, is troublesome for exchange rate policy, monetary policy, economic policy, and as someone pointed out in the panel, that moves us much more to a barter economy internationally.

Do you see that as—could that be not a disastrous direction in which to head?

Mr. GILPIN. There has been a lot of movement toward barter, especially with respect to energy. I am not sure the——

Senator BRADLEY. Do you see that as a positive direction or not?

Mr. GILPIN. Toward the barter economy? No, I think it would be a very dangerous movement to move in that direction.

Senator BRADLEY. And why?

Mr. GILPIN. Well, usually what is bartered is, in many cases, are armaments, and locking up markets for a long time. It is a movement toward a politicized world economy. I think what I am trying to argue, for example, with respect to the whole question of economic sanctions is that we should move away from a politicized

world economy. The reasons for the bartering, of course, have to do with the availability of hard currency to certain countries who are able to make certain deals with respect to military arms in return for oil, political influence, and that type of thing. Also, some of the oil producers, worrying about the value of the dollar and accumulating too many dollars prefer barter.

It is also associated with the whole question of too many dollars out there floating around and not pinned down.

Senator BRADLEY. Senator Danforth, do you want to ask any questions? I will come back.

Senator DANFORTH. Professor Gilpin, with respect to where investment decisions are made, I suppose there are various options, direct grants, for example, by Government, or direct subsidies of particular sectors of the market would be a very specific way of influencing investment decisions.

This committee, in addition to having jurisdiction over trade policy, also has jurisdiction over tax policy, and tax policy can or cannot be used to try to influence investment decisions. For example, this morning we had hearings on the question of should we have a tax cut, what kind of a tax cut for 1981, and there are various approaches to the corporate component of the tax cut. One approach is rate reductions, corporate rate reductions on the theory that corporate rate reductions are untargeted, apply equally to service oriented businesses as well as capital intensive businesses, and permit all kinds of business people to just simply make the decisions today with respect to what the future rate of return is going to be after taxes.

That approach this year is, I would say, very much a minority approach with respect to what kind of tax cut we are going to have. More people are talking about accelerated depreciation. Some are talking about increasing the investment credit. But those would be more general approaches to targeting a tax cut to capital-intensive businesses, in other words, skewing business decisions toward investment in new plant and equipment. The ultimate, of course, would be tax shelters where the Congress, in effect says to the private sector, you will receive a reward in the form of a tax break if you—and then fill in the blank, you know, build tugboats or apartment houses or whatever.

One of the things that we have been considering is a special tax credit for business spending on research and development, which is the way in which tax policy can be used to influence a certain kind of activity.

So I was wondering to what extent your comments on marketplace investment decisions apply to the tax work of this committee in fashioning some sort of tax cut for business.

Mr. GILPIN. I should preface what I have to say, Senator, by noting that I am not an economist. I do not have any real expertise in this area. I would make a comment, for what it is worth, and that is with respect to this whole question of making, as I understand the question, specific tax cuts for particular purposes such as increasing R. &. D, versus more general tax cuts, My impression from what I have read is that a tax cut to encourage, for example, greater investment in R. &. D, is not a very good route to that objective because business is not making investment in R. &. D for

market reasons or for long term questions of uncertainty. The other problem is how do you police such a decision. I know other countries such as the French and the British and some other countries which have tried to do this have suddenly discovered that the definition of R. &. D has expanded out into a great number of areas where it never existed before in terms of company accounting. So it becomes very difficult to earmark, I think, taxes for such a purpose.

I think if there is a reason for a tax cut, it should be general reasons rather than to try to encourage industry to invest in R. &. D. Industry will invest in R. &. D if it feels that there will be a payoff of some kind. The tax cut is a necessary condition, if you will, but it is not a sufficient condition to bring that about. That really is a layman's judgment.

Senator DANFORTH. And how about the more general question, though, of conditioning a tax cut on a business decision to build a new plant or to invest in new equipment, that is, depreciation as opposed to a rate cut?

Mr. GILPIN. Again, I really think I will have to pass on that, Senator. I just don't have the technical knowledge.

Senator DANFORTH. Let me just ask you, if you could, to elaborte on the comment which you made rather quickly—it may be in more depth in your statement. I haven't had a chance to read it yet—but that economic sanctions don't work. We have tried them a couple of times very recently, once with respect to Iran, once as a response to the Soviet invasion of Afghanistan.

Your view is that this is counterproductive, doesn't work and tends to interrupt American markets.

Mr. GILPIN. They do not work in the sense that they do not achieve their purpose. They certainly impose costs. They impose costs both on the target states, the Soviet Union and Iran; they impose costs on the United States. But they do not achieve the objective of getting the Soviet Union to move out of Afghanistan, they have not achieved the objective of getting the hostages released.

The tendency is for economic sanctions to produce in the sanctioned country a rally around the flag syndrome. The Soviet Government can use the sanctions to strengthen their position with respect to their own people. Khomeini has done the same thing in Iran. There have been a number of other cases where we have used economic sanctions over the years.

You can only impose economic sanctions if you have some sort of market monopoly position. We do not have that anymore. We do not have it in agriculture; we don't have it in any area of technology, really. We certainly can hurt.

There are reasons, for particular strategic embargoes. For example, you may not want to sell the Soviet Union a particular computer which will enhance their strategic capabilities. But it is a different question to try to have a general embargo in order to change the policy of a foreign country.

A colleague and I did a long study of this subject about 18 months ago and looked at all past cases of economic sanctions, against Mussolini in 1936, against the Japanese in 1941, even going back to the first economic sanctions of the United States against

the British in the War of 1812. The history of sanctions shows that they don't work, that they are counterproductive and that other measures are to be preferred in international politics.

I always try to make the point that for the United States, which is trying to reestablish itself as a world trading country, it is especially damning. A number of countries have sought to diversify their trade away from the United States because they do not want to be caught in the position of being dependent upon a capricious American foreign policy. This is the point I brought it up in the context of American trade policy.

Senator DANFORTH. Now, there are other reasons for denying sales, for example, with respect to nuclear powerplants, or nuclear fuels.

Mr. GILPIN. For strategic reasons, yes.

Senator DANFORTH. Is that a different issue?

Mr. GILPIN. I think it is quite different, yes.

Senator DANFORTH. The argument that can be made on the other side is well, if they don't get it from us, they get it from somebody else.

Mr. GILPIN. That is frequently made, and sometimes it is the case. But to say that economic sanctions don't work is not to argue that one should sell a hydrogen bomb to Qaddafi. There are cases where you would want to have strategic embargoes ranging from weapons to the capacity to produce a particular type of weapon. That would have to be on a case-by-case basis, but I am talking about general embargoes to achieve political goals which is the case in the recent policies of the United States.

Senator BRADLEY. Professor Gilpin, applying your analysis of, say, the past 50 years, to events today and considering the thought that the 1980's will be the decade not of nuclear war but of investment wars, what factors are pushing countries into investment wars or economic wars, wars that result in a net loss for all parties?

In a world as interdependent as today, how can any country engage in protective policies, thinking that they would benefit?

Mr. GILPIN. Well, they might benefit in the short term. I think in the long term they will not benefit.

There will indeed be these problems of investment wars, if you want to call it that, but I think it is really much too strong a term. I don't see us moving into that sort of world of economic conflict, whether it is straight conflict or investment conflict. There are possible sequences one could imagine, for example, with respect to demands for energy, the population explosion, and so forth, but I don't subscribe to the view of a recent author who said that we are moving out of geopolitics into ecopolitics and that the economic struggle among nations will determine their fate. I don't think we have moved out of the era when the basic fate of nations is determined much more by military power and the political factors rather than how well one does in trade and investment. They are very important, but I don't think we have somehow moved into a different world than it has been in the past.

What has happened is that we as a country have become much more dependent upon the world's trading system. We Americans have discovered the world economy. Other nations knew it was

there a long time ago because they had to trade to import. For the first time we have to trade to import, and that is one of the great changes. We have become functionally a much more open economy, even though the foreign sector is down to around 7 to 10 percent of our economy. But we have to import energy and other raw materials or suffer a major decline in our standard of living. I don't think our survival is at stake.

Senator BRADLEY. I know you have argued that we should keep government and business separate, we should let the economic sector make its own investment judgments and not cloud it with government intervention. But the fact of the matter is that the decade of the 1980's is going to be one of much greater government cooperation with and involvement in, business, not just in government-to-government energy barter deals, and not just in deals with Eastern European countries, but also through joint business-government ventures in the Third World and in OECD countries, through multi-party financing and investment arrangements sponsored by international financial institutions, such as the cofinancing program of the World Bank or the investment ventures of its International Financial Corporation. How do you determine, and assess, the political risk in such joint business-government ventures?

For example, we now find ourselves having extended to the Soviet Union close to $25 or $30 billion in loans and, close to $90 billion in loans to Eastern Europe. A default on those loans could pose a serious threat to the national security of this country.

How do we begin to place these political risk considerations into an analytical framework?

Mr. GILPIN. Well, I agree with you entirely. One of the consequences of the relative decline of American power is that we are no longer in the position that we were in the late 1950's and 1960's to set the rules of the game. We have moved into much more of a politicized international economy, the role of the State in the domestic economy, barter, all these things. To say that risk has increased is another way to say what the earlier speakers talked about, that is, the increased problem of uncertainty.

The whole question of risk assessment, as you probably know, has now become a growth industry among the American consulting firms, with all sort of elaborate mathematical models to try to determine whether or not a particular country is risky.

Of course, in economics the way one handles risk is through diversification, so-called portfolio management, and so forth, and I presume that this is what one has to do in the economic sphere as well—to not put all your eggs in one industry and all your investments in one country; there is an effort to try to diversify.

Senator BRADLEY. What does that mean for the value of the dollar?

Mr. GILPIN. It will probably mean that the value of the dollar will go down because other countries will be moving into deutschmark, Swiss francs, et cetera. They are diversifying because—and this is one of the changes in the world—because the dollar has become uncertain. It is no longer as good as gold as it was a few years ago, and it is again one of the major factors in the more uncertain world that we live in.

Senator BRADLEY. Senator Danforth, do you have anything else?

All right, thank you very much, Professor Gilpin.

[The prepared statement of Mr. Gilpin follows:]

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The Crisis of the World Political Economy: Contrasting American Perspectives

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April 15, 1971 marked the end of the post-war era of international economic relations. On that date President Richard Nixon, responding to the first American trade deficit since 1893 and accelerating speculative attacks on the dollar, announced a new foreign economic policy for the United States. In imposing a surcharge on American imports and suspending the convertability of the dollar, in addition to other remedial actions, the American President dramatically altered the set of relationships and understandings that had characterized the world economy since the establishment of the Bretton Woods system at the close of the Second World War. More importantly, President Nixon's action initiated a process which continues to challenge the free-market economies: the reestablishment of a set of effective, cooperative arrangements in the face of a changing political, social, and economic context on both the domestic and international levels. In particular, the problem posed is how the OECD countries, individually and in cooperation with one another as well as with non-OECD countries, can achieve a satisfactory level of economic growth, full unemployment, and stable prices.

Although there is widespread agreement that the world political economy is in a state of crisis, there is no general consensus regarding the nature of this crisis. One in fact encounters a broad spectrum of intelligent and informed opinion. It is possible, however, to group Americans concerned with these matters into two broad schools of thought, though few individuals are exclusively attached to one or another of these perspectives on the nature of the changes taking place within and among OECD countries.

The first school of thought may be called the conjunctural perspective in that individuals associated with this position tend to believe that contemporary problems of slow economic growth, unemployment, and inflation are due to a unique conjuncture of fortuitous circumstances; these individuals do not believe that any fundamental and long-term changes in the world economy have taken place. As such, this school of thought believes current difficulties can be surmounted by relatively moderate policy adjustments. The second or structural position, on the other hand, believes that a number of significant changes have taken place due to long-term secular trends and shifts in fundamental relationships in both the economic and political spheres. As a consequence this school of thought believes that rather far-reaching policy adjustments are called for if our present difficulties are to be resolved. Prior to an examination of these two positions - where they differ and where they agree - let us first recall the essential features and foundations of

the international economy prior to August 15, 1971.

The World Economy Prior to August 15, 1971

At the end of the Second World War, the world economy was reestablished on the basis of the so-called Bretton Woods system. The principal features of this system were the following: (1) a commitment to the liberalization of trade, embodied in the General Agreements on Trade and Tariffs (GATT); (2) freedom of capital movements; and (3) an international monetary system based on fixed exchange rates, the convertibility of all currencies into gold, and the pivatol role of the dollar as principal reserve and transaction currency. While there were deviations from this liberal, multilateral system, principally the creation of the European Economic Community, the international political economy prior to August 1971 had been evolving in the direction of non-discrimination and ever greater flows of goods and capital.

In retrospect, the system was remarkably successful. It facilitated the rapid recovery of the economies which had been destroyed and distorted by the Second World War. International trade especially in manufactured goods among the advanced economies expanded at a more rapid rate than GNP. Along with trade and the system of fixed exchange rates, foreign investment by multinational corporations created a highly interdependent world economy. The rate of economic growth for most advanced countries was unprecedented. Not since the last decades of the nineteenth century had the world enjoyed such a period of rapid and sustained growth and prosperity.

The foundations of this highly successful economic system were provided by a set of understandings and relationships, some of which were explicit and others of which were only implicit. It is only now in retrospect that the importance of these economic, technological, and political factors which facilitated the operation of the Bretton Woods system have become appreciated. The crisis of the system is due essentially to the fact these foundations have become heavily eroded over the past decade or so. For this reason several of the more important reasons for the success of the Bretton Woods system merit attention.

In the first place, the United States had the capacity and will to undertake the leadership role in fashioning a liberal and open world economy. As the distinguished French economist, Francois Perroux, has argued the world economy has evolved through a succession of leading or dominant economies such as The Netherlands in the early modern period and Great Britain in the nineteenth century. Since 1945 the United States has played this role; its economy was the principal engine of growth, the major provider of foreign investment capital, and the supplier of the world's currency.

The reasons why the United States undertook these leadership responsibilities were four-fold. First, American political leadership at the end of the Second World War was convinced that the war itself had been the consequence of the nationalistic and protectionist economic policies of the 1930s; it was therefore imperative if peace were to be preserved to create an open

world economy. Second, the major economic groupings in the United States - finance. industry, agriculture, and labor - had come to realize that their interests lay with free trade. The financial, industrial, and technological superiority of the American economy encouraged Americans to believe they could outcompete other economies in an open system. And, third, the rebuilding of the war devastated European and Japanese economies as well as their integration into a system of liberalized trade seemed imperative if Soviet-backed communism were to be defeated.

The second major factor underlying the success of the world political economy was the political and military alliances composed of Japan, Western Europe, and the United States. These anti-Soviet and subsequently anti-Chinese alliances facilitated economic cooperation. In this connection, one aspect was of critical importance. Largely for political reasons America's European and Japanese allies accepted the American role as the world's banker and the dollar as the principal currency. This situation had two important consequences. First, the United States could not devalue the dollar in order to improve its international competitiveness and trade balance. Second, the United States was largely freed from balance of payments constraints in the conduct of its foreign policies and therefore - in the opinion of such critics as Charles de Gaulle of France - could freely print dollars to buy foreign corporations, import goods, and finance the Vietnam War.

A third factor underlying the rapid rate of economic growth and economic success was a set of highly favorable terms of trade for the advanced economies, especially with respect to petroleum. A significant aspect of this favorable situation from the point of view of developed economies was that America - and to a lesser extent European-multinational corporations generally controlled the production, transportation, refining, and, marketing of petroleum and other raw materials. While this was a lucrative business, it also meant that these multinational corporations were able to guarantee security of supply and, at least in the case of petroleum, lower prices than otherwise might have been the case.

A fourth factor underlying rapid economic growth and international economic cooperation was the complementarily of the major OECD economies and of their foreign economic policies. For its part, while the United States exported agricultural products and high-technology goods, American corporations tended to follow a foreign investment rather than an export strategy. Due in large measure to an overvalued dollar, foreign assets were relatively inexpensive and therefore goods produced in foreign subsidiaries of American multinational corporations were more price competitive than goods produced in the United States for export. The European and Japanese economies, on the other hand, had undervalued currencies and therefore tended to follow an export strategy. Moreover, at least until relatively recently, they did not compete with the United States in high technology areas such as computers, aviation, and electronics. The con-

trasting strategies and a complementary division of labor, despite occasional frictions, facilitated the growth of international economic interdependence.

In particular, this complementarily and the international role of the dollar meant that the United States could pursue economic expansionary policies, drawing in imports, and thereby performing the role of the engine of growth for the rest of the world economy. This outflow of dollars provided the world with sufficient liquidity to finance trade and investment. Though the United States after 1959 had a chronic balance of payments deficit, other countries acquiesced because it enabled them to rebuild their monetary reserves and pursue export-led growth policies. The system was dependent, however, upon confidence in the value of the dollar and the underlying strength of the American economy. In recent years these favorable foundations of international economic cooperation have been battered by numerous political and economic events. Whether these foundations have been irreparably damaged and are threatened with destruction brings one to the debate between the conjunctural and structuralist positions. For this reason, we will discuss each position in turn and, then, suggest that at least in the United States there are several major points on which the two schools of thought appear to be in agreement.

The Conjunctural Position

According to this position, the world economy has been buffeted over the past half decade by a series of exogenous

shocks and ill-conceived policy decisions. These circumstantial and hopefully non-repeatable events include the following: the economic distortions and inflation caused by the Vietnam War; the several-fold increase in the price of petroleum; the sale of massive amounts of wheat to the Soviet Union and other changes in the world food economy; mismanagement of macro-economic policy; increasing synchronization of the business/political cycles in the major OECD countries; and the devaluation of the dollar and attendant realignment of exchange rates. These developments, it is argued, caused a major disequilibrium in the world economy and constituted the major cause of the phenomenon of "stagflation" - the combination of high levels of inflation and unemployment.

The proponents of this position tend to believe that this temporary disequilibrium can be resolved and the OECD economies can return to a normal growth path with full employment and price stability through orthodox instruments of macro-economic policy. Though they may differ on the relative mix of fiscal or monetary policy, they do not believe "conventional" economic theory and policy instruments have been undermined by recent developments. Mainly what is required is time to dampen down inflationary pressures and to adjust to one-time major economic shifts such as the change in the relative price of petroleum and the realignment of exchange rates. Within this broad consensus of faith regarding the efficacy of traditional policy instruments, however, there are those who stress the obstacles to rational policy-making wrought by contemporary social and political developments. These obstacles constitute the following:

(1) The first major change is due to the fact that recent developments have created an inflationary mentality or atmosphere. Inflationary expectations have become a built-in feature of almost every free market economy and by virtue of this fact have become a source of inflation generation. As business, labor unions, and other groups seek to anticipate and counter the future effects of inflation through price and wage increases, they contribute to inflationary pressure. This new atmosphere of inflationary expectations has unleashed a spiral of wage and price rises as unions and management anticipate and seek to compensate for future rises in wages or prices. As a consequence "fine tuning" of the economy has become more difficult. For this reason, the major task of economic policy must be to neutralize this inflationary psychology and break the vicious cycle of wage and price increases. Policies advocated include a restrained but gradual increase in demand; the exercise of monetary restraint; the imposition of wage and price controls; the negotiation of a "social contract"; etc.

(2) A second and related view is that economic adjustments and the return to equilibrium have been made more difficult due to the fact that in every free-market economy there is an increasing concentration of economic power. The free play of market forces is increasingly being displaced by large corporations and labor unions able to resist deflationary forces. Prices and wages have become "sticky" downward. Despite recent high rates of unemployed plant and labor, for example, prices and real wages did not fall, at least in a number of economies.

Thus, each reflation of the economy following a recession takes place at an already inflated wage-price level. This in turn has altered the trade-off between inflation and unemployment; in order to reduce the level of unemployment one must anticipate a higher level of inflation than in the past. What is required, therefore, is greater exercise of restraint by these new centers of economic power if the common good is to be achieved.

(3) Another inflationary factor is the combination of rising social expectations and declining industrial productivity. In most every free-market economy several decades of rapid economic growth and increasing affluence have raised the economic expectations of society in general and of the labor force in particular. People demand an even higher standard of living, better social welfare, a cleaner environment, and greater leisure. At the same time, evidence mounts that in a number of economies, certainly the United States for example, the rate of growth of productivity has declined. The gap between these rising demands and a decreasing capacity to finance them has become a major source of inflation, a slower rate of economic growth, and a decreasing international competitiveness. Society must realize, it is argued, that there are limits to what the economy can provide and that these limits are set by the productivity of the economy.

(4) Another change of concern to many advocates of the conjunctural position is that "temporary" shortages may restrict growth and employment as well as create inflationary pressures. The conspicuous example is of course energy. In this case,

"temporary" may mean decades until new sources of energy are realized. (For this reason, the significance of the "energy revolution" will be treated in the following section on the structural perspective.) But in the areas of food, raw materials, housing, and services, government is believed to have a responsibility to change regulations and eliminate bottlenecks which restrict supplies. In brief, the traditional emphasis of economists and governments on the demand side of the economic equation must be supplemented by a greater concern with the supply side.

(5) Perhaps the most significant change stressed by many adherents of the conjunctural position (and, as shall be shown, structuralists as well) is a decline in the supply of capital and of capital formation. A number of reasons are given for the concern that capital availability will restrict future growth and employment: (a) In all the OECD countries, there has taken place a decline of profits; (b) in certain OECD countries, the rate of savings is inadequate relative to perceived investment needs; (c) the rise of real wages, the increased tax burden, and the threat of inflation have decreased the incentive to invest. Whatever the cause, a potential capital shortage is perceived as a major issue of public policy which if not resolved will have disastrous long-term effects on growth, employment, and inflation.

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(6) Finally, although their diagnosis and remedy are more fundamental than most conjuncturalists, one should include within this camp, the monetarists led by the University of Chicago's Milton Friedman. This group which enjoys wide support in business and conservative Republican circles argues that excessive taxation, government intervention in the economy, and creation of money have stiffled private initiative, have eliminated profits necessary for productive investment, and have caused run-away inflation. This situation in turn is held to be responsible for the plight of the dollar and the strains in the world economy. The solution, therefore, is a return to reliance upon the market, a massive reduction in taxes, and severe restraints on the creation of money. At the moment this counter-revolution against the welfare state and keynesianism is spurred on by a growing tax-payers' revolt which began in California with the passage of Proposition Thirteen.

In summary, the conjunctural position believes that present difficulties can be transcended if businesses, labor unions, and governments exercise restraint with respect to their demands on the economic system. Past excesses and irresponsibility have produced a set of inflationary expectations which inhibit the smooth functioning of the Western market economies. In time, with fiscal and monetary responsibility, these economies can adjust to the impacts of the energy and related shocks and return once again to an equilibrium growth path with high levels of employment and stable prices.

The Structural Position

In contrast to the relatively benign view of the conjunctural position regarding the present economic situation, the structural view believes a number of fundamental changes have taken place and that more drastic policy responses are required. While there is no unanimity with respect to the nature of these changes, the advocates of this position stress one or another of several long-term secular trends or developments which have transformed the socio-economic and political environment in which economic policy decisions must be made.

Among the significant developments stressed by this school of thought are the following:

(1) The most significant determinant of this changing socio-economic and political context is said to be the altered position of the United States in the world economy. Since the end of the Second World War, the world economy has been largely American centered; the American market was the most dynamic and the American dollar became the key international currency. American economic leadership, supported by Western Europe and Japan, led the way in creating, after decades of depression and war, a relatively open international economy. Trade, capital, and monetary flows were unprecedented, producing a highly interdependent set of relationships among the advanced free-market economies.

Although the United States continues to be the most powerful economy in the world, an important shift is believed nevertheless

to have taken place in the distribution of economic and industrial power among the United States, Western Europe, and Japan. In part, what has happened of course is that Western Europe and Japan have regained the economic and industrial position they lost due to the destruction and distortions of the Second World War. But what has also happened, according to this position, is the relative decline in the economic and industrial preeminence of the United States. Thus, whereas a few years the United States alone was regarded as the "engine" of the world economy, the locomotive role is now increasingly believed to be beyond the United States alone and must be shared by certain other OECD countries as well.

While the meaning and significance of this transformation of the position of the United States are a matter of debate and controversy, certain of the consequences appear already evident to the structuralists. First, America's fluctuating trade and balance of payments have stimulated powerful protectionist sentiments in the United States, particularly on the part of organized labor. Second, the international monetary system has been changed from one based on fixed exchange rates to one of more or less flexible exchange rates raising the specter of competitive exchange rate policies. And, third, as the American economy appears less able by itself to be the motor of the international economy, there is a consequent need for greater coordinated leadership and economic management on the part of the OECD countries.

(2) A second, and related set of developments, relate to structural changes in the OECD economies and in the world economy as a whole. What is meant by "structural" problems differs of course for various observers. For some it refers to the fact that various OECD countries have a different set of priorities regarding the trade-off between employment and inflation due to contrasting historical experiences and domestic economic systems. For others, it refers to the difficulties posed by the existing composition of exports and imports among OECD economies. For still others, we have entered a post-Keynesian era where traditional methods of fiscal and monetary policy and demand management will no longer prove effective. In particular, this latter school of thought has reviewed, in one form or another, the "stagnation" thesis which has historically haunted free-market economies.

A common theme of "structuralists" is that the economies of the OECD countries and certain other developing economies as well have become increasingly similar with respect to industrial sectors and the composition of exports. This belief is coupled with the perception that the Western European, Japanese, and certain lesser developed economies (Taiwan, South Korea, Brazil, etc.) can now engage in import substitution or the export of goods which were once available only from the leading industrial countries. At the same time, American industry is said to have failed to develop sufficiently new products for home and foreign markets to take the place of goods other countries can now produce for themselves or can

produce more cheaply for export. Thus, in a number of industrial sectors--steel, petrochemicals, automobiles, textiles, electronics, shipbuilding, etc.--there is said to exist a world-wide over capacity. For this reason there is said to exist a need for cartel-like market sharing arrangements, or what the French call "organized free trade."

(3) A third transformation stressed by the structural position is the energy revolution which occurred during the winter of 1973. In brief, this transformation of the energy situation is believed to involve three major but related developments. The first was the transfer of effective control over the supply and pricing of world petroleum from American and other multinational oil companies to the producing countries themselves represented by the Organization of Petroleum Exporting Countries (OPEC). The second was a several-fold increase in the cost of petroleum. And, the third was the fact that the United States for the first time in its history became dependent upon foreign suppliers for a vital resource; it was this latter situation which in fact made the first two developments possible.

While certain of the economic and political consequences of this dramatic change with respect to energy supplies and pricing have already been made manifest, the most significant effects it is believed will be long-term and will be felt over the next several decades. These immediate and longer-term consequences include the following:

(A) The most dramatic and immediate effect of the energy revolution was of course the price increase itself and its in-

flationary impact. While a price change of such a magnitude is undoubtedly a one-time effect, it will take many years for its longer-term consequences to work their way throught the world economy. Moreover, the possibility of future erratic changes in the supply and price of energy (or other raw materials) has endowed economic affairs with a new and high degree of uncertainty. This uncertainty itself undermines business confidenco and thus is held to inhibit long-term investment decisions.

(b) The most significant political consequence of the energy revolution is said to be its impact on national security. Until new sources of energy are developed, the economies of the OECD countries will become increasingly dependent upon Persian Gulf petroleum, a source which at best can only be described as highly vulnerable. In particular, this new sense of dependence and insecurity has set in train major changes in economic and foreign policy, changes whose long-term effects are yet to be perceived. All of the OECD economies in cooperation with one another and singularly are undertaking measures to insure security of supply and reduce this vulnerability to a sudden cut-off of energy supplies.

(C) The third set of effects relate to the international trading and monetary ststem. In the first place, the terms of trade have been radically transformed for all importers of petroleum, producing in its wake massive trade and financial inbalances especially for most lesser developed countries and the United States. In the case of the United States, this shift

in the terms of trade has been accentuated by accelerating imports of petroleum and the simultaneous decline of income from overseas petroleum investments. For lesser developed and certain OECD countries, the consequence has been increasing indebtedness to international private bankers; this in turn has raised the specter of major defaults on the part of numerous borrowing countries.

(D) A fourth consequence of the energy revolution is its impact on domestic economies and future economic growth. The industrial plant of all the OECD countries was built on the basis of a particular set of relative factor prices, i.e., the relative cost of labor, capital, and resources (energy). By one fell swoop, these factor prices were drastically changed and much of the industrial plant was made in effect obsolete. The replacement of this existing plant in accordance with the new set of factor prices has become a necessity, and will be a retardant of economic growth. What the other consequences of this shift in factor prices will be has become a matter of intense controversy among structuralists. Whether or not it will cause a shortage of capital or induce business to shift to more labor-intensive production techniques will have important consequences for both national and international economies.

(E) The fact that Saudi Arabia, Kuwait, and other Gulf petroleum exporters have been unable to spend their immense and sudden riches is believed to have had a major impact on the world economy and especially on the international monetary system.

As described by the American Assistant Secretary of State Richard Cooper (though himself not a structuralist), the price rise of petroleum has functioned as a massive excise tax which has depressed OECD economies. At the same time, it has produced a spectacular increase in world liquidity which is in the hands of the private banking sector. In combination with the growing reliance of many countries on private banks to finance their petroleum imports, this liquidity has transformed the nature and function of the international monetary system in significant ways.

(F) In the longer-term one of the most important aspects of the energy revolution stressed by structuralists is that it entails a massive redistribution of world wealth, undoubtedly the greatest transfer of wealth in world history over such a relatively short time-span. Thus far, this transfer of wealth has been principally monetary in nature. In time, however, it will mean a transfer of real wealth from developed and non-oil producing less developed countries to the OPEC economies as these economies exchange their monetary balances for imports. This in turn of course will mean a lower standard of living for oil-deficit countries than what it would have been in the absence of the price increase. Moreover, it is feared there will be intense export competition among OECD countries with respect to these markets in order to reduce trade and balance of payments deficits.

(G) And, finally, the significance of the energy revolution is feared to be its demonstration effect on other resource-

exporting economies. In response to the success of OPEC, the copper, uranium, bauxite, wheat, and other resource-exporters have come to ask themselves: "If the oil exporters can do it, why can't we?" And, while it is difficult to conceive of a cartel in these other resources which could duplicate the OPEC achievements, there can be no doubt resource producers will increasingly seek to increase their prices through cartel-like arrangements. Such demands for better terms of trade are an important component of the demand of lesser developed economies for a new international economic order.

(4) A fourth change emphasized by the structural position is the increasing role of the state in the economy and, as a consequence, the growth of inter-state economic competition. The reasons for this greater government participation in the private sphere are several: (1) the challenges posed by the energy revolution; (2) the increasing cost of technology, especially so-called "high" technology; (3) the concern over "stagflation" itself; and (4) new sets of social demands in areas of social welfare and environment which necessitate greater government intervention in the economy. This change in the role of the government not only has numerous economic consequences but it tends to "politicize" international economic relations. The tendency is for the free market to give way to inter-state negotiations regarding such matters as "orderly marketing agreements" and market shares for domestic industry. While some structuralists welcome these developments, others fear their

long-term consequences for the OECD countries and the world economy as a whole.

(5) The fifth change in the socio-economic context stressed by numerous members of the structural school is the belief that inflation has become an inherent feature in the OECD economies, at least for the immediate future. In addition to a steadily increasing cost of energy, several other recent inflationary trends are emphasized: an enhanced capacity of workers to increase real wages faster than increases in productivity; the increasing concentration of industry and the substitution of "administered" for market-determined prices; rising expectations with respect to social welfare, housing, medical care, and environment; and a leveling off of increases in industrial and agricultural productivity. Such inflationary pressures, it is feared, cannot be kept in check by the traditional techniques advocated by the proponents of the conjunctural position.

(6) The structuralists, or at least some of them, argue that the factors and assumptions that underlay America's commitment to liberalized trade have been greatly eroded. In the first place, the American industrial, technological, and financial superiority upon which this commitment rested has been weakened and in certain important areas actually eliminated. Second, the domestic political alliance behind America's free trade policy has also been weakened. Large elements of organized labor and business are now actively opposed to free trade. And, thirdly, the assumption that a strengthened Europe and Japan would make a

greater contribution to the anti-Soviet alliance is now questioned. Many now believe an economically strong Europe and Japan have made it more difficult and costly for the United States to compete politically and militarily against the Soviet Union; also, the fact that China is no longer considered to be an enemy is leading to a reassessment of policies fashioned in an earlier era. All of these political and economic changes encourage the forces of protectionism in the American economy.

(7) Finally, among the structuralists one should mention the Marxists, democratic socialists, and a desparate group of economists of varying ideological persuasion who have revived the long-wave theory of N. D. Kondratieff. For the Marxists and democratic socialists, the problems of stagflation and the sick dollar reflect underlying constraints and contradictions of the capitalist system. Curiously the Marxists and the conservatives among the conjuncturalists make much the same diagnosis. In Marxist terminology, the problem is seen as a conflict between the needs of capital accumulation and the nature of the modern democratic, welfare state. But whereas the Marxists and the social democrats see a need for greater government planning and intervention in the economy, the conservatives want less economic democracy and a rollback of the welfare state.

The neo-Kondratieffians are an extremely interesting development and are beginning to obtain a hearing, even within the fraternity of the orthodox economic profession. Kondratieff, you will recall, was a Soviet scholar who wrote in the 1920s

that capitalism was subject to long-swings (fifty to seventy years) of rising and falling prices. Contrary to the Marxist theory of ever deepening capitalistic crisis and increasing severe contradictions, Kondratieff sought to show that capitalism was characterized by a long-term equilibrium. Hence, the displacment of capitalism by socialism was not inevitable. For this apostasy, Stalin exiled him to Siberia where he died.

The neo-Kondratieffians argue that the advanced capitalist economies, after having enjoyed an unprecedented era of favorable terms of trade and a decline in real prices, have entered upon a steep inflationary upswing. Though there are differences among them, the major reasons given for this economic reversal are the increasing cost of energy, rising world food costs, and the demand of labor for inflationary increases in monetary wages. For some, in particular W.W. Rostow (The World Economy; Getting From Here to There); Why The Poor get Richer and the Rich Slow Down) these fundamental changes provide new areas of investment opportunity and economic expansionism; others such as W. Arther Lewis (Growth and Fluctuation 1870-1913) and Robert Heilbroner (Beyond Boom and Crash) are more pessimistic regarding a solution. The latter two fear that constraints will greatly retard economic growth, a decrease of unemployment, and the expansion of world trade.

Apparent Points of Agreement

Thus far, this paper has considered the points of divergence

between the conjunctural and structural schools of thought; with respect to certain issues, particularly energy, the differences are more a matter of emphasis or attitude rather than differences on the facts of the matter. In addition to these points of contrasting interpretations of contemporary developments, there appear to be a number of significant points of agreement, or at least, the disagreements are less fundamental and appear to be breachable. Among the more important convergences of view are the following:

(1) Many adherents of both the conjunctural and structural positions believe that economic growth will be less rapid in the future than it has been during the last several decades. The various reasons given include the increased cost of energy, fear of inflation, the decline of profit margins relative to national income, the uncertain business climate, a general decrease in the rate of productivity growth, etc. The "mature" industrial countries have exhausted their pools of low paid labor. Some believe that the backlog of innovations which fired European and Japanese growth has largely disappeared. In Europe and America consumer demand has shifted from manufacturers to services which have a lower rate of productivity growth. And, for more speculative, no major growth industries of a Schunpeterian-type appear on the horizon.

All these reasons cited by students of growth such as W. Arther Lewis and others suggest to many conjuncturalists and structuralists important political and economic challenge. While most feel that the OECD countries have the necessary policy

instruments to forestall a collapse in demand and a repeat of the Great Depression an era of lower economic growth would have serious domestic and international consequences. At the domestic level a decreased role of economic growth will mean either a higher level of unemployment or a decline in the general standard of living. In either case the politics of plenty and growth will become converted into the more divisive politics of scarcity and distribution.

In the international sphere, decreased economic growth will mean a leveling off of the growth of trade and economic interdependence. Here much will depend upon the future direction of the European Economic Community and its degree of openness. In any event, a general decline in the growth rate will make it increasingly difficult to resist demands for protection against foreign goods and to accommodate the desires of lesser developed economies for a greater share of world markets.

(2) A second shared concern--one intimately related to the first--is the long-term adequacy of economic investment and the consequent need for greater government concern with capital formation. There is no general consensus, however, regarding the reasons for this situation. For some, the crux of the problem is the prevailing climate of economic and political uncertainty and increased level of risk; they do not believe this inherently more risky business climate can be ameliorated and as a result investors will emphasize low risk, short-term investments. For others, and particularly for some countries, there is believed to be

a shortage of capital due to inadequate savings. And still others emphasize the lack of investment prospects at sufficiently attractive rates of return; levels of taxation, government regulations, and social welfare problems are said to have created an unattractive environment for investors. Whatever the alleged situation, a decline in long-term investment is held to be a threat to adequate levels of economic growth and employment among many, if not all, OECD countries. These developments in turn will slow down the growth of international trade.

(3) In addition to these economic changes, proponents of both positions believe a number of sociological and political changes have created a new context for decision-making. Some individuals, for example, sense a loss of risk-taking and a pervasive quest for certainty which will be detrimental to entrepreneurship and innovation. Others believe there is a decline in the work ethic and the sense of public responsibility. Still others emphasize the increasing ungovernability of democratic societies and the rise of minority or coalition governments unable to make hard but necessary policy decisions. As a consequence, the social and political discipline required if full employment, price stability, and trade expansion are to be achieved is said to be lacking in many societies.

(4) An increasing number of both conjuncturalists and structuralists believe that the over-valued dollar and the undervaluation of other currencies has had an unfortunate effect on patterns of international trade and investment. For the United States it has meant an over-reliance on foreign in-

vestment rather than exports. For other economies, especially West Germany and Japan, it has meant the creation of an export oriented economy. While this situation is obviously not the sole cause, it is considered a major reason for America's chronic trade and balance of payments deficits and for the surpluses of Japan and West Germany. Until this trade imbalance is rectified the dollar will not regain its strength and the world political economy will continue in its present state of uncertainty. The question on which the conjuncturalists and structuralists differ is whether recent changes in currency values and minor adjustments will resolve this difficulty or whether more far-reaching policy changes are required.

(5) Finally, and underlying many of the other changes already noted, for many concerned observers there appears to be taking place a general decline in the support of scientific research and technological development, especially of the type of long-term, high-risk R/D which leads to major technological breakthroughs. On the contrary, available evidence suggest to these individuals that research has become more defensive and short-term in nature. A number of reasons have been suggested for this decline in R/D investment: (a) Decline in profit margins and hence available capital for risky ventures; (b) the recession and high level of business uncertainty; (c) a general disenchantment with scienceand technology; (d) the stifling effect of government regulations on business; (e) the increasing concentration of industry and a sharp decline in the number of small innovative

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firms; (f) concentration on improvement of existing products rather than the innovation of new ones; and (g) a general shift in the direction of research from the search for efficiency and new products to meeting government demands in the areas of safety, environment, etc.

Although some experts fear that the expenditure on R/D is reaching the point of diminishing returns and that technological stagnation may become a reality, most emphasize with equal force that major technological breakthroughs are possible which would sustain future economic growth and trade expansion. However, this latter group fears that current stagflation has inhibited the commercial development of these new technologies. They also take note of the fact that the cost of research and technological innovation appear to be rising at the same time that a threatened capital shortage is increasing the cost of capital.

If this is a correct assessment of the present state of R/D and if, as appears likely, the rate of economic growth in the future will be less than in the immediate past, then, the long-term consequences of a decline in research and innovation may be extremely serious for the OECD economies. As the research of today creates the industries and exports of tomorrow, the current decline in support for R/D could inhibit the development of the growth industries of the future. It is with respect to this issue, more than any other, that the issue of whether the conjuncturalists or the structuralists are correct will be decided.

(6) Both conjuncturalists and structuralists (excluding the Marxists) believe that the contemporary economic crisis can be surmounted. During earlier crisis periods of capitalism--what we prefer to call the free enterprise system--radical critics have pronounced its imminent collapse. Reduced to essentials, these pessimistic predictions have been based on one of two arguments: the saturation of consumer demand or, else, the onset of technological stagnation. There is little solid evidence to suggest either has happened: While consumer demand for particular goods, e.g., gas guzzling automobiles, has declined the general demand for goods in this country and abroad is far from met. Though technological advance in particular sectors may have leveled off, new technological possibilities with vast implications for new goods and trade are continuing apace. The capitalist world economy has survived past crises of greater severity than that of the present; there is no inherent reason for assuming it can not do so once again.

Statement of Dr. Richard G. Anderson, Assistant Professor of Economics
Department of Economics, Michigan State University
August 6, 1980

It is with pleasure that I submit this Statement for the Record of the U.S. Senate's Committee on Finance.

Equilibrium in the United State's balance of payments has been an explicit economic policy goal since the Employment Act of 1946. Throughout the post-World War II period, the United States has maintained approximate equilibrium in the trade balance of manufactured goods. However, during this period, some individual industries within the U.S. manufacturing sector have declined in international comparative advantage, while others have improved their competitive position. Previous research has attempted to discern special factors accounting for this disparate behavior.*

The latter part of the decade of the 1970's has been a banner period for U.S. manufactured exports, even while the overall balance of payments has shown substantial deficits, and 1979 was perhaps the best year of the decade. (Indeed, these export gains in manufactures have been aided by the decline in the exchange value of the dollar, which has been due to the balance of payments deficits.) Yet, two major industrial segments of U.S. manufacturing failed to share these gains, and thus must have lost comparative advantage in trade relative to the other segments of U.S. manufacturing which experienced substantial improvement in their trade position. These industries are steel and steel products, and motor vehicles.

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*See, e.g., Rachel McCulloch, "U.S. Trade Performance: The Role of Technology," Eastern Economic Journal, Volume VI, Number 1, January 1980, and Stanley Ruttenberg, "The Impact of Manufacturing Trade on Employment," in Trade and Employment, Special Report No. 30, National Commission for Manpower Policy, September 1978.

The crucial, unanswered question for policy analysis is: Why did steel and motor vehicles suffer a worsening of their trade position, while simultaneously aggregate manufacturing was enjoying an improvement in its position? In the study which accompanies this Statement, Professor Mordechai Kreinin and I investigate some hypotheses regarding the loss in comparative advantage by these two "ailing" industries. We find that the increases in nominal labor compensation (wage payments plus supplementary benefits) have been similar in the two industries since 1957, but that the behavior of labor productivity has been sharply different. In steel, labor productivity has increased at a very slow rate, while in motor vehicles the rate of increase has been much larger. Thus, implied unit labor costs in steel have increased much faster than in the balance of U.S. manufacturing, suggesting that steel may have lost comparative advantage in production relative to the other segments of U.S. manufacturing. I believe that if the behavior of unit labor cost in steel had been similar to that in aggregate manufacturing, the steel industry would not be suffering its present difficulties in international trade.

The motor vehicle industry stands in sharp contrast to steel. The decline in the competitive position of U.S. motor vehicle manufacturers may not be attributed to excessive increases in unit labor costs, since these have behaved similar to aggregate manufacturing. Rather, the difficulties in motor vehicles are due to past decisions regarding their product mixture offered to the market. While the wisdom of decisions made by U.S. automobile manufacturers in 1974-75 to continue production of large vehicles may be debated (the debate hinging upon the divergent views in 1975 concerning the future course of real gasoline costs), it is undeniable that the "second OPEC crisis" in 1979 harmed the position of the U.S. motor vehicle industry. We expect that this industry will recover from its present temporary difficulties.

A more complete discussion of the policy implications of our work is contained in section C of the study.

Senator BRADLEY. The subcommittee will stand in recess until Friday at 10 a.m. when we will continue in this series of hearings.

[Whereupon, at 5:35 p.m., the subcommittee recessed, to reconvene at 10 a.m., Friday, August 1, 1980.]

U.S. INTERNATIONAL TRADE STRATEGY

FRIDAY, AUGUST 1, 1980

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met at 10:30 a.m., pursuant to notice, in room 2221 of the Dirksen Senate Office Building, Hon. Bill Bradley presiding.

Senator BRADLEY. The subcommittee will come to order.

The subcommittee today has the honor of hearing testimony from Mr. Roger Kubarych, vice president and assistant director of research of the Federal Reserve Bank of New York. Mr. Kubarych is an expert in international financial matters. I want to thank him for coming before the subcommittee today to discuss the impact of recent energy shocks on the world economy.

Energy shocks lie at the core of most of the new economic forces that during the past decade have challenged the United States, its partners in trade and development, and the international economic system generally. Unless the world makes timely adjustment, these challenges will be felt even more forcefully and dangerously in the coming decades.

Energy shocks have come in the form of rapid price increases and sudden supply interruptions. Their effects on the world economy are both direct and indirect. They immediately inflate the price of a commodity that is central to production and daily living, thereby causing real income loss and antiquating past economic decisions. This saps business and consumer confidence in their ability to make ends meet.

Yet, however disruptive to the economy the direct economic effects of energy shocks might be, their indirect or secondary effects are even more pernicious. The shocks set in motion a variety of efforts to compensate for the real loss of resources due to higher energy prices.

These compensating efforts tend to create greater disequilibrium in the economy and often impair our traditional macroeconomic tools. For example, efforts by business and labor to cover their energy loss by increasing prices and wages set off new, defeating inflationary rounds. Monetary restraints applied to contain this secondary inflation may do less to contain it than to exacerbate the depressing effect that the oil "tax," in the form of higher prices already has placed on investment and production.

Because of energy shocks past and anticipated, we live in a Scylla/Charybdis world of inflationary perils along one shore and

recessionary risks along the other. Very little room is left for maneuvering along a course of stable and real world growth.

We will not be free from dangerous, diverting currents until the world has dramatically reduced its energy consumption, diversified its sources of energy supply, and thereby reduced the vulnerability of the world economy to energy price and supply shocks of the kind that have been so vivid in the last decade. Only such structural reform of our energy system will eliminate the shocks. Trade and financial adjustments can do no more than lessen the trauma along the way.

Nevertheless, in the meanwhile, because of oil price shocks, much of the non-oil-producing world is trapped in a cycle of chronic payments deficits requiring costly external financing. Credit and earnings which would otherwise go to growth and development are instead diverted to large pools of so-called petrodollars held by oil surplus countries.

On the whole, those petrodollars have not been substantially absorbed by imports or direct investment. Rather they have been held as short-term assets in Western financial institutions. The imbalance created by the drain of capital resources from oil-poor to oil-rich countries has been mediated by an elaborate system of international capital recycling. The private Western banks, awash in the short-term assets, deposited by OPEC members, have run this system since 1974.

There are strong indications that the private recycling system will soon reach its limits. Yet recycling requirements likely will be greater in the coming years than in the past. The danger of failing to recycle petrodollars at a level adequate to keep vital the world economy is perhaps as great as the danger of building inflationary pressures and straining the international banking system by increasing the level of recycling in order to accommodate the world's increased financing needs.

There is no easy choice and the world must look for new ways to meet growth and development targets while still satisfying competing objectives, such as containing inflation, stabilizing currencies, preserving prudential banking practices, and avoiding the infringement of the sovereignty of nations.

There is building a consensus that both the postwar Bretton Woods monetary system and the post-1974 petrodollar recycling system are unsuited to tomorrow's requirements. The financial discipline appropriate to reconstructing economies wrecked by war is not appropriate to the task of adjusting rich and poor economies to the distortions of an energy crisis and the bounds of prudential private banking are too narrow to accommodate the needs of poor and fragile nations.

At present there is no consensus on the alternatives to these systems. There is only a consensus on the need for creative mechanisms to channel a more direct flow of capital from surplus to deficit nations. I would give priority to directing this capital toward and for development of alternative sources of energy supply.

But there are a number of options, each with its own balance sheet of costs and benefits in both economic and political currencies. No option is completely "safe." Each carries risks.

But the greatest risk is to do nothing. What we must do is understand the choices. With this in mind, I welcome the testimony of our witness who is well qualified to help us elucidate these choices.

In today's hearing we will go into some depth in analyzing how well we have recycled petrodollars, what it means for the international banking system, what it means for the international economy and our domestic economy, and what we might do in the way of structural reform to prepare the country and our allies for the increasingly dangerous currents that await us in the 1980's as the probability of oil price hikes and supply interruptions increase.

I would like to welcome you to the committee, Mr. Kubarych, and ask you to proceed with your statement. We will then have questions and I hope other members of the subcommittee will be here, but if they are not, your statement and our exchanges will appear in the record in full form for the perusal of all members of the subcommittee. I am sure they will find it interesting.

STATEMENT OF ROGER M. KUBARYCH, VICE PRESIDENT AND ASSISTANT DIRECTOR OF RESEARCH, FEDERAL RESERVE BANK OF NEW YORK

Mr. KUBARYCH. I appreciate your presentation. I want to say I am here to talk as a keen student of these problems and as an economist who has been focusing on the international side for some time, but not as an official representative of the Federal Reserve Bank of New York and not to present some particular official view, but my personal views on these very important problems.

I will try to go through this statement that I have prepared for you and I have also submitted for the record a longer and more detailed academic treatment of the issues.

From my perspective, the second oil shock has been a worse blow than the first one. For one thing its adverse effects are likely to be more permanent and less likely to dissipate. The events and instabilities that led to the sharp price escalation showed how shaky the supply and demand balance of the oil market could be, and I think the lesson is clear.

OPEC has the ability to force real oil prices higher so long as its members are willing to permit oil production cutbacks. That has been the case and will probably continue to be the case for some time. Even with the substantial reductions in demand we have seen lately—reductions caused by recessionary forces, by an end to rampant inventory building and by some conservation responses—significant downward pressures on prices have not materialized.

Once a pickup in overall economic activity gets underway next year, the prospects for declines in real oil prices are pretty dim. So we are very unlikely to see a repetition of the gradual declines in real oil prices that there were between 1975 and late 1978.

Second, the enormous increase in OPEC's financial surplus is not likely to be reversed for at least several years. This is in contrast to the experience after the last oil shock. The reasons are straightforward. In the aftermath of the first oil shock individual OPEC countries learned how difficult it is to construct, man, and keep running large-scale projects without creating waste and excessive costs.

Several of the high population, high growth OPEC countries found out how easy it was to slip into current-account deficit, despite oil wealth, and be forced to borrow themselves. Many OPEC members also became aware of the social and political implications of rapid development, population shifts and increases in income and consumption. The Iranian situation drove those points home hard.

All in all, OPEC imports will probably grow much more slowly than they did before, not because of bottlenecks and mismanagement, but because the authorities are more cautious and more selective about what new projects will be undertaken. That means the overall financial surplus is likely to decline much more slowly than it did before.

The third reason why I feel the second oil shock is a worse blow than the first one is that most oil-consuming countries never really adjusted to the previous shock. Major efforts to repair and revitalize weakened sectors of the industrial economies were not made. Effective conservation measures were not taken. Consumers were shielded to a significant extent from the reality of oil vulnerability and so were given little price incentive to adjust their spending patterns.

In some countries governments actually cut gasoline taxes, thereby compounding the problem. It is just the opposite of what was needed. In these respects the oil-consuming countries were in a poor position to absorb the second shock.

However, one important positive change has occurred. There has been a much greater appreciation of the need to limit the adverse effects on inflation. In particular, wage increases have remained moderate in a number of industrial countries. So a more serious wage-price spiral has been averted up to now, with all of the positive effects that means for the whole investment climate.

If you look at the figures you see that wage increases have been much more moderate in a number of industrial countries and there is no evidence so far of a serious wage price spiral developing, which is very definitely in contrast to last time. Thus, I am not entirely pessimistic on every aspect of this discussion, although it is still a situation of enormous touchiness. It could still go either way. We have still not cured the inflation problem at all.

Finally, to move to the financial side, the deficits arising from the second oil shock may prove more difficult to finance, especially those of certain developing countries. That is not because of any spectacular erosion of the standard ratios that analysts look at: measures of debt burden—for instance, debt-servicing expenses as a proportion of export earnings—have not deteriorated badly for the larger borrowers.

It is also not so much a reflection of a general weakening in LDC-governments' ability to run stabilization policies. That has probably improved in more countries than it has worsened and some countries have actually accelerated the process of adjustment.

Nor in general have previous borrowings been wasted on excessive consumption. The evidence is that the biggest borrowers from commercial banks after the first oil shock were those countries that invested the most and had the strongest growth rates of both income and exports.

And it is not because the multilateral credit institutions have been neglected. To the contrary, there has been a serious, good faith effort to expand credit facilities and design ways of broadening the responsibilities and perspectives of key institutions like the IMF and the World Bank.

Rather I think the central cause of concern about the recycling process now is that many large commercial banks and other private lenders simply cannot visualize how some of the deficits that need to be financed can be reduced during a period of contraction or prolonged slow growth for the industrial economies.

Industrial countries' deficits almost certainly will narrow over the next year or 18 months. That means LDC deficits could go up in aggregate, despite the serious adjustment efforts that many developing countries are now either contemplating, promising, or implementing.

So the dilemma is striking. The most favorable scenario you can honestly draw has to assume conscientious stabilization efforts, no domestic social turmoil, no new unforeseen shock, no collapse in LDC commodity prices, no sweeping protectionist measures in the industrial countries, and no costly mistakes in domestic investment projects.

But even in that most favorable scenario aggregate LDC deficits may very well rise. It is not surprising that banks would be reassessing the risks involved on the assumption that something truly bad could happen for at least some countries.

My impression is that the commercial banks would probably like to have the confidence and the arguments to justify playing about the same relative role in recycling as they did last time around. It has been profitable business. Loan loss records have been better than on domestic loans.

The difficult work-out situations that did arise were handled professionally and set few bad precedents. And over the long term the LDC's are going to be the principal growth areas in the world.

But make no mistake about it, confidence has been shaken and there is a definite reluctance to seek out new LDC loans in a number of cases. So the pace of the new business has been slow. And the longer it takes to restore a more normal tempo of lending, the more difficult it is going to be to accommodate all who wish to borrow.

In the first half of the year it was perhaps two-thirds of what it was in the first half of the year before. That is despite the increased deficits that countries must finance. In my view the longer it takes to restore a more normal tempo of lending so that there is no bunching up, with everybody trying to borrow at the same time, the more difficult it will be to run recycling smoothly.

In a way there is a kind of standoff in the market between the borrowers, who quite obviously have a clear interest in raising money, and the lenders who are reassessing the risks and trying to determine what kind of trade-off there is between risk and return, which is the appropriate basis for portfolio decisions.

When you have this kind of standoff, neither side wants to break first. So you push off into the future, or push forward, the time when large amounts of recycled funds need to be committed for the

longer term maturities. In the meantime, countries substitute short-term finance for the more desirable longer term financing.

Now clearly there is a danger in overgeneralizing across banks. And I have been careful not to overgeneralize across borrowers. Among banks, attitudes differ, and management policies governing those lending limits do too.

In addition, foreign banks have different marketing strategies than U.S. banks, who have been comparatively less active for some time. But I think the general theme is valid for most institutions I know about. Private lenders are more reluctant to commit additional funds because of the existing amount of debt, because of the anticipated permanence of oil-induced deficits, and because of the heightened costs of mistakes.

And I do not believe that the money will come forth swiftly once profit margins on loans widen, as they probably will. For many bank managers that may only be seen as confirming what they had been worrying about in abstract terms for a while: That risks are increasing.

So to avoid a sudden, destabilizing and largely unnecessary disruption of economic activity and world trade, other channels of financing have to be kept open or opened up. Much serious attention has been given to these contingencies at the IMF and at the World Bank and their role must be strengthened.

But beyond that, OPEC members with heavy surpluses must recognize that they bear a responsibility for handling an increasing share of recycling directly. They might argue that they would rather not take the risks. But this is an incomplete argument. Increased risks can be compensated by increased yields or more attractive features on financial instruments. The urgency is for those LDC's most interested in supplementing funds likely to be available from banks and multilateral institutions to get together with OPEC surplus countries to discuss new methods of financing that are mutually beneficial.

I can think of a few useful options to consider. One obvious example would be SDR-denominated loans designed to lower exchange rate risks. This has been suggested a number of times.

A more novel idea might be what we call "development equity" securities. This may be very useful for countries that do not have equity markets developed in their own countries at the moment.

Or a broader version might be called a "national income equity" security which would pay a yield based on the overall rate of growth of the country's economy. Other people have recommended different ideas and those suggestions should also be considered.

Whatever options turn out to be soundest and most practical, it seems to be clear that this shortcut approach to recycling is good for everyone. It lets the LDC country and the OPEC country define mutually acceptable methods of financing. It spreads the risks in recycling in a way that would strengthen the capacity of commercial banks to continue to play an important role.

And it does not put a burden on the industrial countries to recommend options that they themselves might be unwilling to recommend for their own use. I think that is important.

I would hope that we as economists could contribute as much analytical support as we can, investigating objectively the potential

costs and benefits of various ideas and proposals and making the results available to anyone interested.

Imaginative new financing tools are going to be indispensable to make sure that the developing nations are not overwhelmed by the difficulty of financing oil-induced deficits. We have to maintain tolerable levels of world economic activity in the period of oil vulnerability, which is a pressing objective.

But equally important is the objective of preventing a third oil shock. That means loosening OPEC's hold on the oil price and seeing to it that massive payments imbalances are gotten rid of. The only choice is to produce more energy and to conserve vastly more energy.

The long-term solution is development of alternative energy sources because that is the only credible way of assuring citizens of permanent gains in their living standards. But that development will take a lot of time and money.

In the meantime, we have to do something decisive. We will be better off if we can induce OPEC to rethink its arithmetic. If we can make the option of keeping oil in the ground a poorer economic decision than selling it and investing the proceeds in financial assets, then it will be in OPEC's own interest to produce more. As they sell more the real oil price will moderate.

But how do you achieve this result? We have to achieve the expectation of falling demand and market softness. That entails significant conservation efforts, much greater than anything we have tried yet. Practically it means stiff taxes on gasoline to stimulate rapid cutbacks in use.

It means inspiring public trust that Government, having collected the taxes, will apply the proceeds judiciously: In part to cut other taxes, but in part to recycle revenues to develop alternative energy sources.

I think this approach has a big potential payoff and I think it is the only feasible way of bridging the gap between the vulnerability we have today and a more agreeable time in the future when we have enough energy of our own to disregard OPEC. Thank you.

[The prepared statement of Mr. Kubarych follows:]

STATEMENT OF ROGER M. KUBARYCH*

HEARINGS OF THE SUBCOMMITTEE ON

INTERNATIONAL TRADE, SENATE FINANCE COMMITTEE

AUGUST 1, 1980

I am pleased to testify before this Committee on the critical issues of how the world economy and financial system are adjusting to the second oil shock. I am not here as an official representative of the Federal Reserve Bank of New York, but as an economist concerned about the international situation, and as what you might call a professional student of financial markets and the people who work in them.

In several respects, the second oil shock has been a worse blow than the first one of 1973-74. For one thing, its adverse effects are likely to be more permanent than before and less likely to dissipate over time. Events leading up to and validating the 150 percent price escalation showed how shaky the supply and demand balance in the oil market could be. The lesson is clear. OPEC has the ability to force real oil prices higher, so long as its members are willing to permit oil production cutbacks. That has been the case and will probably continue to be

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the case for some time. Even with the substantial reductions in demand we have seen lately -- reductions caused by recessionary forces, by an end to rampant inventory building, and by some conservation responses -- significant downward pressures on prices have not materialized. Once a pick-up in overall economic activity gets under way next year, the prospects for declines in real oil prices are pretty dim. So we are very unlikely to see a repetition of the gradual declines in real oil prices that there were between 1975 and late 1978.

Second, the enormous increase in OPEC's financial surplus is not likely to be reversed for at least several years. The reasons are straightforward. In the aftermath of the first oil shock individual OPEC countries learned how difficult it is to construct, man, and keep running large-scale projects without creating waste and excessive costs. Several of the high population, high growth OPEC countries found out how easy it was to slip into current-account deficit, despite oil wealth. Many OPEC members also became aware of the social and political implications of rapid development, population shifts, and increases in income and consumption. The Iranian situation drove those points home hard. All in all, OPEC imports will probably grow much more slowly than

they did before, not because of bottlenecks and mismanagement, but because the authorities are more cautious and more selective about what new projects will be undertaken. That means the overall financial surplus is likely to decline much more slowly than it did before.

The third reason why I feel the second oil shock is a worse blow than the first one is that most oil-consuming countries never really adjusted to the previous shock. Major efforts to repair and revitalize weakened sectors of the industrial economies were not made. Effective conservation measures were not taken. Consumers were shielded to a significant extent from the reality of oil vulnerability, and so were given little price incentive to adjust their spending patterns. In some countries, governments actually cut gasoline taxes, thereby compounding the problem. In these respects, the oil-consuming countries were in a poor position to absorb the second shock. However, one important positive change has occurred. There has been a much greater appreciation of the need to limit the adverse effects on inflation. In particular, wage increases have remained moderate in a number of industrial countries. So a more serious wage-price spiral has been averted up to now.

Finally, the deficits arising from the second oil shock may prove more difficult to finance, especially those of certain developing countries. That is not because of any spectacular erosion of the standard ratios that analysts look at: measures of debt burden -- for instance, debt-servicing expenses as a proportion of export earnings -- have not deteriorated badly for the larger borrowers. It is also not so much a reflection of a general weakening in LDC-governments' ability to run stabilization policies. That has probably improved in more countries than it has worsened, and some countries have actually accelerated the process of adjustment. Nor in general have previous borrowings been wasted on excessive consumption. The evidence is that the biggest borrowers from commercial banks after the first oil shock were those countries that invested the most and had the strongest growth rates of both income and exports. And it is not because the multilateral credit institutions have been neglected. To the contrary, there has been a serious, good faith effort to expand credit facilities and design ways of broadening the responsibilities and perspectives of key institutions like the IMF and the World Bank.

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Rather, I think the central cause of concern about the recycling process now is that many large commercial banks and other private lenders simply cannot visualize how some of the deficits that need to be financed can be reduced during a period of contraction or prolonged slow growth for the industrial economies. Industrial countries' deficits almost certainly will narrow over the next year or 18 months. That means LDC deficits could go up in aggregate, despite the serious adjustment efforts that many developing countries are now either contemplating, promising, or implementing. So the dilemma is striking. The most favorable scenario you can honestly draw has to assume conscientious stabilization efforts, no domestic social turmoil, no new unforeseen shock, no collapse in LDC commodity prices, no sweeping protectionist measures in the industrial countries, and no costly mistakes in domestic investment projects. But even in that most favorable scenario, aggregate LDC deficits may very well rise. It is not surprising that banks would be reassessing the risks involved on the assumption that something truly bad could happen for at least some countries.

My impression is that the commercial banks would probably like to have the confidence and the arguments to justify playing about the same relative role in recycling as they did last time around. It has been profitable business. Loan loss records have been better than on domestic loans. The difficult work-out situations that did arise were handled professionally and set few bad precedents. And over the long term, the LDC's are going to be the principal growth areas in the world. But, confidence has been shaken and there is a definite reluctance to seek out new LDC loans in a number of cases. So the pace of new business has been slow. And the longer it takes to restore a more normal tempo of lending, the more difficult it is going to be to accommodate all who wish to borrow.

Clearly, there is a danger in over-generalizing across banks. And I have been careful not to over-generalize across borrowers. Among banks, attitudes differ, existing exposures differ, internal lending ceilings differ, and management policies governing those lending limits do too. In addition, foreign banks have different marketing strategies than U.S. banks, who have been comparatively less active for some time. But I think the general theme is valid for most institutions I know about. Private lenders are more reluctant to commit additional funds because of the existing amount of debt, because of the anticipated permanence of oil-induced deficits, and because of the heightened costs of mistakes. And I do not believe that the money will come forth swiftly once profit margins on loans widen, as they probably will. For many bank managers, that may only be seen as confirming what they had been worrying about in abstract terms for a while -- that risks are increasing.

So, to avoid a sudden, destabilizing, and largely unnecessary disruption of economic activity and world trade, other channels of financing have to be kept open or opened up. Much serious attention has been given to these contingencies at the IMF and at the World Bank, and their role must be strengthened.

But beyond that, OPEC members with heavy surpluses must recognize that they bear a responsibility for handling an increasing share of recycling directly. They might argue that they would rather not take the risks. But this is an incomplete argument. Increased risks can be compensated by increased yields or more attractive features on financial instruments. The urgency is for those LDC's most interested in supplemeting funds likely to be available from banks and multilateral institutions to get together with OPEC surplus countries to discuss new methods of financing that are mutually beneficial.

I can think of a few useful options to consider. One obvious example would be SDR-denominated loans designed to lower exchange rate risks. A more novel idea might be what we call "development equity" securities. These would be LDC securities that pay a yield based on the average real rate of return on a package of development projects. Or a broader version might be called a "national income equity" security, which would pay a yield based on the overall rate of growth of the country's economy. Other people have recommended different ideas, and those suggestions should also be considered.

Whatever options turn out to be soundest and most practical, it seems to be clear that this short-cut approach to recycling is good for everyone. It lets the LDC country and the OPEC country define mutually acceptable methods of financing. It spreads the risks in recycling in a way that would strengthen the capacity of commercial banks to continue to play an important role. And it does not put a burden on the industrial countries to recommend options that they themselves might be unwilling to recommend for their own use. I would hope that we as economists could contribute as much analytical support as we can, investigating objectively the potential costs and benefits of various ideas and proposals, and making the results available to anyone interested.

Imaginative new financing tools are going to be indispensable to make sure that the developing nations are not overwhelmed by the difficulty of financing oil-induced deficits. Maintaining tolerable levels of world economic activity in the period of oil vulnerability is a pressing objective. But equally important is the objective of preventing a third oil shock. That means loosening OPEC's hold on the oil price and seeing to

it that massive payments imbalances are gotten rid of. The only choice is to produce more energy and to conserve vastly more energy. The long-term solution is development of alternative energy sources because that is the only credible way of assuring citizens of permanent gains in their living standards. But that development will take a lot of time and money.

In the meantime, we will be better off if we can induce OPEC to re-think its arithmetic. If we can make the option of keeping oil in the ground a poorer economic decision than selling it and investing the proceeds in financial assets, then it will be in OPEC's own interest to produce more. As they sell more, the real oil price will moderate.

But to achieve this result, we need to create the expectation of falling demand and market softness. That entails significant conservation efforts, much greater than anything we have tried yet. Practically, it means stiff taxes on gasoline to stimulate rapid cutbacks in use. It means inspiring public trust that government, having collected the taxes, will apply the proceeds judiciously -- in part to cut other taxes, but in part to recycle revenues to develop alternative energy sources. But this approach has a big potential payoff. It is the only feasible way of bridging the time gap between today's extreme oil vulnerability and a more agreeable time when we have enough of our own energy to disregard OPEC .

The Economic and Financial Effects of the Oil Shock

Roger M. Kubarych*

* The views expressed are those of the author and do not necessarily represent the views of the Federal Reserve Bank of New York or the Federal Reserve System. The author wants to acknowledge the considerable contributions of Akbar Akhtar, Marcelle Arak, Zdenek Cernohous, Stephen V.O. Clarke, Mark Dalzell, William Gasser, David Roberts, Krishan Saini, and Dorothy Sobol.

Impact of the Oil Shock

The average OPEC oil price at end-June was about $31 per barrel, some 150 percent above the level at end-1978. This huge increase in oil prices transferred wealth and real income from the oil importing countries to the OPEC countries. It has also already had significant adverse repercussions on prices, real growth and current account balances both in the OECD area and in the non-OPEC developing countries. And these effects are far from over. While it is difficult, if not impossible, to estimate precisely the magnitude and timing of various consequences, it seems clear that the oil price increases of the last year and a half will continue to have major effects on the world economy for at least another year. And the precarious position of the oil importing nations, their vulnerability to actions of the OPEC cartel, will persist until oil dependence is drastically reduced, major consertation is achieved, and alternative supplies come on stream.

The OECD countries were in the middle to late stages of an economic expansion as the current round of oil price increases began. In the United States and the United Kingdom, economic activity slowed during 1979, while in many other countries, growth continued at a moderate pace into the first quarter of 1980. Up until mid-1979 the expansion of demand had not caused a major upsurge in domestic inflation rates in many industrial countries as was the case at the time of 1973-74 oil price increases. Also, the latest oil price shock occurred at a time when a few of the industrial

countries -- the U.K., and Norway -- had become essentially self sufficient in energy production.

The rise in oil import prices has seriously worsened inflation in industrial countries, however, OECD oil imports from OPEC account for about 1/3 of the current total energy requirements, and were on average 2 3/4 percent of total domestic demand in 1978-79. Just the direct effects of higher prices on imported petroleum could eventually raise the price levels in these countries by 4 1/2 percent. Considering that other energy prices will increase too and that other prices and wages may be affected, its overall impact could be on the order of 8-10 percent. Perhaps a bit more than half of this effect has already been transmitted to domestic prices. In the recent sequence of OPEC price rises, domestic energy prices have responded very rapidly. Most of the pass through of the higher oil costs has occurred within one to two quarters. This is primarily due to an increased willingness in the industrial countries to allow domestic energy prices to move to world levels.

The longer term effect on prices may be even greater if the rapid rise in prices induces increased money wage demands to compensate for the lost purchasing power. These changes, in turn, could lead to wage-price interactions that ratchet inflation higher. Up until now, however, wage settlements in several of the largest industrial countries have been moderate. Moreover, the slowdown in domestic demand -- underway at present -- is helping restrain wages and prices.

For the OECD countries, the oil price hikes of 1979-80 will directly cut real incomes by about 3 percent. Besides the direct burden of a loss of this size, the income transfer could reduce aggregate demand and increase unemployment, lowering real incomes even further. If OPEC does not fully spend its enlarged oil revenues or lend to those who will spend, while OECD residents cut their spending substantially because of their reduced incomes, then demand for OECD goods and services will decline. This reduction in total demand occurred in 1974 and it will probably occur again now. OPEC's ability to absorb imports is limited by physical constraints and by social and economic policies. Moreover, there may be additional deflationary impact from changes in consumer and business confidence and from the obsolescence of a part of the capital stock associated with higher oil prices.

The U.S., U.K. and Canada are now going through a contraction in output which is aggravated by the oil shock. Economic activity is also slowing in several European countries. No substantial improvement in output growth is expected for the OECD area until well into 1981.

The recent growth effects can be offset in part by reductions in oil purchases. A shift to energy sources other than oil, for example, would reduce the need for oil imports. Also, allowing domestic energy prices to reflect the full impact of OPEC price changes induces some conservation.

Conservation measures can also be promoted or mandated by government. Although in the short run, the response of energy consumption to price increases is modest, prices do have a noticeable impact on energy usuage. And, over the longer run, the oil price increases, conservation measures and other adjustments such as investments in energy-saving production processes and design of products embodying energy saving features should induce substantial reduction in the volume of imports.

Also, over the longer run, additional OPEC spending in the OECD area may lead to partially offsetting effects on exports and output.

For the non-OPEC developing countries, the direct effect of the oil price increases on real growth is likely to be relatively small providing that they can obtain financing for their deficits. Oil imports themselves account for about 2 percent of the groups combined GDP, and these imports are highly concentrated in a few of the newly industrializing countries. These countries have maintained relatively high growth since the last oil shock, but their oil imports have grown also quite rapidly. The volume of Brazil's oil imports, for example, has grown nearly 50 percent since 1973, while that of Korea's has nearly doubled, despite both countries high domestic oil prices and significant conservation and substitution efforts. While oil is relatively less important in the poorer LDCs, it is critical for their modern sectors -- for mechanized agriculture, irrigation, transportation, and

electricity. Thus, the oil price has reduced the growth potential for all LDCs, even those where oil is not now a significant component of domestic product.

But on top of these direct effects of higher oil prices, the indirect effects of a slowdown in growth in the industrial countries and the resulting decline in export volume growth and commodity prices could be quite substantial. Most of the indirect effects will be appearing in late 1980 and in 1981. For the non-OPEC developing countries, the total impact on real growth might be on the order of 2 percent by 1981.

If, however, financing problems impel some non-oil developing countries to slow their rate of import growth further their overall rate of economic growth will slow substantially as well. For most LDCs imported goods are vital in the production and development process -- there are no good domestic substitutes. While there is usually some scope for cutting non-essential imports without cutting growth, beyond some point, the restriction of imports will impede growth. Moreover, some countries may undertake contractionary macroeconomic policies to reduce imports. Together, these factors suggest

that growth will be slowed. Indeed, after the last oil shock, both the growth of imports and that of GNP slowed significantly from their rates in the years preceding 1974.

Implied in the preceding discussion are substantial adverse current account effects for both the OECD countries and the non-OPEC developing countries. The 1980 OECD current account deficit is expected to be $75-80 billion, up from around $37 billion deficit in 1979 and $9 billion surplus in 1978. The deterioration is due almost entirely to higher oil payments. The OECD deficit is projected to fall considerably in 1981, reflecting slower income growth and the associated decline in import volume.

The oil bill of the area will be around $290 billion in 1980, up from around $140 billion in 1978. On the basis of present projections, the oil bill could increase another 10-12 percent in 1981.

The $80 billion swing in the OECD current account deficit between 1978 and 1980 would be about 1 percent of GNP, rougly the same percentage as the $35 billion swing between 1972 and 1974. However, the pattern of current account balances within the OECD area is distributed better in 1979-80 than in 1973-4. For example, Germany and Japan, which can easily finance them, are incurring large deficits while France, Italy, and U.K. have small deficits in contrast to last time.

The combined current account deficit of the non-OPEC developing countries is estimated to increase by $20 billion or more to about $55 billion in 1980. This projection is

based on a relatively modest import volume growth of about 4 percent in 1980, about one half the average growth over the last 3 years. In 1981, the effects of weakening economic activity in the industrial countries, on top of the oil price effects, will produce further deterioration in the current account position of these countries.

The deterioration in the current account balances for the OECD area and the non-OPEC developing countries is mirrored in large surpluses for OPEC. OPEC is now running a substantial current account surplus -- over $100 billion at an annual rate and is expected to run a surplus only slightly less in 1981. The 150 percent increase in oil prices since 1978 and the relatively modest growth of OPEC imports, partly due to a precipitous fall in Iranian imports, are the major factors behind the substantial enlargement of the surplus.

These large surpluses are likely to persist. That would be in contrast to the experience after the first oil price shock, when the erosion of the real price of oil and a surge in import growth practically eliminated the huge surpluses OPEC had been running by 1978. First, the real price of oil is expected to remain firm because OPEC members appear prepared to trim output to match demand. Already this year reductions in OPEC oil production of nearly 3 million barrels daily have partly offset reductions in oil demand caused by conservation, recession and an end to oil stockbuilding.* That response has prevented a major oil glut

*Non-OPEC oil production, meanwhile, has risen by less than 1/2 million barrels a day.

from developing which could have put strong downward pressure on oil prices. It is worth noting, however, that the oil market has eased enough so that spot oil prices have declined considerably from their 1979 peaks.

Second, the growth of OPEC imports is expected to average only 15 percent in real terms over the next few years. By comparison real growth averaged 50 percent in 1974-75. However, in subsequent years import growth moderated and in 1978 imports actually fell by 1 percent. Then in 1979 a 70 percent decline in Iranian import volume contributed to a 15 percent decline in OPEC import volume as a whole. Iran's imports, which previously accounted for 20 percent of the world's exports to OPEC, have not recovered from this plunge and the prospects for the Iranian economy and import demand remain bleak. Elsewhere in OPEC, concerns about the inflationary and social costs of too rapid economic growth were sharpened by the Iranian experience and may lead to greater efforts to constrain import growth in the future. Moreover, recollection of sizable current account deficits and heavy borrowing from 1977 to 1979 may keep several OPEC countries from moving too quickly back into deficit.

Not only will OPEC imports grow modestly relative to their surplus, but the import demands are likely to be spread very unevenly among exporting countries. On the basis of past experience, the OPEC countries tend to import mainly from the industrial countries and mainly from those which produce capital goods and military equipment (See Table I). However, while the LDCs have not gotten a large share of the OPEC goods

Table I

Imports of OPEC Countries
(in billions of U.S. dollars)

	1973	1976	1979
From:			
Industrial Countries	15.90	52.88	75.24
Non-Oil Developing Countries	2.59	7.96	14.65
Other	1.23	3.09	5.65
World Total	19.72	63.93	95.54

Source: IMF Direction of Trade Yearbook, 1980

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trade, they are participating actively in construction projects in the OPEC nations.

Financing the deficits

How will the OPEC surpluses reach the countries which need to finance deficits? So far, it appears that the industrial countries with deficits will be receiving sufficient inflows through the private markets and through some officially negotiated facilities. However, there is considerable uncertainty on how the deficits of the LDCs will be financed.

In 1979, there were large private and OPEC capital inflows into the OECD area. This helped to finance the swing of the OECD current account from a surplus of $9 billion in 1978 to a deficit of $37 billion in 1979. Within the area, however, several countries because of the pattern of flows temporarily used reserves. Early this year the net capital inflow into the area accelerated, aided by a relaxation of capital controls in several major countries. This pattern of capital movements into the OECD countries as a group is expected to continue through the next year. As a result, few of these countries are likely to encounter serious difficuties in financing their current account deficits.

For the developing countries, the impact of the latest oil shock on current account deficits should be roughly comparable to the effect of the first oil shock. But financing these deficits may pose more difficult problems this time.

Between 1973 and 1975 LDC imports grew by over 60 percent and the aggregate current account deficit rose from 2 percent of GDP to almost 6 percent of GDP. Financing these large deficits led to a rapid increase in external debt. Total external debt more than doubled within four years and reached $350 billion by the end of the decade.

Taken as a group, developing countries have been able to bear the increased debt burden relatively well. Although the standard measures of debt burden indicate some increases over the period, most countries have been able to stimulate sufficient growth in GDP and exports to avoid serious payments difficulties. But the direct and indirect effects of the latest oil shock will require substantial additional flows from official and private lenders to maintain growth in GDP at tolerable levels.

The means of financing the current account deficits vary widely among developing countries. Private financial lending has been the major source of funds for only a small group of LDCs. Ten countries received over three-quarters of total bank lending.* These major borrowers have large economies and rapidly growing export sectors. They account for about half of the current account deficits of all developing countries. Although the 1973 shock reduced their rate of GNP growth, they have managed to continue their development. As a group, their ratio of total debt to exports has actually declined since 1973 while the debt service/exports ratio increased only moderately. Still several of the major borrowers

* These ten are Argentina, Brazil, Chile, Colombia, Mexico, Peru, Korea, Philippines, Taiwan, and Thailand.

depend heavily on imported oil to support industralization. The latest oil shock will make their development process more difficult. However, provided that these countries maintain sound economic policies, there is no reason to believe that their long-term prospects or their underlying credit-worthiness have been permanently eroded.

Of course it is possible that individual countries within this group will encounter occasional payments difficulties. A few of these major borrowers -- Brazil, Korea and Taiwan -- are heavily dependent on imported oil, while others -- Argentina and Colombia -- are nearly self sufficient and a couple -- Mexico and Peru -- are net oil exporters. Thus the direct impact of the oil price shock varies greatly within the group. However, past experience has shown this to be a group of relatively flexible and dynamic economies with strong long-term growth potentials. As a result, their ability to adjust to the oil price shock depends as much on their taking appropriate policy actions as the size of the initial shock. With proper adjustment policies no serious persistent disruption need occur. Commercial banks have shown themselves willing to cooperate in these circumstances. Moreover, international lending agencies, particularly the IMF, can play an important role in providing both funds and guidance toward solving these problems.

For the large number developing countries which have not obtained substantial private finance, the problems of financing their deficits are more difficult. These

countries generally have slower growth in GDP and exports. They frequently depend on exports of primary commodities whose prices tend to fall as world economic activity slows. While their oil imports are not large by world standards, most have few alternatives to imported oil for their small modern sectors. Increased costs of petroleum-based fertilizers and insecticides have harmed their agricultural development. Indeed, GDP growth averaged only about 4 percent after 1973 which, combined with their rapidly growing populations, meant almost no increase in per-capita income. Moreover, current account deficits of these low income countries have averaged over 6 percent of GDP.

Financing these deficits led to a tripling of their external debt. Although most of these funds were obtained from official lenders, who offered relatively low interest rates and long maturities on these loans, the debt burden of these countries has risen substantially. The proportion of GDP required to pay debt service is increasing and the public debt service/exports ratio has increased from almost 8 percent in 1973 to over 12 percent by 1979. Although these countries have generally been able to avoid defaults, the debt burden on countries which have the lowest per-capita incomes in becoming increasingly heavy. Financing the substantial additional current account deficit caused by the latest oil shock is a very serious problem.

Table II

Financing the Current Account Deficits
of Non-Oil LDCs
(billions of dollars)

	1973[e]	1974	1975	1976	1977	1978	1979[e]	1980[p]	1981[p]
Balance on Goods Services and Private Transfers	-11	-31	-38	-26	-21	-32	-48	-67	-79
Financing by Official Sources	9	14	19	19	18	21	25	35	42
Net Official Transfers	4	6	6	6	7	9	10	12	14
Bilateral Credits	3	4	8	6	7	8	10	13	17
Multilateral Credits	2	4	5	7	4	4	5	10	11
Financing by Private Sources	10	20	20	18	15	24	30	32	37
Direct Investment	4	5	5	5	5	6	7		
G-10 Reporting Banks	9	16	19	18	18	23	37		
Other, including errors and omissions	-3	-1	-4	-5	-8	-5	-14		
Growth in Reserve Assets	8	3	1	11	12	13	7	-	-

e - Partly estimated

p - Illustrative projections based on plausible assumptions for current account developments and official source capital.

Sources: IMF Annual Report, 1979 and World Economic Outlook; BIS Annual Report; FRBNY Staff estimates for consistent country coverage and projections.

The Role of Commercial Banks

International banks provided the bulk of LDC finance following the last oil price shock, recycling funds from the surplus OPEC countries to the deficit countries. Their long-term lending to non-oil LDC governments and government-guaranteed projects rose more than $50 billion in the 1974-78 period. In addition, these banks provided an important source of funds in the form of non-guaranteed and short term trade-related credits. Overall, banks from G-10 countries which report to the BIS have recorded about a $100 billion increase in their total claims on non-OPEC LDCs since reasonably comprehensive data became available in 1974 (See Table II).

Through most of 1979, international banks again played the major role in recycling. Bank claims on non-OPEC developing countries reporting to the BIS rose more than $35 billion over the course of the year. But again three quarters of this lending went to the ten major borrowers. Moreover, events in late 1979 began to seriously cloud the outlook for substantial increases in bank lending to a number of LDC borrowers. Events in Iran increased the perception of political risk, even on investments in countries whose economies had strong growth records. The higher oil prices and deteriorating world economic outlook has raised the perceived economic risk as well. Thus, spreads have widened for some borrowers, while maturities have been cut back.

Many of the major LDCs have delayed or cut back planned borrowings so the pace of new bank lending has fallen dramatically in the first half of this year, despite the growing

deficits. For example, new publicly announced eurocurrency credits were only $9 billion in the first six months compared with $15 1/2 billion in the same period last year. Although the pace picked up some in the second quarter when $5.6 billion were announced, this remains well below the $6.8 billion of a year earlier. Unpublicized loans and more reliance on trade or suppliers credits may have replaced syndicated loans to some extent. However, borrowing needs of the non-oil LDCs had increased considerably so that the banks were handling less of the recycling than might have been anticipated. It appeared that banks were unwilling to lend larger amounts at the same spread over LIBOR. And earlier this year, interest rates rose sharply, further discouraging many borrowers who instead drew down their reserves. Of course, their reserve drawdowns are not sustainable. Moreover, alternative sources of funds such as trade credits and private borrowing tend to be more expensive than syndicated bank loans. These factors suggest that creditworthy borrowers will again seek syndicated credits, but will encounter wider spreads over LIBOR than had prevailed in the past few years.

Bilateral aid and credits

A substantial portion of the LDC deficit financing, particularly for those who have not borrowed from the banks, has been through official institutions. For example in 1979, bilateral grants to the LDCs totaled about $10 billion and new bilateral credits, most provided on concessional terms,

were also about $10 billion.

As far as the industrial countries are concerned, there is little domestic sentiment in favor of increasing grants and soft loans to the LDCs. The OPEC nations, on the other hand, have increased their loans to certain of the LDCs -- mainly countries such as Egypt, Syria, Sudan and Jordan -- but neither the scale of this lending nor its distribution is sufficient to finance more than a small part of the new current account deficits of the LDCs.

Multilateral aid and credits

While bilateral credits are unlikely to expand much, the prospects for increased multilateral credits are encouraging. Net lending by the IMF to nonoil developing countries could well be at a record level in 1980, surpassing the increase in IMF lending after the first oil shock in 1974-75. This expectation is based upon the sizable growth in IMF commitments as well as the $1.3 billion in lending that has already occurred this year.

Standby credit arrangements with the nonoil LDCs rose from less than $1.6 billion at end-1978 to $3 billion at end-1979 and $4.2 billion at the end of May 1980. Moreover, last June the IMF agreed to a new standby arrangement for two Southern European countries: $1.6 billion for Turkey and about $450 million for Yugoslavia, raising the total commitment to the broader group of LDCs to over $6 billion.

The standby credits represent credit tranche and extended fund facility credits which will be available for drawing on the average over the next 18 months, subject to the borrowing country's meeting IMF policy guidelines.

New drawings of Fund credit are likely to increase substantially over the next 6-12 months if the Fund approves drawings of all commitments as scheduled. Out of the $4 billion standby credit committed at the end of May, about $3 billion was still unused and available for drawing. The funding of the available standby credit includes $2 billion earmarked from the Special Financing Facility (SFF). In June, about $2 billion addditional was earmarked as part of the funding of standby credits to Turkey and Yugoslavia. Thus, with the one billion already used in the funding of earlier drawings, the amount of SFF funds committed has reached about $5 billion, half of the $10 billion SFF total.

The scheduled 50 pereent increase in the general quota would add, at current exchange rates, about $25 billion to the Fund's resources of which some $16-18 billion should be "usable currencies" available for lending.

The World Bank Group (IBRD, IDA, IFC) lending has been growing, but it still provides only a small part of the financing. This year it would provide about $5 billion, or less than 10 pereent of the LDC current account deficit. Moreover, while the World Bank loan commitments should approach the $12 billion mark this year (about double the amount in 1975), the disbursements remain slow due to the fairly long time

required to complete projects. The newly-instituted "structural adjustment" lending is intended to speed up disbursements, but it is unlikely to exceed $1 billion over the next 18 months. This lending is designed to support policy reforms which would help developing countries adjust to changes in world economic conditions. The structural adjustment lending program is similar to the Extended Fund facility lending program of the IMF and could very well be administered in a coordinated way.

Alternative Financing Approaches

The strains on the world economy resulting from the second oil shock are unlikely to moderate in the near future. On the contrary, these strains are likely to intensify, leaving some countries poorly equipped to cope with their effects.

In this environment, the major concern is not about the OECD countries. These countries should continue to receive adequate financing for their payments deficits from the commercial banks and other sources. Rather, the concern focuses on some of the non-oil LDCs whose payments outlook has become or threatens to become serious. In reassessing the risks involved, commercial banks have become more reluctant to expand their exposure in the low income LDCs, and to offer the same magnitude of financing to certain other countries as was forthcoming in the period following the first oil shock. Consequently, other channels of financing need to be kept open to assure that adequate growth of world trade and income is sustained in the difficult period ahead.

While the World Bank is increasing its range of activities, the IMF has the major responsibility for balance of payments financing. Compared to other lenders able to provide resources on a large scale, the value of the Fund rests primarily in its ability to ensure that any transfer of resources, beyond a specified fraction of a member's quota, is related to the adoption of policies designed to correct the need for the financing. The imposition of these policies

effectively provides the necessary confidence that adjustment will be achieved and thereby ensures that flows of external funds from other sources will also be available on a continuing basis.

One of the problems that has resulted from the Funds's conditional form of lending, however, is that countries have often proved reluctant to submit their economies to the Fund's guidance until other sources of funds dried up. Recognizing this, the Fund began to review its policies on conditionality a few years ago and last year formalized a new set of guidelines in ways which allow for a greater degree of flexibility than previously prevailed. These new guidelines emphasize the need to encourage members to adopt corrective policies at an early stage of their payments difficulties and recognize that some countries may require adjustment periods of more than one year usually associated with Fund lending. Further, the new guidelines stipulate that performance criteria should normally be confined to macroeconomic variables and that the domestic social and political objectives of countries should be considered.

In addition, the Fund has also adopted a number of measures in recent years to increase the volume and availability of loans relative to quotas. For example, in 1979 the Fund provided that resources from the supplementary financing facility could be used up to 300 percent of quota.

This raised the potential use of conditional reserves as far as 465 percent of quota in the context of an extended agreement. In view of the potential magnitude of the payments deficits many countries will be facing the years ahead, it may be desirable for the Fund to liberalize further these criteria.

These innovations on the part of the Fund are constructive. The lengthening of its lending periods, for example, widens the choice of alternative policy instruments available to borrowing countries and provides greater latitude with respect to adjustment programs. More gradual progress toward adjustment can improve the feasibility of a program, in particular, if it permits a more acceptable distribution of the burdens involved.

At the same time, however, there may be other ways for the Fund to improve the recycling process. For example, the Fund may be able to take a more active part than it now does in promoting and mobilizing an increasing amount of financial flows through its technical assistance in organizing and participating in consultative groups and creditor clubs.

Furthermore, in view of the overriding importance of energy costs in the recent payments imbalances, the Fund may wish to give special attention to energy policies in formulating its support programs. This is an area of particular expertise for the World Bank. In this, as well as in other policy areas, the Fund and the Bank may find it useful to develop and coordinate further their respective lending activities.

It is probable that the Fund's regular resources together with the as yet uncommitted part of its supplemental financing facility and planned quota increases will be adequate for the near term. But some strengthening of the Fund's liquidity may be desirable in 1981 and beyond, particularly since the Fund may by then be assuming an even more active role in the recycling problem that it has assumed to date. This contingency is recognized in the directive adopted by the Interim Committee at its April meeting in Hamburg. It encourages the Managing Director of the Fund to begin discussions with potential official lenders regarding the terms and conditions under which the Fund could borrow additional funds if, and when, the need arose. Provision of additional resources by means of further quota increases or direct borrowing should be seriously considered. Direct borrowing could be arranged through either certain groups of lenders or a set of bilateral agreements.

There is good reason to support a strengthened role for the IMF in the recycling effort. But, in addition, the oil-producing countries must also take a more direct part in recycling their surplus funds to LDCs in deficit. An increase in their direct investment and aid flows would be especially desirable. But, realistically, investments in financial assets are the most obvious vehicle.

However, the range of financial assets available to OPEC investors in LDCs is not broad. Local capital markets are largely undeveloped; equity markets typically are non-

existent. Nevertheless, OPEC members have an interest in a diversified portfolio of assets and that should normally include some types of LDC-based securities. The challenge is for the two sides to develop financial instruments that serve mutual interests. Potentially, those instruments could include features that are not normally available in the financial markets of industrial countries. It is difficult to say precisely what specific forms these instruments should take. But features that greatly reduced exchange rate risks, for example, SDR denominated issues, would be natural ones to explore, and other options may also prove mutually attractive.

Another suggestion to encourage direct lending by OPEC investors to non-oil developing countries would be to have the potential borrowers group together to offer collective insurance against payments interruptions. This alternative, while discussed before without enthusiasm, might be reconsidered.

Finally, in those LDCs where equity markets are not developed, the concept of the government issuing "development equity" securities -- LDC instruments whose rate of return is keyed to the average return on a basket of development projects -- could have appeal to foreign investors. In addition, some countries could consider issuing broader "national income equity" instruments, whose yield is keyed into the overall growth rate of the economy. This general area deserves attention and further studying to determine the methods which have the best chance of stimulating significant inflows of funds.

The important point is that OPEC countries must recognize a responsibility for the financial consequences of their pricing actions. A cooperative approach of working with individual LDCs, when appropriate with the technical assistance of the IMF or World Bank, could lead to development of imaginative financing tools that could relieve some of the pain of the oil-induced deficits of LDCs.

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Energy Policy

Imaginative financing arrangements to permit deficits to be adequately financed are indispensable to avoid unacceptable economic disruption in the near term. But these arrangements cannot correct the fundamental difficulties that have given rise to the international oil problem. Elimination of these difficulties requires major efforts in the oil-consuming countries both to conserve energy, in particular petroleum, and also to develop alternative energy sources. It is heartening that consumers are responding to higher prices by cutting back purchases. The elasticities are perhaps smaller than they could be, but they are still there. And some national policies have also contributed to energy conservation. However, the U.S. and other industrial countries can do much to encourage conservation.

The governments of these countries have recognized this, at least in general terms. At the Venice Summit the United States and other major countries agreed to encourage the use of existing petroleum substitutes both by households and businesses, to conserve energy by improving insulation in buildings, improving on mass transit, and increasing fuel efficiency in motor vehicles. Moreover, the summit declaration mentions a wide range of possibilities for developing energy supplies other than oil. These include the increased use of coal in the medium term, and a substantial rise in the production of synthetic fuels and solar power in the longer term.

The program outlined at the Venice Summit deserves vigorous support, but as the governments themselves recognize, the proposed policies could not have a major influence on the oil market for some years. The pressing need is for measures that would have an immediate impact. There are several options. One possibility is to put on substantial excise taxes on gasoline, implemented through a series of yearly increments. This overall approach would constitute a form of "domestic recycling", whereby part of the taxes that would otherwise be paid to OPEC in the form of higher oil prices could be paid to ourselves instead.

Domestic recycling through such a tax would have multiple benefits. A further rise in gasoline prices would speed the process of consumer conservation, as well as accelerate efforts to achieve greater fuel economy in motor vehicles. A portion of the revenues raised by the tax can be put back into the economy.

Part can also be recycled into development of alternative energy source development, and into investments to embody more energy saving in new products. Finally, domestic recycling, to the extent that it reduces the resource drain to OPEC, can improve the balance of payments and relieve pressure, both direct and indirect, on the dollar.

Most important, a serious effort to conserve would carry a clear message to OPEC that the United States is determined to reduce its dependence on imported oil. It would set a standard that other oil-consuming countries could also seek to follow. And it could change the OPEC calculus and make it far more likely that leaving oil in the ground would be a poorer economic decision than selling the oil and investing in financial assets. That is the surest way of relieving long-term tautness in the oil market and reducing the chance that the world economy would be subjected to yet another oil shock in the future.

Senator BRADLEY. Thank you very much, Mr. Kubarych, for your statement. There are creative ideas in there as well as a clear and thorough analysis of financial problems that result from the energy shocks. Now, I would like to proceed by asking more general questions and then coming to some of your specific recommendations a little later in the hearing.

I think the pernicious aspects that these oil shocks have had is, as I said in my opening statement, the combination of recessionary pressures and inflationary pressures both resulting from oil price increases.

I was wondering which you regard as the greatest danger to our economy?

Mr. KUBARYCH. I put it in a slightly different way. The greatest danger is the massive shift of wealth, real wealth. We are poorer because they have raised prices and have an ability to raise prices further. Because we are poorer we must consume less or have less resources to spend on those particular projects and social objectives that we would like to spend money on. We do not have that flexibility any more.

The recessionary effect, is part of the dynamic process of adjustment. But the basic pain of OPEC is that they have made us less wealthy. We will try to adjust to that drain.

Some people try to get that money back to spend by seeking higher nominal wage increases. But because the absolute transfer of wealth has already happened we all as individuals in this economy cannot do that. We simply create inflationary dynamics that make other aspects of policy more difficult.

On the recessionary effects that stem from the loss of income, it is worth remembering that the shift in wealth to OPEC changes in a very important way the world's overall propensity to save. In that sense it provides a kind of opportunity.

On the average, OPEC saves more of a dollar of their earnings, particularly the low absorbers like the countries in the Persian Gulf, than ordinary people in industrial countries and developing countries.

So you have a shift in world patterns of spending toward saving. Now the basic textbooks that we grew up on present that as an

opportunity. If we cannot close that gap with greater investment but try to consume the difference, then we are nowhere. That is because they retain the ability to raise oil prices and we are consuming out of actually a weakened level of income and wealth; and we have nothing to show for it.

But because that savings is there—it is not just potential savings, it is actual savings—we can take steps to mobilize that savings, increasing our own investment. In a way this additional savings shows that OPEC countries in the aggregate do not feel that they have the investment programs that are worthwhile taking, either because of sociological and political concerns or whatever.

We have such projects in this country, other industrial countries and certainly the LDC's. So we can offset the depressing effects of their increased savings by increasing our investment. Or we can mistakenly try to offset the depressing effects by increasing our consumption. If we do that, we do not solve the problem. We compound it.

Senator BRADLEY. I want to come back to this again, but just to follow that line of thinking, as you attempt to lure back the part of the dollar that certain OPEC countries save, a part that is larger than what would be saved in Western economies, what has to occur? It has to be lured into a long-term investment, not a short-term investment, wouldn't you agree?

Mr. KUBARYCH. They have to buy long-term financial assets rather than short-term financial assets.

Senator BRADLEY. And they haven't done that.

Mr. KUBARYCH. Well, I do not think that they have done so sufficiently. There is no fixed pattern to their investments and it changes over time. When you look at the aggregate it depends a great deal on three or four countries, or the major savers in this group. There is obviously a dynamic to the way they invest their resources. Characteristically, surpluses start off invested in short-term bank deposits and then more and more other types of assets get bought over time.

I agree with you completely that their interests should be in acquiring longer term financial assets because their interests must be in the long-term future of their overall economic position. They must look beyond this temporary oil vulnerability and recognize an underlying interest in long-term assets.

There is a problem. It is not a great problem for us, since we have a great menu of potential assets of a long-term nature that they can buy here, including equity participation. That raises other problems but at this level of abstraction it is worth reminding ourselves that we have this financial menu to offer them.

Most other countries do not have that financial variety. So that is why I emphasize that while the general problem is the same for all countries which are net oil importers, the specific problem of mobilizing OPEC savings for investment is going to be more difficult in those countries which do not have strong financial markets than for us.

That does not mean that we are guaranteed to make the necessary shift from consumption to investment smoothly. It will take other incentives. But at least we do not have a gaping hole in financial markets. We have strong financial markets. Maybe I am

oblique to your point. But I do think there is a complicated set of different problems for different parts of both the industrial world and the developing world.

Senator BRADLEY. When you are confronted with a situation like Iran, a drop in production, and therefore a very rapid increase in price, 110 percent in 1 year, it is the initial response of the policy-maker to respond to that inflationary price increase by contracting economic activity.

I think that is what has happened to the economy in the course of the last 3 or 4 months. Now what I am asking, and the thought underlying the question that I first posed, isn't there a danger of over contracting the economy in response to an oil price rise because one does not understand the recessionary pressures that are implicit in a dramatic increase in the price of oil.

Shouldn't we therefore try to be a little more balanced in our response?

Mr. KUBARYCH. Now I understand exactly what your question is, and I basically do not agree with you. I do not basically think that the steepness of this correction that we have had in our domestic economy was triggered by the effects from the oil shock, although oil was an element in the process.

I think we became poorer as soon as that 110 percent oil price rise that you mentioned started to come through. And because we had been so slow in reacting before and then finally reached a consensus in favor of oil price decontrol, we had a double barreled effect. In that situation, I think that our consumers behaved quite naturally. They tried to maintain a level of consumption that was not at all compatible and harmonious with their changed real position. So they put off the day for quite some time when they would have to adjust their living standards. That did not happen gradually.

What happened was that the adjustment got telescoped into a very short number of weeks because of a strong psychological change among consumers. There were a number of reasons for that. The credit restraint program was one of the catalysts and there were other catalysts.

But the fact of the matter is that if our consumers would have gradually changed the structure and pattern of their spending in harmony with the reduced wealth because of the oil shock, we would not have had this sharp recession. We would have had a much more gradual period of adjustment.

But they did not do that. You know what happened to the savings rate. It went in just the perverse way. When that swung around sharply in April from well under 4 percent to almost 5 percent in a period of a few days, then you had that sharp correction on the consumer side.

So I am certainly agreeing with you that it would have been much better not to have had that type of correction but the reason we had that correction was not because of some overkill from policy.

Senator BRADLEY. The failure to adjust?

Mr. KUBARYCH. The consumer acts in a discrete way and not in a smooth incremental way. That kind of consumer behavior leads to enormous unpredictability. I do not think one would have predicted

such a sharp change in consumer patterns in such a short period of time.

Senator BRADLEY. There are those people who argue that if you have a rapid increase in the price of oil that one of the ways you can accommodate that loss, to the economy what you refer to when you say "people are poorer," is by increasing the money supply. Now, do you feel that you can increase the money supply in response to an oil price increase without releasing rather severe inflationary secondary effects in the economy?

Mr. KUBARYCH. I totally disagree with the point that you can offset the effect on the consumer of a major shift in relative prices by increasing the money supply beyond what you would have had otherwise. That is because at a time when many sectors of the economy are fairly near their full capacity utilization, there is not a lot of slack in the economy. There is not very much give or flexibility to produce more in a short period of time.

Under those circumstances, to validate that relative price change with monetary expansion has to be inflationary. Not only must it be inflationary but even ordinary people are going to see it is inflationary. They are going to do things like sell off bonds as they did in January, move into real estate, and borrow to finance purchases. You are not going to be able to deceive people under those kinds of circumstances.

There are other circumstances where there is slack in the economy when increasing the monetary growth from where it was would not have a broad inflationary effect. It would be minor. But when there is a strong perception that the economy is fairly near full capacity in many sectors, if you accelerated monetary expansion to validate that——

Senator BRADLEY. Did you say "invalidate"?

Mr. KUBARYCH. To validate the oil price change, then the inflationary effects will be very strong because people will not be deceived. That is a very uncomfortable answer but that is my judgment.

Senator BRADLEY. Well, it is the answer of someone who wants to squeeze tighter, but I understand your point. Do you anticipate that the OPEC surpluses will increase or decrease as we move into the 1980's?

Mr. KUBARYCH. I think that they will be in a narrow band between something on the order of $90 billion and something on the order of $130 billion. They will be larger when the world economy is growing a little bit faster and they will be smaller the other way.

Next year they will probably be under $100 billion but if they turned out to be higher during late 1981 and into 1982, when growth probably will improve in the OECD, then I could easily see something around $130 billion. This would be on the basis of what we might call neutral oil price assumptions——

Senator BRADLEY. Which means no shock?

Mr. KUBARYCH. No new shock.

Senator BRADLEY. Have you worked through any figures as to what the oil price effect might be if part of the Persian Gulf supply to us, say the 3.5 million barrels we import a day were lost?

Mr. KUBARYCH. If you lose how many barrels a day?

Senator BRADLEY. The United States gets about 3.5 million barrels a day from the Persian Gulf. Let us say, for argument's sake, that the world production is 49 to 50 million barrels a day. If you lose 4 million barrels a day, roughly 8 to 9 percent of the world's supply, what would that translate into in world price of oil?

Mr. KUBARYCH. That is about the hardest question so far. It depends on how permanently we lose it and of course it depends very much on who loses it. If it is lost, for example, for reasons that look unrecoverable, particularly in those areas that have large proven reserves so that not only the current 3.5 million barrels a day is extinct but the future production is in jeopardy, then the changes in perceptions will be phenomenal and the price increases are going to be very sharp indeed.

I will not give you a number because it would be such a large number that it would sound alarmist. But if it were 3.5 million barrels a day spread out among a number of countries, and that could easily happen, then that may be all that is necessary to support a moderate real oil price increase.

Senator BRADLEY. Let me tell you what the Congressional Budget Office said. If you lost 3.5 million barrels of oil a day for 1 year, that would translate into an increase in inflation of up to 20 percent inflation and it would result as well in a loss to the economy of $110 billion to $150 billion in 1 year.

Now I think that is a vivid demonstration of this combination effect.

Mr. KUBARYCH. That is definitely well within the realm of understanding. You can get that kind of scenario without stretching credibility.

Senator BRADLEY. One of the suggestions to bridge that gap has been made is a so-called disruption tariff. Let me explain the concept. If we lost 3.5 million barrels of oil tomorrow, we know the price is going to go up. The question is who is going to benefit from that increase in price? Will it be OPEC or will it be the consuming nations?

For example, in the last year when prices went up 110 percent, the Government of France made more money and got more revenue than the Government of Venezuela because they had a price structure that was highly tax oriented. The argument of the disruption tariff is that when an interruption occurs you put in a big tariff so the money stays in the United States. You also get decreasing consumption because of the higher price. Now, from an economic standpoint, does that make sense?

Mr. KUBARYCH. I think it makes excellent sense. I think you are not going to be able to predict with any certainty exactly how easily the adjustment can be made.

Senator BRADLEY. What kind of questions would you ask in order to determine what the level of the tariff should be?

Mr. KUBARYCH. As for the numbers, 3.5 million barrels a day mentioned, OPEC production has gone down by 3 million barrels a day this year. The reasons we have not had a new round of massive price increases is because demand has gone down for the reasons I mentioned.

Senator BRADLEY. And also because the decrease in production has been done quietly?

Mr. KUBARYCH. It is spread out, it was not concentrated, and it was not in an area that looked like it was a once and for all change. Instead, it looks primarily like a modulation of production plans. So that is very important in this calculus.

But let us look at this tariff idea or any kind of tax idea. If any amount of oil is taken out, the most important question is what kind of demand responses are there going to be? Now, if you have uncoordinated, myopic decisions by different countries and different companies to take care of themselves by building up stocks and finding every barrel for inventory that they can find, then the price escalation is going to be phenomenal. You are going to have a kind of frenetic inventory process that is going to be mutually self-defeating because by your assumption that oil is not there. By everybody acting individually and trying to protect themselves, they will be the ones that will force the oil price up sharply.

The high tariff policy can generate an expectation immediately on the part of the people who would be building up those inventories that the demand will be contained. It changes their perceptions of what they need in inventory. You prevent that inventory buildup. Right from the start you do that by giving a strong signal that the demand is going to be lower because you are using a price mechanism to reduce that demand.

You can do that in other ways too. At this level of analysis you could try to foster the expectation of lower demand by just telling people not to consume it. I do not think that works, but the price mechanism can work. That is the best payoff from the tariff or high tax approach because you truncate the inventory building process that otherwise provides the momentum for the price increase.

If you can get a hold on the price increase right from the start, you essentially create the conditions for overall market supply and demand that do not lead people to be bidding seriously for the oil that is there.

Senator BRADLEY. Has the Federal Reserve done any elasticity studies on this?

Mr. KUBARYCH. We have done some.

Senator BRADLEY. What is your number?

Mr. KUBARYCH. We use something on the order of 0.4 in the short term for gasoline and 0.8 in the medium term.

Senator BRADLEY. Those are your figures and your people have arrived at that?

Mr. KUBARYCH. They have arrived at that by digesting the results of a number of econometric studies.

Senator BRADLEY. That is not a Department of Energy figure?

Mr. KUBARYCH. No, it does not mean that they are any better or any worse. These are the figures that our economists use.

Senator BRADLEY. That is 0.4 for gasoline?

Mr. KUBARYCH. Something like 0.4 for gasoline in the first year and something on the order of 0.8 for longer time periods. For all oil it is a little higher than that because in the short term industry can adjust more easily than the automobile driver.

Senator BRADLEY. You directed some attention in your prepared statement to the question of inducing oil producers to produce oil because it is more in their interest.

Mr. KUBARYCH. That is right.

Senator BRADLEY. Than to keep it in the ground.

Mr. KUBARYCH. Yes.

Senator BRADLEY. Now, if they would do that, that would require them to believe that they would get a higher return on investing earnings from oil sales now than on keeping oil in the ground. That assumes that their investments held long term will out-pace inflation, among other things.

Now, there are a lot of ideas around. You have given us two today and I would like to get your reaction to several others. One idea is to offer OPEC bonds, to pay for the oil with bonds backed by gold in full or in part.

Others such as Walter Levy have suggested that the bond be linked to a basket of various industrial or major industrial goods. You have suggested development equity and an income equity securities.

Could you talk about the relative merits of each of those four? First, I would like you to talk about the first two and then we will come to your two suggestions.

Mr. KUBARYCH. I do not think, or my general point is I do not think——

Senator BRADLEY. And let me just say this: I asked this question having spent a number of hours with oil ministers in Saudi Arabia and Iraq and having them tell me that they are going to keep the oil in the ground unless they have an assurance that they will make more than inflation by investing in the Western world.

Mr. KUBARYCH. I understand why they might tell you that because I cannot understand how they would ever want to tell you anything else.

Senator BRADLEY. You can tell me how they can do that now.

Mr. KUBARYCH. I want to be very careful here that we first take heed of principle No. 1. Let us not propose for other people that which we will not be willing to do for ourselves. I do not think this is presumptuous. To the contrary, it may seem patronizing to people in other countries when some of these ideas are put forward in that spirit. I would reject them just on that principle.

Senator BRADLEY. I do not understand that.

Mr. KUBARYCH. I would not be terribly comfortable with the United States issuing gold-backed securities.

Senator BRADLEY. Why is that?

Mr. KUBARYCH. To anybody.

Senator BRADLEY. Why is that? I am sure you are aware that we are going to have a presidential campaign where this might be an issue, where we will have one candiate talking about the return to the gold standard. It won't be William Jennings Bryan, he opposed that, and it won't be William McKinley this time either.

Mr. KUBARYCH. First of all the problem with introducing these kinds of instruments when you already have a fairly sophisticated market is that you have a tremendous problem in convincing people that they should not lose confidence in what has been your basic strength for a long time—a deep, broad, and very efficient Government securities market.

There is a public good associated with that market. It shows in a tangible way in that the U.S. Government borrows cheaper than anybody else in the financial markets. One of the primary reasons it borrows more cheaply is that the market is better. It is a strong market and a very flexible one. Muddying the waters by introducing new kinds of instruments into that market can be a problem for the existing issues. That is an important point.

Senator BRADLEY. It makes those issues less attractive?

Mr. KUBARYCH. It is going to create public confusion. People are going to say, "What is the superior issue?" I personally feel that it is wrong to force that question following long periods of negative real interest rates.

I think that is exactly the wrong kind of signal you want to give to people in an economy where we need more investment and revitalization of our industries, to give a signal to people that by buying financial instruments to finance that industrial revitalization they may be making a mistake.

That is my personal view, I think over the long haul interest rates should yield a real return to the saver to compensate the saver for helping to finance this improvement in our industrial strength. That should happen through market forces and I think it will.

But I think it is going to be very difficult if we start introducing new kinds of instruments that confuse the public and make it seem that by introducing this it gives the public reason to be concerned that the Government fears that it will not be offering a real return to savers on its traditional obligations. I do not think that the Government wants to give that signal.

It is much more important to give the signal to the public that we recognize that we need to provide savers a real return and that we are going to maintain discipline in financial affairs so that happens. Then that money will be available. That is the broader point.

On the narrow point of gold, why not use pork bellies or why not copper or why not some combination of commodities? The only thing I can think of that is different about gold than some of these other commodities is that some governments own a lot of gold in their national reserves and other governments wish to accumulate gold. But by and large governments do not own an awful lot of these other kinds of commodities.

So governments have great influence over time on the nature of the private gold market. They create agreements, they sometimes orchestrate policies and they even have programs to auction the gold off. Thus it seems to me that the gold market is not close to being a perfectly free market that can signal a general commodity price level.

It is a very unique market among commodity markets in that the private flow that creates an efficient response is not there. It is a highly politicized market.

If you ask about commodity securities, I would say first: anything but gold. But commodity-type based securities are also something that would help spoil certain aspects of our Government securities markets, and I would stay away from them.

Senator BRADLEY. What about linking to a basket of industrial goods?

Mr. KUBARYCH. These are kissing cousins of general indexation. For instance, the British Government has a certain amount of indexed linked securities for old age pensioners and the idea of indexing bonds has been around for a long time. Basically I am against indexing securities for this country at this time for the same reasons I would be against the gold link—because I do not see how it could be easily fit into our financial markets.

Now, whether we adopted the British style of approach, where a special feature is introduced for particular groups of people who are needy and have a need for some kind of further assurance, that is different. But when we speak about recycling, we are talking about very large sums of money. Very big amounts of securities must be sold to very few people. Index-linked bonds would be immensely competitive with our existing Government securities market.

Furthermore, I do not know whether it is in our national interest to take OPEC off the hook. I recognize that they want to be assured of a real rate of return and that I can understand. What I cannot understand is why they think that we have to take them off the hook and provide them with the ability to easily recycle their funds, that we are going to do their work for them.

I think the responsibilities are the other way, that it should be our task to make them realize that they create the problem with their pricing and production policy and that they have the responsibility for contributing directly to a smooth recycling process.

That is why I look to mutual agreements between OPEC and other countries where there are not strong financial markets, where they can reach new arrangements that they feel are in both of their interests. But if they look to us to ease the problem that they create, I think that that is inconsistent.

Of these various proposals, the idea of a development equity security would clearly meet a specialized need. There are no equity markets in most countries and OPEC investors could not buy a share of stock in something even if they wanted to. By contrast, that is a market that we already have.

Now you ask yourself the question, how can you imitate that?

Senator BRADLEY. Before we get to your idea of a development equity bond, I would like to go back to your reaction to indexation, say the British example, and indexation generally.

If you were to index the principal, not the interest, but the principal against inflation and then offer an interest rate of, say, 2 percent, with the purpose of attracting short-term money into long-term investment, what is the difference between that kind of indexation and market interest rates in an inflationary environment where the Government issues must be made at 16 or 17 or 18 percent as inflation rises?

What I'd like you to compare are a bond where the principal is indexed to inflation which might be called the inflation defense bond, and the normal Government bond which in inflationary environment has to carry interests of 16 or 17 or 18 percent.

Mr. KUBARYCH. I hope it is not that high. You could probably find a country where they have that.

Senator BRADLEY. Well, if the rates of interest don't reach that high, that means we are successfully combating inflation, which means that the increase in the principal due to indexation would not be significant either.

Mr. KUBARYCH. What shall I say? The lure of indexation has a seductive charm to it because it looks like it removes uncertainty or it looks like a kind of mechanism that is in everybody's interest on the face of it. That is why it keeps coming up.

It has been tried in a number of countries and it is interesting to look at the cases of those countries that tried it and then backed away from it. One is Finland, for example, in the 1950's.

The problem of indexing important parts of the Government's debt—in addition to setting up a kind of a tiering among Government obligations—is what does that mean for indexing in the rest of the economy?

Senator BRADLEY. What is that?

Mr. KUBARYCH. What kind of a signal it creates for opening up additional indexing in the rest of the economy. You do not stop with indexing bonds. Other things will be indexed too: Wage agreements.

Senator BRADLEY. Wage agreements already are and social security obviously is.

Mr. KUBARYCH. There is more indexing in this country than there used to be, but there is still comparatively little if you compared the United States to, say, Italy.

Senator BRADLEY. What I fail to see on that——

Mr. KUBARYCH. It is very difficult to reduce the inflation rate, the greater the proportion of indexing you have, and I would think that we have a long-term interest in reducing the inflation rate. We cannot start from scratch. There is massive outstanding Government debt built up over many years and you cannot start from scratch and say, "Well, if you were starting today with no debt at all given the prospects for inflation, would you be willing to start indexing bonds?"

Your answer would be quite different than when you start with a great deal of debt already.

Senator BRADLEY. Well maybe that is an answer. Maybe that is an answer to my question because what I wanted to pose was if indexation has a Rubicon effect that once you cross it you are in a different world, we have already crossed that with most wage agreements and many pensions including social security.

Therefore since we have already crossed that, what is the difference between indexing wage agreements and pensions and indexing a bond?

Mr. KUBARYCH. Well that is a very subtle way of asking the question because you ask it in a very difficult way. It is easier for me to say it is more harmless under those circumstances because if you have a great deal of cancer and adding another type of cancer is not going to make the patient any sicker than he already is.

So you can get the answer, yes, it only increases marginally to his illness. I am not sure your premise is right.

Senator BRADLEY. Do you think that all indexing is cancer, is that right, and there is not a difference? I was thinking there was a difference.

Mr. KUBARYCH. I think all indexing—we can push these analogies a little further than we want to, but I think all indexing is cancerous and makes it much more difficult on those parts of the economy that are nonindexed.

I understand the literature that teaches that if everything is indexed, the economy can manage fine. It is just a moving picture show rather than a sequence of snapshots. I understand the logic of that and I understand the problem, now that we have more indexing than we used to. But we are still very far away from everybody being indexed.

Introducing more areas of indexation little by little is pernicious. I think that is a better word than cancerous. I reject these seductive arguments in favor of indexation for this country.

Senator BRADLEY. I would like for you now to compare these kinds of instruments that we have been discussing and your idea for development equity and income equity securities.

Mr. KUBARYCH. The comparison is very simple. In this country an investor, a foreign investor—OPEC or otherwise—has a lot of financial assets to choose from. In most developing countries—and I am considerably more worried about the ability to achieve recycling to those countries than I am about the recycling to industrial countries—they don't have these markets, although you might say they should have them.

They also have a different mix of public sector, quasipublic sector and private activities than we do. The private activities are, generally speaking, a smaller fraction of their total economic activity. That is the way things are, and in some countries there is very little private activity in major industry at all.

So, it is hard to foresee large amounts of equity instruments being available to OPEC or other foreign investors in developing countries.

Let us imitate the equity option. I am not suggesting selling of shares, for example, in the Government Development Bank. That may be tricky to arrange and raise other kinds of problems; but it shouldn't be too hard to put together a package of, say, 40 development projects, industrial development projects, with some help from the World Bank and IMF or other intermediary, and offer a piece of paper to the buyer that says, "In return for *x* million dollars which you are going to lend to us, we will promise to pay you the London Interbank offer rate plus *x* percent if these projects yield 3 percent in real terms, or plus *y* percent if they yield 5 percent."

You can work out the dimensions of what that markup would be. "The more profitable these projects are, the more money you are going to get, but you are going to get at least some minimal return."

Senator BRADLEY. Lenders would have an equity position and they would own 2 percent of the Hoover Dam, for instance?

Mr. KUBARYCH. That is right. There would be an outside agency, an honest broker, monitoring the cash flows and economic returns so that the lender is protected.

There are domestic analogies. You know a lot of real estate development projects in this country have been financed through

techniques that involve so-called equity kickers. The germ of the idea of an equity kicker is where a financial institution will find a developer who wants to put up a new shopping center in Woodbridge or wherever and wants to borrow the money. The loan agreement says, "The lender gets *x* percent a year plus 1 percent of the cash flow of the Woodbridge Shopping Mall."

Now, that is a kind of financing that exists. I am trying to invent a way to take that kind of financing and apply it on a macrolevel to a country. It seems to me it is doable. It is not a brandnew idea. But let us use some of the techniques we already do that work and apply them to the recycling problem.

It works for real estate developments—and some of these are very big. The same idea can be adapted by developing countries, worked out between the country and the OPEC investor directly.

Senator BRADLEY. You say primarily a developing country?

Mr. KUBARYCH. I think it is more necessary there because of my basic premise that they don't have the other alternatives. You can't buy a share of stock in the local real estate developer as you can for many of the major real estate developers in this country or major manufacturers or other companies.

Senator BRADLEY. Do you think the yield from such an investment is going to be greater than the increase in the price of oil in the next 10 years? That is what the OPEC country would have to determine.

Mr. KUBARYCH. Well, the OPEC investor is not going to know that, because he doesn't know how serious our conservation efforts are going to be in the industrial world and how lucky we may be on some of these alternative energy sources.

I would imagine 10 years from now we are going to be successful on one of these alternative energy projects in a big way. So we are talking about a major problem for 5 to 7 years. By the end of that 10-year period OPEC will see that oil is not the only energy source and that we will have others.

So what I want to do is bring forward these changes in perceptions. Once they know that we have these alternatives, then they will want to sell the oil. You can bring that forward by conservation and then get them to realize that conservation gives the potential for the oil price not to go up.

If there are no conservation efforts at all and the alternative energy sources don't go anywhere, then, of course, OPEC is not going to feel that real oil prices are going to stay constant or go down.

But we cannot go from here on the basis of the worst possible scenario; we have to go on a basis of an intermediate scenario, where we need to take positive steps, recognizing at the same time not everything is going to come out right.

Mr. BRADLEY. Would not OPEC countries simply cut back production to, or below, levels of demand with conservation?

Mr. KUBARYCH. Well, with the present world oil production you have a few countries that are producing more oil than they need for their domestic economic purposes, Saudi Arabia being the biggest slack country—that is, with about 4 million barrels they are producing beyond their domestic purposes.

Senator BRADLEY. With their need to finance their imports and so on?

Mr. KUBARYCH. Yes, and whatever development projects that they have in mind.

In Kuwait there is some flexibility. Iraq is another one. You have about 6 or 7 million barrels of oil in the world today that is potential slack. Now, that requires a reduction in consumption in the oil consuming countries in the neighborhood of 12 to 15 percent, before you will even get to the crunch.

The oil producing countries are going to still be cautious. If they see us reducing consumption, Saudi Arabia will cut back, but as it cuts back it reaches its optimum production level. But until you cut back 6 to 7 million barrels a day through conservation you are not likely to have pushed the oil producing countries below their optimum production level.

Senator BRADLEY. Now, for what you said to be true, for them to perceive that oil in the ground is less valuable than investments, the conservation effect would have to be far greater than 6 to 7 million barrels a day.

Mr. KUBARYCH. I agree with you, except for one thing: If we could actually pull off even 5 million barrels a day in the industrial world through conservation efforts, they will see we have the potential to go to 7 or 8 or 9 million barrels. We would not have to get all of the way down below that critical point. I agree with your logic, but we are talking about their perceptions.

Do we actually need to physically move down to that critical point, or do we have to raise the odds that we can, that we can turn the screws a little bit harder and reach or even go beyond that breaking point?

So, I see the drift of your point, namely, can we really put this burden on ourselves of conservation? That is without a great payoff to the public until consumption has already gone down to 6 or 7 million barrels a day?

Senator BRADLEY. Can your idea really work? Will the OPEC countries perceive that a development equity security is a better deal than keeping oil in the ground?

Mr. KUBARYCH. The scheme could make a marginal contribution. You are not going to do one thing that is going to solve this world imbalance. It will have to take a wide variety of initiatives, including other options or arrangements with OPEC that they may find they are interested in. They are interested in security and they are interested in the long-term future of their social structure and their social stability. They are not simply focusing entirely on strict economic calculations.

It is a mistake if I have given you an impression that it is simply financial arithmetic.

But as you suggested, they do do this arithmetic. They have to conclude on the basis of the last 5 years that they would have done better with the oil in the ground. But I don't think we need to have to repeat that last 5 years.

Senator BRADLEY. What effect do you think this equity approach would have on the lending of private international banks? Do you think it would decrease if this kind of security became available?

Mr. KUBARYCH. My feeling about that is very simple. I think the

commercial banks feel that international loans are good business. But they want the confidence that they are not being left with a larger and growing share of total recycling. They are comfortable doing a more or less balanced share, about the share that they have done in the past.

With these other kinds of efforts and instruments available, that gives them much more justification for maintaining a good, solid increase in new lending themselves.

So, I don't think as these alternatives develop that the banks would generally respond by cutting back their lending; rather, I think it would give them courage to continue. That seems to be the case with these types of programs. Banks are looking for opportunities to maintain their lending without taking increased risk. Alternative financing options lower risk because they spread the number of channels for absorbing risks. With lower risks, there is a good, solid economic argument for the banks doing as much and maybe even give them some edge for doing more.

I don't see these kinds of ideas as being ways to get the banks out of this business but to sustain their own contribution; and I don't think the banks want to be out of this business. I hope that that answers the question.

Senator BRADLEY. I think it does.

What I would like for you to do—and I want to move on and I don't want to stay on this the whole time, and you can imagine the territory that would be covered if there was a full committee here—so let me ask you, for the record, because what you are proposing is a new idea that is directed at a very critical issue that we have to come to grips with—I would like for you to lay out in step-by-step terms how this development equity security idea would work. Who initiates it? How would it be sold? Who would the buyers be? What would the motivations be? And why would it work? If you can, briefly.

We already have covered a lot of this territory, but I think I would like to have it laid out in sequence.

Mr. KUBARYCH. The participants would be the development banks, perhaps aided by the central banks of those developing countries that don't have equity markets.

The other side would be OPEC investment funds or OPEC investors, including their own development institutions which have funds to invest, and perhaps even including their central banks and financial ministries as well.

The assistance, so to speak, would come from existing international organizations like the Inter-American Development Bank, Asian Development Bank and World Bank and other kinds of organizations that have expertise in putting together cofinancing ventures.

The financial instrument involved is a loan agreement between the participants that specifies a group of development projects which yield returns to the economy. Those returns are measurable by outside experts like the World Bank's and a rate of return schedule would be drawn up based on how profitable these projects are over time. The total yield would include a base rate of return in nominal terms to the investor, plus a margin determined by the schedule of returns relative to the profitability of the package of

projects. So each year the investor would get back on his x million dollars invested a nominal yield plus an additional percentage based on how profitable the projects have been for the last year. That calculation would be done each year, but hopefully the arrangement itself would be of a medium-term or long-term—10- or 15- year—duration.

Senator BRADLEY. And the country that would have these oil payments facilitated would be developing countries and it would not affect the United States directly?

Mr. KUBARYCH. I think it is redundant to think of an idea like this for the United States, because we have plenty of excellent stocks and equities that foreign investors can buy, and do buy.

This imitates something for developing countries that wished to avail themselves of the benefits of equity instruments to sell to OPEC investors. It allows them to create an analogous instrument.

Senator BRADLEY. Why do you think that involvement of international financial institutions as intermediaries is important?

Mr. KUBARYCH. I think you have to have an honest broker in this, to make sure that the projects are evaluated properly. In addition, "cofinance" could be an important element. Many projects would have been partly financed by multilateral financial institutions, so they are natural participants in the lending process.

Senator BRADLEY. One of the questions that arises about cofinancing in my conversations with people who have been involved in it, is how to determine who is apportioned what part of the default. I don't want you to address that now, and maybe you could answer that in writing for the record.

Mr. KUBARYCH. All right.

Senator BRADLEY. I want to move on, if we can.

Mr. KUBARYCH. I think that is even harder to answer.

[The information follows:]

It is our understanding that World Bank cofinancing projects with either official or private institutions will generally include in their loan agreements a cross-default clause. This is very similar to a clause routinely included in commercial bank international lending agreements. It links the loan of several lenders in such a way that a default on any associated loan is treated as a default on all associated loans. In the cofinancing schemes entered into by the World Bank, the clause typically gives the Bank the right to suspend disbursements or accelerate repayments if another lender (or lenders) declares the loan in default.

In accepting the inclusion of cross-default clauses in their loan agreements for cofinancing schemes, however, the World Bank apparently does not agree to apply automatically any of the remedies to which it is entitled. Even if, for example, another lender should decide to take action as the result of a default under the loan agreement, the World Bank may not necessarily follow suit. By not committing itself in advance to apply remedies, the Bank thus retains the right to decide on a case-by-case basis whether and in what way it will take action.

By the way, we know of no defaults to date on any cofinancing schemes in which the World Bank has participated.

Senator BRADLEY. I want to move on to the whole question of the state of our private banking system, worldwide.

In 1973-74, as you pointed out, the financing needs of oil consumers were really handled well by the private banking system. That was in part because it had access to the OPEC surplus, because private banks had relatively low country risk exposures, and because the Eurocurrency market was minimally regulated.

Now, do you think that all these conditions prevail today, and if

not, what are the constraints on Western banks in financing the billions that these undeveloped countries have to pay this year over what they paid last year for their oil?

Mr. KUBARYCH. Well, I think we would figure that the overall nonoil LDC current account deficit for this year would be about $55 billion, and it would be comfortable for the banks to be financing on the order of $25 to $30 billion of that. So that kind of magnitude is still a fairly substantial number.

There have been two or three favorable developments in the last 4 or 5 years that are worth starting with.

The first one is that more banks from more countries are participating in the international markets, whereas, 7 or 8 years ago U.S. banks were predominant and the major lenders in most of these LDC markets.

We have a great number of other banks—for example, German banks and Japanese banks—that are participating. The result has been quite natural that in virtually every country, the share of U.S. banks' exposure to total exposure has gone down. So there is more participation and there is a broader market, and that is a good development.

The other good development has been that there are more countries who are borrowing. The concentration of lending was very extreme 7 or 8 years ago. The top 10 borrowers would account for three-quarters or 80 percent of the total amount of lending to LDC's. That has come down—not a great deal but it has come down. And there are countries who have been borrowing quite routinely that were not in the market at all.

So, where the banks had been lending to, say, 30 countries in total, now it is quite common to see 60 or 70 countries borrowing from commercial banks. For many newcomers, the amounts are small but they are there and they are building banking relationships, and I think that that is a good development.

Senator BRADLEY. So 60 to 70 countries are now borrowing from private banks?

Mr. KUBARYCH. Yes. The U.S. banks have outstanding exposure of a nontrivial sum to 60 or 70 countries?

Senator BRADLEY. U.S. banks?

Mr. KUBARYCH. Yes.

Senator BRADLEY. It could be greater, too you mean?

Mr. KUBARYCH. Yes, and the numbers might even be greater.

Senator BRADLEY. You mean there could be about 125 countries that are doing this?

Mr. KUBARYCH. Yes, but some are very small and the amounts are small. I noticed the other day that in the Wall Street Journal there was an article about lending spreads, and there was a story about Fiji borrowing, and so maybe it is 71 countries who borrow. Those are the good developments.

The other positive development is that both the banks and the regulators and supervisors of the banks have become much more attentive to risk concentrations.

Our approach has been—and we have been very open about this—not focusing on whether a bank should or should not be lending to a particular country; the approach has been entirely looking at the diversification within the bank's international port-

folio. Banks themselves have recognized—and we can prove—that a diversified portfolio is less risky.

The degree of diversification differs from bank to bank but we have seen strong diversification as banks get involved in more and more countries.

Senator BRADLEY. There is a strong risk, you mean?

Mr. KUBARYCH. Diversification tends to lower total risk. So the trend to diversification is a very positive development, too. It means that a bank is not threatened by minor, temporary, and largely painless payments, disruptions because of the diversification in its loan portfolio. So, an appreciation of the diversification is a third positive development.

Senator BRADLEY. So you disagree with the Bank for International Settlements when in its 50th annual report it gave a stern warning about some banks being overexposed.

Mr. KUBARYCH. I know what they said and I think part of it is correct. But actually I think that we can take a certain amount of pride that we were out in front of this issue and for quite a long time now have been developing a system of studying, reviewing, and monitoring country lending in a serious way. That was before a lot of other countries' supervisory authorities had taken as concrete an interest in it.

The BIS may be able to make that statement and I am sure they believed their own statement, but I don't feel for the U.S. banks that we would necessarily agree with it. We have been on top of this for quite some time, and now we have a sophisticated, comprehensive approach. In fact, representatives of other countries have come to discuss with Federal Reserve people how this approach is organized and implemented. So, I think that is a clue that maybe what we are doing is not a bad thing. I don't think that this question of overexposure is a valid concern for U.S. banks right now.

Senator BRADLEY. You don't think U.S. banks are overexposed at all?

Mr. KUBARYCH. I don't think that they are overexposed. I don't think even in individual cases that in looking ahead there is any dangerous threat to an individual bank's stability because of a gross imbalance in its portfolio.

Now, obviously, it doesn't take too much imagination to think of some very terrible things happening in the world.

Senator BRADLEY. Let us say tomorrow the OPEC countries decided to shift out of dollars.

Mr. KUBARYCH. Well, I have read novels about that sort of thing. That is probably not the worst thing that could happen, and I can visualize the sequence of responses to that, that would come into play.

Senator BRADLEY. What are they, for the record?

Mr. KUBARYCH. Any sudden shift from one currency to another is going to cause some exchange rate movement. But if that rate movement, after it has occurred, to a certain extent is resisted and then partially reversed by fairly vigorous central bank intervention, so momentum is not built into the process, then private funds will come into the market and become a buffer to the initial sudden shift.

The key thing is that there is going to have to be some initial rate movement. It is a change of preferences. If a major OPEC or any other country shifted a great deal of money out of dollars into another currency, there is going to be a change in relative currency prices. It is a natural process of change, because preferences have shifted. But it need not lead to a dynamic process of a widening financial crisis when the central banks resist that rate change, as they have done.

If you look at the record of the last couple of years, I think we have had a fairly good amount of success in preventing some very severe shocks, psychological shocks, to the markets from having broad permanent effects. I don't want to get into any detail on what kinds of market developments followed the Iranian situation.

Senator BRADLEY. So you think that was a good idea? I have talked to a number of those bankers who had the task of informing our allies and the Iranians that Iranian assets were frozen, and it was U.S. policy to freeze those assets, and the reaction has been very mixed.

In retrospect, do you think that will leave lasting damage?

Mr. KUBARYCH. The only way I can answer this and not end up on the guillotine at some future time—and this is a serious question—is to tell you what I have learned personally from market people. There was a feeling at one point that there would be massive shifts of funds out of dollars triggered by this particular action. That was not the case, although clearly there were some shifts of funds out of dollars.

There were worries that there would be massive shifts of funds retained in dollars moving from U.S. banks to non-U.S. banks. There was some shift but it was not massive.

There were worries that, because of the setoffs, U.S. banks would become less able to manage Eurocurrency loan syndications. That turned out to be another concern which was overdrawn.

So, in each of these cases all of the terrible effects that were predicted did not occur in a massive way, although clearly there were reactions. I don't know whether they were inevitable reactions, but they were understandable reactions; but they were not in any case massive.

Senator BRADLEY. What were they?

Mr. KUBARYCH. There were shifts of funds out of U.S. banks into non-U.S. banks by some dollar holders. That has been reported. I don't think that is the kind of thing you can easily see in the figures because it is always going to be homogenized with other movements of funds. But I am told by bankers who watch accounts that they have seen shifts. I don't think that I am saying anything that is new. This is something that has been referred to on other occasions. You can't expect something like this not to have effects, but the effects were not massive and they don't seem to have been permanent.

It transpired over a few weeks and now other factors are much more important, like relative interest rates and cycled developments in the economy.

Senator BRADLEY. Let me ask you this: Is the risk analysis which you develop made available to U.S. banks? Do they make their own risk analysis? The reason I ask this question is to hypothesize that

if indeed risk analysis has become much more sophisticated, then perhaps it is less likely that the countries that most need the funds but are the greatest risks, are going to get those funds.

I am curious as to your reaction to that.

Mr. KUBARYCH. Wait a minute. I don't accept your premise.

Senator BRADLEY. I mean without risking that bank's country risk profile.

Mr. KUBARYCH. I understand that, but I don't accept the basic premise that the countries that "need the funds most are the highest risk." There is a lot in that statement and I would be very careful about accepting that.

What we want to know is this: Risk is not a rigid property or a fixed probability of some adverse event happening. There is always going to be risk in any loan; that is part of the business. What is interesting are relative risks and changes in risk perceptions, how the relative risks are stacking up in different countries, and how the risks are changing.

I don't think we have any degree of competence in measuring absolute risk. I certainly wouldn't try. Maybe some people do, but I would be very, very reluctant to ask what is the probability that there will be a payments disruption in country X. Is it .001 or .045? That doesn't even interest me very much. I think something that precise and specific would be meaningless and I am not terribly interested in that route.

I am interested in relative risks, taking countries X, Y, and Z and looking at their economic situations in detail: The structure of their debt; and the profile of the debt payments they need to make; and the amortization schedules they need to make; their current account situation and what drives that and how that is changing; the country's economic policies that influence those external positions; and the domestic policies that influence production, wages, prices, and employment in the country.

You can take each one of those components and compare them to other similar types of borrowing countries. Also, you look at the social and political scene as best as you can figure it out—because I don't think there are many experts on it and we don't claim to be experts on that—and make some judgments about how the relative risks look. That is our approach.

It is basically an approach that focuses on the New York Fed and the Board staff in Washington, and we work very closely together. Some staff people from other regional Federal Reserve Banks also contribute where they have expertise.

We go through in a serious way about 50 countries. The results of that approach are fairly short, readable, and hard-hitting reports. These are reports which go to the Federal bank examiners.

The three Federal supervisory agencies have a very constructively setup interagency committee to evaluate country exposure.

Senator BRADLEY. Country exposure of U.S. banks?

Mr. KUBARYCH. Yes, relative to their capital, because that is the right scaling factor.

Senator BRADLEY. How do you figure this in refinancing?

Mr. KUBARYCH. On refinancing: We don't know all of the refi-

nancing that will be done. But we do have some good evidence, incomplete but good evidence, on amortization schedules; and that is what sets up the need for refinancing. So we know what the current account dynamic for new borrowing is likely to be and we know what the refinancing need is from the amortization schedules. The examiners from the Comptroller of the Currency, Fed, and FDIC get these reports and they use these reports in making their final judgments about the different countries. And then when they go in and examine a bank, they look at the bank's own management procedures for analyzing risk.

And how do they examine this? They bring to the bank management's attention concentrations of exposures that need attention or warrant attention, where the exposures appear high relative to capital and our risk assessments suggest that somebody ought to look at it.

That is the procedure and it seems to me a very sensible one.

Senator BRADLEY. How many times during the last year have you sat down with an American bank manager and said, "Look, based on our assessment we had better pull back concerning loans to this country" or "We ought to go a little slower here"?

Mr. KUBARYCH. That is not the job of the bank examiner, to tell the bank management that. The job of the bank examiner is to raise the questions as you are raising questions.

Senator BRADLEY. So that the bank, if it chose to, even after the Federal Reserve raised the question, could go ahead and continue to refinance and loan recklessly to a country of very high risk?

Mr. KUBARYCH. Typically all we would expect would be said to them is:

> We are going to point out some countries that we think warrant attention based on our risk assessment, and the bank's own posture relative to capital.

The bank may well respond:

> This is how we did our risk assessment, and this is where we think the long-term potential of this country is and why we think it will be a good banking relationship that is necessary to sustain. We are quite comfortable with our exposure there; and, in fact, we may even decide to increase that exposure there, because our assessment is different than yours. We, bank *x*, feel in some respects it may be better than yours.

My response is that they may be right. I don't think that we can put ourselves up as experts in every one of those countries. After all, a lot of these banks have branch officers sitting right in the country, and extensive business contacts, and a network of reports and information daily; they are in a position to sometimes come back and say, "Yes, indeed, we know that we have a big exposure there, and we want it even bigger because we think it is good business and this country has a very strong long-term future."

That is not reckless lending. That is a sober approach.

They also might say that "the exposure is substantial and we think economic conditions have changed, and now we are gradually going to reduce the level of exposure to that country. That is our management policy."

Senator Bradley. But if you see pattern developing, where you made your assessment, and still the bank says it has made a counterassessment, and they are going to increase or sizably refi-

nance, loans don't you see a point where there is action taken by the bank that might not be in the public interest?

I don't say this with any prejudgment and I want to know your view.

Mr. KUBARYCH. That is a serious question. I think the reason why our system is successful is that we have a lot of banks, all of whom have different attitudes and different people running them and everybody knows something that somebody else doesn't know, which is one of our strengths. It is a strength of the competitive banking system.

We also have a very earnest and dedicated supervisory structure which knows different things; but their major job is to ask the questions. We do not have branch officers in 18 different countries that we are lending to. We don't have branch officers anywhere. We have to take a critical approach but not an approach that dictates what banks should be doing.

They have comparative strengths and we have different strengths. Our strengths do not include knowing in each and every case what is the right loan to make.

Senator BRADLEY. Do you know what the press has conveyed about the judgment of some of those banks in making their loans? It has not been a positive judgment. And it seems to me that what you are saying is that the bank proceeds along its judgment of its own interest, which naturally is to increase its loans and therefore its profitability.

If you look at the percent of American banks' assets that are loans abroad, or the percent of their profitability that is derived from transactions abroad, it is a dramatic increase in the last decade or so.

Now, the point is that there comes a time when you have to ask a question about that. If you don't ask a question about that, you allow the bank to proceed on its course until a crack develops. Then the bank comes to you and says, "Now, you are the lender of last resort."

Mr. KUBARYCH. First of all, we have had relative stability in foreign loans as a proportion of U.S. bank assets for the last couple of years. In other words, as I pointed out, there was a big buildup as this kind of lending business was rapidly developed in the early 1970's and middle 1970's.

As exposures grew, U.S. banks tended to become less aggressive in making these loans and banks from other countries became more aggressive and they took a bigger share.

So, if you look at the profile of the ratio you mentioned, it goes way up, as you pointed out, but then it levels off and it has declined a little bit in the last 6 months or so.

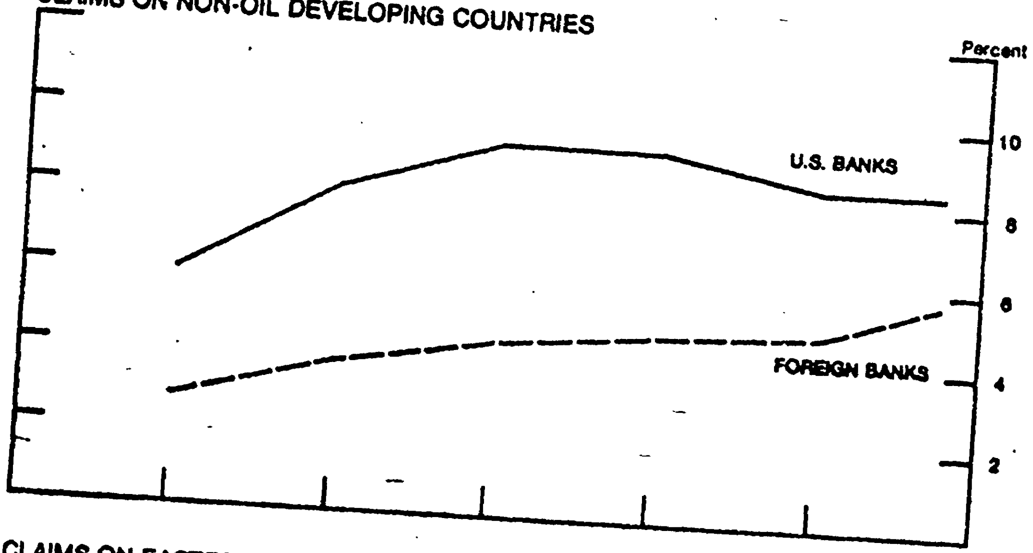
Senator BRADLEY. I don't have those figures. I don't question your figures.

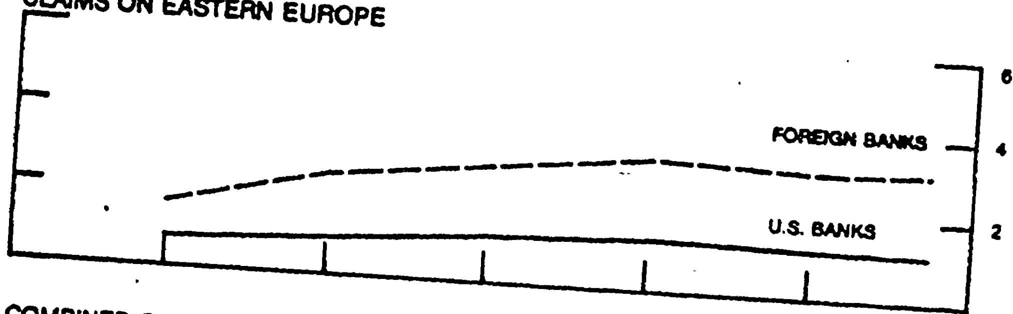
Mr. KUBARYCH. I was looking at this chart.[1] It is obviously a question that I thought might come up, and so I thought I would bring a chart to refresh my memory on this. All this doesn't answer your question; it just puts it in perspective.

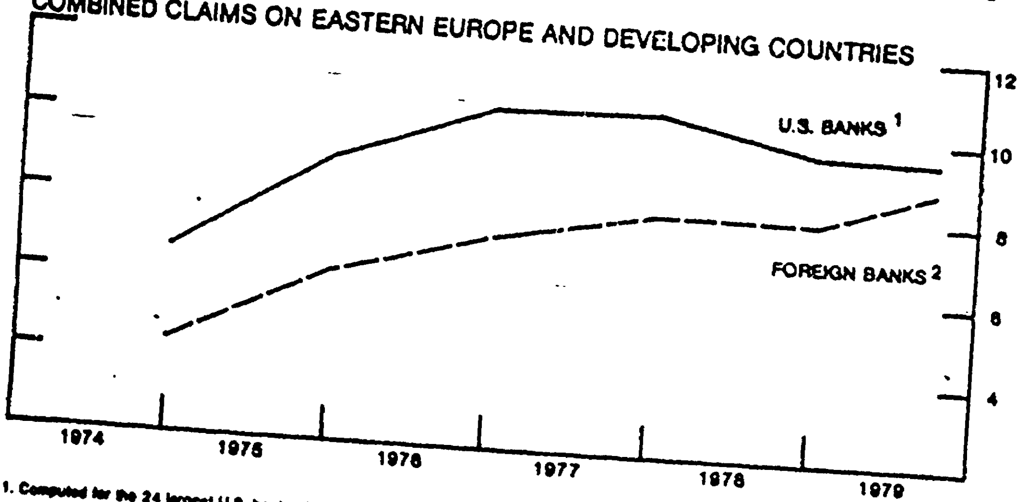
[The chart follows:]

[1] Included in additional materials.

Bank Claims as Percent of Assets







1. Computed for the 24 largest U.S. banks that account for five-sixths of lending to developing countries.
2. Computed for 34 large foreign banks.

Mr. KUBARYCH. The question is basically this: "Is a bank's international lending its responsibility only or are there broader public interests in the banks making good lending decisions?" The answer is, "Yes, there are broader public interests in a strong, sane, sound and safe banking system." That doesn't mean that the bank will never make a loan that doesn't go haywire. There will be such loans; there will be problems. If we seized up because we knew that, then we would have greater economic problems than if we are willing to take prudent risks. The evidence is that the banks have been aware of those risks.

As I pointed out, my impression is that they think those risks have gone up since the second oil shock and therefore they are more reluctant to lend, and so we do not have a situation of a lot of banks who are, without analysis, rushing out to make a lot of loans.

Rather, we have a situation of caution and decided prudence. We are not in a situation where the banks are rushing out to increase exposures. That seems to be an understandable development, given the magnitude of this oil shock.

Now, can any one of us say precisely how much more exposure these banks should put on? I don't think so. I don't think that the Chairman of the Federal Reserve, the Secretary of the Treasury or any of the people who support them are going to be able to give you a magic number of what the exposure of U.S. banks to each individual country should be. That has to work itself out in the marketplace.

Senator BRADLEY. I am not calling for you to do that, but what I am struck by is that the Federal Reserve does not have a mechanism other than expert advice to prevent a bank from reckless lending policies.

Mr. KUBARYCH. That is not true. The supervisory system—not just the Fed, but also the Comptroller of the Currency—is there. The one thing it can do is just that: to prevent reckless lending by looking closely at big changes in a bank's position. That is, very large increases in bank lending—whether to another country or to a particular industry, or to a particular consortium of people—gets excruciating attention. That is not where I think the concern should be. That I think we cover extremely well.

Our biggest problem, of course, is dealing with these problems when the whole growth of the world economy is subject to strain. That is a much bigger and tougher one.

Senator BRADLEY. What happens if the Dresdner Bank fails, and what is its effect on the United States, or if the Banque de France fails, what about that one?

I have complete confidence after this morning's testimony that you and the Federal Reserve and the Comptroller know what is going on in the American banking system.

But, you don't know what is going in the banking systems of our allies as precisely you know about here. Given the level of loans that will be needed in the next 10 years, or even next 5 years, and given the exposure of the private banking system to Third World and Socialist bloc nonmarket economies, policymakers cannot go along without at least hypothesizing a contraction that will endan-

ger one or more of those international banks, in which case I ask you the question: What would be its effect on the United States?

Mr. KUBARYCH. First of all, the question is a serious one. It has inspired setting up an apparatus so it can be dealt with constructively, and the BIS is the forum which has been the meeting house for these supervisory people getting together.

A strong committee, representing all of the G-10 bank supervisory authorities, is in place. They meet fairly frequently, and their discussions go on in fairly concrete terms, discussing supervisory problems of the kinds you are worrying about in each one of the countries.

There is a go-around and an exchange of views on supervisory procedures.

Senator BRADLEY. How often do they meet?

Mr. KUBARYCH. I think that this particular committee, is meeting around four or five times a year, but the regular BIS meetings which take place once a month are discussing these kinds of issues in ways that they really never did before.

The discussions take place at the governors' level, about once a month, They occur at the technicians' level four or five times a year. And there are quite a number of detailed papers that are presented and discussed. That part of the framework is all right.

But that doesn't answer your question. Your question is, "What happens to the United States if there is a major bank failure abroad?" You don't want to take as an answer that we are confident that our counterparts in the central banks abroad would not permit that to happen.

Senator BRADLEY. The fact that nine bank governors meet in Zurich once a month, I know that.

Mr. KUBARYCH. The fact of the matter is that a major bank failure abroad, given the tapestry of international banking right now, would have roughly similar effects on our economy and banking system as a major bank failure of an American bank.

The business is so international now that the relationships are not just limited to a bank operating in its own country. A bank like the two you mentioned operates throughout the world. They now have branches in our country, and those would be affected directly. And they operate heavily in the Eurocurrency market. Those balance-sheet items would be inevitably affected. Of course, if it were a big German bank that failed, U.S. banks operating in Germany would also feel a direct effect in their local operations.

So that is my general answer. The effects would be similar to a big bank failure of an American bank on the American banking system and the effects would be bad.

Senator BRADLEY. What would they be?

Mr. KUBARYCH. There would be a seizing up of the payments mechanism as people tried to sort out who got paid what.

Senator BRADLEY. So you have an enormous restructuring?

Mr. KUBARYCH. An enormous backlog of uncompleted transactions would have to be worked out. That would be one potential effect. We have already seen that in small bank failures.

Senator BRADLEY. What would be the economic effect?

Mr. KUBARYCH. The risk perception of everybody who participates in the economy would go up. All of those kinds of endeavors

that require a relaxed attitude toward risk would be scaled back. Investment would seem to have become riskier. Inevitable stock market problems would obviously be put in the public's eye in a direct way. There would be a crisis of confidence in leadership.

Senator BRADLEY. Would there be a run on the banks?

Mr. KUBARYCH. I doubt that small consumer-type deposits would be pulled out. That, I think, is a thing of the past, because of the FDIC insurance.

Senator BRADLEY. Would there be an enormous cutback in the amount of lending?

Mr. KUBARYCH. There would be certainly some impact on lending policies. If there was a large bank failure, everybody would start immediately reassessing their credit lines; but these things can't happen out of the blue. That is the big problem.

Senator BRADLEY. Let me emphasize something: We do not have precise control over our banks and have much less over those abroad. We don't really know what Dresdner and Banque de France are doing.

We have an international political structure that is based upon the NATO alliance, and on Japanese-American alliance. On specific issues in the area of détente, there is clear disagreement at this stage between the United States and our allies in Europe and Japan. That disagreement might increase. And that disagreement would be translated into economic policies, particularly considering that West Germany gets 13 to 18 percent of its gas from the Soviet Union, and that there is a much greater propensity for those European banks to increase their loan exposure to Eastern Europe and the Soviet Union than there is for American banks.

Now, you could get to a point somewhere down the road where one of the European banks would be very vulnerable to a default by our political adversaries, the Soviet Union or Eastern Europe.

Now, though it is unlikely that the Soviet Union or an Eastern European state would default, because that would mean their credit would be cut off, they could threaten a default and in that way influence the West European political process to a degree that makes the so-called Finlandization of more than Finland a greater probability.

Do you agree with that scenario? I don't say it will happen, but I want you to say, is it the analysis concerning the potential influence via the banking structure sound?

Mr. KUBARYCH. I must say that I have talked about scenarios like this in informal groups of colleagues, and with counterparts from other countries, and I think that there is a lot of power in the line of argument that you just presented.

There is one part of your premise that doesn't really hurt your own argument, but actually, if I could just modify the premise and it may strengthen your argument. It is that European central banks have less control, in some sense, of their banks than in the U.S. situation.

The spectrum of less or more control may not be the right spectrum. That axis may not be the right one to operate on. But clearly the relationship between banks and central banks or banks and regulators in different countries varies all over the map, from

one extreme where the banks are largely owned in whole or in part by the government.

Senator BRADLEY. Where is that?

Mr. KUBARYCH. In France the major banks are owned by the Government, so it is hard to visualize anything but close relationships between authorities and banks.

Senator BRADLEY. That doesn't make me feel more secure.

Mr. KUBARYCH. That is exactly right, and I said it may strengthen your argument, but you came out with a premise that they do not control their banks and I am saying it varies a lot.

The German situation is very similar to ours, a strong, independent central bank, and strong regulatory authority in the Federal Government of Germany, while the banks have interests of their own. But there is more of a German kind of an atmosphere.

With that out of the way, you are better off assuming strong relationships between banks and authorities and then spinning out your scenario. I think there is a lot to be said for that scenario. One has to seriously reappraise what the economic interests of our allies are these days, how they see the use of economic sanctions and economic relationships as a tool of meeting political interests. And where their own economic interests are different, would those be strong enough differences to change their political interests?

I don't have the answer to that. But I must say that I personally am concerned that because there are strong differences in economic interests, because there is a very different attitude toward sanctions, for example, in Europe than there is here—whether it be because of the aftermath of Afghanistan or the Iranian events, they have different attitudes—that your scenario is very plausible.

There could be a time when perceived economic interests and banking interests would have a serious effect on how those countries perceive their political interests comparing relationships with us and the Eastern bloc.

I think we have to face up to that squarely. The way you handle that is by demonstrating more leadership, by making it clear to them that their interests do lie with us, and they shouldn't be seduced by some of these economic ploys that you could conceive of.

Senator BRADLEY. Do you know which countries among our European allies have the greatest exposure in nonmarket economies?

Mr. KUBARYCH. There is a certain amount of detail on that that I can't release, that I have seen in various internal documents. But if you ask anybody on Wall Street, they would say by far the German exposure to Eastern Europe was the highest. I can't give you a set of figures that will prove that, but that impression is a fairly sound one.

Senator BRADLEY. And the second?

Mr. KUBARYCH. It would be a tossup between the French and the British. There is also a significant amount of Italian banking relationships with certain of the countries that you have in mind. But the impression would be, although I can't give you any precise numbers on it, that the German exposure is the greatest.

Senator BRADLEY. Let me ask you—we do not have a lot of time and this will be the last question—can the central bankers—and I want you to explain to me as a technician, as someone who really understands it—how do the governors of the central banks, when

they get together, actually formulate policy that can control activity in the Eurocurrency markets?

Mr. KUBARYCH. There is a very simple answer: We do not have policies for controlling the Euromarket. We have a debate over regulating the Eurocurrency market. It is not a new debate, it certainly is not a finished debate, and to some extent that debate is a problem.

We have written quite a lot about this because it is an interesting, fascinating, and important area.

Senator BRADLEY. What is your estimate of the size?

Mr. KUBARYCH. I would say the gross size right now——

Senator BRADLEY. The net size?

Mr. KUBARYCH. I haven't looked at it this morning, but the net size is something of the order of $450 billion.

Senator BRADLEY. Do you know a man named Jay Sterling? We had testimony last week by Harald Malmgren. Do you know Harald Malmgren?

Mr. KUBARYCH. Yes.

Senator BRADLEY. And on a question of the size of the Eurocurrency market, he quoted an American bank analyst named Jay Sterling who said that the size of the Eurocurrency market was not the $400 to $600 billion, that people normally assessed it at, but that the real gross figure at the end of 1970 may have approached $1.8 trillion.

Mr. KUBARYCH. But that is the gross figure, which includes all of the interbank depositing and that would be about $1.2 trillion right now. I don't dismiss the importance of that gross number, because it speaks to the interbank fabric of connections that we need to be worried about. But you asked the net, and I think that the net size certainly is in that $400 to $600 billion range.

Senator BRADLEY. So there is only $600 billion separating the Federal Reserve and Jay Sterling in gross figures?

Mr. KUBARYCH. That is not our figure; that is a collective figure and actually the BIS does the work. It is not a complete figure, the 1.2 trillion. It would be greater, if the reporting area were enlarged. But I would not think it would be as great as his number.

Mr. BRADLEY. Where do you come down on some kind of regulation of the Eurocurrency market, for example with the reserve requirements?

Mr. KUBARYCH. I don't think reserve requirements are important.

Senator BRADLEY. Why not?

Mr. KUBARYCH. It is quite clear from the negotiations and discussions that have been held that there is no enthusiasm among other European countries for reserve requirements. That is not a very likely outcome.

There is enormous difficulty in measuring capital ratios because of the different accounting standards, and so that is not a very likely one. There is a general antagonism, and I think a proper one, toward capital control, because that breeds all kinds of other problems, and the capital control route is another method. that will not be chosen. So, by a process of elimination there is no good regulatory device that meets with common acceptance, and that is why you don't have regulation.

Now, you do have considerably more prudential concern and better data, but that is not regulation either. We feel very strongly that we have to continue work in this area, both at the New York Fed and at the Board staff. We both have continuing work on the impact of Euromarket flows on domestic monetary aggregates. We target domestic monetary aggregates and the question is what proportion of targeted domestic monetary aggregates are affected directly or indirectly by your Euromarket developments.

Serious technicians in this area differ about where these flows belong. The fact is that this is a more difficult matter, the more transactions are done entirely within the Euromarket.

Here is an illustration. For example, corporation X has a call deposit with a U.S. bank in London and sends it a Telex that says, "Deduct $10 million from our call deposit and pay it to Joe Blow Oil Co., Ltd. into his call deposit with your bank."

When we get that kind of payment order common in the Euromarket, then we have a different kind of environment. Right now that is rare. Transactions balances are generally not common in the Euromarket.

As you know, our focus in the targeting of monetary aggregates has been increasingly on transactions balances, the kind of balances that are mobilized and actually finance transactions.

We have treated Euromarket liabilities in the broader monetary aggregates. Some are in M2, but the majority are in L, the broad liquid assets definition that we just adopted in the last year. But the more transactions that were to take place entirely in the Eurocurrency market, the more seriously we would have to be concerned about its impact on domestic monetary aggregates, and therefore the whole process of making monetary policy.

So it is an empirical issue and not a theoretical one. It can only be studied, watched, and kept track of. But you can't write a mathematical paper that proves what the practice is. All you can do is find out how do people actually do business.

Right now, my impressions from watching this as closely as I can is that the amount of actual transactions in the Euromarket is small. It is no more than selected deals that happen to be done in that way. It is not a standard way of doing transactions.

Senator BRADLEY. The standard way is what?

Mr. KUBARYCH. Still paying through an account in a New York bank. In other words, if you want to make that $10 million payment to Joe Blow Oil Co., Ltd., you Telex London and London sends a message to New York that instructs that money be put into a demand deposit. That transaction account is debited and the money is paid through the standard apparatus to another bank for account of Joe Blow Oil Co., Ltd., and he disposes of the money any way he likes.

So there is a New York bank connection on the transactions. Those transactions flow through accounts that are part of our money supply. As long as that happens, then you can have money transactions involving the Euromarket, but they are mobilizing U.S. based deposits and these are included in our monetary aggregates. We are essentially controlling that as part of the monetary process, but if they short-circuit that, then we may have a problem.

Senator BRADLEY. How would you know if they were?

Mr. KUBARYCH. You have to find out by surveying banking practices, and you have to continuously talk to banks.

Senator BRADLEY. Is it a slow process to find out? My worry is that the process of finding out could not respond to the velocity of events.

Mr. KUBARYCH. In order to do it in a big way, banks would have to advertise, promote it, and market it. It wouldn't be done in the quiet; it would be done with a blaze of marketing effort.

Senator BRADLEY. Why haven't they?

Mr. KUBARYCH. Because presumably it is not as efficient as the current procedures which seem to be efficient and which are more flexible. In sum, the answer is, there is no regulation of the Euromarket. Right now, from our domestic monetary point of view, that shouldn't worry us too much. It could worry us in the future, but we should not consider it a major blow that we don't have comprehensive regulation at this time.

My prediction is, before I get out of this business, we will see it makes sense to regulate a global dollar market globally.

Senator BRADLEY. Have you given thought as to how that could be done?

Mr. KUBARYCH. Well, I think that one useful step would be importing back some of this Euromarket into our own country.

Senator BRADLEY. How do we do that?

Mr. KUBARYCH. I think one suggestion we have supported—our New York Fed president, Mr. Solomon, has supported it and I think it is a good suggestion—is the approval of international banking facilities in the United States. They are what are also called free trade zones in money. The facilities would be able to do a number of the kinds of banking business that are now done in the Euromarkets. So there would be fewer incentives to do them in the Euromarkets. By importing more of the Euromarkets to our country, I think we will make the point to other governments and central banks that we do not have to wait on their own analysis of these issues, that we have tools available to us to deal with at least part of the problem of the Euromarkets by bringing some business back home.

We will not bring back all of it; it will be an incremental change, but it would be a good first step. It will be a signal to other countries that we intend to try to tackle some of these problems firsthand.

Senator BRADLEY. Do you think that an inflation defense bond could serve that in any way?

Mr. KUBARYCH. That is a different issue. This has really to do more with the banking mechanism and monetary mechanism. That has more to do with financial and credit markets.

Senator BRADLEY. We will talk about that at another time.

Let me read again from Malmgren and we have to get out of this room:

In global international lending to nonbanks, corporations and governments, the American bank market's share dropped from 1976 to 1978 from 33 percent to under 7 percent.

Now, this reflects what you said earlier about diversification.

Most American banks had serious net repayments on Eurocurrency loans in 1978 and 1979, and in 1979 preliminary data suggests that this is falling back continual-

ly. Among the reasons is a structural problem. The capital assets ratio for U.S. banks requires a pretax spread of 100 basis points, one percentage point or more on lending in order to obtain a satisfactory rate of return on capital. A French bank will accept a pretax spread of about 45 basis points, and a German bank 55 percent, and Swiss 60, and Japanese 65 basis points.

Moreover, a German bank can fatten its return by buying into a deal and taking a position and drawing dividends and fees, since involvement of banks in operating internal prices is not prohibited by German law or regulations.

The regulatory environment and the capital structure of U.S. banks means that the profit of the 1980's works against U.S. banks in global competition.

Do you agree with that?

Mr. KUBARYCH. Well, let me just restate his point: This is a complaint that our banks are too well capitalized, that in order to maintain their current capital adequacy, or capital ratios, they have to earn a solid rate of return. Otherwise, their capital would be diluted and they would become more heavily leveraged.

As someone who grew up more on the supervisory side of things, I recognize that banks by their very nature, ever since they were invented, absorb risks and that is their role in life. But to say that it is a great burden on our banking system to have a well capitalized banking system is to my mind a very curious kind of argument.

Senator BRADLEY. You think that for U.S. banks to complain might be a little self-serving?

Mr. KUBARYCH. I can understand where a banker might want to say that he really ought to be more leveraged because he could make more money. But I think it makes sense to improve capital in a period of general worries about risk. It does not make sense to argue that you are at some great competitive disadvantage because you are trying to maintain strong capitalization.

I find myself on the other side of that issue and I really don't want to prolong this by talking about that point anymore.

Senator BRADLEY. I think your sentiments were expressed concisely and strongly.

I want to thank you for your testimony. I have found it extremely helpful. I hope you will come back at another time, and perhaps we will have more of my colleagues. I will make sure they see the record. I appreciate your contribution, and I think it has been significant, both concerning your financing ideas and your general expertise in these archaic financial areas, areas which policymakers need to know a lot more about.

Mr. KUBARYCH. I appreciate your having me very much. I must say that I might not have been as capable of being very convincing on some of these new ideas because it isn't easy in a detailed way to come to grips with things that haven't happened. It is a little easier to analyze what has happened. But it is quite clear to me that we have to do some new things before we are through with the repercussions of this oil shock.

Senator BRADLEY. Is that saying some people see things as they are and ask why, and other people see things that never were and ask why not? That is a little political lyric with which to close this hearing.

[Whereupon, at 12:55 p.m., the hearing was adjourned, subject to the call of the Chair.]

68-425 O—80——18

U.S. INTERNATIONAL TRADE STRATEGY

WEDNESDAY, SEPTEMBER 10, 1980

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
COMMITTEE ON FINANCE
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 6226, Dirksen Senate Office Building, Hon. Bill Bradley presiding.

[The press release announcing this hearing follows:]

Press Release #H-52

PRESS RELEASE

FOR IMMEDIATE RELEASE
September 3, 1980

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON INTERNATIONAL TRADE
2227 Dirksen Senate Office Building

FINANCE SUBCOMMITTEE ON INTERNATIONAL TRADE ANNOUNCES THIRD HEARING ON U.S. INTERNATIONAL TRADE STRATEGY

The Honorable Abraham Ribicoff (D., Ct.), Chairman of the Subcommittee on International Trade of the Senate Committee on Finance, announced today that the Honorable Bill Bradley (D., N.J.), will chair the third in a series of hearings on the trade and economic issues confronting the United States and on an international trade strategy for the United States. The series of hearings was described in Finance Committee Press Release #H-35 of July 3, 1980. The third hearing will be held on Wednesday, September 10, 1980, in Room 6226 of the Dirksen Senate Office Building, beginning at 10:00 a.m.

This hearing will receive testimony on possible approaches to U.S. competitiveness in the 1980's. Senator Bradley said, "The U.S. will have to fight hard to compete successfully in the global economic contest of the future. We will need a new strategy and widespread commitment. We will have to change economic habits and direct our resources toward the common purpose of achieving competitive excellence. The hearings will examine alternative approaches to reshaping the economy to improve competitiveness and the different implications of each approach for Americans." He said the hearings would address the following issues:

(1) The changes in U.S. economic thinking and behavior needed to prepare the American economy for the economic competition of the 1980's. Particular attention will be given to assessing the effectiveness of the current structure of economic incentives in inducing long-term competitive performance.

(2) Alternative approaches to improving U.S. competitiveness, including consideration of alternative means to more efficiently allocate capital and human resources to productive investment. The implications of an industrial policy or some degree of economic coordination for the United States will be explored in depth.

(3) The economic and social costs entailed by measures designed to improve U.S. economic competitiveness, and how political bases for necessary changes can be created.

The witnesses who will appear are as follows:

Professor Lester C. Thurow
Professor of Economics and Management
Massachusetts Institute of Technology

Professor Michael J. Boskin
Professor of Economics
Stanford University

Dr. Amitai Etzioni
University Professor
The George Washington University

Written statements.--Persons who desire to present their views to the Subcommittee are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be submitted to Michael Stern, Staff Director, Committee on Finance, Room 2227 of the Dirksen Senate Office Building, Washington, D.C. 20510, not later than Wednesday, September 17, 1980.

Senator BRADLEY. The subcommittee will come to order.

This is another hearing in a series of hearings on the U.S. competitive position. I have a brief statement and then we will get to the panel.

As we begin a new decade, we are taking a hard look at our Nation's economic future. We are more than a little anxious about what we see. Though we have not yet slipped from our long-occupied position at the top of the economic ladder, we sense that our footing is unsteady and our heritage of economic progress is threatened.

But the more we look ahead, the more we realize that to prepare for the challenge we will have to change our economic habits and direct our resources toward the common purpose of achieving long-term competitive excellence.

The question that now detains us is not whether we need to prepare to meet this challenge, but exactly how we should do it. The hearing today will examine alternative approaches to reshaping the domestic economy in order to improve competitiveness and the different implications of each approach for Americans.

It is our good fortune to have three very distinguished witnesses: Prof. Lester Thurow of the Massachusetts Institute of Technology, Prof. Michael Boskin of Stanford University, and Prof. Amitai Etzioni of George Washington University. All have earned well-deserved recognition as creative thinkers on the subject of economic revitalization and competitiveness.

While the first principle of a U.S. economic strategy should be fundamental reliance on the private sector to compete, the second should be that there is a positive and necessary role for Government. Options as to that role lie along a continuum that theoretically ranges from maximum laissez-faire to fully centralized planning.

Real options, particularly for the United States, lie at neither extreme. But there are real options within a range that encompass three general approaches.

One confines Government action to broad macroeconomic policies, such as tax cuts or increases and budget growth or reduction. Policies aim to influence the level of economic activity, but not substantially to influence the kind of economic activity. The allocation of economic resources is left entirely to the private markets.

A second approach seeks greater targeting and coordination of Government economic policies. It assumes that some kind of economic activity such as capital formation or worker training better serve society's overall aims, such as growth, productivity, and adjustment than do others and therefore favors tax and other policy incentives that attract resources to these activities.

A third approach moves in the direction of national planning. It need not entail centralized economic directives but rather entails clear plans and coordinated policies in order to minimize the unproductive use of resources and the confusing signals sent by discordant Government policies to markets. It may also seek to secure the political basis for proceeding with economic adjustment by assuring a fair distribution of the attendant costs and benefits.

I hope that this morning the three witnesses will discuss these alternatives for the American future, as well as the broader ques-

tion of U.S. productivity, what that means, what determines productivity, et cetera.

I'm sure, we will get beyond the popular rhetoric on the subject. Also, I anticipate that we will have some disagreement among the witnesses, or at least I hope so. And from that we might actually get a constructive idea.

The purpose of these hearings is to suggest policy actions as well as to formulate a theoretical basis for a strategy in the 1980's.

[Senator Bradley's statement follows:]

As we begin a new decade, we are taking a hard look at our nation's economic future. We are more than a little anxious about what we see. Though we have not yet slipped from our long-occupied position at the top of the economic ladder, we sense that our footing is unsteady.

But, the more we look ahead, the more we realize that to prepare for the challenge we will have to change our economic habits and direct our resources toward the common purpose of achieving longterm competitive excellence.

The question that now detains us is not whether we need to prepare to meet this challenge, but exactly how we should do it. The hearing today will examine alternative approaches to reshaping the domestic economy in order to improve competitiveness and the different implications of each approach for Americans. It is our good fortune to have three very distinguished witnesses: Professor Lester Thurow of the Massachusetts Institute of Technology, Professor Michael Boskin of Stanford University, and Professor Amitai Etzioni of George Washington University. All have earned well-deserved recognition as creative thinkers on the subject of economic revitalization and competitiveness. Before I invite them to the witness table, I would like to make a few observations about the economic challenges before us.

History has shown that the development and growth of an economy can be achieved by a number of strategies, and that different formulas work better for different societies. Nevertheless, what is clear, I believe, is that the United States is the greatest success story in world economic history, and that what has worked best for the United States has been our fundamental reliance on the economic dynamism of the private sector, given the proven track record of private entrepreneurship, I believe that the prime responsibility for preparing the United States to compete in the global economic contest of the future lies with the private sector.

Relying fundamentally on the economic initiative of the private sector does not mean Government should stick its head in the sand. Public responsibilities mean Government will influence private choices. Therefore, the aim of economic policy should be to influence private choices positively, to steer choices in favor of behavior that advances economic efficiency as well as social equality, in the interests of a better society. Government can best create an atmosphere of common purpose by assuring a fair distribution of work and compensation, of sacrifice and reward, in connection with the global competition.

Thus, while the first principle of a U.S. economic strategy should be fundamental reliance on the private sector to compete, the second should be that there is a positive and necessary role for Government. Options as to that role lie along a continuum that theoretically ranges from maximum laissez-faire to fully centralized planning. Real options, particularly for the United States lie at neither extreme, but there are real options within a range that encompasses three general approaches.

One confines Government action to broad macro-economic policies, such as tax cuts or increases and budget growth or reduction. Policies aim to influence the level of economic activity, but not substantially to influence the kind of economic activity. The allocation of economic resources is left entirely to the private markets.

A second approach seeks greater targeting and coordination of Government economic policies. It assumes that some kinds of economic activity such as capital formation or worker training better serve society's overall aims, such as growth, productivity, and adjustment than do others, and therefore favors tax and other policy incentives that attract resources to these activities.

A third approach moves in the direction of national planning. It need not entail centralized economic directives, but rather clear plans and coordinated policies in order to minimize the unproductive use of resources and the confusing signals sent by discordant Government policies to markets. It may also seek to secure the political basis for proceeding with economic adjustment by assuming a fair distribution of the attendant costs and benefits.

As I said, most current proposals lie along a continuum and can't be patly characterized as "broad brush", "targeted" or "planning". Much would depend on

how proposals were implemented. But my own inclination is to look in the range of targeting and coordination for a strategy for the eighties.

Faced with the profound challenge of our times, we need to set priorities, emphasize efficiency, adjust and build consensus toward common gains—I believe we can do that without stifling the private initiative that fuels economic growth, and without violating the cherished liberties that constitute our political heritage.

Targeting and coordination can be achieved in many ways, some falling in the realm of what is currently referred to as industrial policy, others falling in the sphere of what we speak of as supply-side economics. There is also a host of options as to what should be targeted, which economic activities should be encouraged to facilitate adjustment, strengthen competitiveness and revitalize our economies. For example, we can spur ascending industries, try to revive maturing ones, focus on basic industry or national infrastructure, or simply favor capital spending wherever it may be. Assessing the merits of these options is what we hope to do here today.

But whatever course we choose, I believe there will still be a clear need for the creation of a coordinating economic body in the Government. Elsewhere, I have recommended the establishment of an economic security council in the Office of the President. The council would set the directions necessary to preserve the U.S.'s interest in a strong competitive domestic economy and in an open, economically stable world order. It would seek to clarify our domestic and geopolitical objectives, and to invigorate domestic and international economic considerations into a coherent foreign economic policy for the United States. Its purpose could be summarized as: to preserve the economic security of the U.S. by (1) Promoting U.S. competitiveness and productivity, (2) assuring for the U.S. an adequate supply of strategic raw materials, and (3) recommending courses of foreign economic policy and conducting bilateral and international negotiations to advance U.S. interests in a sound, equitable and stable world economic order.

I've said a great deal about the Government role, largely because as a policy maker this is what I can best influence. But in the last analysis, our economic future, is in the hands of the private sector. All the core decisions which will determine whether we keep our place in the global economic competition will be made not in Washington but in the workplace. They will be made by managers who choose between today's bottom line and tomorrow's cutting edge, by workers who choose between unduly high wages and more jobs with stable growth, and perhaps most of all by coalitions of workers and managers who either join to resist inevitable change and ultimately share only ruin, or who join to guarantee everyone's fair stake in positive change and ultimately share in the reward. Government can not make these decisions. Government can only assist to a limited degree in creating a structure of private economic incentives that sway private citizens toward the right choices.

I believe we will all be more likely to make the right choices for our Nation's future if we have before us a National strategy based on principles of strong competitiveness, positive adjustment and a fair distribution of the associated risks and rewards. The challenge is to define the specific elements of such a strategy. But I believe that to be successful, such a strategy must promote:

First, strongly competitive industries;

Second, a capacity for economic adjustment based on the fair distribution of costs and benefits attending adjustment among the affected segments of American society;

Third, a clear sense of the economic directions that will enhance the competitive advantages of the United States, reinforced by supportive public policies and market behavior; and

Fourth, an improved integration of U.S. domestic and foreign economic policies founded on greater attention to maximizing the benefits of trade to the United States.

Given the size of the challenge and the urgency of meeting it, I am glad we have such knowledgeable witnesses with us today. Therefore, I will hold them up no longer. I am pleased to invite them to share their thoughts with us this morning.

Senator BRADLEY. Our witnesses today are Professor Thurow, Professor Boskin, and Professor Etzioni.

I would like all three to come forward to the panel. We will begin with Professor Thurow, followed by Dr. Boskin and then Dr. Etzioni. Welcome to the subcommittee. We appreciate your willingness to come. I hope some of my colleagues join us, but in any case your testimony and our discussion will be in the record. And if

some exciting things happen we will make sure that more than just my colleagues on the Finance Committee hear about it.

PANEL: LESTER C. THUROW, PROFESSOR OF ECONOMICS AND MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY; MICHAEL J. BOSKIN, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY; AND AMITAI ETZIONI, UNIVERSITY PROFESSOR, THE GEORGE WASHINGTON UNIVERSITY

STATEMENT OF LESTER C. THUROW

Mr. THUROW. The key to making America competitive in international markets is found at home. If productivity continues to fall 3 percent per year in America, as it is, and rise 4 percent per year in Germany and 7 percent per year in Japan, as it is, then America's day in the economic sun is simply over.

It cannot hope to compete. It will gradually retreat into being a relatively underdeveloped exporter of raw materials to the highly developed countries of tomorrow's world.

Having just recently testified to two other congressional committees on the reasons for falling productivity I will not repeat that testimony here, but instead focus on some of the things that have to be done to make us competitive. If you look at my analysis of the productivity decline or the work of those that recently participated in a conference on productivity sponsored by the Boston Federal Reserve Bank, however, there is a common message.

Productivity is not falling because of any one overwhelming unfortunate event but because of a confluence of many factors. It is death by 1,000 cuts. But this also means that the American economy can only be born again if we are willing to make 1,000 changes in the way that we manage our economy and organize our incentives.

Partly because it is the most tractable part of the problem, investment incentives have received practically all of the attention that has been directed at the problem of revitalizing industrial America. As important as these incentives are, they are only part of the answer. But those who have been advocating investment incentives have also been guilty of only dealing with the easy part of the investment problem.

The easy part is the precise tax cut incentives that are to be offered to stimulate more plant and equipment investment. My choice is to abolish the corporate income tax while integrating personal and corporate income taxation. This provides a strong incentive for corporate managers to invest, only a relatively small loss in revenue to the Government, and little adverse effect on the after-tax distribution of income. But there are many other potential solutions.

The hard part is reducing consumption, public or private, and nonproductive investment to make economic room for more plant and equipment investment. The first will require cuts in popular public expenditure programs or tax increases, such as a value added tax, on private consumption. The second will require the removal of popular tax incentives for nonproductive investment.

Consider the capital gains tax. Capital gains taxes should be indexed so that the tax is only levied on real gains, but there is no case for a lower capital gains tax rate on land, antiques, second

homes and other nonproductive investments. If lower tax rates for capital gains make sense, they only make sense for investments in new, highly risky, productive industrial investments.

I have a litmus test to determine whether someone is really serious about stimulating investment. "What incentives for nonproductive investment are you willing to see eliminated?" Anyone who cannot answer that question is not serious about wanting more productive investment. To suggest that more investment can be financed out of general unspecified cuts in social expenditures simply is not credible.

But in addition to a problem of magnitude there is a problem as to how our investment funds should be allocated. In the American tradition industrial investment is primarily financed through retained earnings. This is a tradition that is no longer viable.

Let's consider the problem of the electronic computer chip industry. This industry is one of America's sunrise industries, but it is in the process of shifting from a technology which uses relatively little capital to a technology that is much more capital intensive. Given the firm's retained earnings there is some maximum pace at which the industry can finance its shift to this new technology.

That would be fine if everyone was playing the same economic game. But they are not. The Japanese strategy is to finance their computer chip industry with a large influx of debt capital, get into the new capital intensive technology quickly, go down the learning curve first, and then drive everyone else out of business.

Some of America's research oriented firms are not worried about this process because they believe that they can keep one step ahead of the Japanese on new products. But even if this is true, and similar beliefs have not proven to be true in other industries, the country cannot afford to be driven out of a new industry just when it enters the large-scale manufacturing stage. That is the stage where massive numbers of new jobs are created, especially jobs for those with moderate skills.

To expand its sunrise industries more rapidly, America needs the national equivalent of a corporate investment committee. The job of this committee would not be to plan the American economy, but to direct financial resources with government loan guarantees to those areas where they are necessary to preserve and expand our sunrise industries.

I am aware that many critics say that such a committee would simply be used to prop up our dying sunset industries. This is certainly a danger but if you believe that America cannot organize itself to prevent this possibility, then you believe that America cannot organize itself to survive in the 21st century.

Along with more investment and better directed investment, there is a need to improve our process of disinvestment. America has to learn how to get out of sunset industries so that the capital and manpower that is embedded in these industries can be transferred to its sunrise industries.

In Japan conglomerate firms help by moving resources, human and physical, within the firm. Part of the problem is having some sunrise industries into which capital and people can move, but part of the problem is in realizing that economic progress inevitably means economic losses for many.

When an obsolete, low productivity, New England shoe factory shuts down and a new silicon chip factory opens in California, individuals and communities are going to be hurt. The correct public response, however, is not to protect the domestic shoe market from foreign competition but to help individuals and capital flow into the new growth areas.

America is one country. In the long run no one is hurt if the population of California is slightly larger and the population of New England is slightly smaller. In the most recent month the two States that tie for having the lowest unemployment rate among industrialized States were Texas and Massachusetts.

It is in fact possible for regions to get out of dying industries and to get new ones and make it successful. And I would suggest perhaps eastern New England has made this transition, with a lower unemployment rate than any other industrial State except Texas.

To break the country up into competing blocks that are antagonistic to each other's problems and seeking to stop economic growth in the other's region is a recipe for economic oblivion. And as I have pointed out elsewhere regional differences in population growth do not lead to large differences in income growth for those that are left behind.

The United States also has to realize that it is in a new economic world where it is no longer an isolated continental country where it can do what it wants without regard to the rest of the world. Like the rest of the world has long had to do, we now have to export, not to finance luxury imports, but to finance the oil imports that are necessary to run our economy for the foreseeable future.

Antitrust regulations are one of the areas where this fact of life will require substantial changes. Competition can no longer be defined by looking at how many American firms control what part of the American market. General Motors would be in a competitive fight for its life against the Japanese and Germans even if there were no other American auto producers.

Other countries encouraged firms to cooperate in ways that would be illegal under American antitrust law. Consider the auto industry in Japan. To a great extent it shares technology. When booms arrive it even shares production facilities. Today there is a good chance that your Datsun car is actually made on a Subaru assembly line. One Japanese car manufacturer, Subaru, is helping another Japanese car manufacturer, Datsun, strengthen his position in the American market. Could or would American firms do the same?

Let us suppose that the current antitrust case against IBM were to be settled in the Government's favor. Who would benefit? The Japanese would find it easier to crack an industry that they have found up to now difficult to crack. And how would Americans benefit? Very little since we have enough experience to know that breaking one very large firm into three or four large firms makes very little difference in terms of products or pricing behavior.

Regardless of market shares IBM has domestic competition where it is weakest: in small computers, and potential competition from the Japanese where it is strongest: in large computers. And in

any case it is a sunrise firm that we should be encouraging, not discouraging.

Antitrust laws have lost touch with economic reality and economic goals. They have become the real legal equivalent of the mythical medieval debates on how many angels could dance on the head of a pin. The only difference is that the people of the middle ages were too sensible to actually waste time on such debates while we are actually wasting an enormous amount of resources in an effort that is slowly shackling our economy.

Not quite 1 year ago I participated in a conference sponsored by Fortune magazine on what was wrong with American industry. To get an outside view one-half of the speakers and audience were Japanese. The difference in diagnosis and cures was striking. The speakers from American industry spent most of their time complaining about Government, but the Japanese had a very different diagnosis of American problems.

The Japanese thought that the time horizon of American firms was simply too short. What American firm would have been willing to lose money for 10 years, as Datsun did in the United States, to break into a new market?

The moral of their story was simple. A firm with a 15- to 20-year horizon will almost always beat a firm with a 3- to 5-year horizon. We are the former; you are the latter. We will invest in the market development, research and development, and new investments that have long-run payoffs. You won't.

Some remedy has to be found for the American preoccupation with the current quarter if not the current day. The fault lies in the financial market's preoccupation with the present and in the way that American managers are judged. Typically the American manager is judged on his ability to produce current profits and holds chief executive status for a relatively short period of time.

Overcoming the faults is more difficult. I sometimes believe that the country would be better off if we simply shut down the clamor of our financial markets for a few years and concentrated on producing goods and services. Firms have to learn how to judge whether managers are good at positioning the firm for the long-run pull.

The Japanese have learned to judge management talent with criteria other than current profits and we must learn to do the same. Not long ago I visited the headquarters of a Japanese firm that had fired the American manager of its American subsidiary because he was too much oriented to short-run profits. What American firm has done the same?

Finally let me comment on what is probably the biggest hindrance to industrial revitalization: that is our current anti-inflation policies. Who would or could invest when interest rates were near 20 percent and credit controls were in place earlier this year? Who would or could invest when almost 25 percent of their existing capital capacity is idle as it is now? The answer in both cases is not many.

High interest rates and idle capacity might be a viable anti-inflation strategy if inflation could be quickly cured or if inflation were a one-shot problem. Then we would simply tolerate a period

of time when the anti-inflation policies were killing productive growth as an undesired, but temporary, side-effect.

But no one believes that either of those propositions is true. Even the true believers maintain that it will take many years of high interest rates and high unemployment to tame inflation. And given the highly likely prospect of future energy shocks, inflation is not a once-and-for-all problem. It is going to reoccur no matter how successful we are in stopping it now.

As a result, tight monetary and fiscal policies would have to be in place throughout the 1980's and 1990's if they were to have any chance of success.

But the United States cannot afford to kill productivity growth over the next two decades in an effort to fight inflation. It simply must find some other means to control inflation. Whatever you believe about the ultimate success of the current war on inflation, it will be only too successful as a war on productivity.

As this brief catalog of policy suggestions indicates, the United States is not going to easily regain its position as the world's No. 1 trader and No. 1 economy. The days of Yankee ingenuity are in eclipse. It is our job to see if we can remove the shadow.

[The prepared statement of Lester C. Thurow follows:]

Statement of Lester C. Thurow

MAKING AMERICA COMPETITIVE IN INTERNATIONAL MARKETS

The key to making America competitive in international markets is found at home. If productivity continues to fall 3 percent per year in America—as it is—and rise 4 percent per year in Germany and 7 percent per year in Japan—as it is—then America's day in the economic sun is simply over. It cannot hope to compete. It will gradually retreat into being a relatively underdeveloped exporter of raw materials to the highly developed countries of tomorrow's world.

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Senator BRADLEY. Thank you. Professor Boskin.

STATEMENT OF MICHAEL J. BOSKIN

Mr. BOSKIN. Thank you, Senator. I would like to commend you and your subcommittee for holding hearings on this very important topic. I think there has been a lot of loose talk about industrialization and revitalization. I hope the hearing sheds some light on the substance.

I would like to apologize. Apparently my testimony, of which I have only one copy, did not make it here through the private mail carrier which promises overnight delivery. So, there is at least one anecdotal example of where the private market replacing government has not worked.

Senator BRADLEY. Either that or it is an example of the merits of the targeted approach because I received a copy.

Mr. BOSKIN. You did receive a copy? Well, there is a communication gap up there in any event. I was told it did not arrive. So I am glad you received a copy.

I would like to basically make three points. The first is that our long-term problem of slowdown in productivity and real economic growth, the potential for increased standard of living in the United States, has as its mirror image some of our problems abroad and competing abroad; and that our real problem is promoting our long-term rate of real economic growth in the United States.

If we do not do so, if we suffer the kind of slowdown in the rate of real economic growth we have experienced recently, and there are alternative ways of measuring that and some disagreement about how, I think we will soon see ourselves passed by not only in world markets but in terms of per capita living standards by many of the countries with whom we compare ourselves.

So my second point is we should not be overly alarmed, we should be concerned but not overly alarmed with the improved worldwide position of many other economies. Our share in world manufacturing exports has declined substantially in the last two decades from about 29 percent in 1958 to about 18 or 19 percent today; we helped engineer the greatest expansion in world trade in history through tariff and other trade impediment reductions.

On the other hand, we should expect that as the growth of the rest of the world accelerated relative to the United States, since they started from a much lower base, since they themselves started to develop improved trading operations and decreased impediments to trade such as common markets and the like, we should have expected their exports to grow more rapidly than ours.

My third point is that we do have an ability to reverse or at least to start to halt this trend and to take the longer term view, as Professor Thurow suggests, and start to deal with the problem of inadequate productive growth, inadequate growth in real GNP per potential employee.

And I believe the single most important centerpiece of such a strategy must be to increase our rate of national capital formation.

That is not the exclusive cause by any stretch of the imagination in the slowdown of our productivity growth. The studies by Professor Thurow, Professor Denison, a variety of other people, suggest that only part of our slowdown in productivity growth can be

traced to a slowdown in our rate of national capital formation, and that there are other causes.

I do not mean to deny that. My own research suggests a major component has been the slowdown in our rate of real national capital formation.

Until the early 1970's the capital/labor ratio in the United States grew at about 2.5 percent per year, and it has not grown since then, partly because of the huge influx of workers into the labor force.

The slowing rate of national capital formation, which I will remind everybody is the sum of household capital formation, business capital formation, and Government capital formation, is due in my opinion to three reasons: One, a sharp decline in Government investment. In the 1960's the Government was investing about 4 percent of GNP, and contrary to most opinions, only a small minority of that investment was in defense. We were building highways, roads, school buildings and the like. Today by my own investment the Federal Government's share of GNP that goes into investment is well under 2 percent, between 1, and 1.5 percent, and indeed is probably not sufficient to cover a genuine rate of depreciation and obsolescence on the Government's capital stock. That is, we are drawing down the Government's capital in order to finance current expenditures.

Two, a decline in private saving and investment, and a reallocation of that investment toward nontraditional goods and services such as pollution and safety control, which may serve noble social ends but whose contribution to productivity evaluation thereon is extremely difficult to come by.

How much do people value some increase in safety or some increase in air quality? Even as difficult as those things themselves are to measure, putting values on them, as the market puts values on increased numbers of automobiles and the like, is extremely difficult to do.

So, a small part, but only a small part, I think is due to that, to the continued shift into the service industry and the like. But real net investment last year was between 2 and 3 percent of gross national product, a very, very small amount. Gross investment was the lowest rate in the industrialized world.

And if either of two appealing conjectures upon which economists unfortunately have no substantial empirical information to refute or confirm either of these conjectures, one, that the level of investment is an extremely important determinant of the level of innovation in our society, that is, that there is a learning by doing process in the course of investment itself, new ideas, new technologies, new products, et cetera are produced, or second, that new technology either must for cost reasons or other reasons be embodied in new investment as opposed to old investment, our low rate of capital formation, national capital formation, our low investment rate, gross and net, is leading us to embody new technology in our capital stock more slowly, and perhaps producing that new technology more slowly than we have in the past; and embodying it in our capital stock less rapidly than are our major competitors.

My own opinion is the major reasons for this decline in investment and its reallocation toward some non-productive uses, as Professor Thurow correctly pointed out, are the reduction in the real after-tax and after-inflation returns to such activities such as savings and investment, and the increase in the uncertainty with which those returns will be earned.

It is now well documented that as the inflation rate increases, the expected variance of the inflation rate increases still more than proportionately. So that as our inflation rate goes up, the uncertainty felt about the level of the future inflation rate increases dramatically and acts to, in my opinion, curtail time horizons, make business investment short rather than of long duration.

Second, the interaction of inflation, our unindexed tax system, has resulted in high and rising tax rates on investment and saving income.

The effective marginal tax rate on investment income has risen precipitously in the last decade despite legislation designed to do the reverse. Indeed, by my own estimate the effective marginal tax rate has risen by about one-third on investment income.

Now it varies markedly from industry to industry, from type of investment to type of investment because of many special tax features, the corporate tax and a variety of other special tax features, it varies significantly across industries which must for a variety of reasons rely heavily on equity finance as opposed to debt finance.

Since interest is deductible from the corporate tax, we have seen a big increase in borrowing. And the corporate tax has not been an impediment to investment in industries where there is a substantial reliance on debt finance in my opinion.

But these things have caused a sharp decline in the real net return to savings and investment.

Let me give you one paradoxical and striking example, altough it is not in investment in physical capital, except to the extent State and local governments use these revenues to so invest, is that because of inflation in our unindexed tax system, tax exempt bonds are over-taxed.

That seems strange. We have tax exempt bonds but they are over-taxed. If one thinks about it for a moment, you realize last year a not uncommon return for many individuals holding State and local government bonds, which often are used as the vehicle to finance State and local government capital expenditures, was about 9 percent, and yet our inflation rate was 13 percent.

So even though the tax was zero, because they were tax exempt, these people suffered real losses of 4 percent and were not allowed to deduct them from their other income.

There are other examples on the other side of the balance sheet where people are deducting nominal as opposed to real interest. I do not want to get into elaborate detail on that. But because of our high inflation and our unindexed tax system, as a general proposition the effective tax rates on investment income have increased substantially in the last decade.

The expected return has decreased substantially. And the uncertainty with which that return will be earned has increased substantially.

All of those things I think are eroding not only the level of investment but are shifting it toward investment of expected shorter duration, quicker payoff as opposed to longer term investment, and much of it into, especially by the household sector, investment that might be considered unproductive in the sense of producing goods and services, although perhaps more productive in terms of producing greater potential income later in life.

The next point I would like to make is that in attempting to redress these disincentives that have accumulated over the last decade or more, we should try to adopt a principle of neutrality, neutrality across types of investments, neutrality across industries, neutrality across regions.

I do not mean to say there could never be a case for abandoning that principle on rare occasion when well documented for a variety of reasons. But I think we ought to start from a premise that millions of private investors and thousands of financial intermediaries are likely to do a better job in allocating our scarce capital resources among competing claims for investment opportunities than is a government bureau, a reindustrialization board, however noble its intentions and however high quality the few individuals who would be chairing it are, or indeed Congress itself.

We already have many types of tax and other legislation which discriminate among industries, discriminate among types of investment and the way we deal with depreciation and the like. Our principle ought to be, our starting point, our anchor, our benchmark, our place of departure ought to be neutrality.

And, therefore, I would like to draw a very sharp distinction between the need to promote our general rate of capital formation in order to increase labor productivity in the future and, hence increase future wages and standards of living in the future, and the notion of targeting investment incentives and subsidies into either attempting to pick winners to outguess the market, to outguess the best intentions of competing private investors, or to bail out or restore or reinvigorate or prevent a natural evolution out of certain areas or industries, out of our earlier comparative advantage into our future comparative advantage.

I do not think it would behoove us to bring back the barge as the predominant form of transportation of materials in the United States. And I hear too much, in my opinion, discussion which would lead me to believe that some people are about to propose policies which would move us in that direction.

As Professor Thurow has suggested, and I would like to second, we are one country, having slightly more people in the South and West 10 years from now and slightly fewer in the North and East if current migration patterns continue, should not be viewed as a detriment to society.

People are moving for a variety of good reasons. And I think what we need to do is deal with orderly transitions.

That gets me to my next point, which is the case that is, the one potential case that is compelling is when there is a very sharp, unanticipated change in events such as the dramatic change in energy prices we have experienced in the last decade, et cetera, which could not easily have been anticipated, and hence there might be severe harm done to a particular group in the population,

and I focus it on individuals rather than on firms they may or may not happen to be working for or regions they may or may not in the future or the past happen to be living in, suffer some grave harm, such as a dramatic increase in unemployment because of such events.

In that case I think that retraining insurance, the unemployment insurance system, and relocation assistance are highly desirable. But we should not have as our goal keeping them in industries or in locations or in occupations or in activities that are less than the most productive.

If the market is sending us signals there are more productive investments to be made elsewhere, I think we should be careful of rejecting that signal unless we have compelling information that that market signal is incorrect.

And I think too often the lure of protectionism, the short-time horizon of U.S. businesses, of U.S. workers, of U.S. consumers, of U.S. governmental policymakers and U.S. economists probably too, leads us to suggest remedies which would temporarily, it is hoped, alleviate the situation which wind up becoming long-term subsidies to a variety of areas, occupations, industries, and individuals to prevent them from eventually relocating in areas, locations, industries, which would be both more desirable from their own point of view and from society's.

With that said, let me return to the notion that we have to increase our national rate of capital formation. As Professor Thurow mentioned and as we all agree, there really has to be a major commitment to reduce unproductive investment, channel government or personal consumption into national capital formation, national investment.

That might mean reorganizing the priorities in government expenditures, it might mean removing or redressing the imbalance that we have willy-nilly created between spending and saving in our tax system, it might mean those and other policies.

But what it does mean in my opinion is that our national investment rate must be increased substantially and not just for a year or two once we come out of the recession. We are talking about increasing our rate of national capital formation by a nontrivial amount, by a substantial amount, and sustaining that increase over long periods of time.

The Japanese did not increase their standard of living substantially, the Germans did not increase their standard of living substantially by having a 1- or 2-year increase in their rate of investment. They had high rates of investment for long periods of time, years, indeed decades.

That unfortunately is part of the bitter pill we will have to swallow. If we want to continue to provide our citizens with a continually rising standard of living, we are going to have to increase our rate of national capital formation.

It seems to me that has to be our major goal for the future, and that the ways to go about doing it, in addition to redressing this imbalance that inflation and our unindexed tax system have created, are to attempt to slow inflation, which would increase the after-tax/after-inflation rate of return because of this interaction of inflation and our unindexed tax system; secondly, I think we

should continue the move toward a tax system which integrates the corporate and personal income tax.

I agree wholeheartedly with Professor Thurow that we should attribute the income earned in corporations back to the owners of the shares of those corporations on a pro rata basis, and then move the base for that personal tax away from income toward consumption.

That is, eliminate the double taxation of saving we now have in our income tax.

There are a variety of proposals before Congress and a variety of other suggestions that would move us part way in that direction. My own personal point of view is that if we keep this longer term goal in sight rather than just enact a gerry-built system of specific incentives for specific regions or specific areas or specific noble goals for saving or things of that sort, that we can indeed create such a tax system which would be in my opinion both much more efficient and more equitable than our current tax system in the next decade.

In the short run some proposals which would move us in the right direction and in my opinion would have substantial appeal and substantial short-term payoff would be the adoption of a universal individual retirement account to cover people who are not covered by such vehicles now, for example, workers who are not fully vested in their pensions who pay a very small pension at work who are not able to invest in IRA accounts; increases in the limits and the coverage on the current IRA and Keough accounts; simplification and acceleration of depreciation.

I do not want to identify myself with any specific example of that, but we have a hodge podge of depreciation schedules and an overlay of so-called accelerated depreciation on that in a variety of ways, based on estimates of service lives which have been adjusted but which were done several decades ago at a time when our industrial plant and equipment was very different than it is today; partial corporate tax integration, for example dividend relief; and indeed creating a tax-free rollover reinvestment of—I probably should have added, because I agree with Professor Thurow—productive capital gains.

So I think the tools to start to redress the imbalance are before us. I would just stress that I think that targeted investment incentives and subsidies, while they may on rare occasions have a useful purpose and a desirable goal to serve and be an efficient means of doing so, should be the exception rather than the rule.

Our benchmark and starting place ought to be neutrality and increasing our general rate of capital formation, Government and private.

Thank you.

[The full statement of Michael J. Boskin follows:]

SPURRING ECONOMIC GROWTH: GENERAL CAPITAL FORMATION VERSUS TARGETED INVESTMENT INCENTIVES AND SUBSIDIES BY MICHAEL J. BOSKIN, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

SUMMARY

1. The most important long-term problem facing the United States is our very sluggish rate of real economic growth per employed worker. Put simply, our performance in recent years has been abysmal, both by our own historical standards

and relative to that of other advanced economies. Since the early 1970's, our rate of real GNP growth per employed worker has been virtually zero.

2. At the core of our sluggish real economic growth has been a slowing rate of national capital formation.

3. The slowing rate of national capital formation is due to:

(a) A sharp decline in government investment;

(b)-A decline in private saving and investment and a reallocation of that investment toward non-traditional goods and services, such as pollution and safety control;

(c) A reduction in private saving and real net investment in the United States is due primarily to a reduction in the real after-tax return to such activity and an increase in the uncertainty with which those returns will be earned.

4. The decline in the real net return to saving and investment, and the increase in uncertainty, are caused primarily by our high inflation rate and the insidious interaction of inflation with our unindexed tax system. The effective marginal tax rates on investment income have risen precipitously in the last decade without any specific legislation.

5. We should move to make the decision between saving and spending as neutral as possible. This implies integrating the corporate and personal income tax and shifting to spending as opposed to income as the basis of taxation. This would move us to a tax system which taxed saving and investment income once, not twice. Among the important short-run possiblities moving us toward this overall goal would be some of the following:

(a) A universal IRA account;

(b) Increases in the limits on the current IRA and Keogh accounts;

(c) Substantial extension of the interest exemption to the point where it covers the majority of interest received by the majority of American taxpayers;

(d) Simplification and acceleration of depreciation;

(e) Partial corporate tax integration (e.g., dividend relief); and

(f) Tax-free rollover of re-invested capital gain.

6. Make the general redressing of the disincentives to save and invest in our economy as neutral as possible with respect to industries and locations for such investments. Let private capital markets allocate scarce capital into those investments which are expected to be most productive. Do not attempt to replicate the efficiency of the interaction of millions of investors and thousands of financial intermediaries with government boards or bureaus. Do not attempt "to bail out", "re-invigorate" specific areas or industries via targeted investment subsidies or credits; policy instruments such as the investment tax credit should be made as general as possible.

7. The U.S. economy has veered off course in the last decade and a half. Our major policy goal for the future must be to restore healthy, noninflationary economic growth. This can only be accomplished in an environment with a more stable, predictable, slower rate of monetary expansion; a slower rate of growth in government spending; a concerted effort to remove disincentives that obstruct saving, investing innovating, and working. We have the tools before us to accomplish such goals. We should not confuse increasing our rate of capital formation, productivity and hence future standard of living with targeting investment subsidies and/or specific credits to areas or industries which are suffering temporary economic harm or are declining relative to other—areas and industries as potential sources of productive employment and investment in the United States.

I. INTRODUCTION: THE PROBLEM

In the midst of a substantial recession, and what is hopefully the crest of the worst inflation in the history of the United States, it is tempting to focus almost exclusively on our short-run economic problems. My own personal viewpoint is that we face an even more insidious danger to our economic and social well-being: Our very sluggish rate of real economic growth per employed worker over the last decade or more and its potential continuance in the future. Put simply, our growth performance in recent years has been simply abysmal, both by our own historical standards and relative to that of other advanced economies. Over the last century, the United States, as well as such other societies such as France and Germany, have seen their real GNP per capita, and per employed worker, grow at an average of almost 2 percent per year. While substantial temporary fluctuations have occurred in this rate, such an average was not only maintained over the last century, but if we look at the two and a half decades after World War II, real incomes grew even slightly more rapidly than at this rate. At such a rate, GNP per capita will approximately double between generations; that is, each successive generation will

be approximately twice as wealthy over its lifetime as the generation which preceded it.

Since the early 1970's our rate of real GNP per capita growth has slowed markedly, to about half of its previous post-World War II level. But even this decline dramatically understates our poor economic performance for the period.

Since the 1970's was a decade of unprecedented labor force expansion, due to the combination of substantial increases in female labor force participation and the post-World War II baby boom generation moving into the labor force in unprecedented numbers, real GNP per employed worked has grown at a horrendous one-tenth of one percent per year since 1973. The latter figure compares to about 2.7 percent for France, 3.2 percent for Germany, 3.4 percent for Japan, and 1.6 for Italy. While it was probably unwise for us to expect to be able to grow as rapidly as these countries decades ago when our standard of living was so much higher than theirs, it is becoming decreasingly plausible, that our sluggish growth performance relative to these countries can be explained by the now modest differences in the level of income per capita among us. To put the matter in perspective, if these rates continue, average income in the United States will soon fall *behind* that of France and Germany, and eventually that of Japan.

While the exact causes of our sluggish economic growth are a subject of some current dispute, the general outline of what has been happening is becoming clearer all the time: We have not been adding enough capital to our capital stock; we have not been generating enough new technology and embodying it in that capital stock; we have chosen, sometimes unwittingly, to pursue policies which impede our ability to produce goods and services for other ostensibly noble social ends; and we had the structure of our economy change substantially. For example, we have witnessed an increasing displacement of private economic activity by government economic activity; a changing age, experience and occupational mix of the labor force; a shift in output away from manufacturing towards services; a rapid expansion of government regulatory policies; and high and rising inflation and marginal tax rates on the return to saving and investment, and a declining rate of national capital formation. I have elsewhere[1] reviewed and evaluated some of these studies which try to pinpoint the exact cause of our recent productivity slowdown. What I would like to do in the remainder of this testimony is to state what I believe to be the central core of our problem, discuss very briefly several of its major components, describe what I believe our long-run policy goals ought to be, and propose several important short-run policy proposals which will move us in the proper direction.

II. THE NATIONAL SAVING PROBLEM IN THE UNITED STATES

Private saving is important for two reasons: It is a major form of funding available to finance new investment, and it is the way in which our citizens transfer resources from one part of their lifetime to another, especially from their peak earning years to retirement. By the first quarter of 1980, the personal saving rate in the United States was at a 30 year low and less than half of its average in the mid-1970's; and by way of comparison, it was a small fraction of that in Japan, France or West Germany. Our national saving rate has three components: personal, corporate, and government saving. While our personal saving rate has fallen substantially, business gross saving has remained relatively constant; Federal government dissaving has increased substantially; and state and local government (as the official statistics measure it) gross saving has increased somewhat. Overall, our rate of gross saving has fallen slightly in recent years relative to the 1960's and early 1970's. However, it is important to point out a variety of factors which have occurred in our economy which could and perhaps should have led to a substantial increase in saving over this period and hence, the modest decrease in saving should be viewed properly in my opinion as quite alarming.

First, there has been an enormous change in the economic environment, and demographic situation, facing current and future elderly persons in the United States. A major reason for saving, as mentioned above, is to provide resources to maintain standards of living during retirement. Since 1960, life expectancy of the elderly population of the United States has increased substantially, while at the same time, there has been an acceleration of the explosion in earlier retirement. Only one male in five over the age of 65 is still in the labor force; more people now collect their first social security check at age 62 than at age 65. My own best estimate is that the average length of retirement period has increased about 30

[1] 1. See M. Boskin, ed., "The Economy in the 1980's: A Program for Growth and Stability." Institute for Contemporary Studies, 1980.

percent.[2] By itself, this should have led to a substantial increase in private saving for retirement. In part, at least, it appears that this incentive has been offset by a substantial expansion in coverage and the level of social security benefits. Since social security benefits are financed on a pay-as-you-go basis, whereby the current benefits received by retirees are financed by the current taxes paid by workers, no real capital formation occurs whith this form of financing social security; if, indeed, this substitutes for private saving as many commentators have suggested,[3] it would seriously affect our overall saving rate. While the exact magnitude of these offsets is difficult to determine, and there is some controversy at the moment among professional economists as to the importance of this effect, my own belief, expressed in my study for the JEC Special Study on Economic Change[4] is that there has been a substantial social security offset for private saving in the United States.

A second reason to worry about a non-increasing, let alone decreasing rate of private saving, concerns the changing age structure of our population. Because of the post-World War II baby boom generation, and the recent baby bust generation, early in the next century, the ratio of retirees to workers in our society will increase substantially. If we continue to experience this lengthened retirement period (or see it lengthen still further), and continue to experience very low rates of private saving, the baby boom generation, when it retires, will show up at retirement ages having saved a disproportionately low share of their lifetime income relative to previous generations of retirees, and thus will be thrown relatively more heavily on other sources of retirement income support such as social security. As is well-known, the social security system already faces an immense long-term funding crisis even if current relative replacement ratios are maintained, let alone increased to offset low private saving rates over the years to come.

Thus I conclude that a substantial increase in the rate of private saving in the United States over the long-run is important quite independent of its role in helping to finance investment. But this second major purpose of private saving should not be ignored.

While our national rate of gross investment has not fallen quite as much as our gross saving rate, we have in part financed the differential by substantial increases in our importation of foreign capital. While in the short-run this will help us keep our rate of investment and capital formation from declining still further, it is not providing our citizens with claims to assets which can be transformed into retirement consumption later on. Further, it is unclear how long an advanced economy like the United States can continue to finance a major fraction of its investment by importing capital. While few would object to the notion of there being a substantially operative world short-run capital market, most of the success stories of economies growing by importing capital to finance investment have been those economies which were immature in the economic sense relative to their times: the United States and Canada in the last century, many less developed countries today, etc. History has not always been kind to those advanced economies which have failed to finance their own investment opportunities out of their own saving.

Elsewhere, I have tried to set up a framework for analyzing what an optimal or socially desirable real net rate of saving and investment, or capital formation, would be for the United States.[5] While that analysis is too lengthy to repeat here, suffice it to say that in comparing the opportunities for increasing future standards of living by increasing our rate of capital formation today and foregoing some current consumption, appear to substantially outweigh these costs. My figures suggest that we ought to be saving and investing in real net terms substantially more than we have been for many years. Indeed, it is unclear that we added anything to our ability to produce goods and services in 1979. Of our $386 billion dollars of gross private investment, once we subtract replacement of our wearing out capital stock, residential investment, and anti-pollution and safety control equipment, real net private investment amounted to about $40 billion dollars. My own estimate suggests[6] that real federal government disinvestment was approximately as large. Therefore, I am deeply concerned about the prospect of continuing our low rate of capital formation in the years ahead. I believe that accelerating that rate of capital formation is a

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[2] 2. See M. Boskin, ed., "The Crisis in Social Security," Institute for Contemporary Studies, 1977.

[3] M. Feldstein, "Social Security, Induced Retirement and Aggregate Capital Accumulation," Journal of Political Economy, 1974.

[4] 4. M. Boskin and M. Robinson, "Social Security and Private Saving: Analytical Issues, Econometric Evidence and Policy Implications," in Jt. Econ. Comm., U.S. Congress, "Special Study on Economic Change," in press.

[5] M. Boskin, "Some Issues in Supply-Side Economics," Journal of Monetary Economics, forthcoming.

[6] See M. Boskin, ed., Economy in the 1980's, op. cit.

necessary condition for restoring our reasonably rapid rate of real economic growth and gains in standard of living of the average American; and that increasing that rate of real investment must involve increasing our rate of saving from our own resources.

III. WHAT CAN BE DONE TO INCREASE SAVING?

Private saving decisions are primarily influenced by several factors: The prospective returns as measured by the after-inflation, after-tax rate of return to saving; the potential risks involved; age structure, family structure, and the milieu in which economic decisions are effected by government programs, such as social security.

Our tax system taxes the return to saving and investment approximately twice as heavy relatively as do those of Western Europe. We rely very heavily on taxes on income, with some notable exceptions, and these taxes tax saving twice: first, when it is earned as part of income and then when it earns an interest return. There is now a growing body of evidence, some of my own as well as that of other people,[7] that suggest that private saving decisions are much more responsive to the real after-tax rate of return than was previously supposed. This in turn implies that our heavy taxation of interest income seriously impairs private saving decisions. While it undoubtedly influences the form of saving, because of our comparatively lighter taxation of some saving vehicles than others, high and rising effective marginal tax rates on the return to saving have obviously been a major contributor to our low rate of saving.

Second, our high, and until recently rising, inflation rate has decreased private saving incentives for two reasons: first, it adds substantially to the uncertainty involved in the expected real net rate of return to such saving; it also combines with our unindexed tax system to drive up the effective marginal tax rates on different types of saving. This problem is much more widespread than the commonly known "bracket-creep". Even with a flat rate income tax, the failure to allow a deduction to separate out the inflation component of interest, causes an over taxation of interest returns. A paradoxical example that demonstrates the point was mentioned to me by Professor George Break of the University of California: recently tax exempt bonds have been overtaxed! Think about that for a moment. The bonds are tax exempt. How can they be overtaxed? A not uncommon interest rate in recent months for tax exempt state and local government bonds has been on the order of 9 percent. But inflation has been running much higher than that. Therefore, the owners of these securities have been suffering real losses. Since they cannot deduct these real losses from their other income in computing their tax liability, they are being overtaxed even though their rate of tax is zero. It is clear that so long as either high inflation continues or our tax system continues unindexed, that this problem will remain and seriously retard private saving incentives.

Third, a variety of government programs have formed substitutes for private saving, and some of these programs do not result in any real capital formation. The most important example is social security, and I shall not repeat here what I have said elsewhere on numerous occasions other than to summarize once again the view that social security, while undoubtedly playing an extremely important role in mitigating much economic distress, and while it must remain a cornerstone of our income security system for the aged, has had the unfortunate side-effect of impairing private saving incentives in the United States.

Fourth, our changing demographic and labor force structure and household composition have led to a variety of changes in incentives to consume and to save. While it may well be that in the next decade a modest increase in our saving rate will occur as the baby boom generation moves into their forties, an age at which saving rates tend to be somewhat higher than in the late twenties and thirties, it is clear that we must have a substantial increase in overall saving just to remain even with respect to the relative future contributions to their retirement income of private saving and other sources.

In brief summary, we have generated, usually in an attempt to achieve other goals, a series of obstacles to private saving, and therefore, capital formation and long-term increases in our standard of living in the United States. Among the most important are our high inflation, high and rising effective marginal tax on saving, and a variety of government programs substituting for saving. Unless we begin to reverse this tendency soon, we will see the already damaging consequences worsen in the years ahead. It is my belief that we need to encourage substantially private saving in the United States. Perhaps it would be more accurate to say we need to unravel the disincentives we have created for private saving in the United States. Let me now turn to some suggestions for doing so.

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[7] As discussed in M. Boskin and J. Shoven, "Issues in the Taxation of Capital Income," American Economic Review, 1980, Proceedings of 1979 Annual Meetings.

IV. LONG-TERM POLICY GOALS AND SOME SHORT-TERM INTERIM PROPOSALS

A good general guideline for overall economic policy with respect to saving and investment would be to make the decision between saving and spending as neutral as possible. We have for many years, via deliberate government policies, and by some other policies which were designed for other purposes, continuously stacked the deck in favor of spending and against saving. These policies have included the high and rising effective marginal tax rates on interest income; the extremely high rate of inflation we have experienced in recent years; the interaction of high marginal tax rates and inflation; the growth of a variety of government programs which potentially substitute for private saving; and the failure to realize the crucial role of saving for our long-term economic well-being. In addition, there has often been a substantial short-term bias in government economic policy designed to encourage spending in the often mistaken belief that such spending would enable the government "to fine tune" minor cyclical fluctuations in the economy. Experience has indicated that such programs have as often been destabilizing as stabilizing for the performance of the economy and it is only in times of severe economic disruption that are sustained, over long periods of time, that the government appears to be able to take steps to mitigate these economic problems.

The goal of neutrality would be served by moving toward a tax system which taxed saving and investment once, not twice. While we have moved partially in this direction in several pieces of legislation recently, from IRA and Keogh accounts to the modest interest exclusion which will be introduced into the tax code next year, we still have a long way to go. Our ultimate goal ought to be to integrate the corporate and personal income taxes (for example, by treating retained earnings as income distributed on a pro rata basis to corporate shareholders) and then switch this integrated tax to a personal expenditure tax in which individuals would be allowed a deduction for saving of any type in an unlimited amount. There is a substantial intellectual case for doing so, and the 1977 Blueprints for Basic Tax Reform of the U.S. Treasury documents and elaborates many of the practical details of implementation. I believe that this type of tax system ought to be our goal by the end of this decade. It would restore neutrality in the consumption/saving choice, increase the after-tax rate of return to saving and investment, decrease the disincentives that we now encounter, and substantially increase the rate of capital formation. But a drastic move in this direction all at once is both undesirable and politically impossible. What is important is that tax policy over the next few years be consistent with a move in this direction. Among the important possibilities worthy of consideration are the following:

(a) A universal IRA account. This would extend inclusion in IRA accounts to millions of workers who are not currently eligible.

(b) Substantial increases in the limits on current IRA and Keogh accounts and/or proposed new universal IRA account.

(c) Substantial extension of the interest exemption to a point where it covers the majority of interest received by the majority of American taxpayers. While the original exemption is an important first step in principle and will have an effect on some savers, it clearly is a rather modest amount and does not reach saving decisions at the margin of anywhere near all taxpayers and savers.

(d) Simplification and acceleration of depreciation.

(e) Partial corporate integration, (e.g., dividend relief).

(f) Tax-Free rollover of re-invested capital gains.

A second and related set of proposals is obviously crucial for other reasons: get the inflation rate under control. Just doing this would substantially reduce the effective marginal tax rates on investment income we have been experiencing in recent years, reduce the uncertainty involved in saving and investment, and spur private capital formation. The most important items here are a sustained moderate rate of money supply growth by the FED and decreasing the rate of growth of federal spending and deficits.

Third, get Federal government dis-saving and dis-investment under control. While exact magnitudes are hard to come by because of variety of accounting conventions, perhaps establishment of a separate capital account would be desirable in the budgeting process to reveal just how far our government investment has fallen off in recent years.

Fourth, a restructuring of social security with the twin goals of guaranteeing income adequacy in retirement for the low income part of the elderly population and putting the long-term future of social security on a sound basis is highly desirable. To do so merely by raising the taxes over the years ahead will leave us with tax rates for social security alone on the order of 23 or 24 percent or more of earnings before anyone pays a dime of federal, state or local income or other taxes. It is my own belief that the time has come to reconsider the role of social security

and the overall income security system of the elderly, and to rethink the target retirement ages that are set either explicitly or implicitly in the structuring of our social security system. At a time when our population has rapidly shifted out of physically demanding and dangerous jobs, the life expectancy of the elderly has increased substantially, a large and growing fraction of our labor force is entering the labor force later because of greater college enrollment, it seems time to reconsider our traditional retirement age. Currently there exist a substantial number of disincentives to continue work in the social security system. These are undoubtedly designed to enable those who, for valid reasons, find it extremely difficult to continue to work to retire in a dignified manner. I believe this system can be reformed by continuing to provide adequate income to these persons in what is currently an early retirement phase, while gradually raising the age for full social security benefits for the non-disabled, elderly by perhaps one month per year for the next 24 years. This would leave us with a target or normal retirement age of 67, without reducing the annual retirement benefits to any elderly person. This by itself would substantially eliminate the long-term social security deficit without requiring tax increases above and beyond the enormous tax increases already legislated in the 1977 Amendments and due to take effect in the 1980's and 1990's.

Finally, I also have urged a separation of the transfer and annuity functions of social security. The transfer, or income adequacy, function should be shifted to an expanded supplemental security income program, and the annuity, or earned entitlements part of the program, should be put on a fair actuarial basis for everyone, i.e., they should all earn a common rate of return and no issue of equity or fairness among alternative population groups should be addressed in this part of the program. Ultimately, it might also be desirable, to allow proof of private pension coverage above and beyond a certain amount to satisfy this part of the social insurance problem.

V. AVOID CONFUSING GENERAL CAPITAL FORMATION WITH TARGETED SUBSIDIES AND INCENTIVES

In the last year or two, an increasing number of influential business and labor leaders and politicians have called for "the re-industrialization of America". This phrase encompasses a variety of policy goals and proposals to achieve them. In one fell swoop, proponents of "an industrial policy" believe that we can save declining industries, re-invigorate certain urban locations and promote our general economic growth. While there may on occasion be circumstances in which specifically targeted subsidies or incentives might be temporarily warranted, such situations are bound to be the exception rather than the rule. I cannot emphasize too strongly that our problem is a general lack of capital formation, not low rates of capital formation in specific industries. That is, in all but rare instances, we would expect the private capital market to channel the available supply of investment funds to those investments which were expected to be most productive. It would be naive to assume, however noble it might sound, that a national re-industrialization board, a committee of concerned government, business and labor leaders, or indeed, Congress itself, could in general do a better job in allocating our scarce supply of capital among the many competing investment opportunities than could millions of private investors and thousands of financial intermediaries. Therefore, the first principle to be adopted—and abandoned only in extremely rare cases with overwhelmingly compelling circumstances—is that economic policies with respect to capital formation, investment, saving and innovation should be neutral with respect to industry, location, etc.

Once this is said it is important to point out, as it was done by inference above, that our current sets of policies are by no means neutral with respect to investment decisions. While we have a variety of policies which channel investment into some forms rather than into others, the major problem for some time has been the general erosion of incentives to save and invest caused by the insidious interaction of high inflation, the general double taxation of investment income, and high and rising marginal tax rates thereon. It is redressing these general disincentives which have accumulated over the last decade and more that should be our primary goal in the decade ahead. We must resist the temptation to replace private capital markets with planning bureaus or agencies, or selective investment credits or subsidies in attempting to allocate the supply of capital. Stemming from the first principle discussed above, despite the best intentions of such targeted subsidies or incentives, they are generally likely to lead to an inefficient allocation of our scarce capital stock. Indeed, we would be in danger of having our scarce resources flow to their least productive, rather than most productive, uses.

It is perhaps tempting to combine the general need for capital formation to increase productivity and hence future wages and standards of living with policies

to assist, bail out, prevent the decline of, or re-invigorate certain industries and areas. I do not propose to discuss any particular industry or area in this testimony, but I would like to dispel some popular myths which lie behind the call for such targeted subsidies and incentives. The first myth is that such policies can help promote our long-run economic growth. I believe that nothing can be further from the truth. If, indeed, the most productive use of our scarce capital was to invest in such areas, private capital markets would have generated funds for such investment. If they do not, private capital markets are sending us a signal that there are more productive investments to be made elsewhere. Therefore, in the long-run, our standard of living would be lowered rather than increased by such targeted investment subsidies as opposed to generally neutral treatment of investment income.

A second popular myth supporting targeted investment subsidies or credits suggests that this will lead to many new jobs, especially for the least advantaged in our society. I certainly agree that there is hardly a more noble goal of economic policy than in providing improved job opportunities for the disadvantaged. But are targeted investment incentives a sensible way of doing so? I believe that they would be extremely cost ineffective in promoting such employment. First of all, it is unclear that there would be much net increase in employment at all. Partly, these incentives would tend to cause a substitution of capital for labor in the production of any particular amount of output; this of course would be offset by the general increase in demand for labor due to an expansion of output. But who would get these new jobs? If the subsidies were targeted to specific locations, how are we going to define eligibility for such investment subsidies? How are we going to enforce them? Will we have many agents from the Internal Revenue Service going around counting how many employees in different plants are working per week, let alone employees previously unemployed or who live in a central city ghetto? Indeed, it is unclear that the bulk of any employment redirected to these areas would primarily affect the predominantly disadvantaged in them as opposed to higher skilled workers who would be drawn into these areas from surrounding communities and jobs.

Therefore, my conclusion is that investment and saving, i.e., national capital formation, must be substantially increased in the years ahead. But the first premise of our policies ought to be to redress the disincentives that have been created by inflation and high tax rates in as general and as neutral a manner as possible. In brief summary, capital formation yes; targeted investment subsidies and credits no!

VI. CONCLUSION

The U.S. economy has veered off course in the last decade and a half. The problem is ultimately tied closely to our severe inflation and current recession, but it is a much longer term problem than that. And much of the malfunction can be traced to man-made disincentives to produce income and wealth. Our major economic goal for the future must be to restore healthy, non-inflationary economic growth, and this can only be accomplished in an environment with a more stable, predictable and slower rate of monetary expansion; a slower rate of growth in government spending; and a concerted effort to remove disincentives that obstruct saving, investing, innovating, and working. Our major need is for a steady, coherent, coordinated, long-run series of policies and a general policy framework to achieve these goals. Without deluding ourselves about the possibilities of rapidly reducing inflation or instantly promoting our rate of growth, we must begin to unravel the disincentives for capital formation that high inflation, high and rising taxes, and other policies have created.

Obviously the policies proposed above must form a package implemented steadily and continuously over a long period—certainly over many years, perhaps decades. The gains from doing so will be enormous: restoration of non-inflationary steady economic progress, and the substantially reduced social and economic tension among different population groups that ensues in a growing rather than a stagnant economy.

In brief, we must make a healthy, growing economy our primary domestic concern. A variety of disincentives have been built up over the last decade and a half to stand as obstacles to our long-term economic growth. To promote our economic growth, an increased rate of national capital formation and innovation is necessary. In the long-run, the bulk of this must be financed from increased private saving. The increased growth that will result will allow a variety of other important social objectives to be met; increasing productivity will help us finance future social security benefits without raising tax rates more than currently contemplated; this in turn should allow more ample opportunity for leaving resources in private hands to generate further investment and innovation. The reduction of inflation will substantially mitigate these disincentives, and provide a much more stable environment in which people can save for a secure retirement.

We have the economic capability of reversing the downward trend of our economy. It is clear to me that the cost of not surmounting the obstacles to our own economic growth extend beyond our economic well-being and that of our children and grandchildren. They include the threatened loss of political, diplomatic, and military leadership in the free world as an important example set for the mass of mankind—living on the brink of subsistence, tottering between relatively free societies and dictatorship—becomes extinguished. Our economic success stands as an important symbol of the compatibility of free political institutions, free markets, and rapid economic progress. How we respond to our economic challenge may influence decisively the evolution of many of the world's other economic and political systems.

Senator BRADLEY. Next, Professor Etzioni.

STATEMENT OF AMITAI ETZIONI

Professor ETZIONI. Thank you, Senator Bradley.

I'd like to join my colleagues in congratulating you and your subcommittee and staff on holding this hearing. I, too, feel that there has been an abundance of loose talk, and these hearings may help us clarify the issues.

With your permission I'll deviate somewhat from my prepared statement and submit it for the record, and I'd like to highlight a few points.

I believe it is correct to say that we need to strengthen the economy at home if we are to shore up our competitive status. The issue, that I believe we are discussing this morning, is what are the criteria which will guide our policymaking, and from what intellectual disciplines and analytical schemes are you going to derive the criteria for our consideration.

In my judgment the first criteria, which is all too often omitted from this discussion, is national security. It's elementary that people are first concerned with their security and safety, and economic comforts and other elementary needs come second, and that has great ramification for the issue at hand.

For instance, I can't imagine discussing energy policy without asking questions as to what degree are we still subject to boycotts by other countries, to what degree are we subject to cartel pressures which could wipe out, by our reduction in output and increase in prices, all the consideration and development efforts being made in the preceding year.

When we come to discuss railroads and coal mines, the question of national security is very important. To look at it still another way, if you look at the reports on what it would take for us to deliver a division of American soldiers to Asia and what we are lacking in elementary industrial equipment, the list, the published list, I'd like to say—I don't deal in classified reports—is stunning.

I know that on other occasions you pointed to the fact that we don't have a clear national instrument in which the question of national security and the question of economic policy can be effectively brought together; and that is very much evident in a good part of this discussion, and maybe one of the most productive things to come out of this discussion is an institutionalized, systematic, opportunity to integrate other considerations with what I would like to call the national security, hyphen, industrial policy.

It's the hyphen we're missing. We have some discussion of industrial policy, a lot of discussion of national security, but we don't have good opportunities to link them. Indeed, we are often worried

more about votes in the United Nations, or if a country will or will not send a delegation to the Olympics, than what it's going to do to our hundred billion dollar a year wealth drain.

And the reason basically is that the foreign decisions are made in a context in which you get points if you can swing somebody's U.N. vote, but you don't get a point if you can stop them squeezing us in the oil price market.

Then we come to the economic criteria, and there are different schools of thought. We have some people who have a special ear for "sunsets" and "sunrises", and they know which industries are God blessed and which are cursed. Industries to them come born with labels, and they say these are the sunrise industries, they're the good guys, and then there are the sunset guys, the bad guys. Either God or somebody else attaches these labels to the industries, and then we know which one to kill and which one to water appropriately.

I am not as optimistic about that inner ear or analytical capacity in Government or any other place to predict what 10 years from now, let's say, or how many shoes we need American-made, whether Japanese, West Germans, the Malaysians, the Indonesians, and all other people who could make shoes—I should mention the Italians [laughter] would do, and that by calculating all projections of shoe productions in all countries, and taking into account competitive industries because obviously if you deal here with what's called comparative advantage, it's not enough to know how many shoes everybody is going to make, but you have to know what other shifts are going to be made in other industries.

So, in short, I would disagree with those who feel that it might just strain our analytical capacity a bit to have to engage with such detailed analysis of most industries.

That raises the question then of what other criteria should guide our decisionmaking, one of which is definitely very much a part of what we need—we heard, I think, two very excellent presentations today—is to base our judgment on sound economic theory, in the way it's largely practiced in the United States, which deals with savings rates, and unemployment rates, interest rates, and the hardcore of economic theory.

Then there is the softcore, and I'd like to speak to that part for a moment. It is a branch of economics which is not very popular in the United States. It is slightly stigmatized, though increasingly tolerated as the mainstream has run into one or two difficulties which have been too often pointed to for me to be as unkind to repeat them here.

The other branch of economics is something referred to as developmental economics, historical economics; it is less mathematical and less analytic, and more descriptive and more concrete. And what it does, it looks at histories of countries, to ask how did we do it, what did go into the first industrialization of America or the development of other countries, and then derive from that a list of elements. We may then revisit these elements to see in what shape they are. I'd like to take a minute to run through what such a developmental concept would point to as the seven elements of industrialization, and then maybe a brief comment on each as to what status they seem to be, and in what way they may be shored

up, without going to target industry by industry or having to make decisions about industrial diamonds and ballbearings or whatever specific industries we need to build.

I think there may be relatively wide agreement that the following elements belong in the infrastructure and capital goods sectors, the two foundations of a strong economy. First, the transportation of goods, obviously, if you don't have an effective system to move goods around, raw materials, you in effect fragment the market, and you lose the benefits of economies of scale.

Now, again, which is the best way of moving goods is a secondary question which deserves some discussion. And I would agree with those who say that if you cannot find one way of doing it which is clearly superior to the others, public policy should not intervene to favor railroads over slurry or slurry over railroads, if there is no very strong evidence that railroads are better, or railroads against trucking and so on.

And so the main thing we do need in view of the deterioration of the railroads is to strengthen the capacity to transport goods, and it will require a subsidiary analysis of which one of the alternative avenues if any have a clear advantage. If none has, they all should be given whatever support public policy can accord.

The second element provides a nice contrast, because unlike the transportation system which has been deteriorating—not just the railroads, the highways are beginning to deteriorate, too—is the communications system, which in American history was the introduction of telegraphs and telephones replacing the Pony Express. Today the communications industry is still in relatively good shape.

Some people may say well, we should put all our resources in strengthening the strongest on the assumption that there are our comparative advantages, and that unless we support the computer and communications industries, they are going to weaken, too.

My approach suggests that the communications industry is doing very well, don't fix if it ain't broke. If we do not intervene too much, it may continue to do well, and that we should focus our resources on those necessary elements of industrialization which have weakened.

The third factor is energy. So much has been said, written, analyzed and reported, it's extremely difficult to add anything to the discussion other than I would point to the following.

Sheer conservation, in the sense of reduced activity in order to use less energy, is not compatible with re-industrialization. Increased energy efficiency is. Thus, there is a difference between replacing our jets, which are very fuel wasteful, with new jet engines which are more fuel efficient, or replacing the cars which are fuel wasteful with cars that are more fuel efficient than to say we should walk, ride bicycles and use horses.

Now, there's a great charm and attraction in these activites which are not labor, capital, or energy intensive. And I personally would fight for the rights of all Americans who wish to walk, and ride horses, and ride bicycles to be given all the opportunity they could.

But in terms of an industrial system, using these less productive, less efficient modes of transportation obviously will not do. So

there is here a fork in the road between what might be called conservation school number one, which simply means do less, and in that way you will conserve; and then there is the second school of conservation which says we need to encourage industry to make it more fuel efficient.

By the way, I would agree with those who say the market is doing a surprisingly good job here. The increase in fuel prices has motivated industry enormously to look for fuel efficient ways themselves. So maybe our main effort has to lie in developing our alternative resources.

The innovative capacity—there is somebody at NSF who keeps two files, a rosy file and a dark file, and you can ask for the rosy file, and you would get a list of indicators as to how well we are doing in research and development, and how much more innovations we have and so on; and then if you ask for the dark file, you can get statistics on slippage and falling in our commitment to R. & D.

I think on balance a case can be made that our research and development capacity, in effect the main source of innovation, has been slackening. First of all, in terms of proportional GNP, it has fallen from 3 percent in 1964 to 2.4 in 1979. I don't think that fully captures what's happening.

What's happening is that an increasing proportion of our R. & D. resources goes to "defensive" R. & D., to check, for instance, 30,000 chemicals for their toxic and carcinogenic effects. I don't believe anybody could object to people checking chemicals for toxic or carcinogenic effects. I think there's a great human and ultimatlely economic need to do so.

The effect nevertheless is that if you take 10,000 technicians, engineers, and to some degree scientists and assign them to that duty, as in my judgment they should, that leaves you 10,000 fewer working on new products in the other sense of the term, of adding new elements to our productive capacity.

So I think the answer there in effect is we need not only to return to 3 percent of GNP, we need to increase commitments to R. & D. in order to allow sufficient resources for defensive R. & D. and for innovative R. & D., especially in the energy-related areas. areas.

Moving on down the same list, the three remaining elements are human capital, the supportive legal and financial institutions, and capital formation. And so much has been said about this, including points made this morning, that I'd like to move along to the next issue.

The next issue as reflected in the questions that were prepared by the subcommittee, raise the question "how to." Assuming that one agrees to follow one, or I would recommend strongly a combination of these considerations, taking into account national security needs, taking into account the lessons econometrics teaches us as to saving rates and investment rates and these issues, and taking into account this more historical development list, what is the way to get public policy support of whatever needs supporting.

It's convenient to divide the existing schools of thought into basically three approaches—the fully targeted approach, the semitargeted approach, and the nontargeted.

To start on the left, the fully targeted approach assume, at least implicitly, a high planning posture. It does assume that there will be some kind of trade department with 300 desks, one for each main industry, which will at least analytically survey the need of every and all industries, assess them in comparison to other industries in the United States and in other countries, and derive from that highly targeted signals as to who should be promoted and who should not, on an industry-by-industry basis, leading first of all to extremely high analytical demands.

I would strongly urge if you go in that direction that somebody do a study of past performance. We have a tendency to let people like myself get away with giving advice and then not checking them. I wish there would be a rating system the way we have for bonds, AAA, AA, and A, in which a place where people come and say they can do that, they can predict the future of specific industries in the long run, that we would retrieve their previous predictions on a computer. I think it would moderate us all a bit and will lead us to at least be cautious before we go too far in the direction of a national trade ministry with planning committees for 300 industries.

At the other end of continuum is the completely nontargeted approach, there is the notion of what might be called supply side number one, which basically suggests that if you return the resources to the private sector, they will float on their own goodwill to where they are supposed to end up and shore up America's productive capacity.

What troubles me about that approach, the completely nontargeted, is that first of all it may well lead in the short run to a sharp increase in inflation and consumption, including consumption of imported gasoline. So on that ground alone I would be worried.

More deeply and analytically, I would say that if it is true, as has been argued in favor of returning all those resources to the private sector, that the Government largely distorted and perverted the private economy through heavy regulation and through years of deflecting resources, it would be kind of surprising that by just changing the level of taxation, we could restore all that's wrong in the economy.

I believe we need some semitargeting, the kind of middle-of-the-road approach here, supply side number two, if you wish to call it, which will try to guide the resources released by reducing taxes and Government expenditures to the right sectors, though not to specific industries. We should guide them to go to the infrastructure and to capital formation. And I very much agree with the challenge Professor Thurow put before us this morning that you're not serious if you're not saying from where you want to take it away.

And I would rather like to talk about it after the election than before, but if we have to, the analysis points clearly to the fact that we set up a system over the last 20 years which very heavily promotes residential homes. And the question which must be asked in this moment of pain is can we afford to continue to have tax laws and interest rates and a large variety of institutions which in effect tell Americans that if they invest in real estate,

which in the case of residential home, is a consumer product, that they'd do more for the country than if they had invested in producer goods.

Now, I realize that every American dreams to have their own home, and ways will have to be found to respond to that dream, but for the next 10 years I'm not confident that we can find resources first for defense, then for some minimal decent standard of social services, then for the kind of reindustrialization we talk about, and for continued increase in consumer products.

Just to give one example, the tax laws allow a person who sells a home and buys a new one within 13 months not to pay any tax on the capital gains achieved on the first home. There is no parallel law if you invest your money in a capital good.

I could give many, many more such examples. There is now a new $100,000 exemption (one in a lifetime) on homes that doesn't exist in any other investment area. All this if you put it all together—and there are many more details—if you just came fresh from a faraway planet you would assume that somebody designed a system to deliberately tilt it in favor of investing in consumer goods and not in productive capacity.

And that's exactly what did happen. We came from an era in which we thought we were affluent beyond belief. In the fifties the main concern of some of our leading intellectuals was that we will not find enough outlets for our productive capacity. Then Galbraith wrote "The Affluent Society," and David Riessman, "Affluence For What?" The concern was not how to increase productive capacity, the danger was believed to be in it being idle.

Just to recapture that period, it was suggested in those days that we should bombard Communist China with nylon stockings and dishwashers for two reasons: One is to corrupt this fanatic society and make it as soft-bellied as we are, and a second, to find the assembly lines something to do.

Well, our laws, which tend to be somewhat behind times, reflect still that tilt. What I think we're all talking about is the need to correct them so they will, at least for a decade, favor productive capacity.

The specific list, would have to include, in my judgment, very much the antitrust laws, which reference already has been made to. I would also favor changing the Foreign Corrupt Practices Act.

I would like to see us saying to Americans who work overseas that they should abide by the law of the land in which they're working rather than by American laws. We've long given up the idea that we're going to be the world's policemen. I think we should apply it to this area. So the Italian, and French, and Germans, and Japanese, and American businessmen who are competing in Thailand, should all compete under the same law, the Thai law, and not the respective laws of their land.

This is not an ethical copout. The Thai law does not condone corruption; it prohibits corruption. Now, if the Thai authorities are somewhat less diligent than American morals would like them to be in enforcing these laws, that truly is not our business.

Similarly, I do agree that the antitrust laws should not affect collaboration on technology. For instance, the three car manufacturers are not allowed to share information about pollution control

devices, and therefore face unnecessarily higher cost of developing these.

The justification given by the Department of Justice for that position is that if you allow them to get together on pollution controlling technology, they would lock in on a bad technology.

Senator BRADLEY. On a what technology?

Professor ETZIONI. If we lock in on a bad technology——

Senator BRADLEY. Bad.

Professor ETZIONI. The idea is that if you have no competition among researchers, GM, Ford, and American Motors are going to get together on some inefficient technology, that's from the days before the West Germans, Japanese—they're going to remind us very quickly what the more efficient technology is.

The one review which I cannot find—I checked with the Treasury, the Federal Reserve Board, and with several congressional committees—is a kind of review of the state of use of credit. We tend to take the position, Secretary Miller, Mr. Walker, that controlling credit in any shape or form is an anathema, intervenes in the private sector, the private sector should take care of that, and in the 6 weeks in which the White House put up a limited version of credit controls, everybody felt terribly guilty about this new invasion—well, I shouldn't say everybody, but those people I spoke to—about this new invasion of the private sector, and as soon as it was possible they dismantled these credit controls.

But the truth is that the Government intervenes in the credit markets every day of the week and during weekends. It's done in the way we do it, the American way. Rather than have an overarching plan for it, we spot intervene, spot interventions which are decided independently of all the others.

So we give students interest-free loans for the years they study as if our number one national priority is to have more students and we do not provide similar terms to people who want to get into venture capital which I think is a much more urgent need.

We give tax exempt bonds to municipals, to certain schools and other favorite industries. We do not give them to others.

Actually that is precisely my point. There is no, as far as I can establish, systematic review of what the Government intervention in the credit system is. I think once somebody would generate such an overview the absurdities which have been generated by an accumulation of spot interventions would stand out, I still don't believe that should lead us to a national planning of credit, but I think it would lead us to remove some of the anachronistic and some of the undesirable interventions, in part to return it to a freer market, in part to tilt it away from consumer products to productive capacity.

Last, on the R. & D. business I'd like to make one point which I think is somewhat different from what is at the moment the conventional wisdom. The conventional wisdom is just to increase R. & D., and again, it's somewhat like arguing against virtue to say that that's not the way to go. I believe it's not enough to simply turn more resources in that direction. I believe we're particularly short at the applied end of our research. There is a very vicious prestige factor built into it which makes basic research prestigious,

and desirable, and welcome, and applied research somewhere between dirty and stigmatized.

A survey of scientists found that only 1 percent of 2,051 scientists doing basic research expressed a desire to engage in applied research, 55 percent of 379 applied scientists wished to work in basic research. That leads to a concept on the campus known as "Robin Hooding," in which if you get money for applied projects, do all you can to turn it into a basic project anyhow.

The mechanisms of supervision are such that in effect by and large a very large part of our so-called applied work in effect ends up being basic. Somebody put it very well like this: "We've been asked to report to Congress how much applied work we're doing in our agency. The agency spends roughly $3 billion on research. And we said well, if we report 50 percent applied, that will upset the scientific community; if we report 20 percent applied, Congress will feel we do too little; if we report 30 percent, it's too pat a figure; thus, we report 29 percent. And so we've been reporting 29 percent"—I'm quoting—"for the last years."

The significance of that while it is true that basic research is ultimately the foundation of knowledge, but the yield for innovation, for industrial capacity, for energy drive in the short run has to be found at the applied end, and I would favor your consideration in increasing the applied part, if at all possible.

Ultimately we need a place in which all these considerations, the international part of it and the domestic part of it, can be put together. And just to return to a point I started with, I would welcome an institutionalized opportunity for examining these considerations.

Thank you.

[The prepared statement of Mr. Etzioni follows:]

STATEMENT OF AMITAI ETZIONI

We must go beyond fiddling with the dials, to try to reduce unemployment by *x* points, decrease inflation by *y* points; we must engage in a broad-based effort to shore up America's productive capacity. It is this capacity which provides the resources for all that we do—for defense and social services, for a high standard of living and those government expenditures which are necessary. And it is this capacity which has been weakened by decades of over-consumption in the public and private sectors and underinvestment in maintaining and updating our productive capacity.

The new approach to shoring up America's productive capacity will have to encompass seven elements which shaped the nation's economic strength in the first place. The seven elements of re-industrialization include transportation of resources and goods; communication of information and signals; abundant energy; vigorous innovative capacity; effective mobilization and preparation of labor, or human capital; supportive legal/financial institutions; and a high level of capital information.

1. TRANSPORTATION OF GOODS

A developed economy requires large-scale, expeditious movement of raw materials to processors and of products to markets. Material and products in transit add only to costs, not to production.

A look at the state of the American transportation system shows that airlines, the sector in relatively the best shape, carry less than one percent of the load. The means of transportation on which we rely most are less sound. Railroad tracks, roadbeds, and, to a lesser extent, equipment are seriously deteriorated; even in 1975 dollars, the railroads will need to spend an estimated $62 billion between 1976 and 1985 to maintain and renew rights-of-way and equipment. What is less widely known, is that the nation's highways as well, built with federal funds with insufficient provisions for maintenance, are deteriorating. As of 1975, 42 percent of all paved highways and 27 percent of interstate highways were rated either "fair" or

"poor". The Department of Transportation estimates that it would take an average of $21.8 billion a year, again in 1975 dollars, each year until 1990, simply to maintain highways in their 1975 condition. Actual expenditures are far below these levels.

2. COMMUNICATION SYSTEMS

As transportation moves goods, communication moves symbols—symbols which carry information, control actions, and express sentiments and values. Accessible information is important to productive decisionmaking; instructions and other control signals are vital for large-scale administration; expressions of values broaden parochial loyalties to an encompassing sense of national identity. Thus, rapid and reliable communication is essential to a national economy and national policymaking.

Historically, the introduction of the telegraph and telephone served the first industrialization of America. After World War II, computers, communication satellites, and national TV networks were added. Communication is by far the strongest of the seven elements of industrialization and the least in need of revitalization.

3. POWER

Obviously, a high production society requires enormous amounts of energy from power sources which are routinely available and easily stockpiled. American industry was built on cheap energy, but now cheap energy has vanished.

Much has been written and said as to what is to be done. Let me simply highlight here the main relevant points.

(1) Secure flow of oil takes precedence over costs.

(2) Less rapidly rising costs are vital to re-industrialization.

(3) Conservation simply through lower economic activity is not as helpful as conservation through increased energy-efficiency, combined with development of new oil and of alternative energy sources.

(4) A major drive for energy development can be best financed by an import tax on oil.

(5) Such a drive should be tied to job development and trade-adjustment assistance.

4. R. & D.

Efficient, expanding production of both capital goods and consumer goods and services requires continual innovation and adaptation of tools, techniques, and technologies. Research and development, including inventions, engineering advances, and technological education, undergirds the directly productive segments of an industrial economy and also renews other elements of the infrastructure.

Research and development shows fewer signs of deterioration than some elements. For three years in a row, real growth in research and development expeditures by industry have been increasing, in constant dollars. But as a percentage of Gross National Product, total research and development expenditures fell from 3 percent in 1964 to 2.3 percent in 1979. Second, while many of the nation's industrial, energy, and security needs are highly applied, American R & D is more "basic", less applied than that of several of the nation's main competitors. A return to a higher federal R & D budget and a higher applied yield is urgently needed.

5. HUMAN CAPITAL

Industrialization requires a labor force motivated, educated, and trained to staff the evolving factories, offices, laboratories, and financial institutions. Vocational education must be examined to see if it can be made more job-relevant and tied to the industrial agenda of the 1980s. The higher education drain of resources and the anti-industrial tilt should be reviewed, while we also evolve steps to promote productivity.

6. LEGAL/FINANCIAL INSTITUTIONS

A modern industrial economy demands a legal and financial structure commensurate with its size and complexity. A nationwide, easily mobilized flow of sufficient capital for large projects, which industrial growth requires, depends in its initial phases on such supportive legal and financial institutions as standardization of the currency, a national banking system, and the concept of limited liability. As the economy develops, these institutions must be elaborated and adopted to meet its needs.

The American economy operates within a legal and financial framework which has not been modified as rapidly as conditions have changed, and which reflects a

tendency to impose American values elsewhere. Thus, aside from changes in antitrust laws and venture capital laws, discussed below, it seems to make sense to change the laws concerning the conduct of American business representatives overseas, to state that they would be expected to abide by the law of the land they work in, not the USA. This would return them to equal footing with their overseas competitors, without evading ethical responsibility. Most countries prohibit corruption, and if some are less diligent in enforcing their laws than others, that should not be the business of the United States.

7. CAPITAL GOODS

While early industrial development was in part piggybacked on the produce of field and forest, the machine and its products were preeminent in industrialization proper. The creation of an infrastructure suitable for modern economic development culminates in the accumulation of capital goods.

While U.S. spending on new plants and equipment has continued to rise in recent years, in real terms it has been falling. We must increase plow-back investment, which recently has been less than 10 percent, to 12 percent of the GNP, in order to provide the capital to replace obsolete equipment (especially in steel, rubber, and textiles), and to come closer to the nation's main competitors (West Germany now reinvests about 15 percent, Japan, about 21 percent).

In addition, America's lower rate of personal savings, less than half that in most Western European countries and only about, one third that of Japan, has been said to hinder its economic performance. West Germany's success story is often cited—as the Wall Street Journal reported, since the 1960's the funds made available by savings have helped push productivity ahead faster in Germany than in any other Western nation, and have allowed banks to make ample loans to German companies.

NONTARGETED, SEMITARGETED, AND FULLY TARGETED APPROACHES

How to tilt our collective efforts to rebuilding our industrial base depends on one's conception to the proper relations between the economy and the polity.

I. Nontargeted

In the view of radical conservatives, the less the polity is introduced into the economic realm, and the smaller its take, scope, and mission, the more productive America will be. In economic policy, this suggests large tax cuts as the cornerstone, returning to the private sector resources previously used by the public sector and unleashing incentives for entrepreneurship, saving, and risk taking, all held in check under high tax levels. This view is also known as Supply Side I, or "turning on the spigots"; its most outspoken advocates are Jack Kemp, William Roth and Arthur Laffer. Its attribute most relevant to the issue discussed here is that the transfer of resources from the polity to the private sector is nontargeted; where the resources go and how they are used is left altogether to the operation of the market.

II. Semitargeted

Many conservative economists, including Herbert Stein, Alan Greenspan, and George Schultz, argue instead that while Americans do need less government control, intervention, expenditure, and taxation, there is a need, at least during the restoration era, to guide or semitarget the resources, in order to counter inclinations toward over-consumption and under-investment, to make up for the lag in adaptation, and to serve national security needs.

III. Targeted

Still another view, the thesis of industrial policy, calls for a government masterplan which would target resources fully and specifically. Key to industrial policy is a one-by-one review of industries, either by government agencies or a government-industry-labor committee, to decide which will be promoted, which phased out. While there is room for some such effort, as an overall approach, it is technically impossible and politically incompatible with American institutions and traditions.

Re-industrialization stands between non-targeted assistance and fully-targeted industrial policy as semitargeted. Its concern is with setting priorities, providing incentives, and building consensus. Re-industrialization focuses on elements which serve the needs of all industries, not just certain ones. Re-industrialization would increase the amount of capital available, for example, to all parts of the American economy, not just to steel or rubber. It would improve the transportation system for all parts of the economy, not just for coal or grain. Under a policy of re-industrialization, the polity sets the context, which is productive capacity; within that context,

the market targets. Given an improved context, the market will allocate capital where it will be most efficiently used.

SPECIFIC STEPS

Specific steps must be taken to implement the strategy of re-industrialization.

1. *Antitrust laws*

Existing antitrust laws reflect an earlier era and must be subjected to basic review. Rather than modification, they require basic reformulation.

The main changes to be considered:

(i) Apply U.S. laws only within the U.S., and change them so they will not prohibit collaboration whose purpose is to increase exports or reduce the costs of environmental, worker and consumer protection.

(ii) Allow collaborative R & D in developing pollution control devices, for instance, to reduce the costs of quality-of-life programs.

(iii) Prohibit concentration when it produces a restraint of development, but do not assume concentration is against the public interest on the face of it. In the future economy, large concentrations of capital may be required in many areas, from synthetic fuels to fusion research.

(iv) Remove limit-to-3-percent-share-of-market criteria, for the same reasons.

2. *Credit editing*

Market decisions are distorted, not merely by government intervention via the tax and regulatory systems, but also by relative terms of credit which often are not favorable to new initiatives and capital formation.

(i) Since no systematic overview seems to exist, the first step here is to provide an analysis of the effects of government interventions in the credit marketplace and of market imperfections.

(ii) We should consider removing extraneous factors which tilt credit away from productive capacity.

(iii) Provision of credit for new ventures must be encouraged.

3. *Tax incentives to investment*

A drive to increase the incentive to invest rather than consume is a necessary part of re-industrialization. Various schemes have recently been suggested to increase citizens' incentives to save and to invest. This is not the occasion to review their relative strengths and weaknesses. None of them alone is likely to solve the problem of under-investment; a combination of several might be needed. A change in the laws limiting the right to invest in new corporations ("venture capital") might well be combined with laws encouraging re-investment of dividends and interest. One new way to achieve this should be spelled out briefly. I suggest that dividends and interest reinvested within thirty days in stocks or bonds be taxed not as current income, but at capital gains rates when the stocks or bonds were sold, provided they have been held for at least one year. This would go at least some way to put investment in business on a footing similar to investment in residential houses, now favored by the tax laws. For instance, if one sells his principal residence and buys a new one within 13 months, no capital gains tax is imposed.

4. *More applied R. & D.*

Many steps have been suggested to increase the share of GNP to research and development, and to enhance university-industry ties. Although no particular level of R & D expenditures is sacrosanct, it would indeed be desirable to return R & D expenditures to 3 percent of GNP. It would not be sufficient, however. Because R. & D. is the main source of new products, which in turn keep the economy vigorous, primary emphasis should be on devising ways to increase the applied yield of our research and development enterprise.

HOW TO STOP THE OPEC WEALTH DRAIN

A major hindrance in undertaking a drive for re-industrialization without neglecting our defense needs nor wantonly disregarding our social needs, is the high price of oil. In 1980 Americans will pay $100 billion for imported oil. As Felix Rohatyn has pointed out, the total value of the American corporations listed on the New York Stock Exchange is about $900 billion; thus, in five years the nation's oil bill will amount to more than half the value of the major American corporations.

Obviously a way must be found to reduce this wealth drain. Increased conservation and development of other energy sources are not the whole answer; oil exporters can more than offset gains made in this way by price increases and production cutbacks. There is an urgent need to create an analytic facility to review, from a

combined perspective of American economic needs and international relations, the answer to this drain on our wealth.

AMITAI ETZIONI

Dr. Amitai Etzioni is University Professor at George Washington University and Director of the Center for Policy Research. He is also the father of the re-industrialization thesis.

He is the author of twelve books, including "A Comparative Analysis of Complex Organizations", "Modern Organizations", "Political Unification", "The Active Society", "Genetic Fix" and, most recently, "Social Problems" (Prentice-Hall, 1976).

Dr. Etzioni's achievements in the social sciences have been acknowledged by several fellowships, including The Social Science Research Council (1960-61), The Center for Advanced Study in the Behavioral Sciences (1965-66), and Guggenheim (1968-69). He was a guest scholar at The Brookings Institution in 1978-79. He served as Senior Adviser in the White House, 1979-1980.

His achievements in natural science have also been recognized. His book, "Genetic Fix" (a Harper & Row paperback) was nominated for the 1973 National Book Award in the area of science. He served for two years as a member of the editorial board of Science.

Outside of academia, Dr. Etzioni's voice is frequently heard in the popular press, from the New York Times to the Washington Post, from Psychology Today to network television.

He has consulted widely for government agencies, including the Department of Health, Education, and Welfare; the Departments of Labor, Commerce, and the Treasury; The National Science Foundation; The President's Commission on the Causes and Prevention of Violence; and the White House, during several administrations.

He founded the Center for Policy Research, a not-for-profit corporation dedicated to public policy, in 1968, and has been its director since its inception.

In 1976, the American Revolution Bicentennial Administration accorded Dr. Etzioni a certificate of appreciation for his outstanding contribution to our nation's bicentennial commemoration.

Dr. Etzioni is married and has five sons.

Senator BRADLEY. Thank you very much, Mr. Etzioni.

I think that all of you provided a perspective on the issue and what I'd like to get at is your view as to whether you think investment as a percent of GNP has to increase, or whether it can remain at its present level of about 10 percent of GNP or whether you think investment has to be reallocated. And if it has to be reallocated, what mechanism is best to do that?

Mr. THUROW. I'll start off. I think it has to be increased for a very simple reason. It's not that investment has gone down; it's that our population and labor force are growing very rapidly at the moment. People differ a little bit on exactly how fast the capital stock has been growing in the 1970's, but all estimates show the capital-labor ratio falling at the end of the decade. And it's not that investment went down in 1978 and 1979; it's that our labor force is growing very rapidly.

Japan invests 20 percent of its GNP in plant equipment with a labor force that is not growing; Germany invests 15 percent of its GNP in plant equipment with a labor force that's falling; America invests just 10 percent with a labor force that's growing very rapidly.

That just isn't viable if you believe we're all equally smart. The only way that's viable is if you think Americans are 2½ times smarter than the Japanese and 75 percent smarter than the Germans. I think we just need a much higher rate of capital formation in absolute terms.

I think of propping up losers is a loser. And we don't have the excuse that the British did. When they adopted that policy, nobody

else had it, and you could not demonstrate that it was a disaster. But the British have now demonstrated to the world that propping up losers is the ultimate economic disaster, and that is what the President proposed in his revitalization program. We don't have to have a government agency to kill losers. The market will kill losers for us. And if we were in the world by ourselves, I would say let the market pick winners. But I'm afraid the Japanese will kill our winners. The market will kill the losers, and the Japanese will kill the winners, and we're left with not much in between.

Take my semiconductor example seriously. Most people would say, whether they're right or wrong, that computer chip semiconductors is a growth industry; it's a sunrise industry. But we face a national Japanese strategy to drive us out of that business.

They've done it in steel, they've done it in TV set manufacturing. What makes us think they won't do it here? I had lunch not too long ago with somebody from the Japanese embassy who with a smile said, "You know, we just practice the kind of economics you teach in Ec 1, because in Ec 1 you teach people to have a good idea, then go out and borrow massive amounts of capital, build the factories, and do it. Well, that's what we do."

But if you have a corporate structure which operates on retained earnings and won't in fact either borrow or lend enormous amounts of money to small firms, then you have a structure that can't compete.

I would like to be able to sit here and say well, the country doesn't have to have a policy of picking winners because it's going to be messy, it may get politicized, but I just think that's not viable.

Senator BRADLEY. Following up on what Dr. Etzioni said about national security, some of our so-called losers at the moment, one could argue, are important for our national security. It's important that we have a steel capacity. It's important we produce a certain number of automobiles in the long term. Do you agree that certain industries must be preserved for reasons of national security, or should comparative advantage rule to the extreme, which means not only that we become dependent on foreign sources for raw materials abroad, but we become dependent on foreign sources for certain basic products.

Mr. THUROW. We're all interdependent. We're the world's great provider of food. The rest of the world is—Europe, Japan—dependent on us for that necessity. Does that mean they should go off and try to have independence in food? It's a necessity clearly. You can't run long military wars without food. Well, I think the answer is no. But then the answer also has to be no if we're talking about steel.

And we're not talking about eliminating the steel industry. There are lots of places where the American steel industry is viable—high technology specialized steels. The real question is should we be making millions of tons of pig iron. Perhaps we should be importing some of that raw pig iron and then making it into specialized steel.

Senator BRADLEY. Would you speculate on a percent of GNP you think our investments should aim toward?

We don't want to be in a world where we have a per capita GNP twice the next wealthiest country. It's nice to have wealthy neighbors. It makes the whole world more pleasant. On the other hand, we don't want to have half the per capita GNP they have.

The amount we have to invest I think depends on how much they do. And I would think that if you really look at our growing labor force and the Germans and Japanese between 20 and 15, we need to be in that ballpark.

Senator BRADLEY. Yes.

Mr. BOSKIN. I'd like to second that. I've actually done some analytical work trying to look at not just the issues that Professor Thurow mentioned, but trying to get at people's rate of time preference and the tradeoff between the future consumption that increased investment would allow and the cost of foregoing current consumption. And I think at a minimum we have to raise our investment rate by 5 percentage points over a sustained length of time.

I think that that would result in a substantial acceleration and have a side effect of raising our rate of innovation. I think it would also because such a large fraction of gross investment is replacement, would mean that our rate of real net investment would be increased substantially more as a percentage than the half again increase in the gross investment rate.

I also think that we have to be very, very chary of policies designed to deliberately realine or reallocate investment. Professor Thurow has pointed out sort of the risk in trying to bail out or reinvigorate is the current popular phrase I suppose, industries which he describes as sunset industries. That terminology is one that I don't necessarily agree with.

Senator BRADLEY. You what?

Mr. BOSKIN. I don't necessarily agree with that terminology, because I think it's applied with too broad a brush to an entire industry. I think he was very careful, for example, to point out that steel is really composed of many different smaller industries that are closely related.

The point I would like to make is we have many examples besides the United Kingdom of the so-called industrial policy being an abysmal failure. In Italy, the IRI. The Soviet Union, it is not widely recognized, has an enormous system of differentiated investment subsidies or something that is close to a system of differentiated investment tax credits or profit taxes. They don't call them taxes because there aren't things like taxes in the Soviet Union; they're called contributions by people's enterprises. But the rates are set to vary enormously across industries to try and meet planning targets and quotas, and that has historically been a problem with the Soviet Union.

Argentina, last year the Argentinian national railroad, which has been a constant sponge soaking up government revenues, had gross revenues which were only one-third of its operating expenditures; that is, it ran a deficit twice its gross revenues.

I think there are an enormous number of examples of these situations. I also think it's important to point out that once you get into such a situation still more than we have started to get into—look at the United Kingdom—it is very, very difficult to get out of

it, and not always with bad reason. There are enormous short-term costs to trying to get out of the industrial policy the British adopted, and they're unfortunately going through that right now with the policies of the Thatcher administration.

One of the questions you raised, Senator, on your list of questions you forwarded to us was, is there an example of supply side economics which has helped deal with this, and Professor Etzioni I think correctly drew a distinction between two types of supply-side economics—the one that offers the hope, I believe a somewhat naive one, that a mere cut, across-the-board cut in tax rates will so invigorate the economy so quickly that many of our problems will disappear—what he called supply-side one.

I think there is no convincing empirical evidence or example of that happening. On the other hand, I think we have for too long ignored the structure of incentives, the sets of returns and risks that investors and savers and innovators face, and they basically have been eroded.

And if we go back to what he called supply-side two, I think there is a compelling case to try, in trying to deal with this problem, to redress the imbalance. We are not talking about getting new incentives, getting new tax breaks, et cetera, but we redress the imbalance, redress the disincentives that have grown up over the last decade and more.

And that would lead us away from a tax system, a spending system, and a monetary and fiscal policy which overemphasizes spending at the expense of saving and investment. And in my view, unless we do that we have very little chance of increasing our rate of investment. I would also not neglect the fact that investment is falling enormously, and it is probably time to redress that.

Senator BRADLEY. Do you both agree that increased investment comes from increased saving and reduced consumption?

Mr. BOSKIN. Yes. Ultimately it has to come out of one of two sources. It has to come out of either current American citizens consuming less, either through less public goods through the Government or less current consumption, that is, increasing their own saving, or we have to borrow abroad to finance it.

Now, our investment rate hasn't fallen as far as our saving rate in the last few years because we've increased our imports of foreign capital. One problem is that while that helps to keep our investment rate up and therefore is desirable in the short run, our citizens are not acquiring title to those capital goods, for example, to finance their retirement, or child's education, or the purchase of a home later on in their life.

So I think that in the very short run we could certainly increase our investment rate by importing more foreign capital, and indeed, that in the very short run, policies to stimulate saving would have their immediate impact on our international account rather than domestic investment. Over a span of a few years it would show up in domestic investment and must come therefrom.

History has not been kind, in my opinion, to advanced economies, economies that were mature at the date in history you're looking at, which attempted to promote their growth and finance their investment by importing capital. The overwhelming bulk of the success stories of financing investment and promoting growth

through importation of foreign capital have been the economies that were immature or less developed at the time you're speaking of, either less developed economies today or indeed the United States or Canada at earlier times in their economic history.

Mr. THUROW. I think one thing you have to realize the extent to which the rest of the world goes to reduce consumption. The Swedes have just upped their value added tax, which is a tax on consumption, to 24 percent; so every time you buy something in Sweden, you pay a 24 percent tax to discourage consumption.

It's standard in Europe for most countries to have a 15 percent value added tax, which means that they have a 15 percent tax to persuade you not to buy things. Well, we do the opposite.

Senator BRADLEY. Do you favor a value added tax?

Mr. THUROW. I think we need something the equivalent of a value added tax to force down consumption.

The American family saves 4 to 5 percent of their income and the Japanese family saves 25 to 30 percent. People wave their hands and say "culture." Well, culture may play a little bit of a role, but there are some real incentives there.

Consumer credit is not available. If you want to buy a car, you've got to save all the money ahead of time. That does two things. One, it means somebody else's savings don't have to finance your car; and two, business can use your car savings until you get enough to buy that car. Same thing on mortgages. Instead of having a 20 percent downpayment and an 80 percent mortgage, they tend to do the opposite. Well, it means they're actively discouraging people from buying houses.

The ultimate absurdity is American tax law and housing. Think of all those special provisions which are all available for your second house, your third house, your fourth house. Maybe the country has a little bit of national interest in getting people into good housing on their first house, but why all the big tax breaks on recreational homes? It just doesn't serve any national purpose that I can think of.

Professor ETZIONI. Let me just add a footnote here. I agree very much with most of what's been said already. We do need more capital. I would use as a benchmark, not as an ultimate goal, 12 percent only because——

Senator BRADLEY. You'd what?

Professor ETZIONI. I would use 12 percent as kind of a first target.

Senator BRADLEY. OK.

Professor ETZIONI. Not because I have anything against 15 or 21—12 percent gets you on the way there—but because I'm mindful of my colleagues in economics who studied the past effects of public policy on this percentage and concluded that often if you jumped up and down and sideways, you know, we didn't increase the proportion very much; so it would take a very gigantic, monumental effort to bring it from 10.5 up to 12. But this is not the main point.

The main question I wanted to add a footnote to is where it's going to come from. And while I very much agree it will have to come from reduced public and private consumption, I have to point

again at this $100 billion a year tax imposed on us from the outside.

It was pointed out the other day the total value of all American corporations listed on the New York Stock Exchange is something on the order of $900 billion.

Senator BRADLEY. What do you say to people who say yes, I understand, we're going to pay $100 billion to OPEC next year for our oil, but the Japanese pay a lot, and the West Germans pay a lot. Yet it doesn't seem to have as dramatic an effect on their economic performances, or at least it isn't used as much by their politicians as an explanation of poor performance.

Professor ETZIONI. That's definitely true, though I would like a law to be passed that every time one of us makes these cross-cultural comparisons he be required to list all the other things which also differ between the societies, because these analogs fly so easily—the Japanese do it, let's us do it.

Well, the Japanese are different from us in many, many ways. They bring their children up differently. They are a smaller nation. Their population has different age compositions, different—and I can sit here all week listing how they're different.

So to suggest that if you take one item there we like and copy it, it will work here this might be true for traffic signs and limited technology, but for major social institutions—it will not work. The issue here is therefore, do we have any choice in continuing to transfer that amount of wealth to the oil exporting countries, or to take the next step, being a leader of the Western World, should we help other countries, including Japan and West Germany, to face less of the pressure?

Now, the free market enthusiast's answer is that the high price is good for us. It makes us conserve more and develop more, and it spurs us, and it does what the Government cannot do. It makes the market teach us to use less energy.

But the fact is that if we shift to an energy efficient and develop a different energy system, it will take us 10 years, and we will need at least $100 billion a year for the transition. And so, obviously if in the transition years somebody will keep squeezing us harder and every gain we make will be more than offset by an increase in price and production cuts, we would have to reindustrialize under ever harsher circumstances.

Senator BRADLEY. Yes.

Professor ETZIONI. So that's the reason I would like us to see to what degree we could moderate the price increase of oil.

Mr. BOSKIN. Senator, I'd just like to come back to a point Professor Thurow mentioned, and our fascination with certain successes the Japanese have had. As Professor Thurow mentioned, the Japanese give up a lot in order to export a lot, in order to promote their growth; that is, they've had a generation of people who have had a lower current level of consumption than they otherwise could have had in order to promote their future standard of living, either in old age or their children.

I think it is important to point out that we're judging their success ex post rather than ex ante. I guess if I was going to suggest we draw any lesson from this discussion today in talking about trying to pick winners, guess losers, that saying that the

Japanese have been successful ex post in following certain strategies that we have not followed, we should also point out that there have been many important examples of losers ex post.

The supersonic transport comes immediately to mind. There was a time when President Nixon declared it was important for the United States to be first in everything. He wanted to have the United States build a supersonic transport. And we saved ourselves billions of dollars and a colossal embarrassment, and unlike the French and British we are not now shoving good money after bad because we built so far ahead of the demand for a supersonic transport.

So I think it is important to realize that it is a lot easier to judge success ex post than ex ante, and the notion that we can predict which industries will be flying high, doing very well far into the future better than the market, is highly debatable.

Senator BRADLEY. What do you think of Professor Thurow's idea of a corporate investment committee to begin to direct attention to——

Mr. BOSKIN. My feeling is that most committees are enjoyable social occasions. I think that there is generally a feeling that we need more cooperation and less bitterness about the division of the pie in our society, and it somehow serves that psychological need.

I don't see how that committee could do a better job—that is, take an available amount of investment funds and yield a higher return—than the private market would create. In fact, I would find it very difficult to think of them doing a better job than just buying the Dow Jones——

Senator BRADLEY. What do you say to his example of the computer chip industry? Is the market going to take care of that, do you think?

Mr. BOSKIN. I think there are examples where through specific policies of foreign competitors some of our industries are put at a competitive disadvantage. And I think that with respect to the supply of capital because of the way credit is allocated in those countries and a variety of other instances, I think those are exceptions rather than the general rule. The Japanese are not coming along a broad front and invading every industry in the United States.

I think they are exceptions rather than the general rule, number one, and number two, I think they are generally best dealt with at the source, that is, through reciprocal trade agreements on that level rather than in trying to emulate that policy across the board in many of our industries.

I didn't mean to suggest that there are never cases for targeted investment subsidies or for trying to work out reciprocal agreements when indeed there is special government favoring in other countries of export industries which make our domestic industries face unfair competition.

Senator BRADLEY. I have a vote. I'm going to go vote. I'll be back.

[Recess.]

Senator BRADLEY. Let's see, where were we when I left? I think we were——

Mr. THUROW. I would like to respond a little bit on——

Senator BRADLEY. Fine. OK.

Mr. THUROW. When you think about picking winners, I think the problem is not saying what industry is going to be successful 15, 20 years in the future. I agree with everybody else that's impossible.

When you talk about picking winners, what you're really saying is what industries are successful right now and how can government help them. If the answer is they don't need any help, then that's the answer, and we shouldn't give them any help.

If you look at the industries that are right on the verge of being successful at the moment like the computer industry, what kind of aid do they need, if anything.

That's where the systematic dialog ought to be going on. It's not what kind of industries are a gleam in somebody's eye and going to be successful 25 years from now. I agree there, there are lots of gleams, and nobody knows.

If you look at our current growth industries, some of those industries have problems that perhaps we could help alleviate. And I think that's the place where picking winners where everybody would have some agreement on who those current winners are. Everbody would have some agreement on what problems do those winning industries have to solve, in order to be successful in international competition.

Senator BRADLEY. Do both of you believe that our economy should be export led?

Mr. THUROW. Well, everybody's economy can't be export led. The Japanese are doing something the rest of the world can't do, or we all can't do. This year they're going to have a 8 or 9 million car year, and they're going to consume 3 at home and export 6.

Well, obviously the whole world can't do that. So I don't think we need an export led economy because we all can't have that, but we have to have an economy that's got industries which are export industries and are viable, and where our winning industries can at least win our domestic market. If they get pushed out of our domestic market, then we're in real trouble.

Senator BRADLEY. One of the things that struck me about your testimony was that both of you advocated integration of corporate and personal income taxes.

Now, are you both talking about the same thing? When you say that, are you both talking about eliminating the corporate income tax and allocating taxable assets to owners of those assets, meaning the——

Mr. THUROW. Yes; I think we're talking about the same thing. But there are a lot of businessmen that don't like that.

Senator BRADLEY. Yes, I know. One question is, if you have that kind of tax reform, the person who has stock, is assessed the tax under this scheme on the retained earnings, so he has to have cash flow somewhere to pay for that, is that correct?

Mr. THUROW. That's right. He's got stock which he can sell, and if you want you can have the government withhold from corporate stock just like we do on earnings. You would get a W-2 form from your corporation saying that it earned this much on your behalf, sent this much on your behalf to the Government, add this into your taxes, and figure out what you owe.

If you're talking about the people who've got a lot of corporate stock, they can also borrow against that stock, they can sell that

stock, they get some dividends. You can have, great sympathy for solving their cash flow problem is nice, but you just can't blockade the world over what is basically a trivial problem.

Senator BRADLEY. Yes.

Mr. BOSKIN. I would just add to that that there are all sorts of other improvements that integrating the corporate and personal income taxes would make. The nominal rate structure of the personal income tax is obviously very different from that in the corporate tax, and there are some individuals and organizations who would face very low tax rates under the personal tax who pay much higher taxes under the corporate tax, including universities, tax exempt organizations, the many low income workers who have their pension funds invested in equity-financed corporate projects. And there are also many people who do the opposite, whose marginal tax rates under the personal tax would be much higher than under the corporate tax, and who through retained earnings, et cetera, have a vehicle for reducing their effective tax rate.

So I think such a system would be more equitable as well as more efficient in promoting balance.

Mr. THUROW. If you were going to do it, you couldn't make the distinction we now make between earned and unearned income in terms of the maximum rate. If you think the maximum rate for earnings is 50 percent, then people who make exactly the same amount of money in corporate income ought to pay the same rate. Or if you think 70 is the magic top rate, then it ought to be 70 for both. People who get $1 million, whether they earn it or it comes in earnings on their shares, ought to pay exactly the same tax rate. And so part of integration would be an equalization of those two maximum rates.

Senator BRADLEY. The equal income-equal tax rule.

Professor ETZIONI. Can I go back for a moment to the national security issue if this tax business is——

Senator BRADLEY. Well, certainly you can, but first I'd like to pursue the tax thing to conclusion. Integration of the corporate and personal income tax, would that facilitate the functioning of the financial markets? Or, what would that do to the financial markets?

Mr. BOSKIN. Well, it would have a variety of impacts. The first thing it would do would be to reduce the overall effective tax rate on investment income, and I think lead to a capital expansion. In the very short run its impact would depend upon whether the effective tax rates of people who are holding the bulk of shares are higher or lower than the corporate rate. I think on average they're pretty close, so I don't think it would have a major impact on the stock market right away or anything of that sort.

It would provide some redistribution or some increase in the value of shares for assets or companies which are predominantly held by lower income individuals and reverse for higher income individuals. But overall I think it would lead to a big increase in the—lead to a substantial increase in the return to investment because of a lowering of the effective tax rate, and hence stimulate investment demand.

Senator BRADLEY. Why is it in the interest of the corporation?

Mr. BOSKIN. Why is it in the interest of the corporation? It is in the interest of the corporation, in my opinion, because it's in the interest of the shareholders.

Mr. THUROW. I think that's an important point to make. It may not be in the interest of the corporate manager, which is different than the interest of the corporation. One of the great virtues of the current tax system, if you're the manager or president of a big firm, is that you've essentially got some imprisoned revenue that you can allocate, that your shareholders are not going to demand. A lot of corporate managers don't want to do it because it clearly would make their life a little bit more difficult in that there would be pressure to pay out dividends—especially if you weren't earning the rate of return that other investment opportunities were earning.

Now they don't want that money because they would have to pay a lot of taxes when they got it. So even though you're earning 5 percent and the rest of the world is earning 10, when they take the taxes, it doesn't make sense to take it away from you.

I think you need to make a big distinction between what's good for the economy, what's good for the corporation, and what's good for the corporate president.

If you raise the aftertax rate of return by abolishing the tax from 10 to 20 percent, that's a tremendous incentive to go off and do some investing. It would have a very positive effect on investments. And if you believe in capital markets, it puts more of the money at the test of the market.

Now, most of the money businesses invests never meets the market test, because a corporation earns it, keeps it, and invests it regardless of whether they're earning the market rate of return.

You can see that in steel where the American steel industry invested in open hearth furnaces 8 years after the Japanese quit. During that entire period of time they were making a rate of return on capital investment that was less than half the national average. The only reason they could do so is that they had a large source of retained earnings that nobody could take away from them. They could misinvest it and that's exactly what they did.

Senator BRADLEY. Mr. Etzioni.

Professor ETZIONI. Thank you.

To return to the national security considerations, I really would like to discuss it a bit more, because I'm slightly troubled by the notion that we all should just do our comparative advantage and let the national security chips fall where they may.

The point has been made that while we grow food, would that mean that other countries would have to grow their own food, and I think that might be a good place to return to the discussion. And I think the answer is definitely yes, that's exactly what they're doing.

Britain, for instance, as a matter of deliberate policy decided not to allow the farm sector to decline beyond a certain point, though the British conditions for growing food are very disadvantageous, precisely because they didn't want to, in the case of war, depend on imported food completely. And other countries have taken a similar position. Or to put it in a more generalized manner, all coun-

tries in worrying about their national security engage in some kind of protectionist measures.

Now, I'm not talking about hurting competition like not allowing the Japanese to import pickup trucks, but for instance, those people who think we should let all our blue collar industries go overseas. In effect, by us engaging mainly in computers, and electronic, and other futuristic, and postindustrial business, this has an implication for national security.

Now, it's true we don't need all the steel, but we need some kind of steel, some stronger railroads, more boxcars, more coal. And again, it may be comparatively advantageous to dig coal in Australia—I don't know that it is—but I'm saying we and all other nations allow to mitigate the comparative advantage considerations by some national security considerations.

Mr. THUROW. You can probably find legitimate cases where there are industries that we ought to support for national security reasons.

The problem is the argument gets vastly exaggerated as to how many of these industries there are. When I was working for the New York Times last year, I wrote an article about protective textile, and the head of Burlington Industries wrote a letter to the paper basically saying, "Do you want American soldiers to be marching to battle in uniforms made in Taiwan?" His obvious answer was no.

Well, is it really horrible to have uniforms made in Taiwan? I suspect the answer is no. Maybe there are some specific types of military things that are so important we need to bolster those industries in the United States. But you know, the famous children's nursery rhyme for want of a nail, if you want to do that kind of thing, you could make everything in the United States into a military necessity, and it just isn't true.

Professor ETZIONI. OK. Fair enough. I'm happy we came to some kind of consensus. It seems we also agree we need less consumption, more investment, and just floating resources to the private sector won't do it.

To the other point, just one sentence on it, which I think is very important. We should distinguish industrial policy one from industrial policy two. Industrial policy one wants a desk for every industry, and in effect it's just a polite term for planning. And we're talking about something different, that there are a few industries which may be challenged by the Japanese that may be needing support.

I couldn't flag that difference too much. Certain toxics, if you use them in medication, if you use very small amounts you're doing fine; if you use too much, you kill the patient.

And so, yes, I can see supporting a few industries to keep us competitive, but that's a long way from industrial policy the way it's usually understood.

Senator BRADLEY. I gather from what all of you say that the problem of time horizon is a significant one—in financial markets, in protectionist legislation, in general reluctance on the part of all sectors, including the political community—to fail to look at the long term.

What can we do to encourage focus on the long term, to get away from the short term thinking?

Professor ETZIONI. Well, here Congress can help because there is such a thing as public consciousness, first of all, and it is affected by public dialog and by leadership. I don't say that's a cure-all, but that's one place to start.

Then we have institutionalized habits which encourage the short term, and they have to be changed.

Senator BRADLEY. Such as?

Professor ETZIONI. We put pressure on banks not to invest in companies whose debt-equity ratio is unfavorable, and unfavorable is defined one to one. The Japanese—forgive me if I do draw an analog from that society—the ratio they tolerate is up to one to nine.

So we could ask the comptroller of currency as part of the deregulation to lay off a bit, not all the way, and allow the banks to be a little more adventuresome, and in the same way not to demand such quick return. We could have multiyear budgeting instead of one year at a time more widely practiced. We could make people be able to better predict the economic environment.

We don't know now what the next year's tax is going to be. If Congress would give us a reading on what the tax and the depreciation scale and all these things are going to be for 3 to 5 years, it surely would help the business community to know what the future is like.

Mr. THUROW. I would like to back that up. Take nuclear power rules and regulations. What are the rules and regulations going to be a week from now or 6 years from now. We ought to have a grandfather clause so if you start a plant today, you get to operate under today's rules and regulations and for the length of that plant or at least for the length of building it. But changing rules and regulations in the process of building big projects like nuclear powerplants, synthetic fuel plants, petroleum refineries, just drives everybody up the wall, and it leads them not to do it.

Senator BRADLEY. Do you think that if we move more from equity financing to debt financing that would force managers to look at the long term?

Mr. THUROW. I think it would have a little bit. I think part of it is the culture of American management. I don't think government is to blame for all of our problems. This whole business about taking every mid-level manager, setting him up as a profit center, and then promoting him or not promoting him just based on whether his profits go up in a nice quarterly pattern I think is absolutely crazy.

There are a lot of things I think we need to do in the private economy to give that longer time horizon.

Take investors. In the United States, investors have an in-and-out strategy. If you don't like the corporate manager and you think he's inefficient, you don't go to work as a shareholder to get good management that are doing the right things; instead you just sell your shares. You leave the same dolts running the company, but you get out.

We've just got to start changing, and it really takes a thousand band-aids. There are no magic solutions.

Professor ETZIONI. A greater capital gains which would——

Senator BRADLEY. We're going to get to that.

Mr. BOSKIN. I would just like to come back to the point I made earlier, which is I think that the best way to increase people's time horizon is to decrease uncertainty.

Professor Thurow mentioned regulatory uncertainty about future rules and regulations. I think probably the two biggest sources of uncertainty in investment other than the natural evolution of business cycles from shocks from abroad and things of that sort, are inflation—high and vacillating inflation rate—and fiscal policy—trying to figure out what the effective tax rates are going to be so you can get a notion of what you're expected return on an investment project will be.

I think reducing the inflation rate and reducing the effective tax rates on investment income are the two things that are necessary to increase people's time horizon and make them willing to engage in longer term investment opportunities.

I think that gets back to things like changing structural revisions in the tax laws, perhaps allowing tax-free rollover of reinvested productive capital gains, and things of that sort, and keeping a close to stable price level.

Senator BRADLEY. Do you agree with Professor Thurow that one of the major problems with our productivity arises from the way we have fought inflation by creating idle capacity?

Mr. BOSKIN. I think that is one component. I don't think it's the major component, but I think it's an important one.

Senator BRADLEY. And, Professor Thurow, if you believe it's a much bigger component, which I believe you do, what ways do you think would be more effective to fight inflation?

Mr. THUROW. I don't know whether we're really disagreeing on the magnitudes here or not, I don't think the way we're fighting inflation is 50 percent of the answer. Let's say it's 15 percent of the answer.

There isn't any way to solve the inflation problem until we first solve the energy problem. As long as you're getting huge energy shocks in a highly indexed economy, you really have a choice of having inflation or having big recessions, neither one of which helps investment.

You have to have a long-run strategy for solving economic problems. When you get the energy independence and are not getting these external shocks, then you can think about a whole range of policies, including the conventional ones we're applying at the moment that might be able to squeeze inflation out of the system.

People do what they call feedback control. The problem is that they're just out of sync, and it's explosive. If you ask yourself how long the current recession will take to drive the current 10-percent rate of inflation down to zero, well, that's a long time; but how long do you expect it to be until we get the next energy shock, well, it's a much shorter time. And the strategy just doesn't work when you've got those kind of time constants.

Senator BRADLEY. Yet the inflation rate in West Germany and Japan is a lot lower than it is here, and they've had the same oil shocks, shocks much more fundamental to their economy than to this economy.

Mr. THUROW. You've got to be careful. First of all, our inflation rate at the moment is zero, and the German's is 6 percent. Second, the Germans don't count mortgage interest rates or the cost of buying a house. It's not at all obvious that the German inflation rate is lower than ours. The measured inflation rate is lower than ours, but that's because housing does not show up in the German index at all. And even in July as opposed to August when we had, I guess, a 10-percent rate of inflation, 47 percent of it was mortgage interest rates, so we had a 5-percent rate of inflation in July, which was less than the German 6 on their basis.

It's not at all obvious we're doing worse on the inflation front, but productivity comes into this, too. If you have an energy shock which takes 2 percent of your GNP, and you've got 7 percent gain in productivity like the Japanese, and let's say workers settle for 9 percent, well, since net productivity is going up 5, you end up with a 4 percent rate of inflation.

But if American workers signed for exactly the same wage increase, 9, the productivity is going down 3, OPEC takes 2, and you've got a 13 percent rate of inflation. I don't think it's obvious that we've done worse than the Germans and the Japanese in handling those energy shocks; and on a first difference basis, they upped the German rate of inflation just as much as they upped ours. They went from 2 to 6; we went from 6 to 10.

Senator BRADLEY. When you say energy independence, do you mean we should be able to produce all the oil or other forms of energy we consume in this country.

Mr. THUROW. We either produce enough energy or have the potential to produce enough energy that people can't simply raise the price of oil as a political decision.

Senator BRADLEY. OK. Let me ask you, if that is the case, given the level of interdependence in the world, wouldn't we still be directly affected by price increases in oil to our allies? It's one economic system.

Mr. THUROW. Oh, I think energy independence means more than independence for the United States. We've got to be helping our allies get energy independence at the same time. That's where you come down and get into trouble with the nuclear power industry. If you do your arithmetic and ask, could the United States become energy independent without nuclear power, let's say by 1990 or the year 2000, you can just barely squeeze into it. If you say can the industrialized world do without nuclear power, I think the simple answer is no. When you're talking about energy independence, you have to go back and rethink nuclear power. I think the United States can talk about industrial independence without it; the industrialized world cannot.

Senator BRADLEY. Because we're getting down to the wire and pressed for time, let me raise another aspect of productivity—the labor component, and have each of you tell me what you think we can do to improve the human capital that we have and its contribution to productivity. And a variant on that, let me ask you to describe what you think we must do to get down the learning curve faster, to produce more goods at cheaper costs given the same amount of labor.

Professor ETZIONI. Well, we go back again to one point on which we seem all to agree——

Senator BRADLEY. And whether or not you believe this raises fundamental questions, and your best guess as to whether the political system can handle it. You have about a minute and a half.

Professor ETZIONI. All right. I wonder what I will do with the second half of that time period.

We seem all to agree that there are no magic cures in this area, and if there are none in the other ones, when you come to these human factors, if anything it gets more complicated.

But quickly, I do believe our school system has particularly moved away from feeding the industrial needs. So for instance, hearings are scheduled, I understand, on some other committee on a vocational educational act, and it's very heavily tilted away from industrial needs, and it's very much engineered to some purposes introduced in the sixties which I happen to be very fond of, since as increasing equality and increasing the number of women in the labor force, which is all fine and good. But they are almost deliberately designed not to deal with this training and preparation for work. And so reintroducing sensitivity to industrial needs into training programs is one element in that.

The other is a more philosophical argument. About half the schools in the country have what is called automatic promotion, which means you are promoted whatever your achievements. That's not a preparation for a competitive system. There is now a countermovement, referred to sometimes as minimum competence, so people that graduate at least have certain skills. And that struggle in effect to some degree is very closely tied to the consumer social golden age, and to return to somewhat more self-discipline.

College is the same thing. We went through an era where we threw out many requirements, and structure of curriculum, in varying degrees in varying places. There is now a return to structure, to some self-discipline, and a somewhat more serious study.

These matters to a very large degree should not and cannot be federally mandated or controlled, but the degree that national policymakers give signals here, they could help what is already a movement anyhow—return to structure, to return to some kind of a greater rationality and greater measure of self-discipline.

Closer to the tax and incentives system, attempts have been made to tie achievements in productivity and get workers opportunities to share in gains in productivity, for example, in the idea of profit sharing and stock sharing, which have their problems because in a large corporation you can't see readily the connection between your effort or renewed effort and your payoff, and there are very serious measurement difficulties, because a change in productivity may be affected by breakdowns in assembly lines in somebody else's company.

So there are no easy solutions, but I believe something has to be done in all those points, from the schools to the colleges to the tax incentives.

Mr. BOSKIN. I'll try to meet your 90-second deadline, Senator.

Senator BRADLEY. Take a minute.

Mr. BOSKIN. I guess I would like to draw a distinction between two things; that is, the creation of productive employment for people who are currently or in the future prospectively out of work, which I think is something we did not unfortunately have a chance to address today, and I'd like to spend a second discussing in a moment; and second, enhancing the productivity of people who are already working or likely to find jobs easily.

I think the second is basically an issue of promoting our rate of investment innovation, and for the Government basically to smooth transitions in region and in industry that would naturally occur as resources flow from the lowest to the most productive uses, net of tax and risk.

With respect to providing employment for people who are currently unemployed because of the recession or for groups in the population that have chronically high unemployment rates, I think that basically we're learning more and more is not an easy thing to do with broad brush macroeconomic policies and requires, as Professor Thurow put it, specific programs on a large number of fronts, whether dealing with the structure of minimum wages because of teenage unemployment or unemployment in particular areas of the economy where people might be provided relocation insurance or retraining programs and things of that sort.

I think the answer there basically is to try and run a strong, healthy economy. That will get us down to some basic overall level of unemployment, and then from there dealing with things like minority teenage unemployment requires structural policies.

I think that getting those people who are unemployed to work would do the most to increase the productivity of the economy than what modest gains we'll have in the productivity of people already working.

Mr. THUROW. Let me say when we start talking about human capital, I think we tend to jump too much to the schools and blame the schools. Well, most human capital I don't think is created in the schools. A lot of it is done at home and in the firms.

There are a number of things in the human capital area though that I think we need to think about. I would argue that one of the human characteristics we've got to change is kind of our adversary system to more cooperation.

Now, that's trite to say, and it's difficult to do, but I think it's really important. If you look at the amount of resources we grind up in adversary relationships which are complete—they're not zero sum games; they're negative sum games. If I sue you and win, some lawyer gets the resources, and I can't take anything away from you except something you've already got.

Last year I had an accident and severed an achilles tendon, and spent a large part of the year in a cast. And the first question everybody asked me, I think almost without exception, was not is your leg ever going to get better, but did you sue the bastard?

Well, that a standard American reaction. A year ago the head of Nippon Steel was giving a talk on how to do business in Japan. He started out by saying in the United States there are 220 million people and 500,000 lawyers; in Japan there are 110 million people and 13,000 lawyers. If I sued somebody or my company sued somebody, we would both be dishonored. I would never do it. What

American businessman or American individual would say that kind of thing?

If you grind up a lot of resources with 500,000 lawyers, then you've got 500,000 people not doing anything. Take the question of security guards. Since 1972 we've added 152,000 private security guards to the American economy. We now have in a million, 1 percent of our labor force are either public or private policemen. If you have a society that doesn't need public and private policemen, then those people produce output.

In terms of productivity measures we don't care whether you have your camera or some thief has your camera, it's what's the output per hour of work.

There are lots of things you can say about schools. I think at the moment clearly we have no problem in terms of substantive knowledge. We've got unemployed everybodys, Ph. D.'s on down, and so it's not in that problem we have labor force problems.

Maybe it's the whole pattern of the way we teach school. I've sometimes joked the most important thing I learned in school I learned in the first grade, and that was the rule was one finger when you need to go to the bathroom right now, two fingers when you needed to go but you didn't have to go right now, and three when you wanted to speak; otherwise, keep your mouth shut and sit in your seat.

Well, that's not the way we teach first grade any more. But if you think about it in a worker on the assembly line, what I learned in the first grade may be the most valuable thing the schools ever taught me.

Senator BRADLEY. You can offer no other suggestions here? [Laughter.]

About how we may—I mean, there are a wide variety of possibilities—you know, bonuses and lifetime employment and a lot of other very practical suggestions which I'm sure that other committee members would like to hear. Because I think the problem is that we tend to think of productivity too much as inanimate, and it's not.

Mr. THUROW. But, see, I think that comes back also to a question of management.

Senator BRADLEY. So you would try to get managers to be less concerned with the bottom line at the end of the year——

Mr. THUROW. But, see, let's take the issue of cooperation. You know, most Americans have lifetime employment in the sense we have a seniority system of hiring and firing; and so if you've worked in a place 5, 10 years, your chances of getting fired are remote for most Americans. But we don't take advantage of it in the sense of trying to engender an attitude that this means that we're all in the same ship together, and the question is how can we make successful cars if we're workers and managers at Chrysler.

Now, then the question is, is that something wrong with the American character, or is it something wrong with American management that we can't get that kind of cooperative relationship? The objective facts are if you're a worker at Chrysler, you depend on Chrysler being able to sell good cars, and so presumably you should want to build good cars, you have a direct selfinterest. We have been very bad in a management sense of conveying direct

selfinterest. Supposedly one of the good things happening out of the current crisis in the automobile industry is they're building up a lot more cooperative relationships between workers and management in terms of quality control.

In the human capital area the reason I'm a little bit flip is I just don't think that it is something where the Federal Government is going to solve the problem one way or the other.

Mr. BOSKIN. I'd just like to reiterate that. Many of the most obvious incentive schemes are those that can be created in private industry, and the issue remains if they're not there now, why aren't they? And I think that Professor Etzioni pointed to one example, which is it is extremely difficult to monitor when somebody makes a productivity-enhancing improvement, exactly where that is in a complicated production process.

But certainly things like bonuses, a variety of types of recognition, these are things that are standard practice in many types of firms, from dropping things into the suggestion box to patenting or generating a new product or a new type of process.

So I certainly think that the major area or major opportunity there lies in providing incentives in terms of pecuniary and recognition incentives within firms for doing that sort of thing. I don't see what the Government can really do to enhance that.

Senator BRADLEY. I'd like each of you to say a quick word about disinvestment.

Mr. THUROW. The real problem is politically we won't let the market work. And I think that is why we really have got to have an economic-social safety net for individuals but not firms. You know, the idea of letting everybody perform their economic high wire act and let them fall to the ground isn't viable because people aren't willing to live in that kind of a world.

And the problem with having a safety net by propping up dying firms is that it ends up being an inefficient social safety net that grinds up a lot of resources and doesn't get you to where you want to be. The important part of disinvestment is having a social welfare system that we're all willing to live with. If this firm collapses and these guys go out of business, people's standards of living are going to fall, but they're going to fall down to an individual safety net with which they can live and with which the rest of us are willing to see them living.

I think a strategy of propping up individuals rather than firms, is better than propping up dying industry.

Mr. BOSKIN. I would agree that the market is forcing disinvestment. I think the issue that has been raised here is when that disinvestment is really market forced in a genuine competitive sense and when we can differentiate that from a disinvestment or a potential disinvestment that is forced by unfair competition or a situation that gets created—for example, encroachment by foreign industry operating under different rules of the game, or different tax structures, or different supplies of capital channeled to them through government sources, and our companies are being outcompeted for that reason rather than facing a genuine world competitive market.

I think the market will do a good job of forcing the disinvestment in general, and I think the case for propping up a firm or an

industry, apart from the case for mitigating the full economic harm done by individuals who might be temporarily unemployed if Chrysler or some firm like that went under, really revolve around being careful in identifying when those firms or that industry is being faced with some competition that is deemed unfair for a viable reason.

Senator BRADLEY. Let me say that I'm sorry. I have 3 minutes to vote. We're at the end of the hearing. I want to thank all of you for coming and participating, and maybe we can do this again when we have a little more time than we had today. And I think that your contribution is important. The record is open. And I appreciate your cooperation.

The hearing is adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

LABOR COST AND U.S. COMPARATIVE ADVANTAGE IN STEEL AND MOTOR VEHICLES

by

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This paper examines the apparent "illness" afflicting the U.S. automobile and steel industries. The international competitive position of these two industries has deteriorated sharply in recent years, even while the U.S. competitive position in aggregate manufacturing remained reasonably stable (or deteriorated slightly) relative to our major trading partners. The relative decline of the two major industries may have resulted from interindustry distortions in the patterns of relative wages and prices in the United States, or it may be attributable to other factors. The paper examines the behavior of wage rates and labor productivity in the two industries, relative to that in U.S. manufacturing as a whole, to shed light on the root cause of their deterioration.

A. The Problem

Postwar changes in U.S. comparative advantage in manufactured products may be divided into (at least) two periods. Early after World War II, the United States along with other industrialized countries lost comparative advantage in traditional labor intensive industries - such as textiles, clothing, and leather goods - to a group of developing countries (the so called "new industrial states", or NIC's), which gradually captured world markets in the products suited to their mix of factor endowments.

Second, the last fifteen years witnessed a decline in the U.S. competitive position in two traditionally capital-intensive "heavy" industries: iron and steel, and road motor vehicles. World markets in

these products are being gradually captured by Europe and Japan, as the regular cyclical fluctuations in the markets for these products are reinforced by structural difficulties within the United States. Table 1 presents data regarding both the U.S. trade balance and the share of U.S. exports in total world exports for aggregate manufacturing, steel, and motor vehicles. While throughout the period 1963-1977 the U.S. trade position in all manufactures was either in balance or showed a small annual surplus, there has been a sharp rise in the trade deficit in the road motor vehicles and iron and steel industries. In addition, the U.S. share in world exports of these two product groups declined much more sharply than the U.S. share in all manufactured goods exports. Both these indicators of international comparative advantage clearly show a relative decline in the U.S. competitive position in the two industrial product categories. This trend continued and accelerated in 1979, when U.S. manufacturing exports and trade balance surplus rose sharply, while the opposite occurred in steel and motor vehicles.

In the international trade literature, measures of "revealed" comparative advantage for various countries are based upon the countries' trade performance over time in a vast array of products. On these measures, the U.S. is shown as losing comparative advantage in the products of the two industries under consideration. Yet, these measures reveal nothing about the internal causes of these changes. Under a regime of floating exchange rates, such as that which prevailed during the 1970's, the trade position of individual industries is determined by their ranking by comparative advantage in production, or equivalently, by its inverse, the unit cost of production. Once so ranked, the

Table 1

United States Trade in Autos and Steel

A. U.S. Trade Position (billions of current dollars)

	All Manufactures			Road Motor Vehicles			Iron and Steel		
Year	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance
1963	$13.3	$ 6.9	$6.4	$ 1.3	$ 0.6	$+0.7	$0.5	$0.7	$-0.2
1968	22.4	18.6	3.8	3.3	3.9	-0.6	0.6	2.1	-1.5
1973	42.7	42.5	0.2	6.0	10.1	-4.1	1.3	3.0	-1.7
1977	77.8	74.5	3.1	11.6	17.5	-5.9	1.7	6.0	-4.3

B. Share of U.S. Exports in the Exports of North America, Western Europe and Japan (per cent)

Year	All Manufactures	Road Motor Vehicles	Iron and Steel
1968	18.6%	22.5%	6.6%
1973	17.0%	16.7%	6.0%
1977	16.5%	16.0%	5.0%

Source: General Agreement on Trade and Tariffs, *International Trade*, Various issues, Appendix Tables.

classification of industries (and products) into export, non-trade, and import-competing categories is determined by the market value of the dollar exchange rate.[1] The question is: did changes in labor compensation and/or productivity occur in the United States during the past fifteen years which moved the two industries from a strong to a weak position in a ranking by comparative advantage? Or were there other changes, relating perhaps to management decisions regarding product mix, marketing strategy, etc., which were responsible for the loss of competitive position?

B. Labor Compensation, Productivity and Costs

This section examines the recent behavior of labor compensation, productivity, and implied unit labor cost for aggregate U.S. manufacturing, as well as the two "ailing industries" of basic steel and steel products (SIC 331) and motor vehicles and parts (SIC 371). The data are drawn from the U.S. Census of Manufactures for 1957, 1967, 1972, and 1977, and from related government publications (see appendix B for a description of data sources), and are summarized in tables 2 through 4. The tables are arranged in a manner similar to "growth triangles." Each entry is the percentage increase in the appropriate quantity during a period which begins with the year listed at the top of the column and ends with the year listed at the beginning of the row. Thus, in the first column of panel I-A, average hourly earnings for all manufacturing workers are seen to have risen by 43 percent from 1957 to 1967, by 93 percent from 1957 to 1972, and by 195 percent from 1957 to 1977. Similarly, the second column shows an increase of 35 percent from 1967 to 1972, and the third column shows an increase of 53 percent from 1972 to 1977. The year 1957 was chosen as a base year for this study because it was a Census year for manufactures and because the trade statistics indicate that the decline in the United States' international competitive position in steel and motor vehicles did not begin until after 1957.[2]

Table 2 shows that the percentage increases in wage rates in steel and motor vehicles have consistently exceeded (by a wide margin) those in aggregate manufacturing, both for all workers and for production workers considered separately. We note that the percentage increases in the two industries have been strikingly similar, attesting to widely-held belief

regarding the unusual strength of the two major industrial unions in these industries. Wage rates, however, are only one component of labor compensation paid by firms. Compensation also includes legally-required payments for Social Security, unemployment insurance, and workers compensation insurance, plus negotiated payments for worker fringe benefits, such as vacations and pensions. In addition, significant amounts of time "in the plant" are used for non-output-producing activities, such as "clean-up" and "set-up" time, and paid rest periods. Appendix A presents detailed figures, compiled from a variety of sources, about labor remuneration in all forms. The results are in line with the conclusion drawn from table 2: Labor compensation increased more rapidly in the "ailing" industries than in total manufacturing.

Table 3 presents, in the same format as table 2, data regarding the percentage increases in output per worker for both all manufacturing workers and production workers only. The data regarding output per hour of all manufacturing workers, presented in the left-hand column of table 3, shows that the rate of increase in labor productivity in the motor vehicle industry has consistently exceeded such gains for aggregate manufacturing by about fifty percent, while the rate of productivity increase in the steel industry has averaged only about two-thirds of that attained by all manufacturing.

By definition, the unit labor cost of production is equal to the ratio of hourly payments to labor and output per hour; hence, its growth rate equals the algebraic difference between the growth rate in hourly labor compensation and in output per hour. Table 4 presents estimates of the implied percentage increases in unit labor costs for aggregate

Table 2

Percentage Increase in Average Hourly Earnings, Selected Periods
(current dollars)

	I. All Workers[1]				II. Production Workers Only			
	Terminal year	Initial Year 1957	1967	1972	Terminal year	Initial Year 1957	1967	1972
A. All Manufactures	1967	43%			1967	40%		
	1972	93	35%		1972	89	35%	
	1977	195	106	53%	1977	182	102	49%
B. Steel & Steel Products (SIC 331)	1967	36%			1967	34%		
	1972	93	42%		1972	92	43%	
	1977	224	138	68%	1977	227	143	70%
C. Motor Vehicles and Parts (SIC 371)	1967	51%			1967	46%		
	1972	113	42%		1972	108	42%	
	1977	230	119	55%	1977	223	121	55%

[1] Nonproduction Workers are assumed to work the same annual hours as production workers. For increases in payroll per employee, see Appendix table A-1, column II.

Source: Calculations by authors from Census of Manufactures data; see appendix table A-3.

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Table 3

Percentage Increase in Output per Hour of Labor Input, Selected Periods

A. All Manufactures[1]

I. All Workers

	1957	1967	1972
1967	33%		
1972	55	16%	
1977	69	27	9%

II. Production Workers Only

[not available][2]

B. Steel & Steel Products (SIC 331)

I. All Workers

	1957	1967	1972
1967	19%		
1972	34	13%	
1977	37	16	3%

II. Production Workers Only

	1957	1967	1972
1967	23%		
1972	40	14%	
1977	47	20	5%

C. Motor Vehicles & Parts (SIC 371)

I. All Workers

	1957	1967	1972
1967	45%		
1972	77	20%	
1977	110	42	19%

II. Production Workers Only

	1957	1967	1972
1967	48%		
1972	78%	20%	
1977	111%	42%	18%

1. for all manufactures, "output" equals real GDP originating; for steel and motor vehicles, "output" is a physical production series constructed by Bureau of Labor Statistics from industry data.
2. No index available from Bureau of Labor Statistics.

Source: Calculations by authors from Bureau of Labor Statistics data; see appendix table A-3.

Table 4

Percentage Increases in Unit Labor Cost, Selected Periods

A. All manufactures

I. All Workers

	1957	1967	1972
1967	10%		
1972	38	19%	
1977	126	79	44%

II. Production Workers Only

[not available]

B. Steel & Steel Products (SIC 331)

I. All Workers

	1957	1967	1972
1967	17%		
1972	59%	29%	
1977	187%	122%	65%

II. Production Workers Only

	1957	1967	1972
1967	11%		
1972	52	29%	
1977	180	123	65%

C. Motor Vehicles & Parts (SIC 371)

I. All Workers

	1957	1967	1972
1967	6%		
1972	36	22%	
1977	120	77	36%

II. Production Workers Only

	1957	1967	1972
1967	2%		
1972	30	22%	
1977	112	79	37%

<u>Source</u>: Calculated from tables 2 and 3, above.

manufacturing and for the steel and motor vehicle industries, based upon the data contained in tables 2 and 3 above. The increases in unit labor cost are starkly different for the two "ailing industries." In motor vehicles, labor cost increases have been consistently equal to or somewhat below the comparable increases for aggregate manufacturing, while in steel the increases in unit labor cost have averaged approximately fifty percent higher than those for all manufacturing.[3]

C. Implications for Policy

It is clear from the data presented above that the illnesses afflicting our two "ailing industries" are not alike. Steel lost its position in the ranking of industries by comparative advantage due to increases in production costs which far exceeded the average for all manufacturing. In turn, these increases were due to a combination of above-average increases in labor compensation (both in wages and supplementary benefits) and below-average increases in productivity.[4] In the motor vehicle industry, while wage rates rose at rates well above the average of all manufacturing, advances in labor productivity offset most if not all of the increase; labor costs remained roughly in-step with the national average. Thus, it is likely that the industry's position in the ranking of U.S. industries by comparative advantage has not changed. The deterioration of the industry's foreign trade position, therefore, must be attributed to other factors, such as producing the wrong product mix to satisfy current market demand, or the reluctance of the multinational U.S. automobile companies to export domestically produced vehicles to countries wherein they own subsidaries.[5]

This is not to imply that the automobile industry could not have benefited from more moderate increases in labor costs. If wage rates had risen at rates comparable to the average of all manufacturing - 195 percent between 1957 and 1977 - the rise in unit labor cost of production would have been approximately 85%, substantially below the average of 126% for all manufacturing. That would have strengthened the competitive position of the industry, perhaps offsetting other adverse factors.

Among the other adverse factors affecting the competitive position of U.S. motor vehicle manufacturers is the increase in the price of steel, an important input in auto production. Table 5 summarizes the recent price behavior of aggregate manufacturing, and of one segment of the steel industry (SIC 3312, the only steel producing industry for which such data are available). Data concerning the importance of steel as an input into motor vehicle manufacture can be obtained from the 1972 national input-output tables, and are summarized in Table 6. Direct purchases by motor vehicle manufacturers from primary iron and steel manufacturers were about 14% of total purchased inputs; additional indirect purchases were made through the purchase of screw machine products and stampings (43%) and fabricated metals (12%). A decomposition of the latter two categories of products into their steel content yields an estimated total (direct plus indirect) steel value-share for motor vehicle output of 17.6% (i.e., 17.6¢ of steel at 1972 prices per dollar of motor vehicle sales to final demand at 1972 prices).

Import protection of the steel industry through the use of tariffs, quotas, voluntary export restraints, and the trigger price mechanism <u>artificially</u> increases the price of steel in the U.S. above world market

Table 5

Percentage Increase in Output Price Index,
U.S. Manufacturing, Selected Periods

A. Producer Price Index, Aggregate U.S. Manufacturing

	1957	1967	1972	1977
1967	8%			
1972	27	18%		
1977	93	79	52%	
1978	105	90	61	6%

B. Output Price Index, Basic Steel (SIC 3312)

	1957	1967	1972	1977
1967	8%			
1972	41	31%		
1977	134	117	66%	
1978	156	137	81	9%

Source: Calculations by authors from Bureau of Labor Statistics data; see appendix table A-5 for sources.

Table 6

1972 Input-Output Coefficients, Steel and Motor Vehicle Manufacture[1]

I. Direct purchases of I-O 59, Motor Vehicles and Equipment, as a percent of total purchases, from:

I-O 37, Primary Iron and Steel Mfg.	13.7%
I-O 41, Screw Machine Products & Stampings	43.3%
I-O 42, Other fabricated metals	11.7%

II. Total Requirements of the Output of I-O 37 per Dollar of Deliveries to Final Demand of I-O 59: 17.6%

[1]Relationship of 1972 SIC and I-O Industry Classifications

	1972 I-O Code	1972 SIC Code
Primary Iron and Steel manufacturing	37	331-2, 339, 3462
Screw Machine Products and Stampings	41	345, 3465-6, 3469
Other fabricated metal products	42	342, 347, 349
Motor Vehicles and Equipment	59	371

Source: Ritz (1979), Appendix B, Tables 1 and 5.

levels. Since steel is an important input into the motor vehicle industry - comprising nearly one-fifth of the value of the product - the protection of steel is formally equivalent to a tax on domestically-produced automobiles. For every five percent increase in the domestic price of steel above the world market price, the price of domestically-produced automobiles increases by one percent, further undermining the competitive position of the industry.[6]

These results lend themselves to a couple of tentative policy conclusions. Should the United States adopt a sectoral "industrial policy", the two "ailing industries" ought to be treated differently. The steel industry should be permitted to shrink in size, retaining only its highly efficient segments and most modern plants. Maintaining or restoring it to its original size would be much too costly. Import restrictions on steel, in all their forms, only perpetuate inefficiency. They need to be removed, so that only the viable segments of the industry, that can meet international competition, would remain. Should the resulting size of the industry be deemed too small to meet national security requirements, modernization of additional plants (to make them competitive) should be financed by a direct subsidy out of the defense budget.

Keeping steel prices at international level would have a salutory effect throughout the entire manufacturing sector. Steel is an important input in many industries. Consequently, the ever rising steel prices contribute to inflation[7] on a broad front, and at the same time erode the competitive position of selected industries where steel is a particularly important input. Because the degree of dependence on steel as an input varies from one industry to another, a rise in steel prices can distort the ranking of industries by comparative advantage. One of the industries so affected is autos. The trend of rising steel prices needs to be arrested and reversed.

No such shrinkage is called for in the motor vehicle industry. What is required is acceleration of the changes in plant capacity to supply a product mix in better conformity with consumer preferences; more aggressive mangerial decisions concerning marketing strategy in foreign countries; lower steel prices; and a somewhat more moderate wage policy for production workers and managerial personnel. In no way will import controls, so avidly promoted by both the union and the companies, contribute to the long run restructuring of the industry. Conversely, it is the competitive pressure emanating from Japanese and European producers that forces the domestic industry to keep prices down and satisfy consumer preferences. The current plight of the industry is a warning signal that should be heeded by labor and management alike, if it is not to follow in the way of steel. Based on the data presented here, there is no reason why the auto industry should not be viable and internationally competitive.

FOOTNOTES

[1]See e.g., Kreinin (1979), pp. 230-232.

[2]In addition, 1957, 1967, 1972, and 1977 were all prosperous years in the U.S. economy, so that the effect of cyclical fluctuations on changes in wage rates and productivity is held to a minimum.

[3]In contrast, the major "expanding" industries in U.S. trade (such as aircraft and equipment, computers, and semiconductors) have had implied unit labor cost increases well below that of average manufacturing; see, e.g., Ruttenberg (1978).

[4]The relatively low rate of capital investment in the steel industry may be an important determinant of the low rate of productivity growth. This observation in no way weakens the conclusion in the text, however. We ask only if labor costs and productivity growth are related to the loss in U.S. comparative advantage in steel, and reach an affirmative conclusion. An explanation of the low rates of capital spending and productivity growth would require a simultaneous structural model of factor demand and production in the industry, a task beyond the scope of this study.

[5]International trade statistics show a continuous rise in auto imports, the net trade deficit in autos, and the share of imports in apparent U.S. auto consumption. The import share reached 28 percent in 1979; see U.S. International Trade Commission, Automotive Trade Statistics 1964-1979 (Washington, D.C.: June 1980), pp. 6, 7.

[6]This discussion springs from the theory of effective protection. See M.E. Kreinin, op. cit., pp. 293-300.

[7]Rising production costs, for whatever the reason, are often "validated" by the Federal Reserve in increasing money supply.

Appendix A
Fringe Benefits and Non-wage Payments

The analysis of labor compensation presented in section B, above, is based upon the Census' definition of "payroll" cost, which is similar to the Federal tax law definition of business labor cost. Increases in supplementary benefits and payments - such as increased paid vacation, sick time, paid holidays and personal absences, paid "set-up" and "clean-up" time, extended rest periods, etc. - are only partially included in these figures. Specifically, the Census' estimates of "total production hours" are equivalent to "total hours spent in the plant," and the "payroll" figures are the dollar amounts paid to workers by firms during these in-plant work hours. A more inclusive estimate of the increase in labor compensation may be constructed by combining data published by the Bureau of the Census in the Annual Survey of Manufactures with data published by the U.S. Chamber of Commerce in its survey Employee Benefits.

Since 1967, the Annual Survey of Manufactures has published data regarding total labor remunerations and its three major components: payroll, social security and other legally-mandated payments, and other employee fringe benefits. The last component includes payments made to workers while not at the plant, such as paid personal holidays, sick leave, and vacation. Separate series regarding production and nonproduction workers are not available.

Table A-1 presents the percentage increases in these payments on a per employee basis from 1967 to 1976. (Since the number of hours per employee per year has declined during this period in the Census data,

the percentage increases in payroll per employee are somewhat less than the percentage increases in payroll per hour, as reported in table 2.) The figures in column I show that the percentage increases in total labor compensation per worker for the steel and motor vehicles industries have consistently exceeded those for aggregate manufacturing. Columns II - IV provide a breakdown of these increases into their major components. In part, the increases in column III may be attributed to the increases in the social security tax base during the period, which affects high annual earnings industries such as steel and motor vehicles more severely than the average of all manufacturing. Column IV shows, however, that the steel workers have been significantly more successful than aggregate manufacturing or the motor vehicle workers in achieving payments for hours not at the plant; the 1967 - 1976 percentage increase for steel workers exceeds the average of all manufacturing by about one-quarter, and exceeds the gains of the auto workers by about one-sixth.

Supportive evidence (albeit at a more aggregate level) is provided by the U.S. Chamber of Commerce's survey Employee Benefits. Table A-2 presents data from the 1967 and 1977 surveys regarding two classes of fringe benefit payments for primary metals (SIC 33) and transportation equipment (SIC 37). The category entitled "Hours Paid But Not Worked", which includes, e.g., vacation and paid personal absences, has increased as a percent of payroll by about one-fourth from 1967 to 1977 for both aggregate manufacturing and the two major industry groups. However, the category "Paid Rest Periods", which includes hours paid-for "in-the-plant but not at work", has increased as a percent of payroll by over one-half for primary metals workers, by one-fifth for aggregate manufacturing, and by one-seventh for transportation workers in SIC 37. Since these hours in-plant but not at work are counted in production worker hours, this sharp increase in primary metals may explain a portion of the shortfall in productivity growth in this industry relative to aggregate manufacturing.

Table A-1

Percentage Increase in Total Labor Compensation and Payroll, U.S. Manufacturing, 1967, 1972, 1976
(all workers; per employee)

		I. Labor Compensation[1]		II. Payroll[2]		III. Social Security[3]		IV. Other Payments[4]	
		1967	1972	1967	1972	1967	1972	1967	1972
A. Total Manufacture	1972	37%		33%		50%		81%	
	1976	92%	40%	80%	35%	152%	68%	217%	75%
B. Steel (SIC 331)	1972	47%		42%		56%		85%	
	1976	133%	58%	112%	49%	194%	89%	276%	103%
C. Motor Vehicles (SIC 371)	1972	53%		46%		70%		99%	
	1976	122%	45%	104%	39%	198%	75%	234%	68%

1. Labor compensation equals the sum of payroll, social security, and other payments.
2. Payroll cost includes employees payments for social security.
3. Social Security plus other legally-mandated payments, such as unemployment insurance and workers compensation insurance.
4. All other benefit payments, including pension, vacation, etc.

Source: U.S. Census of Manufactures and Annual Survey of Manufactures, various issues.

Table A-2

Supplementary Benefits and Payments,

As Per Cent of Payroll Cost

	Paid Rest Periods[1]		Hours Paid But Not Worked[2]	
	1967	1977	1967	1977
Aggregate Manufacturing	3.0%	3.6%	7.3%	9.2%
Primary Metals (SIC 33)	2.3%	3.6%	8.1%	9.8%
Transportation Equipment (SIC 37)	3.1%	3.5%	7.9%	10.2%

1. Various categories of hours at the plant, paid but not worked. These hours and payments are included in Census categories "production worker hours" and "payroll."

2. Various categories of hours not at the plant, paid but not worked. Payments are included in Census "total labor cost"; see text.

Source: Employee Benefits (Washington, D.C.: U.S. Chamber of Commerce), 1967, 1977.

APPENDIX B

Data Tables & Sources

Table A-3

Average Hourly Earnings and Productivity, U.S. Manufacturing, 1957, 1967, 1972, 1977
(current dollars)

A. Average Hourly Earnings

	All Manufacturing		Basic Steel and Steel Products (SIC 331)		Motor Vehicles and Parts (SIC 371)	
	All Workers	Production Workers Only	All Workers	Production Workers Only	All Workers	Production Workers Only
1957	$2.34	$2.09	$3.05	$2.90	$2.65	$2.57
1967	3.35	2.92	4.15	3.90	3.99	3.76
1972	4.51	3.95	5.89	5.57	5.65	5.35
1977	6.90	5.89	9.89	9.48	8.74	8.30

B. Indexes of Labor Productivity (1967 = 100)

	All Manufacturing All Workers				
1957	75.0	84.3	81.6	68.9	67.6
1967	100.0	100.0	100.0	100.0	100.0
1972	116.0	112.7	114.2	122.1	120.3
1977	126.9	115.6	119.6	144.7	142.4

Source: Average Hourly Earnings: Census of Manufactures, 1957, 1967, 1972, 1977, Volume 1, General Statistics. Nonproduction employees are assumed to work the same annual hours as production employees.

Labor Productivity: Productivity Indexes for Selected Industries, 1979 [SIC 331 and 371]
Handbook of Labor Statistics, 1978 [aggregate manufacturing]

Table A-4

Total Labor Compensation and Payroll per Employee, 1967, 1972, 1976
($1,000 per year)

	1967	1972	1976
I. All Manufacturing			
A. Total Labor compensation per Employee	$7,490	$10,270	$14,390
B. Direct Payroll payment per Employee	$6,680	$8,910	$12,050
(Ratio (A/B)	1.12	1.15	1.19)
C. Social Security and Legally mandated payments	$357	$536	$898
D. Other payments	$457	$829	$1448
II. Basic Steel & Products (SIC 331)			
A. Total Labor compensation per Employee	$9,560	$14,090	$22,240
B. Payroll payment per Employee	$8,140	$11,550	$17,230
(Ratio (A/B)	1.17	1.22	1.29)
C. Social Security and Legally mandated payments	$421	655	1,236
D. Other Payments	$1,005	$1,862	$3,779
III. Motor Vehicles and Parts (SIC 371)			
A. Labor compensation per Employee	$9,472	$14,482	$21,013
B. Payroll payment per Employee	8,024	11,718	16,336
(Ratio	1.18	1.24	1.29)
C. Social Security and Legally mandated payments	$426	726	1,268
D. Other fringes	1,022	2,032	3,413

Source: Annual Survey of Manufactures, 1968-69, 1974, 1975-76, Supplementary Labor Cost. (Data available annually, 1967-1976; not included in Census of Manufactures reports).

Table A-5

Output Price Indexes, Aggregate Manufacturing and Steel, Selected Years

All Manufactures		Steel (SIC 3312)
1957	92.8	92.7
1967	100.0	100.0
1972	117.9	130.7
1977	179.0	216.9
1978	190.1	236.9

Source: Bureau of Labor Statistics, Handbook of Labor Statistics, 1978 (Washington, D.C.: June 1979), Tables 128 and 129.

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STATEMENT OF

REUBEN L. JOHNSON
DIRECTOR OF LEGISLATIVE SERVICES
NATIONAL FARMERS UNION

TO THE

SUBCOMMITTEE ON INTERNATIONAL TRADE
COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D. C.

Relative to U. S. Trade Policy
As it Affects American Agriculture

July 28, 1980

At the 78th annual convention of National Farmers Union held March 2-6, 1980, in Denver, Colorado, our delegates approved a policy statement on "INTERNATIONAL COOPERATION AND THE FAMILY FARM."

This statement, which is attached, presents recommendations for a more effective trade policy, including views on trade expansion, revitalization of the Food-for-Peace program, development and implementation of international commodity agreements with meaningful pricing provisions, access for farmers to world markets, and development aid to the emerging nations.

Despite the fact that U. S. agricultural exports reached a record $32 billion in value in fiscal 1979 and appear to be heading towards another all-time high in the current year, there are several shortcomings and disincentives in U. S. trade policy which prevent a substantially better performance.

During the past decade, the U. S. government has engaged in a variety of trade promotion activities, including market information, credit assistance, tax incentives, trade missions and exhibitions, with most of these efforts oriented to access to markets.

During that same time, U. S. federal policy has largely skirted the question of fair prices for raw commodity producers.

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U. S. agencies, notably the State and Treasury Departments, have consistently opposed international commodity agreements which proposed any effective machinery for assuring remunerative prices to producers of raw materials. Unfortunately, USDA officials have often concurred in such policy decisions even though the effects have been damaging to U. S. farmers.

The results of this bias are clear enough. During the past ten years, the prices of manufactured goods have risen 33 percent faster than the prices of raw materials, placing farmers and other producers of raw materials at a severe disadvantage.

This bias against agreements which would assure remunerative prices on raw commodities has repeatedly shown itself in individual commodity negotiations, and particularly in the United Nations Conference on Trade and Development (UNCTAD) negotiations on the so-called "Integrated Commodities Program," or Common Fund.

Opposition by the U. S. and other industrialized nations to fair prices on raw commodities dragged out the UNCTAD negotiations for almost four years. When agreement was finally reached late in June, the industrialized nations gave themselves a veto power by insisting that all key economic decisions would have to be approved by a 75 percent majority.

Further, the implementation of the Integrated Commodity Program was delayed until the second half of 1981 and until the agreement is ratified by 90 of the 101 participating nations and by states accounting for two-thirds of the fund's $470 million in assets.

It should be no surprise that producers of several commodities, having been rebuffed in their efforts to develop international commodity agreements with pricing features, have turned to the exploration of approaches which would enable them to ration the supplies going to market.

The most notable exception to the "cheap food/cheap raw materials" system has been the OPEC oil cartel. The success of OPEC may eventually be emulated by producers of tin, copper, cocoa, tea, coffee, sugar, and other commodities.

When that happens, as with petroleum, our nation and consumers will pay a vastly higher price than if we had agreed to a reasonable floor under raw materials prices.

In addition to its central bias against fair prices for farm and raw materials producers, U. S. policy also has inhibited export performance by interfering with the opportunities of producers to freely export their products.

Export controls have been imposed by the federal government six times during the past 15 years, mostly on the pretext of shortness of domestic supplies, but in the most recent instance on the basis of foreign policy reason.

These export stoppages have caused American farmers and industries losses running into several billions of dollars, losses which also have an impact on the national economy.

Besides hurting farm producers, the insistence of federal decision-makers that U. S. farm commodities must continue to be sold in international markets at "clearance prices," well below the cost of production, continues to aggravate our balance of payments situation.

Our agricultural export earnings could easily be $4 to $5 billion higher annually if our export products were priced at a fairer level. We now export about 1.4 billion bushels of wheat, 2.5 billion bushels of corn, 800 million bushels of soybeans and over 80 million hundredweight of rice. Just adding a dollar to the export selling price of each of these commodities would improve our export earnings by almost $5 billion.

What's more, this could be achieved readily, without any appreciable loss of market volume, through international commodity arrangements with effective pricing provisions.

Our trade deficits with a number of individual countries or groups of countries could be substantially improved by a more reasonable pricing policy on exported farm commodities.

For example, our trade deficit with Japan for 1980 is expected to be $9 billion and to increase to $10 billion in 1981. Yet we continue to be satisfied to sell Japan our grain and other farm commodities at bargain prices.

The United States now imports about $45 billion worth of petroleum from the oil-exporting countries and sells them about $2 billion in farm commodities. It does not make sense to sell oil-producing nations our grain at give-away prices. This policy not only hurts us but hurts other grain exporting nations as well.

The experience under the International Wheat Agreements from 1949 through 1969 was that, in the context of such orderly marketing conditions and pricing provisions, the United States doubled both its wheat export volume and its market share of world wheat exports.

Current United States policies include a number of disincentives to expanded exports and incentives to damaging levels of imports. Among these are:

- The virtual neglect of the trade development aspects of Public Law 480, the "Agricultural Trade Development and Assistance Act," better known as the Food-for-Peace program. Further there is a lack of emphasis on food-for-work assistance which would increase the purchasing power of developing country residents for food and other necessities.

- The lack of provisions in the Trade Reform Act of 1974 (P.L. 93-618), the Trade Agreements Act of 1979 (P.L. 96-39), and the Export Administration Act of 1979 (P.L. 96-72), making import injury adjustment assistance readily available to farmers and the agricultural industry. These adjustment assistance provisions were largely designed for industrial cases and have been difficult for agriculture to use effectively.

- The tendency of the U.S. International Trade Commission (ITC) to apply a highly-strained interpretation of the law and the intent of Congress as regards the finding of injury, refusing to recognize import injury unless the imports are the principal cause of economic difficulties in an industry.

There seems to be little on the horizon which appears encouraging.

A special committee of the International Wheat Council, which took place in London, June 23-26, occupied itself with a proposed International Wheat Agreement, largely consultative in nature, and contemplating a reserve stocking program at a token level of 10 million tons.

With little prospect for a multilateral grain agreement with economic provisions, the emphasis in USDA and other United States agencies will likely be on bilateral trade agreements.

While bilateral trade agreements introduce a small amount of predictability into an otherwise chaotic free market, they are weak in that they do not normally deal at all with price levels.

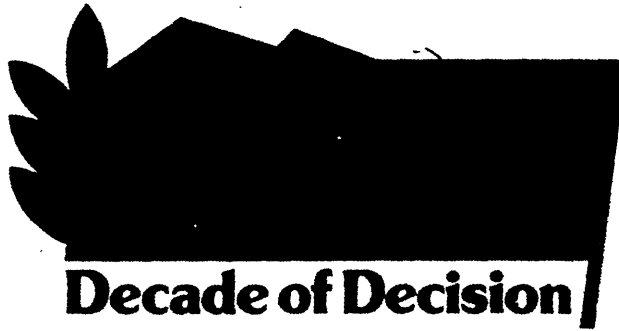
The five-year grain agreement with the USSR was notable for its lack of any price provisions.

Likewise, the soybean agreement with Japan dealt only with quantities, not with price.

The bilateral grain agreements could help assure our customers of United States credibility as a grain supplier. However, this will probably not be very convincing until federal officials renounce interference with United States agricultural exports for purely political motives.

In conclusion, as we observed earlier in this statement, the emphasis of most export measures is misplaced, in that it is oriented to volume rather than to price.

Until price stability is achieved at levels satisfactory to basic producers, there will continue to be a growing trend towards protectionism. The alternative to protectionism is the creation of a context of orderly marketing in which reasonable returns are assured to raw materials producers.



1980 POLICY OF NATIONAL FARMERS UNION

Adopted by Delegates to
the 78th Annual Convention

Denver, Colorado
March 2-6, 1980

ARTICLE II
INTERNATIONAL COOPERATION AND THE FAMILY FARM

American farmers today live and work in a global food and agricultural economy. The prices they receive are dependent primarily upon what their commodities will bring in world trade. This in turn depends upon cooperative efforts among the nations to maintain prices for raw commodities at fair levels and provide for orderly conduct of commerce.

A. International Trade

We favor the negotiation of agreements with other nations to achieve expansion of international trade. The primary goal of such measures should be to create increased opportunities for the impoverished people of the world to sell their goods in the markets of the developed countries to earn foreign exchange so they can buy essential imports, including food, to promote economic development, expansion of employment, and higher living standards.

Expansion of U.S. agricultural exports is one of the primary purposes of Public Law 480, the "Agricultural Trade Development and Assistance Act" (Food for Peace). But this function has been seriously neglected in recent years. The development of two-way trade, as a means of enabling poor and hungry people to get jobs and earn money to buy food both from their own farmers and exporting countries, is consistent with the humanitarian purposes of the Act.

Particular emphasis should be directed in 1980 and 1981 to development and expansion of markets in countries with which we are likely to be able to maintain trade without political interruption. There is a great potential to develop markets in the developing nations by this process, as we did a generation ago in Japan, Europe, Korea, and others. This market development should be pressed with great urgency because the markets lost by the January, 1980, grain embargo are not likely to be recovered soon, if at all, and likely will remain subject to similar interruption again.

The present requirement that 70 percent of P.L. 480 exports must be restricted to a limited number of the very poorest countries interferes with effective market development and should be repealed. Food aid should be directed to people who are hungry, regardless of the country in which they live, and should be administered primarily so as to contribute to the improvement of their nutrition and economic situation.

Therefore, we recommend that the Act be amended to provide:

1. That positive measures be required in P.L. 480 agreements to assure increased employment or by other means to assure that the consumption of food in the importing countries will be expanded in balance with the resulting increase in the supply.

2. That P.L. 480 agreements be designed to foster expanded markets for U.S. farm commodities through the development of long-range, two-way trade between the United States and countries receiving P.L. 480 imports.

Our P.L. 480 efforts should stress both donations and concessional sales. Title I (concessional sales) provisions should be liberalized to provide for the sale of local currencies received from the sale of commodities to contractors on the condition that they be used in public works projects in the importing country for payment of wages to workers who would otherwise remain unemployed.

B. International Commodity Agreements

Negotiations for a new international grains agreement should be resumed promptly. Farmers Union recommends that a new grains agreement should provide for:

1. All trade in grains be conducted within a price range approximating 90 to 110 percent of parity.

2. World reserves of grains to be maintained as a responsibility of both exporting and importing countries.

3. An improved "Food Aid Convention" to be supported by both importing and exporting countries, with the aim of providing for emergencies, promoting economic and market development, and generating employment for the world's hungry.

4. Equitable sharing among both exporting and importing countries of the responsibility for and the cost of reserve stocks, and food aid, and adjusting market supplies so as to maintain prices within the desired range.

We recommend that international commodity agreements be considered for other agricultural products which are widely traded in international commerce and that the central purpose be to assure prices that are remunerative to raw materials producers and fair to consumers.

C. Policies Toward Developing Nations

We urge the use of the economic strength of the United States, in cooperation with other nations, to promote the economic development of the less developed nations.

1. AID

The authority and purposes of the Agency for International Development (AID) should be revised so as to expedite the promotion of two-way trade between the developing nations and the United States, including the exchange of United States foodstuffs for goods, services, and investments in the developing countries. AID should make maximum use of the expertise and assistance of United States farmers' organizations and cooperatives in its rural development efforts.

2. ACDI

We support the programs of the Agricultural Cooperative Development International (ACDI) for cooperative development and farm leadership training in the developing world. We support continuation of the United States Peace Corps and urge its eventual integration into a United Nations Volunteer Corps.

3. CARE

Food donation programs conducted by the Cooperative for American Relief Everywhere, Inc. (CARE) and other voluntary relief agencies and the United Nations should continue to stress improved nutrition for children and other highly vulnerable groups.

D. Access to World Markets

Farmers need and deserve to be assured that they will have the right to sell their products in world markets if they are to maintain their productive capacity to serve the world market. Farmers are concerned that there have been six stoppages of United States farm exports by government action during the past fifteen years, and that the power to restrict exports is institutionalized in the Export Administration Act and the five-year US/USSR grain agreement.

Section 1002 of the Food and Agriculture Act of 1977 provides for an automatic increase in price levels to 90 percent of parity when there is a suspension of exports due to shortness of domestic supply. This is a good provision, but it does not apply to circumstances in which the stoppage is for political or national security reasons. We, therefore, recommend that Section 1002 be amended to make it immediately operable when limits are placed on exports of farm commodities for whatever cause.

We recommend amendment of the Commodity Credit Corporation (CCC) charter to provide for establishment of a grain marketing board elected by grain producers to negotiate and transact export sales of grain produced in the United States.

This national agency shall be the exclusive contracting agency for the sales and pricing of all agricultural commodities that are imported or exported, and shall give preference to farmers' cooperatives in selecting agents of the board for handling export sales.

STATEMENT

of

AMERICAN IMPORTERS ASSOCIATION

for the

SUBCOMMITTEE ON INTERNATIONAL TRADE
UNITED STATES SENATE COMMITTEE ON FINANCE

hearings on

UNITED STATES
INTERNATIONAL TRADE STRATEGY

July 1980

August 29, 1980

Daniels, Houlihan & Palmeter
Washington, D. C.

AMERICAN IMPORTERS ASSOCIATION INC
11 West 42nd Street, New York, N.Y. 10036 • 212 - 944 - 2230

American Importers Association Inc. 11 West 42nd Street, New York, N.Y. 10036 ▪ (212) 944-2230

Mr. Chairman and Members of the Committee:

The American Importers Association is a non-profit organization of over 1300 members formed in 1921 to represent American companies engaged in the import trade. As the only association of national scope representing American firms directly and indirectly involved with the importation and distribution of imported goods, AIA is the recognized spokesman for importers throughout the nation.

We welcome the opportunity to present our views on United States international trade strategy.

I. INTRODUCTION

The International trade environment is entering a new and delicate phase. Worldwide problems of inflation, high energy costs and slow growth have created an uncertain international environment in which all economic institutions are strained. In the United States, there is much concern that the economy is in its most precarious position since the 1930's. The nation feels an unparalleled degree of economic uncertainty, which affects its national mood and impacts on its proper role in international affairs. Unacceptable swings between high inflation and high unemployment, lagging productivity, a declining dollar, and a general feeling here and abroad that the United States is losing its competitive position internationally, all suggest that the basic mechanisms of our economy are not operating satisfactorily.

As a result, increasing demands for new and far reaching protection, and for expanding existing protection, are being made by politically potent sectors in the United States economy -- steel, automobiles, textiles and apparel. Quite often, these demands are based on the perceived political power of these industries and their unions rather than on economic need or the national interest. Government responses are directed at political crises in an ad hoc fashion rather than at longer-term national and economic goals. At this time, pressures for protection against U. S. products are increasing among our trading partners in such areas as man-made fibers and chemicals. Left unchecked, the possibility exists that increased protectionism here and abroad will plunge the world into ever more serious rounds of retaliatory actions. The U. S. Representative, Ambassador Askew, recently warned of this danger:

> "a headlong rush into protectionism would risk re-creating the economic chaos of the 1930's. Protectionist measures by America would only be answered by protectionist measures abroad."

Now is an appropriate moment for this Committee to step back and examine trade policy.

II. THE CURRENT U. S. TRADE POSITION

In the context of this uncertain trade situation, it is essential that the current U. S. trade position be objectively evaluated. Generally, our trade position is viewed in the context of the U. S. merchandise trade balance. (Table 1) The recent deterioration in this trade balance has been pointed to as indicative of severe U. S. economic trade problems, particularly a loss of U. S. competitiveness internationally. This gross measure of our trade position, however, presents a misleading and overly negative picture in a number of respects. First, while it is impossible to determine the precise effects of the numerous economic and political factors suggested as contributing to the deterioration of our trade position, the impact of oil imports clearly stands out as the principal cause of recent trade imbalances (Table 2). The effects of oil imports can be seen in attached table 3 which sets forth two alternative measures of the underlying U. S. trade position when the effects of oil imports are removed: The "non-OPEC" trade balance, excludes both export and import trade with OPEC countries; the "non-oil/non-OPEC" trade balance excludes all oil imports and all OPEC trade.

Using these two alternative measures of merchandise trade balances, the U. S. non-OPEC trade balance improved from a deficit of 12 billion dollars in 1978 to a surplus of over 5.6 billion dollars in 1979, a favorable non-oil

merchandise trade movement in excess of 17 billion dollars; the U. S. non-oil/non-OPEC trade balance moved from a deficit in excess of 8.5 billion dollars to a surplus of 13 billion dollars, an improvement in non-oil merchandise trade in excess of 21.5 billion dollars. The contrast between the U. S. merchandise trade balance and the non-oil alternative balances points to both positive and negative aspects of the current U. S. trade position: the most recent U. S. non-oil merchandise trade is favorable and improving; it is not favorable enough, however, to pay for massive U. S. oil imports.

Oil imports also affect our relative trade position with regard to our trading partners such as Germany and Japan. Despite these countries' greater dependence on foreign oil supplies, their successful commitment to energy conservation has resulted in relatively less imports of oil. (Table 4) Thus, on a per capita basis, Japan and Germany consume just over half as much as the United States; France, United Kingdom and Italy less than half. (Table 5)

A second misleading and overly negative aspect of the U. S. merchandise trade balance is that by definition this balance excludes so-called "invisible" trade, i.e., services and investments.

Together, these "invisibles" represent one-fourth of total U. S. trade, i.e. merchandise and "invisibles." In contrast to the deficit position of U. S. merchandise trade, in recent years, U. S. invisible trade surpluses have exceeded 20 billion dollars annually. As a result, our balances on goods and services, while posting deficits in 1977 and 1978, posted a surplus in excess of 5 billion dollars in 1979, and our balance on current account, including remittances, pensions, and other unilateral transfers, was in balance in 1979 as well. (Table 6)

This is not to say that our trade position is not a cause for concern. Clearly, improvement is needed. However, our trade position when viewed in its full sense is not as poor as generally assumed. Furthermore, the principal cause of our trade imbalance -- the heavy reliance on imported oil at levels substantially above the early 1970's -- is an economic problem which extends far beyond trade. Thus, only through a combination of trade (especially increased exports) and other economic adjustment mechanisms -- particularly a concerted effort on energy conservation and alternative sources of energy -- can significant improvement in our current trade position be achieved.

III. THE NEGATIVE EFFECT OF GOVERNMENT POLICIES

At the same time, the importance of other contributing factors, especially government policies, to our current trade and economic difficulties must not be overlooked.

AIA believes that the economic and trade problems confronting the U. S. have arisen in no small part from two major shortcomings of government policy planning and implementation. The first of these shortcomings is the failure to recognize the extent to which government decisions in such areas as regulation, transportation, education, environmental protection, savings, and taxation affect our economic and trade condition. Examples of this tunnel vision are legion. Congress revises U. S. maritime policy but ignores the related problems of domestic transportation resulting from an increasing use of intermodal forms of transportation. We push simultaneously for conversion from oil to coal and for stringent air pollution controls. We enact a Foreign Corrupt Practices Act and allow different agencies to interpret it without regard to each other or to the Act's effect on our ability to compete in exports.

Of perhaps even greater direct relevance to trade policy is the second of these shortcomings -- the longstanding failure of the United States to treat economic and trade problems, both domestic and international, in an integrated fashion. Our country has consistently addressed these issues individually and without regard for the broader effects of any solution. It makes no sense to talk about revitalizing our economy and at the same time implement trade policies which inhibit restructuring by protecting existing non-competitive industries at the expense of growth industries. It also makes no sense to treat the elements of trade policy in isolation from each other. It is naive and self-defeating to pretend that we can simultaneously maintain an expansionist-oriented export policy and an import policy which severely restricts the export opportunities of our trading partners.

AIA believes that a major change in the nation's approach to trade policy is necessary -- a change from a fragmented "sectoral" approach to an integrated approach which recognizes the relationship of elements of policy and planning to each other.

IV. "REINDUSTRIALIZATION" AND INTERNATIONAL TRADE

In recent months, the uncertain economic and trade environment has generated much discussion of the concept of "reindustrialization" and the idea of the United States establishing an "industrial policy." These once arcane terms are rapidly becoming cliches, and there is danger that they will be perceived in a superficial manner, as a painless, quickfix solution.

In this regard, Japan, with its system of administrative guidance, is often cited as the model for a successful industrial policy. So is Germany, which more in keeping with American tradition, allows market mechanisms and the private sector

to determine the direction in which most productive resources flow. However, it is important to recognize that other countries have had considerably less success with their industrial policies. Britain, for example, is now undertaking the painful process of dismantling the results of its two decades old industrial policy. Italy's industrial policy, which appeared so successful only a few years ago, now shows serious signs of following the unsuccessful British pattern.

For the concept of an industrial policy to have meaning, whether in a more tightly controlled system such as in Japan, or in a more open system such as in Germany or our country, requires that government, economic and trade policies facilitate the movement of productive resources into areas of future growth compatible with a country's economic development and competitive position, that is, into tomorrow's industries, not yesterday's. Yet the phrases "industrial policy" and "reindustrialization" often have served as a euphemism for protection and subsidization of dying firms and industries -- the antithesis of these concepts.

Merely creating an "industrial policy" will not necessarily solve our country's economic and trade problems. Indeed, it can be counterproductive if economic goals are subordinated to short term political considerations contrary to the national economic interest. Our own experience in such areas as apparel and footwear, the recent bailout of Chrysler, and the Administration's announcement that the steel industry is the next target of its new "industrial policy," all suggest that the United States is not immune to the unsuccessful British approach to industrial policy making.

If we are serious about revitalizing our economy and improving our trade position internationally one of the primary goals of our overall industrial policy

must be to develop trade programs which encourage the shift from low wage, semi-skilled industries where the United States is increasingly noncompetitive, to higher wage, high technology areas where the United States remains a world leader or may become one. These have been the growth areas in our economy over the past decade, as production in areas such as chemicals, fabricated metal products, and electric and non-electric machinery has increased far more significantly than iron and steel or apparel. (Table 7)

We also must recognize that our work force is changing and that we need to move in this direction to use the skills of our people most productively.

Recent studies by the Bureau of Labor Statistics show that the largest increase in the U. S. labor force over the next ten years will be in the 35-44 age group, and that the labor force in the 16-24 age group will actually decline in numbers. Furthermore, as noted in a Report of the House Select Committee on Population, our work force already has experienced a sharp increase in educational levels, with over 85% of younger workers currently high school graduates, compared to 61% in 1960, and 38% in 1940. Given these unalterable demographic factors, if we are to prevent a generation of U. S. workers from experiencing a lifetime of lower paying and unsatifying jobs, we must use our capital and technology to create jobs in high wage, high skilled areas.

These demographics also suggest the folly of protecting low skill, low wage industries such as apparel and footwear. As educational levels increase and the number of young workers declines in the labor force, fewer people will be available to fill jobs in these industries. This is the conclusion of a recent study published by the Conference Board, which concluded:

> The inexperienced, semi-skilled or unskilled worker will not only decline in number, but will increasingly be sought by employers.

Already, employable unskilled and semi-skilled labor is becoming so scarce that our government has taken the incredible step of training new sewing machine operators for an apparel industry protected by import restraints. In these circumstances, is it in our national economic interest to protect marginal apparel producers in New York, rather than enhance semi-conductor production in California's Silicon Valley? AIA strongly believes we must move forward.

AIA does not wish to imply that industries should be abandoned. Certainly, even in labor intensive industries such as footwear and apparel, and certainly in our steel industry, restructuring can take place which will result in productive, viable industries.

Major segments of these industries are internationally competitive today. Our textile mill sector has undergone a significant transformation over the last decade. It has made great progress toward successful adjustment as a result of substantial capital investments, which in 1979 alone exceeded one billion dollars and as a result of consolidation, specialization, and the trend toward use of section 807 assembly abroad of garments cut of U. S. fabric. This adjustment has enabled the textile mill industry to move from a deficit trade balance in the early 1970s to a positive balance of almost a billion dollars in 1979.

U. S. imports of textile mill products have declined by over 50% since 1971 from 3.85 billion square yard equivalents to 1.98 square yard equivalents; during the same period, U. S. exports of textile mill products nearly tripled, from 336 million pounds to 933 million pounds. The textile mill industry has

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become so competitive internationally it now is threatened by protectionist policies abroad.

In the steel sector, newer, more efficient and more productive non-integrated producers are easily able to compete with imports, and the industry will become more competitive as older inefficient production facilities are retired. Further, the industry is showing an increasingly competitive world trade advantage in many basic steel products; e.g., exports of semi-finished steel in the first six months of 1980 were ten times the quantity of imports. Exports of other steel products such as concrete reinforcing bar, black plate, terne and tin plate and strip have exceeded imports in the first six months of 1980 by nearly 230 thousand tons.

In the case of automobiles, the U. S. industry is in the process of retooling and recapitalizing to improve quality and productivity and to produce more small, fuel efficient vehicles. David Eisenberg, a noted automobile industry analyst, predicts a reduction of imports to 19 percent in the next few years. General Motors will emerge from this process of adjustment in a very strong position. Ford will remain a major producer internationally as well as in the United States. AMC will concentrate in its particular niche in the market -- four-wheel drive vehicles and jeeps -- and will be further strengthened in other segments by its association with Renault. Only Chrysler's future is clearly in doubt, despite the subsidies granted by the Government.

Even in apparel, recent studies by Georgia State University and Kurt Salmon Associates have shown that strong management, improved market research and market intelligence, consolidation into multi-product firms with competitive

marketing strategies, new technologies and new modes of production, such as production sharing under TSUS Item 807, have made industry segments more competitive. We anticipate this trend will continue.

The nation must ask itself: Where are we going as a nation? What is our vision of our country's future? In answering these questions, we must recognize that America has changed over the years, as has the rest of the world. Certainly, our competitive position in labor intensive sectors such as apparel, footwear, steel, and automobiles has deteriorated over the last twenty years. On the other hand, the United States has maintained or improved its competitive status in many areas, including research intensive industries, agriculture, and services.

The value of U. S. exports of foods, feeds and tobacco grew by almost 400% between 1970 and 1979, and the U. S. balance of trade in these products went from a deficit of over one billion dollars to a surplus of almost seven billion dollars during the same period. (Table 3) Between 1970 and 1979, U. S. export of R & D intensive manufactured products as defined by the National Science Foundation increased by over 310%, from 19.3 billion dollars to 79.1 billion dollars; in 1979 alone the U. S. trade surplus in R & D intensive products exceeded 39 billion dollars. (Table 8) U. S. service trade grew even more rapidly over the decade increasing on a net basis by over 1000%, and as noted above, the surplus balance of trade in services in 1979 exceeded 20 billion dollars. (Table 6) Despite these favorable trends in our economy's structure, as a nation we continue our obsession with protecting non-competitive industries and refuse to capitalize on our strengths. The United States continues to ignore the reality of greatly increased international economic integration. Our successful trading partners have not made that mistake.

Trade policy must be made an integral and important element of any conscious United States industrial policy. Each year, foreign trade increases as a share of our total gross national product. We are all quite conscious of our country's increased imports, particularly oil imports. However, we should not forget that our exports are growing as well. For example, between 1970 and 1978, exports as a share of total U.S. production of goods increased from 14.4% to 22.4%. Given the increased dependence on imported oil and other essential imported raw materials such as tin, chromium, iron ore, natural rubber, etc., (Table 9) our economic and trade positions can improve only by increased exports.

AIA is concerned, however, that government policies, whether under the banner of "reindustrialization", "industrial policy" or some other popular phrase or slogan, will extend beyond facilitating adjustments through expanded export and import trade and will result in counterproductive protectionist trade policies inhibiting adjustment and revitalization.

Protectionist trade policies are incompatible with and contrary to a forward-looking industrial policy. As a nation, we recognize the importance of free functioning market mechanisms to allow our economy to adapt to internal competition. Sound industrial policies will support these mechanisms. Why, then, do we tolerate trade policies which distort market mechanisms and prevent our economy from adapting to international competition?

Restrictive trade policies only reinforce the existing inflationary and recessionary tendencies in our economy. Restricting the availability of more efficiently produced imported goods forces consumers to purchase inefficiently produced, higher priced domestic goods. Restrictive import policies eliminate

the competitive factors which might otherwise moderate future cost increases, encouraging continued inefficiencies and higher prices.

Restrictive policies also divert limited investment resources from the segments of our economy most capable of productivity increases to those least capable. They shift our orientation from future possibilities to past problems. The long-term implication of such policies is the erosion of the United States' competitive position in those segments of our economy most likely to provide growth and better job opportunities.

V. COMPREHENSIVE VERSUS "SECTORAL" TRADE POLICYMAKING

Unfortunately, United States international trade policy is developed, as is industrial policy, in an ad hoc fashion. Attention is focused intensively within the narrow confines of immediate problems; little thought is given to the wide range of indirect, often long-term effects of the chosen policy. Often no attempt is made to remedy root causes of the problem. "Sectoral" international trade policymaking and "sectoral" industrial policymaking over the years have caused this country to become much less competitive.

A clear example of sectoral policymaking is the present effort to develop export and import policies in isolation from each other. Restrictive import policies clearly affect our ability to expand exports. We have already noted the important contribution which exports make to our economic well-being. Yet, it is unrealistic to believe that an export policy can be developed in a vacuum. We should not delude ourselves. Our trading partners will not acquiesce to restrictions on their exports without imposing restrictions on our exports. We cannot be outraged by European restrictions on our fiber and textile exports at the very moment Europe's exports of steel to the United

States are under attack in this country. The injurious effects to the United States which can result from reciprocal restrictive trade policies with Europe should not be underestimated. Our trade surplus with EC countries between 1977 and 1979 totalled over $17.2 billion and grew from just over $3 billion in 1978 to almost $9.3 billion in 1979. (Table 10) Given this favorable balance, reduced trade resulting from protectionist policies and retaliatory measures by both parties cannot benefit the U. S. trade and economic position.

Our efforts to reduce existing unwarranted restrictions on our exports are undermined when we demonstrate a readiness to use import restrictions to protect narrow domestic special interests. The contradictions in our trade policy toward developing countries is particularly relevant in this regard. There is no question that in many of the more advanced developing countries, excessively restrictive import policies continue as a vestige of more sensitive periods of their development. The GATT codes properly recognize that some forms of special treatment are appropriate for developing countries. Yet differential treatment becomes increasingly inappropriate and unacceptable as countries industrialize and become major trading partners and competitors. Advanced developing countries have reached the point where their economies and people can benefit from trade liberalization. U. S. trade policy should seek to accelerate this process, including efforts to increase developing countries' participation in, and adherence to, the GATT codes.

Even today, these countries are major export markets for the United States. (Table 10). Their full potential, however, remains unrealized because some of their import policies continue to be restrictive. Yet, how can the United States approach these countries on a fair and equitable basis to reduce barriers to trade when time and again we restrict the exports to our country of those products

which they are best able to produce? Textile and apparel trade is the most obvious example. However, numerous other examples of restrictions directed at these countries -- footwear, television sets, cookware, to name a few -- also exist. Recent events suggest steel restrictions also may be sought.

The potential benefits of expanding U. S. exports are extremely high. World markets for goods and services are expanding at a more rapid rate than our own, increasing in 1979 alone by over 25%, (Table 11) and our country is becoming increasingly dependent on exports as a source of new jobs in manufacturing and as an outlet for our agricultural production. Rising protectionism limits these potential benefits. As a 1978 study by the Senate Subcommittee on International Finance noted, foreign trade barriers on non-agricultural products cost the United States over 424,000 jobs and $7.5 billion in export sales. However, dismantling these barriers can only be successful if the United States establishes import policies consistent with the principles of liberal trade which we expect other countries to apply.

Particularly in the case of developing countries, the economic effects of our restrictive import policies also limit the full potential of our export trade. The importance of this trade should not be underestimated. U. S. exports to non-OPEC developing countries represented over one-fourth of all U. S. exports in 1979 and increased at a faster rate than our exports generally, from 36 billion to 48 billion over 1978 levels.

However, particularly as a result of the rising cost of oil, the economies of these countries will be forced to limit their imports unless they can expand their exports. A recent GATT study noted that while imports by non-OPEC developing countries were estimated to have risen by over 30% in 1979, more than

half of this increase was due to higher prices. Given the fact that their import prices continued to rise faster than export prices, the terms of trade of non-OPEC developing countries declined in 1979, mainly under the impact of oil price increases, for the second year in a row. The GATT study estimates the current account deficit of the non-OPEC developing countries to have widened from $30 billion in 1978 to $50 billion in 1979.

The deteriorating trade position of these countries makes increased exports absolutely essential for these countries to earn foreign exchange for import purchases. Oil imports by these countries are generally at the lowest possible levels for their economies to function. Thus, absent additional foreign exchange earnings, these countries will be forced to cut back imports of other goods, particularly capital goods in which the United States is most competitive. Furthermore, these countries tend to import, where feasible, from countries which purchase their exports. Thus, restrictive U. S. import policies not only limit the market potential of developing countries, but also shift the trade focus of these countries away from the United States.

For example, Korea, which had a balance of payments surplus with the United States in 1977 and 1978, adopted a conscious policy of increasing its imports of U. S. products. In 1979, the United States achieved a favorable balance in its trade with Korea, as a result of Korea entering into future contracts with United States companies for such major items as ESS telephone switching equipment, aircraft, and nuclear power facilities. U. S. exports to Korea of electric machinery and equipment increased 29 percent; non-electric machinery exports to Korea increased 40 percent. The United States was chosen over stiff competition from competing European suppliers and displaced Japanese producers.

It is clear, however, that to the extent our import policies restrict Korea's exports to the United States, they also limit U. S. export opportunities to Korea. In this regard, there is an ominous message for the United States in the May 1980 State Department Foreign Economic Trade Report on Korea, which states:

> "Another element that remains in force is the Korean Government's policy to encourage diversification of imports away from Japan, because of its still unfavorable trade balance with that country. The U.S. Embassy in Seoul -- and other western Embassies as well — continues to receive a growing number of business inquiries and business visitors from companies seeking new sources of supply, many of whom pointedly refer to their government's import diversification policy."

The lesson for the United States should be clear: in developing countries, bilateral export-import trade is inevitably linked as a matter of survival.

Our current trade relationship with the People's Republic of China represents a particularly important example of the possible adverse effects of our import policies on our export potential. U. S. exports to the PRC in 1979 totalled 1.7 billion dollars, including over one billion dollars worth of grain and over 240 million dollars in pipe and oil/gas equipment. The Commerce Department projects that by 1985, U. S. exports will exceed 5.3 billion dollars. Our export potential to the PRC is enormous; the PRC wants and desperately needs our products. Yet the trade climate between the two countries was nearly soured by protracted textile negotiations because the United States insisted that the PRC accept quantitative restrictions on its exports at levels normally expected of a country of five million, not a billion people. This position was not only totally unreasonable on its face, but it also ignored the fact that the PRC

experienced an unfavorable balance of trade with the United States in excess of one billion dollars in 1979 -- an enormous amount for any country at an early stage of development. In a practical economic sense, the United States is severely constricting the principal source of foreign exchange by which the PRC can purchase U. S. products.

Even if we chose to ignore the contradiction of our export and import policies vis-a-vis the PRC, they do not. This was made abundantly clear in comments of Chinese officials, following an unsuccessful round of textile negotiations earlier this year, who suggested that the Chinese government might eventually be forced to reduce purchases of cotton, wheat, aircraft and oil-drilling equipment as a result of the lack of foreign exchange and the US-PRC trade imbalances. As noted above, in 1979 our exports of these and similar items to the PRC totalled over $1.7 billion. Clearly, it was not rational trade policy to threaten this trade over a few thousand dozen man-made fiber sweaters. The final textile agreement between the United States and the PRC is reported to have allowed for increases over previously imposed unilateral restraints but below actual trade levels achieved. To the extent the United States limits the growth of PRC textile and apparel exports, it also limits U. S. exports of agricultural and high technology exports to that country, as well as cotton, synthetic fiber and textile machinery.

The linkage between exports and imports is not limited to Korea and the PRC. Increased exports of oil from Mexico have enabled Mexico to expand its imports from the United States as part of its long term development plans. The resulting increased U. S. exports include not only high technology items, but also certain steel products in which the United States remains internationally competitive.

Similarly, in the case of Brazil, as U. S. imports of goods from that country have increased, so have U. S. exports to that country. In both instances our trade balance with other countries has been favorable in recent years. (Table 10)

U. S. export policy is not the only victim of our shortsighted import policies; so is our adjustment assistance program. An effective adjustment assistance program is an essential element of any successful industrial policy. Hardships to workers must be minimized when jobs are affected by restructuring and adjustment, whether trade related or otherwise. This means protecting people, not specific jobs in inefficient and noncompetitive firms. American workers must be reassured that industrial adjustment will not reduce the number of jobs, but will increase them, and will provide greater opportunities for higher paid jobs. Also, workers must be reassured that when jobs are affected, they will have effective adjustment assistance. This means above all, training for higher skills, as well as adequate compensation, or relocation aid. However, because we focus our attention on preserving the status quo through protectionist trade policies, we have failed to commit ourselves to the establishment of a truly effective system of trade adjustment assistance. We need to reverse these policies if we are to succeed in reinvigorating our economy.

The United States must become internationally competitive. The full potential of this nation will never be achieved if we persist in sectoral policymaking and fail to restructure the nation's productive functions.

VI. A NATIONAL COMMISSION

The role of trade policy in an "industrial policy" and the elements of a trade policy appropriate in an overall plan for economic redevelopment are subjects which require careful study. AIA strongly recommends that a Commission on Trade

and Industrial Policy be formed to undertake just such a study.

The Commission should address the wide-range of our domestic and international economic policy issues: The direction our industries are moving in; the needs of our citizens both as consumers and as workers; the problems of inflation. Among other areas of study we suggest the following:

1) An international trade policy which not only effectively promotes U. S. exports but also takes advantage of the benefits to commerce and U. S. exports of minimizing restrictions on imports;

2) The development of an industrial policy which encourages adjustment to competitive products and services and minimizes protection for non-competitive industries;

3) An identification of product sectors in international trade in which the United States should emphasize the development of a competitive advantage and those from which we should consider shifting away;

4) The development of a conscious program of incentives for research and development and for investment and savings;

5) Meaningful adjustment programs for the labor force -- one which protects workers, not jobs;

6) An examination of the role of tax policies which discourage adjustment and hamper our international marketing efforts;

7) The examination of the viability and appropriateness of unilateral imposition of the strictures embodied in the Foreign Corrupt Practices Act which place U. S. exporters at a disadvantage and the feasibility of a multilateral approach to these problems;

8) The severe limitations on trade policymaking which result when -- due to removal of most administrative discretion -- effective control over such trade restrictions as antidumping and countervailing duties are permitted to shift to narrow segments of the private sector;

9) An examination of other problems created by new antidumping and countervailing duty law and the possibility of a unitary import relief statute based on the concept of serious injury;

10) The ways in which our educational systems may be improved to provide a generally better quality labor force, to be internationally competitive in science and mathematics teaching, and to strengthen our language and social studies teaching to improve our international marketing capacities;

11) An examination of our transportation system and its ability to move international and intermodal shipments as well as carrying basic commodities such as grain and coal for export; and

12) Consideration of the government organization needed to maintain adequate trade and industrial policies.

Commissions in the past have performed a valuable educational function in the trade area but even the Report of the Williams Commission in 1971 has become outdated by the overwhelming changes in the world trade economy. As these remarks thus far have suggested, U. S. trade policy far too often focuses on short-term narrow issues, and far too often neglects the broader long-term implications of those policies. It is necessary that this nation change its focus. The Commission

AIA proposes would serve an important function in shifting our trade policy orientation to the long-term and the broad scope.

A commission should not address just government policymakers; it also should write a report for the general public which would serve as the beginning of a campaign of education on the benefits of trade. AIA is concerned over the depth of public misunderstanding of trade issues. The findings of a recent poll by the Roper Organization for the League of Women Voters Education Fund, entitled "Public Perceptions of World Trade" are astounding. Roper found, for example, that 29% of the public believe the United States is nearly or completely self-sufficient; that 49% believe the American standard of living would be about the same or better if we stopped buying from or selling to other countries; and--most incredibly--that almost as many Americans (71%) favor restrictions on exports as favor restrictions on imports (81%). Clearly the national leadership must educate the public about the real effects of international trade. An industrial policy which includes trade will not be successful if based on such inaccurate perceptions.

The New York Times/CBS News Poll published June 26, 1980, found that only 19% of the American public favors "lower prices at the cost of some domestic unemployment." The issues the nation faces in trade cannot, however, be accurately summarized in such an oversimplified notion that there must be unemployment in order to benefit from low-cost imported goods. The real trade issue is whether the United States can maintain an efficient and growing industrial base which creates new and better jobs without the healthy pressure of free and fair competition. The national leadership has the responsibility not only for the development of such an industrial base but also to see that the American public understands the real choices.

VII. GOVERNMENT POLICYMAKING STRUCTURE

Among the questions which the Commission we propose should address is whether the current institutional framework governing trade matters in the United States is capable of developing the long-term policies and planning necessary to deal with the issues discussed above. While it is far too early to make any definitive judgments about the new agency structure emerging from the recent reorganization, AIA believes that it will probably yield mixed results. Perhaps most relevant to our testimony is that the reorganization did not address the development of coordinated industrial and trade policies.

On the subject of reorganization, AIA supports the reorganization plan's concept of establishing the U. S. Trade Representative as the central policymaker for trade matters and principal coordinator for the various agencies with trade responsibilities. AIA is concerned, however, as to whether USTR will be able to function, as planned, in the role of overall leader in the area of trade policy. To function in such a role, USTR must be able to exercise some control over the programs and actions of the administering agencies. The separation of USTR's responsibilities for policy formulation from trade administration raises serious questions as to whether USTR will be able to conform agency actions to the policies USTR develops. In this regard, AIA shares the concern of Senator Stevenson who has remarked:

> Policymaking bodies void of implementing authority tend to atrophy. Moreover, compartmentalization of "policy" and "implementation" may work in the flow charts at OMB, but in reality "policy" tends to evolve from agency operation at least as often as it devolves on them.

Ambassador Askew, the current Trade Representative, is a responsible and forward-looking trade official, whose views on the need for expanded exports and the dangers of protectionist policies we find greatly encouraging. Importers hope that the policies and guidelines put forward by Ambassador Askew will be implemented within the government. Given the pitfalls inherent in the current framework for trade policy, we are not optimistic that this will always be the case.

The U. S. Trade Representative also must play an integral role in the development of related industrial policies, and must have the institutional clout separate from his degree of influence with the President to ensure their implementation. The present organization may not be adequate for this purpose as well.

AIA's feelings about the new and expanded roles of the Department of Commerce in the trade are somewhat mixed. The internal reorganization of the Commerce Department should serve to enhance the attention and priority given trade by expanding staff and by placing trade functions under the control of high level administrators. We are particularly pleased that the reorganization places both the commercial attaches transferred from the State Department and the counterpart U. S. field offices under a single office within the Department. This provides a rational framework for export promotion activities and provides a more efficient chain of communications within government and between government and industry. It is also imperative that these functions be adequately funded.

AIA is less pleased with Commerce's new jurisdiction to administer the import laws, particularly the antidumping and countervailing duty laws. We are concerned that Commerce's traditional role as an advocate of domestic business may conflict

with its responsibilities as an unbiased adjudicator of competing claims in these cases. We reserve our judgment on this matter as it is far too early to determine whether our fear is justified.

We are also concerned about the absence of input which the Trade Representative is allowed in antidumping and countervailing duty cases under the existing structure. Although by law the Secretary of Commerce is required to consult with the USTR in carrying out his functions under these laws, the President has indicated that the USTR may not interfere with Commerce determinations in antidumping and countervailing duty cases. If the USTR may not require that its standards and interpretations be followed in individual cases, what realistic authority over antidumping and countervailing duty statutes does it have?

This concern is heightened by the fact that although USTR has authority for negotiations involving the suspension of antidumping and countervailing duty proceedings, only the Secretary of Commerce can accept the assurances which serve as a basis for suspending such investigations. While we hope that as a practical matter USTR will become involved in critical cases involving allegations of dumping or subsidies, we feel that the discretion which USTR may exercise in achieving pragmatic solutions may be severely limited.

VII. TRADE POLICYMAKING BY THE PRIVATE SECTOR

AIA's chief concern in the area of antidumping and countervailing duty, however, is with the new laws themselves, which we consider to be highly anticompetitive and protectionist. The new laws are excessively legalistic, and leave no room for even the most basic considerations of broader trade policy. The new procedures limit Executive discretion and flexibility; they shift

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initiative and control of antidumping and countervailing duty proceedings away from the government to narrow private interests. The government has become a prisoner of its own regulations with very little room left for the use of government discretion to implement trade policy in the national interest.

We have already seen the disastrous effects of these new laws in one of the first cases brought under them -- the U. S. Steel Corporation antidumping action against steel imports from seven of our European allies. With steel exports to the United States from these countries exceeding one billion dollars annually, the Administration recognizes that antidumping proceedings are inappropriate for resolving the steel trade issue. Hence, the Administration previously had instituted the trigger price mechanism, itself a form of protection, but one generally accepted by all parties. U.S. Steel was able to scuttle the TPM system through initiation of the antidumping proceedings -- contrary to the desire of the rest of American industry generally, contrary to the wishes of the Administration, and contrary to the national interest.

The Administration is currently grappling with the problem of trying to overcome the inflexible and extremely harsh all-or-nothing result of the antidumping laws. Various proposals including a new TPM and some sort of quantitative restrictions are being contemplated by the Administration, yet it has extremely limited authority to implement these solutions under our laws. Under the new system, the U. S. Steel Corporation is able to say when and if a negotiated resolution of this matter can occur, and thus far it has refused to allow a resolution, despite the damage which its actions are causing our trade relations with these countries. That a single domestic company can blackmail the Government and exercise veto power over crucial, sensitive trade matters affecting our most

important allies is a damaging condemnation of the antidumping and countervailing duty system as it presently exists.

Such a system is the antithesis of a rational trade and industrial policy. The new laws also show a marked protectionist bias, which encourages domestic interests to initiate antidumping and countervailing proceedings, even with weak cases. Our principal concern, in this regard, is the shortened time periods in which Commerce is required to make preliminary determinations. Given the extraordinarly complicated process of review and analysis required in these cases, it is quite likely that in many instances Commerce will be unable to perform these functions adequately. Since it is highly unlikely that the benefit of the doubt in these cases will be given to affected foreign producers or governments, an increased number of affirmative preliminary determinations are likely. This in turn subjects the affected foreign produced goods to suspension of liquidation and bonding requirements, creating serious disincentives for importation of these products.

In addition, the new law allows domestic interests to appeal negative determinations, but does not allow affected foreign producers to appeal affirmative preliminary determinations. Thus, the new law increases the likelihood that antidumping and countervailing duty cases will be brought as harassment and that import restrictions will result.

Numerous other protectionist elements exist in the new antidumping and countervailing duty laws. The provisions allowing petitioners to invoke "critical circumstances" by alleging "massive" imports of dumped or subsidized merchandise raises the real possibility of retroactive suspension of liquidation for the first time; the new settlement procedures create so much commercial

uncertainty that they are unlikely to be used extensively; the definition of material injury and the standard of causation are uncertain and in early ITC cases appear to be overly restrictive; the concept of subsidy has been expanded by limiting the adjustments that may be made to the gross subsidy to calculate net benefit or net subsidy; disclosure of confidential information under protective order is broader for information submitted principally by foreign producers to Commerce, than for information submitted principally by domestic producers to the International Trade Commission; the use of constructed value and discretion to compute foreign market value has been expanded.

We are also concerned about the United States' interpretation of Article XIV of the Subsidies Code. As we understand it, the United States is refusing to accept developing countries as "countries under the Agreement" in the absence of a commitment by LDC signatories that they will reduce or eliminate export subsidies. This would deny the material injury provision of the countervailing duty law to these countries in spite of the clear intent of the Subsidies Code that material injury must be shown to exist prior to the application of countervailing duties. We consider this seriously inconsistent with the spirit of our international obligations and a detriment to the aspirations of developing countries. We strongly urge that the United States apply a material injury standard in countervailing duty cases to all signatories to the Code, and that it not make unilateral determinations with regard to the obligations of lesser developed countries under the Code.

The multitude of shortcomings in the antidumping and countervailing duty laws which we have described represent a significant protectionist bias which Congress should correct in amending legislation. At a minimum, there must be

correction of the fatal absence of procedures for policy input and administrative flexibility in antidumping and countervailing duty cases which leaves the United States vulnerable to the whims of narrow interests and without power to prevent the resulting deterioration of our trade relationships. We believe the procedures in the escape clause proceedings, which allow the President to reject ITC recommendations subject to Congressional override, provide a reasoned and balanced system for protecting private rights without neglecting national interests. AIA recommends that Presidential discretion on the basis of national interest, similar to escape clause procedures, be adopted into law for antidumping and countervailing duty proceedings.

The Antidumping Act in particular has become an administrative monstrosity. In addition to the procedural matters discussed above, calculations of the elements involved in less than fair value determinations have become extraordinarily complicated and arbitrary. They bear little or no relationship to commercial practices or accounting procedures. We venture to say that few foreign exporters really know whether they are dumping or not. The findings are often capricious, depending upon technicalities of methods of sale and particular business practices in foreign countries. The most obvious examples are considerations of exchange rate where a foreign exporter may be maintaining a constant price in the United States market and find, simply because of changes in exchange rates, that he has become a "dumper." Similarly arbitrary limits on price adjustments for differences in circumstances of sale in the U. S. and home markets, such as selling commissions and advertising costs, may result in a finding of dumping when no dumping was intended and when, in practical terms, no dumping occurred.

Time does not permit a complete analysis of what is wrong with our antidumping law, but these considerations at least suggest that a whole new look should be taken at the antidumping concept, whether or not the United States becomes committed to a policy of reindustrialization. What real difference does it make to the United States what the price of a product is in the home market of the manufacturer? What we should be concerned with is the price in the United States market and whether the resultant volume of imports is injurious or not.

AIA submits that any fair, impartial analysis of these laws would deem them in principle anti-competitive, pro-restrictive, protectionist and unfair. Conduct that is permitted in domestic commerce is condemned by the antidumping laws solely because it is international in nature. What is involved essentially is a condemnation of differential pricing, specifically that sales for export at prices below those of the home market are "unfair."

But why should differential pricing between markets be prohibited in the first place? Why is differential pricing across the Rio Grande or St. Lawrence Rivers "unfair", but differential pricing across the Mississippi, the Ohio or the Potomac not?

A secondary premise of the antidumping laws is that international sales below cost of production also can be "unfair", yet in recent years, companies such as Chrysler, Bethlehem Steel and Lockheed have operated at losses, and therefore, presumably have sold their products below the cost of production. This may be very undesirable from their perspective, but is it "unfair"? If it is not, why is it unfair for a foreign exporter to do the same thing?

Differential pricing and sales below cost of production are not inherently and essentially evil or immoral. Nevertheless, the U. S. has attached emotionally-laden, pejorative labels to this conduct -- labels like "unfair" and "dumping". But the conduct to which those labels apply usually is rather ordinary in every-day commerce. It is not conduct that is responsible for the economic problems of this country.

We suggest that the Committee take a serious look at the Antidumping Act and consider again whether it would not be far preferable to have a unitary statute based upon the concept of serious injury, where pricing of imported goods would become an element in the consideration of injurious impact.

There is really no need in our view for the labyrinthian procedures involved in determining fair value, or little sense in the tortured and arbitrary analysis of accounting data which is involved. Whether exports are priced at below cost or at below home market price is irrelevant. What is relevant is whether imports are causing serious injury. We believe that no other inquiry other than that of injury is really required in order to afford legitimate protection to American industry.

We voice these concerns because of our fears that with the new antidumping provisions, importers will be faced with a multiplicity of cases which affect a large portion of our international trade. The nation is now seeing the beginnings of what could become an "antidumping war" as the steel cases continue and Europe proceeds in its cases against fiber, textile and chemical imports from the United States.

The Safeguard proceeding (Section 201 of the Trade Act) already provides a reasonable system of import relief to assist temporarily domestic industries seriously injured by imports, irrespective of the price of those imports. This proceeding recognizes the seriousness of import restraint. Thus, it requires that imports be a substantial cause of serious injury before import relief may be granted. The safeguard proceeding recognizes that import restraints are intended to be temporary in duration, in effect only for the minimum period of time necessary to allow the affected domestic industry to undertake necessary competitive adjustments. The escape clause proceeding also is non-discriminatory in application. Except in unusual circumstances and through a process of negotiations, restrictions against imports of a specific country or countries may not be granted. Also, as noted above, escape clause proceedings provide the President with discretion to reject relief if contrary to the national economic interest while providing for Congressional override.

AIA supports the Administration's efforts to extend the principles of the escape clause internationally through negotiations of a Safeguards Code. We are completely opposed, however, to any safeguard which would allow the unilateral application of relief on a discriminatory, selective basis. We believe that such application, as in our own law, should be allowed only if it is negotiated with the exporting country or countries involved and only if it is clearly established that it is the exports of that country or those countries which caused the injury.

In the case of United States law, import relief takes place only after a thorough investigation with an opportunity for all parties to present evidence and to argue their point of view. While it would be difficult to ensure that

all countries seeking to invoke such provisions had similar procedures, we believe that at least the attempt should be made (as we understand it has been made in Geneva) to accomplish that end.

We do not believe that the time has come when nations will surrender their sovereignty to an international body which would make binding determinations. Nonetheless, we believe that the idea of surveillance by an international body should be acceptable. Since the United States has completely transparent procedures in the safeguard area, we should not hesitate to subject our findings to such review and comment. It would certainly make sense if we could ensure that other importing nations similarly subjected their findings to international review. We strongly support Ambassador Askew's testimony before the Ways and Means Committee on June 26, 1980, that structural improvements are needed in the world trading system and that the GATT "must be made the genuine international trade organization the world long has needed -- an institution by design and not by default." We believe that the present trading system is tilting too far towards a rule by power and away from a rule by law.

IX. PROTECTIONISM AND AN INDUSTRIAL POLICY

Our testimony today is intended to emphasize a fundamental idea. The United States needs to review and revise its trade policies to make them consistent with other industrial policies designed to encourage and support our country's economic restructure and revitalization. Also, as a beginning step, we must completely revise our antidumping and countervailing duty laws, to eliminate their protectionist bias, and to provide government officials with the flexibility and discretion essential for the administration of trade matters consistent with our broad national economic interest. Under the existing uncertain domestic and international economic situation, these changes are absolutely essential.

As we stated at the outset, the international trade environment is entering a new and delicate phase. Despite the self-congratulatory rhetoric accompanying the conclusion of the Tokyo Round of the MTN, the negotiations themselves were at best a holding action, and the post World War II international trade order shows signs of increasing instability. Worldwide problems of inflation, high energy costs and slow growth have created an uncertain international environment in which all economic institutions are strained.

Trade itself is not the problem. Trade did not raise the price of oil. Trade did not lower productivity. On the contrary, trade has made these problems more manageable by generating resources to purchase oil and creating competition to spur productivity.

Trade relations are severely affected by these problems, however. Protectionism always grows more attractive during troubled times. However, as Ambassador Askew has so wisely suggested, the pressure for protectionism is understandable but self-defeating. Ambassador Askew went on to say:

> If used as a crutch against legitimate competition, protectionism would shield and prolong inefficient production, increase inflation, decrease our standard of living, and generally cause us to continue our descent into a less competitive position internationally.

The threat of protectionism in a number of important product sectors is now endangering our trade relationships worldwide. The most publicized, of course, are steel, automobiles, and textile products.

We have already noted that the current trade crisis in steel was brought about by the actions of a single company, contrary to the wishes of the rest of the steel industry and our government. But what is perhaps most frightening

about this situation is that everyone was aware of what was happening, everybody wanted to avoid the situation, yet no one was able to because of the rigidities of the Antidumping Act. The steel industry itself knows that its problems are rising raw material prices, its failure to shift to new technologies, and rising labor costs. The problem is not imports from Europe, which have not grown in recent years and which represent less than 5% of the domestic market. The European countries will not be content to know that restrictions imposed on their exports technically satisfy our antidumping laws. There is no question that if restrictions are imposed, these countries will find some way to retaliate.

The situation in automobiles is similar. The Japanese did not force the big three automakers to continue building over-sized automobiles despite the quadrupling of world oil prices in 1973. The Japanese did not artificially restrain the price of gasoline in the U. S. market to delude the American people about the necessity of gasoline conservation. The Japanese did not raise interest rates in the United States to the point where it was impossible to finance automobile purchases. Imports are not the essential problem, and restraining imports will not provide a real solution. Nor will pressuring the Japanese to build automobile facilities in the United States, which will begin production five years from now, after the American automobile industry has undergone its process of adjustment, improve the industry's current economic difficulties. The difficulties of the automobile situation contribute greatly to a strained U.S. - Japan trade relationship, and give credence to Japan's perception that trade liberalization is intended to be a one-way street. As a result, our efforts to open up Japan's markets and reduce trade barriers in such areas as telecommunications are met with responses pointing to Japan's own

domestic political pressures. Unlike the steel case, the automobile case was brought under an appropriate statute -- the escape clause. If the ITC finds that imports are a substantial source of serious injury to the domestic automobile industry, appropriate relief can be granted -- flexible, temporary, non-discriminating. However, the recent request of President Carter for the ITC to accelerate its investigation of automobiles, while not contrary to law, raised the specter of Administration political pressure on the ITC to compromise its objectivity for election year considerations. Fortunately, the ITC rejected the President's request.

The automobile question is reaching a crucial stage, and the manner in which our government reacts will have an important bearing on our future trade relations. If the ITC finds relief to be appropriate, the President's determination on the form and amount of import relief also will have a strong influence on the overall state of U.S./Japan trade relations. Again, a strong politically oriented response will inevitably have severe adverse repercussions on trade relations between the two countries, and on the international trade environment.

Thus far in both the steel and automobile disputes our government is not the principal problem. In both instances, the Administration has maintained a reasonable and firm position against trade restrictions. The same cannot be said for the Administration's actions in the textile and apparel area. Textiles are the most regulated and restricted of all products in international trade. Yet the pressure for increased protection is insatiable. Unfortunately our government's reaction to these pressures has been to collapse acquiescently at every possible occasion.

We always seem to be confronted by textile problems. Yet the so-called White Paper is both a cause and a symbol of the severity of our present difficulties. The White Paper represents the model for a failed trade and industrial policy.

The White Paper commits the Administration to the textile and apparel industries health and growth. However, as noted above, particularly in the apparel industry, health and growth are not synonomous or even complimentary. The apparel industry can be healthy only if it adjusts to import competition, which will result in a competitive and productive industry, but one which is somewhat contracted. We are not unmindful of the difficult social problems involved in any adjustment process. However, as the Business Week exposition of reindustrialization (June 30, 1980) recognized, adjustment of this sort is the only rational policy for the apparel industry:

> This is another target for selective shrinkage. For the U.S. to produce, as it does, 90% of its apparel is an economic absurdity sustained only by the strongest protectionist measures.

The White Paper also served as a principal justification for last year's sorry spectacle of our Government pressuring the major textile supplying countries to further restrict their exports, contrary to the provisions of existing bilateral agreements, and contrary to the Multifiber Arrangement. How can the United States insist upon adherence to the GATT codes when we ourselves undermine the MFA?

We fear that the worst is yet to come. In this election year, pressure is mounting for this country to support regressive changes in the MFA at its renewal next year. The concept of a globalization and other changes being

sought by the domestic apparel and textile industries threaten the very foundation of the MFA. This can only lead to a breakdown in negotiations for extension of the MFA and the international textile trade order. We strongly urge that these pressures be resisted and that the MFA be renewed in its present form without a reasonable departures clause and with full adherence by the United States.

X. CONCLUSION

Trade policy is an area where private and public interests often come into conflict. Our government must have sufficient discretion and flexibility to protect private rights yet balance them with the competing broader public interest. We at AIA see the current trade policy framework as lacking the flexibility and discretion to perform this function properly.

The United States clearly faces a need to adjust to the domestic and international economic changes of the past decade. AIA believes that an integrated economic and industrial policy which recognizes international trade as an integral and growth-productive part of the domestic economy offers the United States the most successful path to economic health for the remainder of this century.

TABLE 1

U.S. MERCHANDISE-TRADE BALANCE 1/ 1970-1979
(Billions of dollars)

PERIOD	MERCHANDISE EXPORTS	MERCHANDISE IMPORTS	MERCHANDISE BALANCE
1970	42.5	39.9	2.6
1971	43.3	45.6	-2.3
1972	49.4	55.8	-6.4
1973	71.4	70.5	.9
1974	98.3	103.7	-5.4
1975	107.1	98.0	9.0
1976	114.7	124.1	-9.4
1977	120.8	151.7	-30.9
1978	142.1	175.8	-33.7
1979	182.1	211.5	-29.4

1/ Balance-of-Payments Basis.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

TABLE 2

U.S. MERCHANDISE TRADE[1] BALANCE BY MAJOR PRODUCT GROUPING

(Values in Millions of U.S. Dollars, FAS)

1970-1979

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
U.S. Merchandise Exports	43,224	44,130	49,778	71,338	98,506	107,652	114,992	120,163	141,126	178,578
Foods, Feeds & Tobacco	5,058	5,076	6,569	12,938	15,233	16,792	17,234	15,950	20,604	24,582
Crude Materials and Fuels	6,693	6,441	7,090	10,735	15,801	15,198	16,095	18,335	20,957	28,216
Manufactured Products	30,840	31,974	35,320	46,573	66,110	74,113	79,990	83,678	94,535	116,676
U.S. Merchandise Imports	39,952[2]	45,563[2]	55,582[2]	69,476[2]	110,251	96,116	120,678	146,817	171,978	206,327
Foods, Feeds & Tobacco	6,230	6,404	7,379	9,236	10,708	9,922	11,892	14,153	15,742	17,737
Crude Materials and Fuels	6,382	7,269	8,639	13,446	32,064	32,596	41,478	52,769	51,901	71,452
Manufactured Products	27,340	31,890	39,366	46,794	57,479	53,597	67,321	79,896	100,317	112,234
U.S. Merchandise Trade Balance	3,272	−1,433	−5,804	1,862	−1,745	11,536	−5,686	−26,654	−30,852	−27,749
Foods, Feeds & Tobacco	−1,172	−1,328	−810	3,702	4,525	6,870	5,342	1,797	4,862	6,845
Crude Materials and Fuels	311	−828	−1,749	−2,711	−16,263	−17,398	−25,383	−34,434	−30,944	−43,236
Manufactured Products	3,500	84	−4,046	−221	8,631	20,516	12,669	3,782	−5,782	4,442

1 Census Data Basis.

2 FAS values not available; data are on customs value basis.

Source: U.S. Department of Commerce: Highlights of U.S. Export and Import Trade, FT990, various issues.

TABLE 3

ALTERNATE MEASURES OF U.S. TRADE BALANCE 1/ TAKING OIL IMPORTS INTO ACCOUNT, 1975-1979

(Values in Millions of U.S. Dollars, FAS)

	1975	1976	1977	1978	1979
Nonoil Trade Balance					
U.S Merchandise Exports	107,652	114,992	120,163	143,663	181,802
U.S. Merchandise Imports, Excluding Crude Oil and Refined Petroleum Products from All Countries	71,307	88,892	105,434	132,874	150,281
Nonoil Trade Balance	36,345	26,100	14,729	10,789	31,521
Non-OPEC Trade Balance					
U.S. Merchandise Exports, Excluding Exports to OPEC	96,887	102,474	106,144	124,340	163,318
U.S. Merchandise Imports, Excluding Imports from OPEC	79,033	95,661	113,787	136,398	157,650
Non-OPEC Trade Balance	17,854	6,813	−7,643	-12,058	5,668
Nonoil/Non-OPEC Trade Balance					
U.S. Merchandise Exports, Excluding Exports to OPEC	96,887	102,474	106,144	124,340	163,318
U.S. Merchandise Imports, Excluding Crude Oil and Refined Petroleum Products from All Countries	71,307	88,892	105,434	132,874	150,281
Nonoil/Non-OPEC Trade Balance	25,580	13,582	710	-8,534	+13,037

1/ Census Data Basis.

Source: U.S. Department of Commerce, Highlights of U.S. Export and Import Trade, FT990, various issues.

TABLE 4

PETROLEUM CONSUMPTION ON MAJOR FREE-WORLD INDUSTRIALIZED COUNTRIES
1978-1979
(Thousands of Barrels Per Day)

Period	Total International Energy Agency (IEA) Membership 1/	United States	IEA Members, Excluding the United States	Japan 2/	West Germany
1973	34,050	17,308	16,742	5,000	2,693
1974	32,850	16,653	16,192	4,872	2,408
1975	31,700	16,322	15,378	4,568	2,319
1976	33,600	17,461	16,139	4,786	2,507
1977	34,810	18,431	16,379	5,015	2,478
1978	35,750	18,847	16,903	5,115	2,596
1979	35,800	18,434	17,366	5,170	2,664

1/ The 20 signatory nations of the International Energy Agency (IEA) are; Australia, Austria, Belgium, Canada, Denmark, Federal Republic of Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States. Except for the United States, inland consumption excludes bunkers, refinery fuel, and losses.

2/ Excludes liquified petroleum gases and condensates.

Source: U.S. Department of Energy, Monthly Energy Review, July, 1980.

TABLE 5

PER CAPITA PETROLEUM CONSUMPTION
IN MAJOR INDUSTRIALIZED COUNTRIES — 1978

(Barrels Per Capita Per Year)

Country	Barrels Per Capita/Year
United States	31.5
Japan	16.4
West Germany	18.1
France	14.8
United Kingdom	12.5
Canada	26.8
Italy	13.9

Source: U.S. Department of Energy Information Administration 1979 Annual Report to Congress Vol. II. January 1980

TABLE 6

U.S. CURRENT ACCOUNT BALANCE [1] 1970-1979

(Billions of Dollars)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Merchandise Trade	2,603	-2,260	-6,416	911	-5,343	9,047	-9,306	-31,503	-33,759	-29,469
Services	3,020	4,528	4,476	10,111	14,652	13,846	18,688	22,039	24,555	34,347
Net Transfers	-3,294	-3,701	-3,854	-3,881	-7,187 [2]	-4,613	-4,998	- 4,605	- 5,055	- 5,666
Current Account Balance	2,330	-1,434	-5,795	7,140	2,124	18,280	4,384	-14,068	-14,259	- 788

NOTE: Totals may not add due to rounding.

1/ Balance of Payments Basis

2/ Inflated by extraordinary transactions with India.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

TABLE 7

INDUSTRIAL PRODUCTION—MAJOR MARKET GROUPS AND SELECTED MANUFACTURES

(1967=100, seasonally adjusted)

DURABLE MANUFACTURES

Period	Primary Metals		Fabricated Metal Products	Non-Electrical Machinery	Electrical Machinery	Transportation Equipment		Lumber and Products
	Total	Iron and Steel				Total	Motor Vehicles and Parts	
1970	106.6	104.7	102.4	104.4	108.1	89.5	92.3	105.6
1977	111.1	103.8	131.0	143.6	145.4	122.2	161.1	131.2
1978	119.9	113.2	141.6	153.6	159.4	132.5	169.9	136.3
1979	121.2	113.2	148.5	163.6	175.0	135.3	160.0	136.9

NON-DURABLE MANUFACTURES

Period	Apparel Products	Printing and Publishing	Chemicals and Products	Foods
1970	101.4	107.0	120.4	108.9
1977	134.2	127.6	185.7	138.8
1978	134.2	131.5	197.4	142.7
1979	130.7	136.9	210.4	147.9

SOURCE: Board of Governors of the Federal Reserve System

TABLE 8

U.S TRADE BALANCE [1] in R&D-INTENSIVE AND NON-R&D-INTENSIVE MANUFACTURED PRODUCT GROUPS 1960-1977

(Dollars in millions)

	R&D-intensive			Non-R&D-intensive		
Year	Balance	Export	Import	Balance	Export	Import
1960	$ 5,891	$ 7,597	$ 1,706	$ -179	$ 4,962	$ 5,141
1961	6,237	8,018	1,781	-12	4,730	4,742
1962	6,720	8,715	1,995	-691	4,940	5,631
1963	6,958	8,975	2,017	-765	5,284	6,049
1964	7,970	10,267	2,297	-678	6,121	6,799
1965	8,148	11,078	2,930	-2,027	6,281	8,308
1966	7,996	12,174	4,178	-3,325	6,913	10,238
1967	8,817	13,407	4,590	-3,729	7,437	11,166
1968	9,775	15,312	5,537	-6,581	8,506	15,087
1969	10,471	16,955	6,484	-6,698	9,830	16,528
1970	11,722	19,274	7,552	-8,285	10,069	18,354
1971	11,727	20,228	8,501	-11,698	10,215	21,913
1972	11,012	22,003	10,991	-15,039	11,737	26,776
1973	15,101	29,088	13,987	-15,370	15,643	31,013
1974	23,873	41,111	17,238	-15,573	22,412	37,985
1975	29,344	46,439	17,095	-9,474	24,511	33,985
1976	28,964	50,830	21,866	-16,499	26,411	42,910
1977	27,627	53,169	25,542	-24,378	27,284	51,662
1978 [2]	29,566	63,908	34,342	-35,373	30,637	66,010
1979 [2]	39,309	79,126	39,817	-34,837	37,550	72,387

[1] Exports less imports

[2] Estimates based on National Science Foundation definitions

SOURCE: Department of Commerce, Domestic and International Business Administration, *Overseas Business Reports* August 1967, April 1972, April 1977 and June 1978.

Science Indicators—1978

TABLE 9

U.S. IMPORTS OF NON-COMPETITIVE PRODUCTS 1970-1979

(Values in Millions of U.S. Dollars, FAS) 1/

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Agricultural Products:										
Green Coffee	1,160	1,168	1,182	1,566	1,505	1,561	2,632	3,910	3,728	3,820
Cocoa Beans	201	181	151	212	317	321	358	483	667	555
Fuels & Lubricants	3,063	3,695	4,777	8,218	25,513	26,631	34,598	44,982	42,906	60,914
Manufacturering:										
Steel Making and Ferro-alloying Materials (unmanufactured)	734	783	863	961	1,353	1,743	1,872	1,853	1,849	2,201
Major Non-ferrous metals, crude and semifinished	1,849	1,706	2,007	2,221	3,417	2,722	3,595	4,041	4,859	4,853
Miscellaneous Nonferrous metals, crude and semifinished	334	268	346	769	1,385	823	898	915	2,934	4,383
Nonmetals Associated with Durable Goods Output, unfinished	712	708	761	1,057	1,688	1,427	1,649	1,989	2,127	2,568
Consumer Durables (unmanufactured)	526	533	724	943	897	859	1,186	1,646	2,232	2,173
Canadian Auto Trade	3,584	4,629	5,264	5,880	5,553	5,759	7,846	9,133	10,357	9,525
Total Noncompetitive Imports	12,163	13,669	16,075	21,827	41,623	41,846	54,633	68,952	71,659	90,992
Total U.S. Merchandise Imports	39,952	45,563	55,582	69,476	100,251	96,116	120,690	146,817	171,978	206,327
Share of Total Imports Accounted for by Imports of Noncompetitive Products	30.4	30.0	28.9	31.4	41.5	43.5	45.3	47.0	41.7	44.1

1/ Census Data Basis

Source: U.S. Department of Commerce, Highlights of U.S. Export and Import Trade, FT990, various issues.

TABLE 10

U.S. EXPORTS, IMPORTS AND TRADE BALANCES WITH MAJOR TRADING PARTNERS 1977-1979

(Millions)

	1977			1978			1979		
	U.S. Exports	U.S. Imports	Balance	U.S. Exports	U.S. Imports	Balance	U.S. Exports	U.S. Imports	Balance
Canada	25788.1	29598.6	-3810.5	28373.7	33525.0	-5151.3	33095.8	38099.3	-5003.5
E. C.	27091.7	22208.5	4883.2	32047.7	29006.0	3041.7	42582.2	33295.2	9287.0
Japan	10528.9	18549.7	-8020.8	12885.1	24457.7	-11572.6	17579.3	26242.9	-8663.6
Mexico	4822.0	4694.2	127.8	6880.3	6093.9	786.4	9847.2	8813.4	1033.8
Saudi Arabia	3575.1	6347.2	-2772.1	4369.9	5307.1	-937.2	4875.0	7983.4	-3108.4
Venezuela	3171.7	4084.4	-912.7	3727.7	3545.1	182.6	3931.3	5452.4	-1521.1
Iran	2730.8	2801.6	-70.8	3684.4	2877.4	807.0	1019.4	2783.7	1764.3
Brazil	2489.8	2240.5	249.3	2980.6	2825.7	154.9	3441.6	3118.8	322.8
Korea	2370.9	2883.1	-512.2	3159.8	3746.0	-586.2	4190.5	4046.8	143.7
Australia	2356.3	1185.0	1171.3	2911.9	1658.8	1253.1	3616.8	2164.2	1452.6
Spain	1875.2	970.8	904.4	1883.8	1256.7	627.1	2506.5	1304.3	1202.2
Taiwan	1798.1	3666.1	-1868.0	2341.9	5170.2	-2828.3	3271.3	5901.2	-2629.9
Soviet Union	1627.5	452.9	1174.6	2252.3	539.1	1713.2	3607.1	872.4	2734.7
China	117.4	201.4	-84.0	282.0	324.2	497.8	1724.0	591.4	1132.6
Nigeria	958.3	6499.1	-5540.8	985.4	4709.2	-3723.8	631.9	8161.5	-7529.6

Exports and
Imports FAS

Source: Highlights of U.S. Export and Import Trade, FT990, various issues

TABLE 11

WORLD TRADE BY AREAS, 1977-1979

(Billion dollars and percentages)

	Exports (f.o.b.)					Imports (c.i.f.)				
	Value			Change Over Previous Year		Value			Change Over Previous Year	
	1977	1978	1979	1978	1979	1977	1978	1979	1978	1979
World, excl. USSR, Eastern Europe, China, etc.	1,028	1,195	1,503	16.2	25.7	1,062	1,239	1,564	16.7	26.2
Developed Countries:	718	861	1,056	19.9	22.6	769	891	1,142	15.9	28.2
Oil exporting countries	144	143	202	-.7	41.3	85	101	104	18.8	3.0
Other developing countries	166	191	244	15.1	27.0	207	248	318	19.8	28.2
USSR, Eastern Europe, China etc. 1/	40	47	62	17.5	31.9	43	51	61	18.6	19.6

1/ Exports, f.o.b. basis,

Sources: IMF, Direction of Trade Yearbook 1980.

U.S. Council for an Open World Economy

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Statement submitted by David J. Steinberg, president, U.S. Council for an Open World Economy, in hearings on U.S. trade strategy before the Subcommittee on International Trade of the Senate Finance Committee, August 28, 1980

(The U.S. Council for an Open World Economy is a private, non-profit organization engaged in research and public education on the merits and problems of achieving an open international economic system in the overall public interest. The Council does not speak on behalf of any private interest. The following statement focuses on some of the Council's concerns in this policy area.)

Free-Trade Policy Needed

Current U.S. trade policy moves the nation basically, but not consistently and dependably, toward freer and fairer international trade. U.S. trade policy still does not feature a determined effort (a) to reduce trade barriers as quickly as possible, (b) to limit special import restrictions to situations where these are regarded as essential components of coherent programs of adjustment aid to deserving industries, and (c) to negotiate an overall free-trade commitment in concert with the other industrialized countries. The recently negotiated multilateral trade agreement is notable progress toward a more open international economic system; but it is much less than the world's richest countries are capable of, and it will achieve much less than the world desperately needs.

Current trade legislation, and the use that has been made of this negotiating authority, have, among other shortcomings, not adequately opened export markets for the developing countries and thus have not adequately contributed to the national export-expansion policy widely regarded as essential to the national interest. Neglect of the significance of the Third World as a present and potential market for U.S. exports reveals a huge void in the nation's understanding of what needs to be done to improve its trade performance and overall balance-of-payments position.

The serious statutory limitations on the freeing of entry for Third World goods have also denied the President greatly needed tools with which to secure dependable access, at equitable prices, to Third World raw materials essential to our national economic well-being. Attaining such access was declared to be a major objective of the Trade Act of 1974. Nothing has been heard of this objective since then from Congress or the Executive, or

(except for our Council) from private-sector advocates of freer world trade. The Trade Act did not provide the negotiating instrument needed for achieving a far-reaching partnership between the world's major users and the world's major producers of critical raw materials. A definitive free-trade strategy by the industrialized countries, together with an impressive foreign-aid policy, are essential to the politics and the economics of such a partnership. The tariff-preference program does not fit the bill.

A definitive free-trade strategy is also essential to stimulating the most efficient, the most productive performance from our own economy. It would spark maximum efforts to compete effectively at home and abroad and shift resources to the most productive uses in a rapidly changing and increasingly competitive world economy. Trade policy to date -- its zigs and zags, its stop and go -- is an uncertain trumpet, eliciting in too many cases an uninspired response. The effects on productivity, inflation and our overall competitiveness have been unfortunate. A free-trade premise must be factored into the decision making of government and business. It is essential to a soundly based policy of national economic development -- to the "re-industrialization" and "industrial policy" that have come to receive considerable attention. These new buzzwords will achieve far less than their potential without a free-trade premise calculated to point the nation's economic restructuring in the most productive direction. The nation today is fumbling with these new fads in policy formation, and will continue to do so at least until it sets its trade-policy navigation firmly in the right direction.

A free-trade strategy is also essential to complete reform of the code of fair international competition. Completely fair international trade waits on the impelling force of a completely free-trade charter. A free-trade charter, in turn, is contingent on total reform of the code of fair international competition.

In February 1978, there was a White House Conference on Balanced National Growth and Economic Development. Emphasizing that a free-trade policy induced the best kind of growth and development, and a protectionist trade policy the worst kind, I told the Conference that a free-trade premise factored into business and government planning "would stimulate the greatest resourcefulness in our dynamic economy, and the best utilization of resources in every sense." I urged the Conference at least to take account of the need for a proper trade policy in its recommendations on national growth and development. Mine was the only testimony to this effect. The Conference report said nothing about the international framework for soundly based growth and development in the United States. Today's attention to industrial restructuring and competitiveness also neglects such international-policy assumptions -- more particularly the free-trade premise our Council has emphasized.

A deliberate free-trade strategy is essential to other worthy

policy objectives. One of these is negotiation of agreements with Canada and Mexico to ensure adequate and equitable U.S. access to the vast energy resources of our immediate neighbors. There is no prospect of negotiating such an energy partnership without overall trade-policy reform that features a clear commitment to free trade in accordance with a realistic timetable, which for some products may have to extend to the end of the century. Because of understandable Canadian and Mexican concerns about being swamped by the size and power of the U.S. economy in any bilateral free-trade arrangement with the United States. the deals struck with these countries will have to be part of a much broader, multilateral free-trade framework.

Reform Industry-Assistance Policy

Such a free-trade initiative may be far down the road, written off by the faint hearted as just a policy vision belonging to visionaries. But the time has come at least to prepare for this strategy by preparing the U.S. economy to adjust to the contingency of free trade with the rest of the world. A major component of such domestic preparedness is the need to reform the way government responds to legitimate industrial demands for government help against injurious import competition. It is not too soon to reform the "escape clause" (the import-relief provisions of the trade legislation) to require that any government restriction of imports (including requests that foreign countries restrict their exports) must be only one component of a balanced, coherent, comprehensive policy of constructive, systematically reviewed aid addressing the real problems and real needs of that industry. Thus, for example, no textile import controls without a coherent textiles policy, no steel import controls without a coherent steel policy, etc. This means, among other things, integration of all justifiable relief measures extended to that industry into one composite adjustment strategy. Measures like Buy American strictures in defense appropriations and elsewhere must no longer enjoy immunity in sacred-cow sanctuaries, as is now the case with Buy American strictures on textiles, specialty metals and other products in the defense appropriations act.

The need to reform the "safeguard mechanism" of the General Agreement on Tariffs and Trade along these lines is clear and present. Failure thus far to negotiate this reform is a major failing of the highly touted multilateral trade agreement recently negotiated. The United States cannot seek the kind of "safeguard" reform needed until it reforms its own import-relief policy -- a step that should be taken unilaterally on its own merits for our own good. Reform of our own law in this field should require that the cost of import controls and other government assistance be determined annually by the President in financial and other terms, and be made public. The

industry to which this aid is given should make commitments, subject to government veto in their overall thrust, on the kinds of adjustment measures it intends to take with this government help provided at public expense. The public should know what it is going to get for its money. The old "pig in a poke" style of escape-clause relief must end. It has gone on for too long.

A first step toward this reform in import-relief policy can and should be taken immediately within the parameters of existing legislation. This would require the International Trade Commission to carry out fully the letter and spirit of Section 201(b)5 of the Trade Act of 1974. The Commission has been neglecting this provision, and so has the Executive. Neither has shown much imagination in this respect.

Under 201(b)5, the Commission, "for the purpose of assisting the President in making his determinations" in import-relief cases where serious injury is found to have occurred or to threaten, is required to "investigate and report on efforts made by firms and workers in the industry to compete more effectively with imports." In its commentary on this requirement, the Senate Finance Committee's report on the "Trade Reform Act of 1974" (page 122) states: "The escape clause is not intended to protect industries which fail to help themselves become more competitive through reasonable research and investment efforts, steps to improve productivity and other measures that competitive industries must continually undertake."

Commission investigation and evaluation in this regard, explicitly required by law as essential to the President's fulfillment of his responsibilities under that law, implicitly call for Commission inquiry (and Presidential judgment in the escape-clause cases that reach him) on the extent to which government domestic policy (statutes, regulations, etc.) may unfairly be impeding or impairing industry efforts to become more competitive against foreign competition. To the extent that unfair and inexcusable impediments or impairments of this kind exist, they should be corrected. Such reforms belong in a coherent policy of government assistance to an ailing industry, regardless of what government action may be taken concerning the imports in question. If the ITC finds statutory or regulatory inequities adversely affecting the petitioning industry's adjustment efforts (regardless of whether the Commission finds serious injury or threat thereof), it should explicitly bring these matters to the President's attention.

For his part, the President should lose no time in couching any escape-clause assistance in comprehensive industry-adjustment terms, including (if necessary) requests for Congressional action

authorizing measures that may be needed but are not currently sanctioned by law. He should annually assess the cost of whatever aid is provided. The President can proceed along these lines right now without new legislation.

Reform the National-Security Clause

The simplistic, pig-in-a-poke shortcomings of the import-relief policy are also characteristic of the national-security clause of the trade legislation. The national-security clause mandates only one remedy (import control) for import-related impairment of the mobilization base. It requires no coherent, coordinated program for strengthening that sector of the mobilization base, and requires no systematic review of the action taken so as to ensure its adequacy and effectiveness. The action on imports tends to divert attention from the other steps needed to ensure correction of the particular weakness in national security. Thus, the national-security clause tends to be a threat to national security.

The history of the oil import controls established under this authority (oil is the only product to which the national-security clause has been applied) attests to the validity of this charge. The remedial action needed on the national-security clause is similar to the remedies proposed above for import-relief policy. Thus, no oil import controls without a coherent oil strategy addressing the nation's real needs in this field. With such a policy in the 1950's (when the national-security clause was enacted), today's energy crisis, placing the nation's economy and security in such jeopardy, might have been prevented or at least materially alleviated.

Government Organization Inadequate

The recent consolidation of trade negotiating functions in the U.S. Trade Representative is a useful reform. As are the steps taken by the Department of Commerce to strengthen its export expansion program, launch a conspicuous effort in the areas of productivity and innovation, and create the new post of Under Secretary of Commerce for International Trade to underscore the Department's priority concern with international-trade responsibilities. However, the government is still not adequately organized in this and closely related policy areas. My reservations on this point do not mean I advocate a single, all-inclusive Department of International Trade and Investment. My proposals are along other lines.

One of my concerns is the failure of the recent trade reorganization to create an adequate inter-agency structure to deal with

the domestic-policy backstop for optimum progress toward existing trade-policy objectives and to program the domestic-adjustment measures needed to secure and sustain the definitive free-trade policy which belongs on our national agenda. Another concern is the need for incisive inter-agency planning that integrates trade policy with other areas of foreign economic policy, including the close coordination of "national export policy" (another buzz word) with import policy, foreign-aid policy and overall national development strategy.

For these purposes, there should be, coordinate with the National Security Council, an inter-agency National Development Council (to coordinate national strategy in economic development, adjustment and productivity) and an inter-agency Council on Foreign Economic Policy (to coordinate national strategy in the various areas of foreign economic policy). The President should chair both, and the respective executive vice chairmen (who should have no other functions) should be subject to Senate confirmation.

To its credit, the Department of Commerce has established an Office of Productivity, Technology and Innovation, to be headed by an Assistant Secretary. There is also an Assistant Secretary for Economic Development (heading the Economic Development Administration). But these (and possibly certain other areas of Commerce responsibility) should be coordinated by an Under Secretary of Commerce for Development and Productivity, one of whose missions would be industrial preparedness for the free-trade commitment that merits priority attention and whose necessity will be more widely seen as the years pass. The symmetry of an Under Secretary for International Trade and an Under Secretary for Development and Productivity is an appealing prospect, signifying balanced treatment of closely related national objectives.

Another administrative failing is the fact that the International Trade Commission has not had its full statutory complement of six commissioners for nearly two years (since September 30, 1978). Among other causes, this may suggest Presidential failure to give trade policy the attention it deserves -- an impression the President should quickly dispel. There does not seem to be any Congressional concern over this matter. If a sixth commissioner is in fact not really needed, the sixth slot should be terminated, at an annual saving of over $50,000 in taxpayer's money.

Policy Fumbling in Steel and Autos

The lack of coherent, well-structured government concern with domestic adjustment problems is illustrated in the following. In

the mid-1960's, an inter-agency task force to deal with problems in coal production and exports was chaired by (of all people) the Secretary of Defense (no personal commentary is intended). In 1977, an inter-agency task force to study the problems of the nation's steel industry was headed by (of all people) the Under Secretary of the Treasury for International Monetary Policy (no personal commentary is intended). This task force proposed various measures to help the steel industry, but very little except the highly questionable trigger-price mechanism was put in place (recently suspended). Only now is a comprehensive steel-aid package coming to the fore, notwithstanding the fact that the government-industry-labor tripartite advisory committee on steel has been in existence since 1977. Even then, there is cause for great concern over the trade-policy orientation of this aid policy. For optimum results in the total national interest, a free-trade premise needs to be cranked into a steel-aid policy (with special provisions for handling unfair trade practices). But the nation is not equipped to do this, reflecting serious inadequacies in both trade policy and domestic-adjustment policy.

The government has inched toward a policy to assist the automobile industry. But its efforts on autos are as fumbling as they have been on steel. Steps being taken on these major industries are called prototypes of the "industrial policy" on which so much is written and so much is staked. Such prototypes are cause for apprehension. The auto-aid package has been called "a step in the right direction" and a "down payment". Why has it taken so long, what is it a step toward and a down payment on? What is the auto-policy objective, and what is its trade-policy premise? Defining the "end" has an important bearing on determining the "means".

What passes for an auto-aid policy began on an ad hoc company-aid basis with the bail-out of Chrysler. This was soon followed by an industry-aid package providing a limited assortment of relief measures in domestic policy, and a request to the International Trade Commission that the ITC accelerate its consideration of the auto union's escape-clause petition. The request to the ITC seems to suggest Administration interest in obtaining authority to seek some form of restraint on auto imports, and obtain it prior to the November election. Whatever the merits of all these steps, the President should lose no time in outlining a total transportation strategy and in seeking a free-trade agreement on autos and auto parts (consistent with the General Agreement on Tariffs and Trade) with as many producing countries as may agree to participate -- denying most-favored-nation treatment to those who for the time being may not. A free-trade strategy on autos would aim at removal of foreign barriers now blocking U.S. access to foreign markets for

these products and at ensuring the best domestic policy to redesign the domestic automobile industry. It would raise the sights of the whole international dialogue on this subject. A total transportation development strategy would, among other benefits, help generate new job opportunities to absorb auto workers whose jobs in automobile production may be permanently lost because of automation and other causes.

Conclusion

On September 2, 1974, in a farewell statement as the last executive director of the Committee for a National Trade Policy, I said:

> "Notwithstanding the impressive strides the nation has made in the past quarter century toward building a freer and stronger world economy, America is seriously unprepared at this time for the far-reaching international economic strategy urgently needed to combat world-wide inflation, get the industrialized countries to cooperate effectively on a wide range of crises, form an equitable partnership between the world's developed "north" and its underdeveloped and resentful "south", and in general build the kind of world economy, as open as possible, in which the American economy can operate most productively.
>
> "Deliberate, dependable progress toward an open world economy is not just an ideal for visionaries to muse over. It is a policy imperative for government to program with deliberate speed. No aspect of this initiative is more urgent than the need to program unrestricted access to the industrialized countries for the complete range of exports from the developing countries. One major purpose is to change dramatically the whole climate and psychology of relations with the Third World and in this way improve the prospects of getting oil prices reduced and inducing Third World exporters of other critical materials to refrain from following the damaging, price-hiking example of the oil cartel.
>
> "America's unpreparedness for these critical initiatives in foreign economic policy is matched and to a large extent caused by unpreparedness for the domestic strategy needed to backstop steady progress toward these international objectives. There is no national adjustment policy worthy of the name -- no coherent, convincing program to facilitate adjustment both to the opportunities and the difficulties which a more open world economy will generate. Various industries may need and deserve government help. But the nation does not have and is not planning coherent policies of government assistance that project rapid, constructive adjustment by these industries without hurting consumers and other sectors of the national interest. Nor is there an adjustment strategy that convincingly assures American workers, millions of them fearful of the effect of an open world economy on their jobs and living standards, that they have everything to gain and nothing to lose from the free international flow of goods and capital."

This is still my view.

BEFORE THE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON INTERNATIONAL TRADE
UNITED STATES SENATE

Hearings on U.S. International Trade Strategy
September 17, 1980

STATEMENT OF MILLERS' NATIONAL FEDERATION
Wayne E. Swegle
President

The Millers' National Federation is the national trade association of the flour milling industry of the United States. Our members represent approximately 87% of the commercial flour milling capacity in the United States. There are flour mills located in over two-thirds of the states.

The Millers' National Federation speaks on behalf of its members on matters of general industry concern, including international trade. The Federation has been active in international trade matters on behalf of its members since approximately 1952.

The Millers' National Federation submits this statement in response to the Subcommittee's request for

comments on the changes in U.S. economic thinking and behavior needed to prepare the American economy for the economic competition of the 1980's and alternative approaches to improving U.S. competitiveness in international trade.

From the standpoint of U.S. flour millers, the marginal effect of exports on the industry is extremely important. The competitiveness of U.S. flour in international markets has been seriously erroded over the past two decades due to the practice of the European Economic Community (EEC) of subsidizing its exports of wheat flour to third country markets. In the early 1960's, the United States was the world's major supplier of wheat flour, followed by the EEC, Canada and Australia in that order. By the beginning of the 1970's, the EEC had moved into first place and continues to increase its world share while shares for each of the others have declined.

The EEC now dominates the world flour market as a result of its subsidy and U.S. wheat flour is unable to compete. Time after time, in country after country, U.S. offers to sell are lost to lower prices offered by the EEC which is aided by its subsidy policy of reducing prices to assure export acceptance.

The Millers' National Federation has sought relief from the EEC's subsidies practices through Section 301 of the

Trade Act of 1974. Its case, Complaint No. 301-6, was filed nearly five years ago. The Federation's case is one of the oldest pending Section 301 cases which remain unresolved.

The 301 case filed by our industry fits squarely under the provisions of Article XVI of the General Agreement on Tariffs and Trade (GATT) and the Subsidies Code negotiated during the multilateral trade negotiations and which has now been in effect for nearly nine months. We believe that a principal change needed in U.S. thinking and behavior is to assure that government officials responsible for U.S. international trade problems become more responsive and aggressive in responding to trade problems affecting U.S. industries, especially by making prompt and full use of available tools such as the GATT and the new nontariff codes.

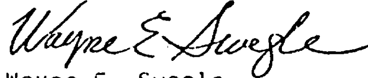
In a related vein, the economic well-being of our nation can also be enhanced by moving from a policy of emphasizing exports of raw materials to a policy of exporting processed or manufactured products. This is highly appropriate policy for a developed nation such as the United States, and one which should be encouraged by the Congress. Such a policy creates additional jobs and would contribute to increased productivity. In the case of flour milling, for example, additional jobs would be created not only in mills, but in the

area of transportation, bag manufacturing and the manufacture of additives, to name a few.

Agricultural exports remain essential to the American economy. Agricultural exports are going to continue to be critical to our effort to diminish our balance of trade deficits. The U.S. government must do more to remove barriers such as the EEC's subsidies on flour so that we may compete effectively with our trading partners in the world marketplace.

The Millers' National Federation commends this Subcommittee's continuing oversight of U.S. trade policy. We urge that you continue to keep a watchful eye to ensure that instruments available for enforcing U.S. trade rights are effectively and vigorously used.

Respectfully submitted,



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STATEMENT OF
RONALD L. DANIELIAN
EXECUTIVE VICE PRESIDENT
INTERNATIONAL ECONOMIC POLICY ASSOCIATION
SUBMITTED TO
SUBCOMMITTEE ON INTERNATIONAL TRADE
SENATE COMMITTEE ON FINANCE

September 17, 1980

The International Economic Policy Association is a nonprofit research organization established in 1957 which has studied international economic issues, including balance of payments, trade, investment, tax, and raw materials and foreign policy issues. We have published three books on the U.S. balance of payments, participated in a major work on raw materials and foreign policy issues, and have appeared before congressional committees on these and other international economic issues affecting the U.S. national interest.

We are pleased to see that the Congress has recognized that U.S. competitiveness in international trade is a critical subject which must be addressed by our Government. The ability of our nation to finance its expenditures abroad for aid and military purposes and to pay for needed imports depends upon our ability to maintain and increase export market shares and be competitive with foreign nations in the export of both goods and services. We must always remember, as Woodrow Wilson said, "We are participants, whether we would or not, in the life of the world."

The United States can no longer treat the international sector as separate from the mainstream of economic activity. It can no longer be accorded second priority to domestic political and economic considerations. U.S. two-way international merchandise trade has more than doubled to 17 percent of GNP in less than a decade. Yet, economic policy decisions

continue to be made on the basis of domestic considerations only, perhaps contrary to the national long-run interest, including its international business opportunities.

Of course, Government policy by itself cannot solve our present economic problems. The whole panoply of factors hampering U.S. competitiveness must be attacked via a comprehensive effort that involves labor and business as well as Government. This effort must focus on such issues as capital formation, business taxation, Federal regulation, including environmental constraints, technology--and especially productivity--and our own disincentives to U.S. exports, as well as foreign discrimination against U.S. trade and investment and other forms of unfair competition. We must also deal with our sick industries--automotive and steel, for example--in ways which will make them competitive again and are also consistent with our international trade commitments and our own national interest in maintaining an open international economic environment.

Over the next decade, all of these issues will be framed by recurring economic tensions.

I. Energy: The Number One Economic Problem of the Decade

The staggering cost of imported oil--estimated to be some $80-$90 billion for 1980 for the United States--is reason enough for public support of an aggressive export practices program. Simultaneously and independent of this policy, it is even more important that we and the other industrial countries start moving forward aggressively to a comprehensive energy policy. Such a policy should seek to lessen dependence on imported oil and to restore a more effective counterweight to the power which OPEC now holds

over world petroleum markets. The support of the LDC's must be enlisted in this effort for they are not only a critical factor in world interdependence, but they are also major losers in the international oil game as it is now being played.

The high and continuing upward spiral for the cost of energy is ruining the hopes of the LDC's for their own development--and indeed their financial viability, and this is impacting on the developed economies as well. Consider, for instance, that in 1978, 38 percent of all U.S. exports went to developing nations (26 percent to non-OPEC nations). For their and our economic stability, a "South-South" dialogue[1] must replace the misplaced emphasis on the North-South dialogue, so that the major OPEC producers will feel themselves under heavier political pressure from the Brazils, Indias, and Yugoslavias of the world to moderate their oil pricing and availability policies. Perhaps then it will be possible to implement such longer term stabilization schemes as those proposed by the Commission On International Development Issues[2] chaired by Willy Brandt, or such variants

[1] In testimony before a subcommittee of the House Foreign Affairs Committee on June 19, 1980, Dr. Timothy W. Stanley recommended that the time had come to break off the unproductive parts of the North-South dialogue and for the North to tell the South, starting in the United Nations at this summer's Special Session on Development: "Don't talk to us about economic justice and wealth redistribution. Go and talk to OPEC. We no longer have the resources to help you, because OPEC is taking them from us. We have to deal not only with our own oil costs (and their effect on our own 'disadvantaged' people) but also with the capital costs of achieving energy independence. So we cannot also deal with the problem of your oil bills. You must work out directly with OPEC, or through the IMF-World Bank, the necessary arrangements to finance them."

[2] North-South: A Program for Survival, Report of the Independent Commission on International Development Issues under the chairmanship of Willy Brandt, (MIT Press, Cambridge, April 1980, p. 170).

as a special "international development tax" on oil moving in international trade but keyed to stable real prices for oil.[3] This will have a positive impact on developed and developing countries alike.

Hopefully, by the early nineties this comprehensive energy policy will have generated enough new non-OPEC energy sources, which in combination with conservation, will restore some balance to the international oil market. However, we still must get through this decade without experiencing an international financial catastrophe which some experts now fear to be more likely than in 1973-74, as OPEC piles up annual surpluses estimated at around $125 billion over the next few years.

An indication of the great market power than OPEC now holds can be conveyed through the phenomenon of the backward bending supply curve or what we might call "negative" elasticity: the higher the price, the less is produced, and the higher still goes the price! So, even in a period of world recession and glut, OPEC is still able to raise prices. OPEC, therefore, can continue to cut production, to raise the price per unit, and increase its total revenue. The dismal effects of these policies in causing recession, slow growth, and inflation in industrial and oil-importing developing countries, though long perceived by many analysts, are finally getting higher official attention and public understanding. The Venice Summit communique says, with regard to energy price and availability, that "unless we can deal with the problems of energy, we cannot cope with other problems . . . "

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[3] "The North-South Dialogue: An Unorthodox View," statement of Timothy W. Stanley before the Joint Subcommittees on International Economic Policy and Trade and on International Organizations of the House Foreign Affairs Committee, June 19, 1980.

The May 1980 World Economic Outlook published by the staff of the IMF says bluntly that "The world economic picture is rather grim . . . severe worldwide inflation; a general pattern of slow growth of output, with a threat of recessionary tendencies . . . a sudden and major worsening of the distribution of balances on external current account among the major groups of countries--resulting mainly from the rapid escalation of world oil prices during 1979 and early 1980."[4] The most recent IMF economic report of June 1980 is equally blunt.

As far as U.S. energy policy goes, the steps taken thus far are in the right direction of allowing market forces to operate to curb demand and stimulate supply; but the leadtimes are long and the consequences of ever-rising energy costs are going to be painful, no matter how inescapable they may be. If the "negative elasticity" problem worsens--or if any of the numerous contingencies which threaten the Middle East oil supply should actually occur, then more drastic actions will be needed. These may have to include rationing and more direct government involvement on the supply side, or even more forceful steps. At a minimum, the United States should proceed to fill its strategic petroleum reserve, as Congress is now mandating. More could also be done in coordination with the other IEA members to try to counterbalance OPEC's ability to keep the consumers divided and above all in restraining them from panic buying on the spot market--the cause of much of last year's Iran-stimulated shortage mentality and price escalation.

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[4] IMF Staff Paper, World Economic Outlook, May 1980.

Energy dislocations have caused massive trade imbalances with industrial oil-importing countries and for LDC's as a group. Also the non-oil developing countries have acquired large amounts of international indebtedness, posing threats to the stability of some individual private lending institutions as well as to the international financial system.[5] Countries such as Brazil are spending most of their foreign exchange on either debt service or imported oil, furthering the tendency toward stagflation in the economy.[6] Pressures to export have intensified greatly as have pressures to protect the domestic market as all oil-importing countries scramble for ways to earn the foreign exchange to pay for the oil they so desperately need. Yet any slide backwards into world protectionism could merely compound disaster.

For the United States, the energy crises of the 1970's have caused painful adjustments. We have gone from a low price energy-intensive society to a high cost energy-mindful nation in 7 years with personal incomes being squeezed and corporate investments being curtailed. Internationally, we have been beset by trade and balance of payments pressures. More critically,

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[5] Some estimates place the LDCs' 1980 oil bill at $60 billion. Since the group will also have small deficits or at best a balance in their non-oil trade, and since their total capital inflows, including aid, are largely offset by debt service and repatriation flows, their combined net deficit may be nearly that much. With many developing countries at their commercial borrowing limits, unless the OPEC members or the OECD countries and the international lending institutions can provide financing to cover this amount, the only means of "paying" this deficit is through the printing press--thus further exacerbating world inflation and currency instability.

[6] In 1980 Brazil's projected foreign exchange earnings will go over half for foreign debt service and amortization, and over a third for imported oil, leaving very little for everything else, including purchases from the United States and elsewhere!

we are becoming a nation that must rely on others, both for energy and capital. In fact, we have changed from being capital exporters in the 1950's, 1960's and part of the 1970's to a position where we must have capital imports to sustain our international economic activities. The massive transfer of paper dollars, which are future claims on our productive resources, to pay for oil have caused havoc with our trade and payments balances.

II. Floating, Inflation and U.S. Trade

Nevertheless, in 1980 we may be falling into the trap of blaming all our trade problems on oil and relying on floating exchange rates (and the dollar depreciation) to solve the negative U.S. trade swing. But floating and dollar depreciation cannot make up the magnitudes involved in our deficits of the past few years. To rely on floating to increase our competitiveness may give illusory gains. In today's world of post-oil embargo slower growth, the hands-off floating approach to U.S. international monetary policy will not solve our problems. In addition, it is difficult to formulate U.S. export policies aimed at earning needed foreign exchange while emphasizing dollar depreciation as a key factor in our export recovery. Analysis of recent figures indicates that parity shifts have a muted trade effect on the U.S. balance of payments. Our trade balances (in dollar terms) with those countries against whose currencies the dollar depreciated most heavily do not seem to be improving with any consistency, certainly not in line with the radical movement of the dollar over the last few years. The improvements that have occurred are not enough to cover the magnitudes of our trade deficit and may have more to do with slower growth in the United States vis-à-vis our trading partners than the depreciation of the

dollar. In fact, both the Wharton LINK model and the IMF's world trade model "show conclusively that year-to-year changes in the volume of imports and exports are dominated by variations in real aggregate demand."[7] Certainly, the world cannot return to the old Bretton Woods fixed exchange rate system but neither should countries rely solely on the present system to remain competitive.

Floating exchange rates are used for adjustments of internal and external imbalances among national economies. Under a floating exchange rate regime the exchange system should equilibrate both the net capital flows and the current account trade in goods and services. For the United States (a deficit country) the depreciating dollar should increase the ability of American exporters to sell more products abroad through an increase in our price competitiveness. At the same time, imports will become more expensive to Americans in dollar terms and this will reduce them, first in volume terms and later (hopefully) in value terms. On the capital account, private holders of wealth would be induced to buy our assets (at a depreciated or bargain price) and thus finance the deficit. At the same time, it was felt that with the automatic adjustment of floating rates, countries can afford a greater independence in designing their macroeconomic policies. But as the United Kingdom and now the United States have learned, floating exchange rates will not equilibrate the payments imbalances in the face of domestic economic policies that feed inflationary pressures. Under such policies, trade balances have not been corrected and capital inflows have not increased without substantial increases in interest rates

[7] See "Fixed and Flexible Exchange Rates: A Renewal of the Debate," by Jacques Artus and John Young in Staff Papers, International Monetary Fund, December 1979, p. 669.

Prior to the use of floating, up through the period of 1971-73 when the "adjustable exchange system" was attempted, balance of payments adjustments were accomplished in several different ways. First, countries could use fiscal and monetary policies internally to affect the level of aggregate demand in economic activity, but under this approach deficit countries would have to deflate and surplus countries stimulate domestic economic activity so as to include more symmetry in the payments system. Second, countries could make periodic changes in the parity level of their currency with a devaluation (for a deficit country) or a revaluation (for a surplus country). However, the practice throughout the 1960's showed the world that such changes were usually delayed until a crisis compelled action, with the devaluing country more likely to act than the country enjoying a surplus. Moreover, the dollar, as a world reserve currency was fixed in value in relation to gold. In any dollar devaluation, the gold-related par value had to be officially changed. However, even then (as now) the acceptance of our major trading partners was needed since any devaluation of the dollar meant that other countries would allow revaluation of their currency. Third, restrictions could be placed on trade and capital flows which, in effect, mask the imbalance in the balance of payments. The United States tried both types of restrictions, imposing them on capital and direct investment outflows in 1968 and an import surcharge in 1971. The effects of both were more cosmetic than real with the capital and direct investment controls giving rise to "paper" balances only.

The unsettled international monetary affairs of the late 1960's and early 1970's led to the abandonment of the fixed exchange rate system. In 1971, the United States officially demonetized gold, and in 1973 a de facto floating exchange rate system was established. Between May of 1970--just

before the 1971 crisis--and the end of the first quarter of 1975, the dollar depreciated by almost 21 percent on a trade-weighted basis against 10 major currencies.[8] Nevertheless, from January 1971 through December 1974 the United States sustained a cumulative trade deficit of $13.1 billion, which was the first such deficit since the turn of the century. The depreciating dollar finally did have an impact on our trade account by 1975 when the United States achieved a record surplus of $9 billion. However, a more significant causal factor in bringing about this reversal came from the sharp recession in the United States in 1974-75 which helped hold down imports, while exports were supported by the continued growth of our trading partners who followed the U.S. economy into recession after a lag of 8 months or so. Nevertheless, economists believe it took up to 24 months for the effects of devaluation (1971 and 1973 combined) to produce a positive trade impetus. Thus, the cumulative effects of two depreciations plus a recession finally impacted favorably in our trade account.

In 1976 the dollar remained relatively stable against the mark and the yen and appreciated against other major currencies. However, in 1977 the dollar came under attack and suffered an almost 8-percent depreciation against the DM.[9] Table 1 shows the dollar movements between years from 1974 to 1979, based upon the yearly average exchange value with the key currencies listed. However, against 22 of the world's leading currencies (including all of Western Europe, Japan and Canada), the trade-weighted value of the dollar

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[8] Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland and the United Kingdom.

[9] Based on the change between the average exchange rate of 1976 and 1977. During 1977 the monthly changes fluctuated + or - to a greater degree.

declined by only 4.7 percent in 1977, 8 percent in 1978, but appreciated by 3.9 percent in 1979.[10] Nevertheless, the wild swings within any one year were substantial and the staff of the House Subcommittee on Trade indicated, in a report on causes of 1977 trade deficits, that "during 1977 the dollar has depreciated in value an average of 15 percent. Under classic theory, this should make our exports more attractive and by making foreign goods more expensive, discourage imports. It appears, however, that there is a considerable lag time before exports increase substantially.[11] In the meantime, imports are much more likely to increase in price and we suffer an inflationary effect. Whatever the effect of floating exchange rates, exports have so far not increased enough to balance rising imports."[12]

A comparison of the U.S. trade balances (Table 2) for selected major U.S. trading partners with the yearly change in those balances and the exchange rate movements (Table 1) shows that there has been little correlation between currency and trade movements for the United States. Where there has been a depreciation from one year to the next we should have recorded a positive trade movement over time, and where there has been an appreciation, we should have recorded a negative trade movement. A weakening of the dollar against a particular currency should be corrected, over time,

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[10] Based on end-of-period index of trade-weighted value of the dollar from IV quarter to IV quarter; June 1979, March 1980, Survey of Current Business.

[11] This lag can be generally 18-24 months. Also, on the import side, the pass-through of the import unit values--and thus import cost increases--is much quicker and is complete usually within one year. See, "Effects of Exchange Rate Changes," by Erich Spitäller in Staff Papers, International Monetary Fund, June 1980, pp. 320-348.

[12] Hearings before the Subcommittee on Trade, House Committee on Ways and Means, November 3 and 4, 1977, p. 17.

by a reduction in our deficit with that country or an increase in our surplus. Admittedly, this pattern is not expected to be instantaneous but it should show up eventually. For instance, from 1975 to December of 1978 the dollar depreciated by 34 percent against the yen. However, our trade deficit with Japan steadily increased. Only in 1979 was there an improvement after dollar/yen depreciations of 9.6 percent and 28.5 percent in the two preceding years. The improvement was almost $3 billion but that seems minor compared to a 34-percent depreciation which escalated imported car prices over time, and created an inflationary impact associated with other imports from Japan. In addition, the world pressure on Japan to pursue a growth policy and accept quantitative controls on their exports probably had more to do with this correction. In the case of West Germany, the dollar depreciated by 23.4 percent during the same (1975-78) period, and while our deficit was reduced moderately in 1976, it widened considerably in 1977 and remained high in the face of continued dollar depreciations in 1978. Only in 1979, when on top of previous depreciations, the dollar fell another 9.4 percent did our trade deficit with Germany improve. However, such a small improvement relative to the substantial depreciations over the years seems to bear out other empirical evidence on the trade adjusting efforts of devaluations. (See footnotes Nos. 7 and 9.)

A major moderating factor against positive trade effects of depreciation of the dollar has been the fact that between 64 and 66 percent of U.S. trade was with countries whose currencies were tied to the dollar or else experienced greater devaluation, such as Canada, our biggest trading partner. Thus, we did not benefit from a price advantage standpoint with these countries through the continued devaluation of our currency. Table 3

68-425 O—80——28

shows that only about one-third of U.S. trade (Group I countries) in 1977-79 could have been responsive to the exchange rate adjustments. Further, it is only with a handful of these nations such as Japan, Germany, France, and (in the last year) to some extent England, that we have been able to achieve any kind of price advantage through devaluation. However, we would have to rely on them to buy approximately $15-$20 billion worth of additional U.S. exports to help improve our trade deficit. But as Tables 1 and 2 have shown, devaluation has not had much impact (certainly not on the order of magnitude necessary) on our dollar balances with these countries.[13] Our ability to massively increase exports to these countries is limited by various tariff and nontariff barriers. While the theory of floating exchange rates would dictate that a balance would occur over time, politically it is difficult to see how these countries could absorb the kind of a net increase in exports we need to correct our imbalances. In addition, the currency of a large number of the countries listed in Group I of the table moved only 6 percent or so against the dollar and that narrow adjustment was mostly overtaken by the rise in U.S. export prices due to our 6.8, 9.1, and 11.3 percent inflation in 1977, 1978 and 1979 respectively. The IMF notes, for instance, that in 1977, U.S. export prices increased by 4 percent. Furthermore, the composition of U.S. exports, with 20 percent in agricultural products, also hampers the automatic adjustment mechanisms of floating. In this area of export trade, currency

[13] The U.S. Treasury has noted that the volume of U.S. exports has indeed increased with large credit given to dollar depreciation. The problem is that we have sacrificed our terms of trade. The unit value of our exports has increased less than that of our competitors. We are exporting more real goods, getting less for them, unable to cover our import costs, and suffering some inflationary bias due to depreciation. See Business Week, July 21, 1980, p. 88

adjustments will not overcome such hindrances as the Common Market variable levies and other protectionist national policies.

Parity changes through floating do not impact directly upon the cost of our largest single import--oil. However, recent U.S. attitudes concerning dollar depreciations do affect the strength of OPEC desires to raise prices to compensate for a weak dollar and thus add to our trade and overall payments deficits. The erosion of the dollar's purchasing power through inflation also impacts on OPEC attitudes about the U.S. economic strength and it raises OPEC's real cost of imports from France, Germany, Japan and elsewhere. In addition, by adding to our overseas payments imbalances the quadrupling of oil prices in 1973-74 has skewed policy perceptions of our trade problems. In 1978 and 1979 imports of petroleum cost the United States $42.3 and $59.1 billion respectively, which was an inflated cost due to the OPEC cartel. It is not appropriate, however, to subtract these total amounts from our trade accounts when analyzing the U.S. trade deficit. Since America would have continued to import oil, and assuming that increases in the average cost of all U.S. imported oil since October 1973 had been tied to the CPI, our oil imports (based on actual volumes used) would have cost us only about $23 billion in 1978 and $26 billion in 1979. Thus, notwithstanding OPEC's price manipulation, the U.S. cost for oil at precartel prices (with adjustments for inflation) would have been below our $34.2 and $29.5 billion trade deficit in those years. Thus, even excluding the cartel-fueled increased cost of energy, U.S. trade would have been in deficit.

The notion that floating will also equilibrate movements on the capital account and thus balance, over time, the overall balance of payments disequilibrium, comes into play only if appropriate domestic fiscal and monetary policies are followed.[14] Nevertheless, one of the persuasive

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[14] Artus and Young, Staff Papers, p. 826

arguments used in 1971 for going on the floating exchange rate system was that it would free U.S. domestic policy and give it a degree of independence from the international pressures that built up through the 1960's. During that peridd, the large liquid liabilities (dollar overhang) abroad forced exchange adjustments from time to time. Under a floating system it was argued our international accounts would be self-correcting without an overriding need to bring U.S. domestic policies in line. However, unless U.S. domestic policy maintains a high interest rate structure, a downward float of the dollar may not have a beneficial effect on capital flows. For instance, during a 24-month period, from the last quarter of 1975 up to the fourth quarter of 1977, our relative interest rates (and in some cases, prospects for a weaker dollar) aided a substantial increase in foreign securities issued in the United States.[15] The outflow of dollars amounted to $15.9 billion (or an average of $2 billion a quarter). In the previous 24-month period (from the last quarter of 1973 to the fourth quarter of 1975) the outflow was only $6 billion (an average of only $750 million per quarter). Clearly, it is more advantageous for a foreign entity to borrow even at no savings in interest rates if the obligation is denominated in a depreciating currency.

The one major inflow on the capital account has been in net foreign-held official assets in U.S. Government securities and banks. This includes foreign government ownership of U.S. Treasury bills and certificates, bonds and notes both marketable and nonmarketable, and official deposits in U.S. banks. From 1960 through 1970 the net amount of such inflows was

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[15] Over 53 percent of the outflow in 1977 was to areas other than Canada which used to account for the largest share of foreign issues in the United States.

only $14.9 billion. However, starting with the 1971 currency crisis through 1978, the inflows amounted to a staggering $148.2 billion, 22 percent (or $33.3 billion) of which was in 1978. In 1979, a year of currency uncertainties, and when U.S. domestic policies were not clearly defined as fighting inflation, a net $14.3 billion flowed out (there was a $22.4 billion outflow from U.S. Treasury securities alone!) which may have been a reflection of the foreign concern for U.S. policies. The net inflows, however, are claims on the U.S. Government by foreigners who are financing our deficits. It is difficult to believe that these can be paid off by real resource transfers from possible future current account surpluses developed by improving our competitive trading edge through devaluations.

By maintaining a high enough domestic interest rate structure while continuing to fight inflation, the United States can help finance its deficits through the capital account. However, on the current account based upon the time lags involved in a trade correction from the last round of devaluations (1971-73), a significant trade improvement cannot be expected immediately. A significant (or large dollar value) trade improvement is more likely to come from reduced imports due to trade restrictions (orderly marketing agreements) as well as the economic slowdown in the United States coinciding with continued growth abroad. However, if Europe and Japan reduce their growth in the latter half of 1980 and the first part of 1981, the improvement in the U.S. trade balance, despite a dollar depreciation, may be cut short.

Estimates have been made that up to 2 percentage points of U.S. inflation in the 1978-79 period were caused by the severe depreciation of the dollar with the rather swift pass-through of the cost effects through import prices. In fact, in 1978-79, U.S. auto producers were able to significantly raise domestic automobile prices on those models comparable to imports because Japanese and German car prices had to rise significantly due to currency changes. Thus, the dollar depreciation had a reinforcing effect on inflationary pressures not only through the increased price levels for imported goods but also through the "price floor" effect devaluation had on U.S. domestic prices. Nominal U.S. GNP increased by $241.2 billion from 1978 to 179 and 2 percent of that increase ($4.8 billion), could be a rough approximation of the domestic cost of depreciation of the dollar. It is doubtful that the United States gained that much in trade as a direct result of the dollar's slide; in fact, the trade balance improved by less than that amount in those years. In addition, only 7.7 percent of our GNP is related to exports and 16.6 percent to both exports and imports, yet any added inflation due to devaluation is spread throughout the whole economy, thus impacting on a broader cross-section of our population.

The total rate of U.S. domestic inflation has a moderating effect on the possible price advantage our exports could gain through devaluation. While the trade-weighted value of the dollar has fluctuated, giving U.S. exporters a slight price advantage, export prices have fluctuated also. According to the OECD, U.S. export prices increased 4.3 percent in 1977, 7.7 percent and 16.1 percent in 1978 and 1979, respectively. These are based on average values but obviously, in some exported goods, the price reduction effect of devaluation was affected by the increase in U.S. export prices.

III. The New Beginning in 1980

The threshold of the decade of the eighties affords us the opportunity to retune our international economic policies to the new high energy cost world. The present relative weakness of the U.S. economy, of course, tends to help U.S. exports and hold down imports--particularly of oil, given the recession-induced decline in consumption aided by high prices. This situation has tended to improve our balance of payments position and strengthen the U.S. dollar in the near term. However, given the magnitude of our recent and projected merchandise trade deficits, at $34.2 billion in 1978, $29.5 billion in 1979 and projected at over $35 billion in 1980, and the fact that this deficit can be expected to widen as the United States experiences a cyclical recovery in 1981 and 1982, we can reasonably expect continued current account deficits and downward pressures on the dollar. Actually, we should be seeking to develop a set of policy initiatives that will help maintain dollar stability, thereby enabling us to reduce the cost of imports, minimize inflationary pressures, and maintain our international financial influence. Given the rocky road ahead, the government should take advantage of the lull before the next storm to develop meaningful and coherent policies for maintaining our international trade competitiveness and strengthen our investment and energy positions.

Such policies require better governmental mechanisms of policy analysis, coordination and implementation follow-up. But even with them, presidential leadership is needed. We can no longer afford the practice of periodic press conferences or Administration pronouncements followed by months of bureaucratic stalemates--or just plain lack of follow-up.

Furthermore, there must be leadership and initiative at all levels, plus standing interdepartmental coordination mechanisms at suitably high levels where the inevitable disputes can be resolved, or appealed for top policy decisions on an expedited basis.

Assuming, then, that we have a new sense of urgency about our competetiveness and international trade and investment, that the requisite determination to do something about it is present, and that the relevant government structures can perform, what is it that we should do? What policies relating to industrial policy and international trade are appropriate for the United States to adopt?

Other countries of the world have taken a generally integrative approach to their international economic activities. Domestic laws are geared to support and not to interfere with international business and this appropriate atmosphere for business development is considered in the national interest. We in the United States have not always taken the same tack.

In Japan, for instance, vertical industrial groupings (keiretsu) are permitted which comprise 15 to 20 manufacturing companies, a major bank, shipping, insurance and trading companies. Usually the major bank or the trading company acts as the organizer of the grouping and international deals are easier to put together. The advantages of such groupings include spreading of the risk in large international projects, vertical integration for large multifaceted projects, and pooling of capital, technology and management skills. This form of business operation has been forestalled in the United States because of our antitrust laws. Thus, only in the 1980's, thirty years after Japan started its use, is the United States even

considering the development of trading companies legislation to allow our firms the same advantages.

In the United States we have developed a web of environmental, worker safety, product safety and other regulatory laws. To this we have added other nonregulatory controls, either in law or through administrative practice, such as antiboycott, corrupt practices and human rights constraints. All of the above, however, are administered by 8 or more different government agencies, each with separate constituencies and each sometimes marching to a different drummer. In Japan, for instance, all regulatory authority is consolidated within a single ministry. Interestingly enough, it is the Ministry of International Trade and Industry.

In other areas of international business activity, whether in taxation, export insurance and financing, or extraterritorial application of antitrust laws, Japan (and in several instances, our other major trading partners, too) allows neutral or favored treatment in order to maintain a national resolve for export.

Even with regard to direct investments, our trading partners have recognized the positive effect from having earning assets abroad which can earn foreign exchange returns, help their exports, maintain a "foot-in-the-door" in critical minerals for their home industrial use, and generally improve their world market penetration. This is something that U.S. business has recognized since the 1950's, but something the Government has been ambivalent to (and sometimes has attacked) in the 1970's and 1980's!

The components of U.S. policy must work together to strengthen our international sector. In 1968 this Association said:

> "Regardless of optimistic official statements, the U.S. balance of payments deficits continue at unacceptably high levels. Basic factors are not improving. . . .
>
> Clearly this is not a temporary situation, but rather an explosive structural strain, which at times results in sharp shocks to the monetary system. It cannot therefore be solved nor long sustained by borrowing abroad, whether by government to offset the effect of expenditures, or by the private sector to maintain investments. Nor is it merely a matter of confidence, relative exchange rates, the price of gold, and a myriad of other explanations which can be dealt with by statistical tranquilizers, floating exchange rates, or increasing the price of gold. There are no alchemists here who can safeguard our security or solve the problems of the poor. Such measures, which might be appropriate if our deficits were a short-term phenomenon, are quite inappropriate and inadequate as a means of coping with long-term strategic problems."
>
> "With present policies, we are headed on a down hill course of constricting investments and income thereon, limiting trade, and ultimately retrenching foreign assistance and retreating from security commitments. This way lies the road to forced isolationism, where our friends will scatter to the four winds in fright, and our own freedoms will be suffocated within the confines of Fortress America. Hopefully, we have enough intellectual resourcefulness to prevent this from happening." [16]

We would hope that 12 years after this problem had been highlighted, the United States would be able to pursue policies designed to maintain our international economic strength. One final piece of evidence of the diminishment of our economic strength is contained in Table 4. It shows the decline in American industrial leadership over the past 20 years.

As a specific guidline to assist in the formulation of an international economic policy, Section IV contains a list of 12 principles in American foreign economic policy that was developed by the Association's expert Committee on Foreign Investments and Trade.

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16 The United States Balance of Payments: A Reappraisal 1968, International Economic Policy Association, 1968.

IV. Priorities in American Foreign Economic Policy

1. Step up surveillance of foreign government trade restrictions (and exceptions to national treatment of investment) and vigorously press trade enforcement actions in those selected areas where they appear essential.

2. Act to reduce those export disincentives which have been identified in the White House report of February 1980. In particular, work with Congress to modify the provisions of Section 911 of the Internal Revenue Code (IRC) this year, for they make it prohibitively expensive in terms of taxes for American businessmen to work abroad, even where they are necessary to supervise investments and promote U.S. exports; modify the use of export controls and restrictions on Ex-Im Bank financing for human rights reasons by providing a "fast track" appeal procedure, and in the procedures of the interagency group, shift the burden of proof to the advocates of denial of an otherwise acceptable business transaction. Readjust U.S. policies of applying U.S. environmental standards on all exports so as to make foreign country of destination standards an acceptable alternative; and redirect the use of export controls on nonstrategic items to limit the broad "foreign policy" standard for denying exports.

3. Give trade in services attention and protection comparable to trade in goods, recognizing that, for example, inbound tourism, royalties for technology, and sale of engineering services, are very much "exports" and provide equivalent benefits for the U.S. balance of payments. In 1979, services provided a net surplus of almost $35 billion for the balance of payments.

4. Seek expedited congressional enactment of legislation establishing export trading companies and providing for appropriate Webb-Pomerene antitrust exemptions and DISC eligibility for them.

5. Given the attitudes of other countries, recognize that American efforts to reach international agreement on illicit payments may never be practical. Therefore we should proceed with plans for Justice Department advisories to business as to what is and is not in violation of the Foreign Corrupt Practices Act, and modify those provisions which have caused the greatest uncertainty and ambiguity on the part of American businesses and their legal advisors, while retaining the basic prohibition against bribery.

6. In export promotion, recognize the fact that the majority of America's exports come from its larger and most competitive companies. While participation of small and medium businesses should be encouraged, the export promotion efforts should focus on where the greatest balance of payments benefits can be obtained.

7. Increase the volume of U.S. aid to developing countries and the proportion which goes through bilateral (as opposed to multilateral) channels, where it should continue to be tied to U.S. procurement so that American aid is in the form of real rather than financial resources.

8. Revise the statement of U.S. policy on direct foreign investment to remove its "neutral" flavor and recognize instead that the U.S. Government has an important interest in open, two-way flows of direct investment, and in ensuring the treatment of U.S. investment abroad by due process of international law. Pursue bilateral investment treaties with developing countries on a more aggressive basis, especially those countries with which the Germans, Dutch, and Japanese have successfully concluded treaties giving their firms some advantages versus U.S. competitors. Remember that since 1948, U.S. investments have returned a net $126.6 billion to the United States over and above the outflow of funds to finance the investment.

9. The Administration should seek to persuade Congress to broaden the coverage available through the Overseas Private Investment Corporation (OPIC) and to eliminate some of the restrictions upon OPEC imposed by Congress in recent years.

10. Recognize that the tax treatment of foreign-source income has important ramifications for U.S. trade and investment and cannot be dealt with simply as a matter of tax administration. Specifically, insure the continued applicability of the foreign tax credit to insure against double taxation. This is now to be limited by proposed Treasury regulations that unrealistically apply a mirror image test at a time when many nations are developing and refining their own tax systems. Adjust the Section 911 provisions to eliminate the disincentive to having Americans abroad selling America's products and American construction companies actively involved in international projects. Reconsider possible adjustments to Section 861 on allocation of expenses which continue to cause problems for U.S. companies which are large investors and exporters.

11. With respect to codes of conduct for multinational corporations, insist that these be clearly and explicitly stated to be voluntary, and in the nature of informational-exemplary guidelines which are not intended to be turned into de facto compulsory arrangements via international agreements or incorporation by reference into national law, such as through national labor-management bargaining processes.

12. Analyze critically those systemic, structural, and cultural factors which affect the U.S. economic performance in the world relative to the other industrial powers. This should include both factors which affect foreign countries as markets and competitors and those which affect public understanding and support in the United States for a coherent foreign economic policy. Place major emphasis on educating the public as to the need for such a policy and about the importance of the foreign economic sector to America's economic health.

Table 1

CHANGE IN U.S. TRADE BALANCES, YEAR TO YEAR, WITH
CHANGE IN U.S. DOLLAR EXCHANGE RATE FOR SELECTED COUNTRIES
1974-1979 (millions of $ and percent)

	1974→1975	1975→1976	1976→1977	1977→1978	1978→1979
GERMANY					
Trade change	+1,261	+114	-1,207	-1,367	+490
$ Currency change	-4.9%	+2.5%	-7.8%	-15.8%	-9.4%
JAPAN					
Trade change	0	-3,645	-2,664	-3,582	+2,953
$ Currency change	+1.8%	-0.1%	-9.6%	-28.5%	+4.8%
UNITED KINGDOM					
Trade change	+561	-197	-47	-98	+1,983
$ Currency change	+5.3%	+23.1%	+3.4%	-9.9%	-10.6%
FRANCE					
Trade change	+292	+43	-541	-300	+743
$ Currency change	-10.9%	+11.5%	+2.9%	-9.2%	-5.8%
CANADA					
Trade change	+2,379	-1,966	-973	-1,211	-100
$ Currency change	+4%	-3.1%	+7.8%	+6.8%	+2.7%

Source: Table 2 and The Federal Reserve Bulletin, March 1977, January and December 1978, June 1980.

Note: The percentage change in U.S. dollar exchange rates is based on yearly average exchange rates for 1974-1975; 1975-1976; 1976-1977, etc.

Trade change is the difference between the U.S. trade balance for each of the years listed from Table 2. A (-) indicates a deterioration in the U.S. trade account from year to year; a (+) indicates an improvement.

$ Currency change is the U.S. dollar depreciation (-) or appreciation (+) from year to year.

Table 2

U.S. MERCHANDISE TRADE BALANCE WITH SELECTED COUNTRIES
1974-1978 (millions of $)

	1974	1975	1976	1977	1978	1979
GERMANY	-1,567	-306	-192	-1,399	-2,766	-2,276
JAPAN	-1,690	-1,690	-5,335	-7,999	-11,581	-8,628
UNITED KINGDOM	+583	+1,144	+947	+900	+802	+2,785
FRANCE	+670	+962	+1,031	+490	+190	+933
CANADA	-552	+1,827	-139	-1,112	-2,323	-2,423

Source: Survey of Current Business, June 1977, 1978, March 1980, and the Monthly Report of the Deutsche Bundesbank, December 1978.

Table 3

U.S. EXPORTS TO COUNTRIES AGAINST WHICH THE DOLLAR
APPRECIATED OR DEPRECIATED
1977 to 1979
(billions of $ and percent)

	1977 $ %	1978 $ %	1979 $ %
GROUP I: Countries against whose currencies the dollar generally depreciated in 1977, 1978, 1979, including: European Community (less Italy in 1977 only), Switzerland, Japan and Australia (and Mexico in 1977 only)	$43.1 / 35.8%	$51.3 / 36.2%	$63.5 / 34.9%
GROUP II: Countries against whose currencies the dollar has remained relatively unchanged or appreciated including: Other Western Europe, Canada, Latin America, other Asia and Africa, and Mexico in 1978 and 1979.	$77.5 / 64.2%	$90.5 / 63.8%	$118.6 / 65.1%

Source: Survey of Current Business, U.S. Department of Commerce, June 1978; Federal Reserve Bulletin, various issues.

Table 4

Declining American Industrial Leadership

INDUSTRY	NUMBER OF AMERICAN FIRMS IN THE LARGEST GROUP	
	1959	1978
1. Commercial Banking	9/15 (1960)	3/15
2. Metal Manufacturing	11/14	5/14
3. Food Products	11/14	10/14
4. Aerospace	10/13	9/13
5. Pharmaceuticals	9/12	7/12
6. Chemicals	7/12	4/12

Source: Geoffrey Carroll, "The Multinational Myth," Europe (European Community magazine) July-August 1980, pp. 27-28.

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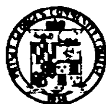


PRINCE GEORGE'S COMMUNITY COLLEGE
ARTS AND SCIENCES

Social Sciences

September 8, 1980

Dear Michael Stern,

I wish to present my views thru this written statement for submission in re possible approaches to U.S. competitiveness in the 1980's.

We must recognize the urgent improvements in productivity, i.e. increasing output per worker for contributing to competitiveness.

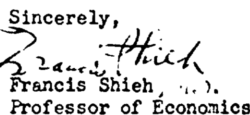
Productivity is a key element in the benign cycle of growth, i.e. a reduction in the cost of producing any given amount of goods -providing less expensive products; increased demand for less expensive products, increasing employment and provide incentive for investment in expansion, thereby enabling sustained higher levels of output and employment while more investment enables more improvements in productivity. This cycle can move on through the multiplier effect and competitiveness becomes self-generating.

However, due to the changing composition of the labor force, there are more women, more minorities and more teenagers. Their concomittant inexperience leads to low productivity and we must use the institutional framework of 1230+community colleges thru out the nation to reach the grassroot workers.

I hope the above would be printed as a record of the hearing for my written statements.

Thank you.

Sincerely,



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STATEMENT TO THE
SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE
SENATE FINANCE COMMITTEE
ON
THE CASE FOR INTERDEPENDENCE IN US TRADE WITH LESS DEVELOPED COUNTRIES
BY
LEAGUE OF WOMEN VOTERS OF THE UNITED STATES
SEPTEMBER 17, 1980

The League of Women Voters of the United States is a voluntary political action organization with 1400 Leagues in 50 states, the District of Columbia, Puerto Rico and the Virgin Islands. We welcome this opportunity to state our position on policies affecting US trade with the less developed countries.

For more than forty years, the League of Women Voters has supported a liberalization of US trade policy through the systematic reduction of tariff and nontariff barriers. League members firmly believe that such a policy serves the political and economic interests of this country and of its citizens, collectively and individually, because it paves the way for political harmony among nations, promotes economic development and expands consumer choice. We also firmly believe that the free flow of investment and technology plays a crucial role in fostering economic development and the improvement of living standards throughout the world.

The League's longstanding support for a liberal US trade policy has its origins in a 1920 study of high postwar prices. This and other early studies convinced the League that high tariffs and restrictive trade practices boost consumer prices, reduce competition in the marketplace and cause friction among nations. Therefore, when the depression of the early thirties compounded the impact of high tariffs, the League took action on trade matters for the first time.

In 1937, the League supported the Reciprocal Trade Agreements Act when it came due for its first renewal. Since then, the League has been involved with every major piece of trade legislation, always coming out strongly for measures that are trade expansive rather than trade restrictive. After reappraising our trade position in the early 1960s, we urged that the United States systematically reduce trade barriers, delegate long-term, flexible negotiating authority to the Executive branch and use trade adjustment assistance as a positive alternative to import restrictions.

In recent years, for example, the League vigorously supported both the Trade Agreements Act of 1974, which authorized US participation in the Tokyo Round of trade negotiations, and the Trade Agreements Act of 1979, which culminated five years of US involvement in those negotiations. Just as vigorously, in 1978, we opposed protectionist amendments to foreign assistance appropriations.

Not only has the League over the years worked to deflect protectionist efforts--such as tariffs, quotas, and so-called "buy America" provisions--but it also has continued to promote public understanding of the benefits of a liberal trading system. Clearly, the need to underscore those benefits is greater than ever

today as the United States contends with trade deficits and slow growth in productivity, as well as record rates of inflation and unemployment. With the price of oil continuing to escalate, causing rapid and dramatic shifts in the global economic structure, we have witnessed growing official and citizen concern about the future of American jobs and industries.

Especially strident have been those voices raised against increased levels of US imports. Labor unions and many industries have called for more barriers to imports and, within Congress, a host of new protectionist measures designed to keep out foreign goods has been introduced. This protectionist pressure has even been extended to include goods imported from less developed countries which depend heavily on export earnings to finance continued development.

However, despite the recent intensification of initiatives that threaten to inhibit freer trade, there is evidence to suggest that the American public as a whole is increasingly becoming more aware of both the reciprocal nature of foreign trade and the rising US economic dependence on other countries. The following are selected highlights from a Roper poll on public attitudes toward international trade conducted in January 1980 for the League of Women Voters Education Fund:

--The American public's perception of US economic dependence has risen slightly from the mid-1970's. About two-thirds of Americans today view the US as more or less economically dependent on other countries.

--Nearly half the American public (44%) views US trade with other countries as benefitting the US. And majorities of a few population groups--the college educated, executives/professionals and those earning $25,000 or more annually--view foreign trade as advantageous to the country.

--Americans consider the most persuasive pro-trade argument to be "exports create jobs." Conversely, they consider the most persuasive anti-trade argument to be "imports cause loss of jobs."

--Americans now are almost as likely to associate competitive imports with lower prices for consumers in the positive sense as with lost jobs in the negative sense.

--Despite the fact that a large majority of Americans (81%) indicated support for some type of import restrictions, this did not connote opposition to foreign trade per se. Of this 81%, roughly one-third wanted to keep import restrictions at the same level, one-third wanted to increase them and 15% wanted to decrease import restrictions.

It is clear from the League's Education Fund poll that the public is becoming steadily more cognizant of exports as a way to generate jobs and lessen the trade deficit. We believe that this emerging awareness is a significant development in light of the fact that foreign trade has long been equated, in a pejorative sense, with "unfair foreign competition." This heightened perception about the benefits of a liberalized trade policy is particularly salient with regard to US trade with the less developed countries. About 25 percent of US exports now go to the less developed countries, excluding OPEC countries. Adding in OPEC, the share comes close to 40 percent of all US manufactured exports.

The League of Women Voters of the US firmly believes that trading with the developing countries has a number of very specific mutual benefits for the United States as well as for the poor countries of the world. Domestically, increased trade with the developing countries means growing markets for US exports. Exports

of goods and services now equal approximately 12 percent of the US gross national product and are estimated to account for one out of every eight jobs in the manufacturing sector and for the production of one-third of the farm acreage in the United States. Furthermore, there is much potential for continued growth in US exports, since demand in the developing countries is far from satisfied and is likely to expand rapidly as these countries advance economically.

Increased trade with developing countries also results in greater economic efficiency in the United States. First, growth in low-cost imports encourages the flow of American capital and other resources away from industries producing goods that can be manufactured more efficiently and cheaply in the developing countries toward industries making more advanced products for export. These increased exports, in turn, further stimulate investment and encourage faster growth rates. Second, by lowering the average US price of certain goods, imports mitigate inflation. Third, import competition encourages US industries to be more innovative and efficient if they expect to be competitive--as is evident by the introduction of compact, fuel-efficient cars in the US auto industry.

The stake of the world's poorer countries in freer trade, however, is even more vital to the survival of those countries. Without future expansion of international trade, the developing countries are certain to experience reduced foreign exchange earnings, increased unemployment and diminished rates of growth in their incomes. In simple terms, without greater access to the markets of the developed world, the less developed nations cannot hope to eliminate their widespread poverty. The fact that they would be unable to buy larger amounts of developed country exports would,

in turn, have a negative effect on the US as well as other developed countries. Approximately one-third of the wheat, cotton and rice grown in the United States, for example, is now sold to developing countries. We currently export more to the developing countries than we do the European Economic Community and Japan combined.

For the less developed countries, trade is a key element in their development strategies. Their receipts from exports far surpass the foreign assistance they receive. In 1977, developing nations acquired more foreign exchange from an average month's exports to Western nations than they received in development assistance for the entire year. Recognizing the impact of trade policy on development, the United States and other developed countries have established special trade advantages for developing nations and consistently have sought to reduce the barriers to world trade.

The League of Women Voters strongly supports US policy that maintains an open trading system free from unnecessary restraints. In the Multilateral Trade Negotiations (MTN), the US has negotiated more than 25 agreements with developing countries reducing tariff and nontariff barriers. We feel this action reflects the US intent to ensure that these nations benefit as much as possible from international efforts to liberalize world trade.

League members also support the "generalized system of preferences" (GSP), authorized by Title V of the Trade Act of 1974. According to this scheme, the US allows duty-free treatment of certain goods exported by developing countries.

The provisions of the GSP scheme thus make allowances for the inability of developing countries to compete on an equal basis with developed countries in the international trading system. The extension of tariff preferences to certain goods from the less developed countries provides a means for helping them increase exports, diversify their economies and, ultimately, lessen their dependence on foreign aid.

The GSP track record to date is positive, indicating that the GSP scheme has provided the less developed countries with opportunities to expand their exports. At the same time, according to the five year review of the GSP submitted to Congress in April, 1980, the scheme has effectively safeguarded the interests of US producers and workers. Although the Administration plans to modify the GSP in 1980, the League believes that the scheme has proven to be initially successful as a mechanism for increasing the economic wealth of developing countries through trade rather than aid.

The League of Women Voters also recognizes the critical role of private foreign investment in promoting economic development in the Third World. Private US capital is clearly an important factor in teaching new skills, creating employment, diversifying economies and earning foreign exchange that developing nations can use to finance further development efforts.

In order to encourage responsible private investment in developing countries, the US established the Overseas Private Investment Corporation (OPIC). Because OPIC promotes the investment of US capital and technology in projects that complement our development assistance efforts, we feel it properly comes under the jurisdic-

tion of the International Development Cooperation Agency (IDCA). Moreover, in recent years, OPIC has shifted its investment activities toward the poorest of the less developed countries.

Similarly, we feel that the recent establishment of the Trade and Development Program reflects the Administration's conviction that trade and economic development are of mutual importance to the United States and developing countries. Under the auspices of the International Development Cooperation Agency, the Trade and Development Program supports feasibility studies for projects that can be financed by developing countries and undertaken by US private industry or government agencies such as the Army Corps of Engineers. The program places a major emphasis on promoting private sector involvement and is directed primarily at those countries not participating in regular Agency for International Development (AID) programs.

In conclusion, League members stand firm in support of a liberal US trade policy. We are convinced that national and international remedies for the US balance-of-payments deficit should be aimed generally in the direction of trade expansion and away from short-range, restrictionist palliatives. Therefore, we support such remedies as efforts by American industry to improve international marketing techniques, government policies designed to promote expansion of US exports and reform of the international monetary system.

The League of Women Voters also firmly believes that, in an increasingly inter-dependent world, the free flow of trade between the US and developing countries

provides clear benefits for all participants. Today, the less developed countries constitute the fastest growing US export market; an estimated 1.2 million American jobs already depend on exports to the developing world. In turn, for the poorer nations of the world, access to the markets of the US and other developed nations is key to the modernization of their economies and the creation of much needed employment.

The League, recognizing the gross disparity in trading positions between the developed and less developed countries, believes the exports of developing countries must be expanded. Because of their need for greater access to US and other industrialized countries' markets, we favor the generalized system of preferences (GSP) for the less developed countries. And, the League of Women Voters believes that one of the prime US objectives vis-a-vis the developing world is the further incorporation of developing countries in the work of the General Agreement on Tariffs and Trade. As recent reports by the Brant Commission and the Presidential Commission on World Hunger conclude, the economic progress of the poorer Third World countries ultimately will determine the economic well-being of the richer nations as well.

Public Perceptions of World Trade: Sell More/Buy Less

by
Alvin Richman

League of Women Voters Education Fund

Public Perceptions of World Trade: Sell More/Buy Less

by Alvin Richman

A report prepared for the League of Women Voters Education Fund by Alvin Richman, Senior Public Opinion Analyst, Department of State. The views expressed in this report are those of the author and not necessarily those of the Department of State or the League of Women Voters Education Fund. The report on the poll is an integral part of "The U.S. Stake in International Trade," an international trade education project sponsored by the League of Women Voters Education Fund with the cooperation of the Chicago Mercantile Exchange, the Johnson Foundation and the Kettering Foundation, along with twenty-one other donors.

June 1980

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Public Perceptions of World Trade: Sell More/Buy Less.

This report presents the findings of a Roper poll on international trade conducted in January 1980 for the League of Women Voters Education Fund.[1] The poll reveals these highlights:

1. The American public's perception of U.S. economic dependence has risen slightly from the mid-1970's, but less than half of the public believes the U.S. clearly benefits from trading with other countries.

2. A small majority is aware that the U.S. has a foreign trade deficit, and this trade imbalance is increasingly viewed as unsatisfactory.

-- But the public tends to attribute the imbalance to factors outside U.S. control (e.g., cheap foreign wages, foreign government subsidies to businesses, and relatively restricitive import policies in other countries) rather than to U.S. business conditions and practices (e.g., U.S. government regulations, limited efforts by American firms to pursue foreign markets, low productivity in some American economic sectors).

3. The public's predominant sentiments on trade are to reduce U.S. imports (especially oil imports) and increase U.S. exports. Both sentiments have risen since the mid-1970's.

-- The public now divides into three fairly equal groups in its preference regarding import restrictions: About one-third favors increased import restrictions, about one-third wants to keep import restrictions at their present level, and about one-third wants to reduce or eliminate restrictions.

4. The most persuasive pro-trade argument is that "exports create jobs"; the most persuasive anti-trade argument is that "imports cause loss of jobs".

-- The public is somewhat more likely to associate imports with the problem of lost jobs than with the benefit of lower prices, despite the fact the poll was taken during a period of intense concern over inflation.

Roper conducted 2,005 personal interviews in a national probability sample of adults 18 or over, between January 5-19, 1980.

The public's attitudes on international trade are examined in six sections: (A) Public perceptions of U.S. economic interdependence, (B) its views of the U.S. trade imbalance, including awareness of the U.S. trade deficit, (C) the public's basic attitude toward U.S. foreign trade, (D) its specific preferences about increasing/decreasing the level of U.S. imports and exports, (E) its preferences regarding restrictions on imports and exports, and (F) the public's ratings of the persuasiveness of various arguments for and against international trade.

Relevant data from other public opinion surveys on international trade are introduced where appropriate to supplement some of the League's findings and to provide trend measures.

A. Perceptions of U.S. Economic Interdependence

About two-thirds of Americans view the U.S. as more or less economically dependent on other countries. Roper trend results show that the public's perception of U.S. overall economic dependence has increased slightly since 1975. The Education Fund asked:

Thinking of what this country has and needs, produces and doesn't produce, buys and sells, which one of these positions would you say best describes the United States at the present time? (CARD SHOWN TO RESPONDENT)

The United States is ...	Jan. 1980	Apr-May 1979	Sept. 1977	May 1977	Oct. 1975
Wholly dependent on other countries	1%	2%	1%	1%	1%
Largely dependent on other countries	16	22	15	17	13
Somewhat dependent on other countries	52	45	47	49	47
(Total perceive U.S. dependent):	(69%)	(69%)	(63%)	(67%)	(61%)
Nearly self-sufficient	23	21	26	21	28
Completely self-sufficient	6	7	9	9	8
(Total perceive U.S. self-suffic):	(29%)	(28%)	(35%)	(30%)	(36%)
Don't know	2	3	2	3	3

Majorities in all major population groups see the U.S. as at least "somewhat" economically dependent on other countries. Perception of U.S. dependence is most widespread among the college educated, executives/professionals, Westerners and rural residents. It is least widespread among the grade school educated, blue collar workers, those living in the Northeast and in major cities, Blacks and adults 60 years of age or over. (Appendix, Table 1.)

A Harris survey in late 1978 also showed that (1) the public's perception of U.S. dependence on other countries for various products had increased since the mid-1970's, (2) the public distinguished clearly between the products the U.S. can largely provide for itself and those which it has to obtain mainly through imports, and (3) the public continued to believe that other countries needed the United States more economically than the U.S. needed them.

Harris asked his respondents to rate the extent of U.S. dependence on other countries (and other countries dependence on the U.S.) for a number of specific products. The proportions responding the U.S. depended "alot" increased for all eight products listed in both surveys (from an average of 25% in December 1974 to an average of 32% in November 1978), and the proportions responding the U.S. depended "not at all" declined for all eight products (from 29% to 16% on the average). (Appendix, Table 2)

Harris also found that . American perceptions of other countries' dependence on the United States declined for all eight products -- from 66 percent (average) in late 1974 who said other countries depended "alot" on the U.S. to 59 percent (average) in late 1978. Nevertheless, it is clear from Harris' 1978 results that the public still viewed other countries as being more economically dependent on the U.S. than vice versa (average of 32% U.S. depends "alot" on others versus average of 59% others depend "alot" on the U.S.). This is best illustrated by the responses in late 1978 to the product category "raw materials for manufacturing": Thirty six percent of the public said the U.S. depended on

other countries "alot" for this type of item, compared to 53% who said other countries depended on the U.S. "alot" for it. (Appendix, Table 2.)

B. Opinions About U.S. Trade Imbalance

The fact that the United States imports more than it exports is perceived by a small majority (57%) of the public, according to the Education Fund's poll. The population groups most aware of the U.S. trade imbalance are the college educated, executive/professionals, those earning $25,000 or more annually, males, Westerners, and Republicans (about 70% in each group is aware). Least aware of it are Blacks, the grade-school educated, and those earning less than $7,000 annually (about 40% aware). (Appendix, Table 3.)

Those who are aware that the U.S. has a trade deficit are more likely than the rest of the public to view the U.S. as dependent economically on other countries. Among those aware of the trade imbalance, 75 percent see the U.S. as at least "somewhat" economically dependant (including 21% who said "largely dependent"). Among those not aware of the trade imbalance, 60 percent view the U.S. as economically dependent (including 10 percent who said "largely dependent").

Most Americans are clearly not pleased by their perception of a U.S. trade deficit. A majority sees the U.S. buying more than it is selling, but only five percent prefer this situation. Much more preferable from the public's viewpoint is to have exports equal imports (47%) or even exceed imports (39%). The Education Fund found that the proportion of the public who want exports to exceed imports has approximately doubled since 1974. The Education Fund asked:

Thinking in terms of the amount of products that the U.S. imports and exports -- do you think it is best for the U.S. to import more from other countries than we export to them, or is it best for the U.S. to export more than it imports, or do you think it is best if the amounts we import and export are equal?

Roper polls of June 1976 and February 1974 asked:

What do you think the long range goal of the United States should be when it comes to foreign trade -- to export more than we import, or to import more than we export, or to have exports just about equal imports?

Best for U.S. if:	Jan. 1980	June 1976	Feb. 1974
Exports exceed imports	39%	26%	18%
Exports equal imports	47	59	65
Imports exceed exports	5	3	4
Don't know	9	12	13

Among certain population groups the proportion who favors an export surplus is somewhat greater than the proportion who favors a balance between exports and imports -- the college educated, executives/professionals, those earning $25,000 or more annually, and those who are aware that the U.S. imports more than it exports (about 48% favor an export surplus vs. about 42% favor an export-import balance among these groups).

The public blames cheap labor costs abroad more than any other reason for the U.S. trade deficit. The Education Fund asked those respondents aware of the deficit to select from a list of eight reasons the ones they regarded as "major reasons why other countries sell more to the U.S. than the U.S. sells to other countries." A large majority of these respondents (80%) chose the reason "workers are paid less and can make the same things cheaper than we can." About one-third attributed the U.S. trade imbalance to relatively tough import restrictions abroad (36%), the high cost of U.S. oil imports (31%) and the relative attractiveness of many foreign products (30%). Few attributed it to factors over which the U.S. has primary control (e.g., only 13 percent attributed the imbalance to U.S. Government export regulations and eight percent said American businesses don't try hard enough to increase exports). (Appendix, Table 4.)

C. Basic Attitude Toward Foreign Trade

Less than half the American public (44%) views U.S. trade with other countries as benefitting the U.S. A larger proportion believes either that foreign trade doesn't make much difference to the U.S. (28%) or that it is actually harmful to our country (21%). The Education Fund asked this question:

Thinking about the standard of living in this country, the products we use in our homes, the clothing we wear, the food we eat, do you think Americans would be better off, worse off, or would our standard of living be about the same if we did not buy from or sell to other countries?

Worse off	44%
About the same	28
Better off	21
Don't know	7

Majorities of a few population groups view foreign trade as advantageous to the U.S. -- the college educated, executives/professionals, those earning $25,000 or more annually, and Westerners (about 55% see trade as beneficial vs. about 15% view it as harmful). Least supportive of trade are the grade-school educated, those earning less than $7,000 annually, and Blacks (about 30% beneficial vs. 25% harmful). Attitudes of union members toward foreign trade are similar to those of the public as a whole (45% of union members say the U.S. would be "worse off" without trade and 20% say the U.S. would be better off). Self-described liberals are somewhat more supportive of trade than are conservatives, while Republicans are somewhat more supportive than Democrats. Those who perceive the U.S. as "dependent" on other countries are much more supportive of foreign trade than those who believe the U.S. is basically "self-sufficient." (Appendix, Table 5.)

D. Preferences on Import and Export Levels

The Education Fund asked respondents three questions on whether the U.S. should try to increase, decrease or maintain the present levels of its (1) oil imports, (2) imports of non-oil products, and (3) exports. The predominant sentiments of the public are to reduce U.S. imports, especially imports of

oil, and to increase U.S. exports. The Education Fund asked these questions:

(1) Now I'd like to ask you a question concerning U.S. imports of oil during the next several years. Do you think the government should try to increase the amount of oil the U.S. buys from other countries, or should it try to decrease the amount it buys, or do you think it should try to keep the amount of oil imported into the U.S. at about the present level?

(2) Concerning U.S. imports of products other than oil -- do you think we should increase our imports of non-oil products, reduce them, or keep them at about the present level?

(3) Now a question about U.S. exports. Do you think we should try to increase our exports, that is the amount of products we sell to other countries, or try to reduce our exports, or try to keep exports at about the present level?

	(1) Oil Imports	(2) Non-oil Imports	(3) Exports
Decrease	67%	47%	14%
Increase	6	4	45
Keep at present level	22	33	23
Qualified (Volunteered - e.g. depends on which products or countries are involved)	--	10	11
Don't know	5	6	7

The prevailing opinion in all major population groups is to reduce both oil and non-oil imports. There was little variation among the groups on these two questions. But on the issue of U.S. exports, opinions among the different groups vary in the same way they do on the issue of trade as a whole: The college educated, for example, are much more in favor of increasing U.S. exports than are those not having a college education. Whites are more in favor of increasing exports than Blacks, and men are more in favor of doing so than women. Also highly supportive of increasing U.S. exports are executives/ professionals, those earning $25,000 or more annually, and those living in the West and Northeast. (Appendix, Table 6.)

Knowledge about the U.S. trade deficit correlates closely with the preferred import and export levels. Those aware of the trade deficit are much more desirous of reducing imports and increasing exports than those unaware of the deficit:

	Aware of U.S. Trade Deficit (57%)	Unaware of U.S. Trade Deficit (43%)
U.S. Oil Imports:		
Decrease	75%	56%
Increase	5	7
Keep at present level	18	28
Don't know	2	9
U.S. Non-oil Imports:		
Decrease	55%	36%
Increase	5	3
Keep at present level	30	38
Qualified (Vol.)	8	12
Don't know	2	11
U.S. Exports:		
Decrease	12%	16%
Increase	59	26
Keep at present level	16	34
Qualified (Vol.)	9	13
Don't know	4	11

E. Preferences on Import and Export Restrictions

The public's desire to restrict imports of competitve foreign products has risen somewhat since the mid-1970's, according to a Roper poll conducted in late 1979. Three times as many respondents on that poll favored restricting the import of foreign goods that were priced lower than comparable American products as opposed such restrictions. Roper has asked this question regularly since 1973:

There have been times when other countries have been able to sell their goods in this country at lower prices than American-made goods. Generally speaking, do you think the government should or should not place restrictions on imports of goods from other countries that are priced lower than American-made goods of the same kind?

	Oct.-Nov 1979	Nov. 1977	Nov. 1975	Nov. 1973
Favor restricting imports	68%	64%	61%	63%
Oppose restricting imports	21	26	27	27
Don't know	11	10	12	10

Roper's January 1980 survey for the Education Fund contained a differently worded question regarding restrictions on U.S. imports and exports. The Education Fund did not intimate, as did Roper's late 1979 poll, that import restrictions would have the effect of increasing prices consumers paid for some products. Consequently, a larger majority on the later poll voiced support for having import restrictions (81%). Somewhat fewer than this favored restrictions on exports (71%).

Those respondents who favored restrictions on U.S. imports (or replied "don't know") were asked whether restrictions should be increased, decreased, or kept the same. A larger proportion favored increasing import restrictions than decreasing them (by 28% vs. 14%), while the plurality desired to maintain the present level of restrictions (30%).

Roper's results are summarized below: [1]

Restrictions on U.S. Exports:

Favor	71%
Oppose	20
Don't know	9

Restrictions on U.S. Imports:

Favor import restrictions		81%
Want to increase them	28%	
Want to keep about the same	31	
Want to decrease them	14	
Undecided about increase or decrease	8	
Oppose import restrictions		10
Don't know		9

The desire to increase import restrictions does not necessarily connote opposition to foreign trade per se. The groups most desirous of tighter restrictions are also among those most favorably disposed toward the idea of trade -- executives/professionals, those earning $25,000 or more annually, males and Westerners (about 35% favor increased import restrictions vs. about 20% favor decreased restrictions or none at all). (Appendix, Table 8.)

[1] The complete questions and results are presented in Appendix B, tables 7 and 8

F. Reasons For and Against International Trade

The Education Fund asked respondents to rate the effectiveness of each of a series of arguments in favor of foreign trade and a series of arguments against trade. The pro-trade arguments rated most effective were (1) the creation of jobs in the export sector, (2) lower prices for consumers, and (3) optimum international subdivision of production (about 40% of the public believed each of these was a "very good argument".) The anti-trade arguments judged most effective were (1) more jobs retained by Americans and (2) making the U.S. more self-sufficient (about 40% rated each a "very good" argument.)

Roper's results are summarized below:

Arguments in Favor of Trade:	Ratings of Arguments: Very Good	Fairly Good	Poor	Don't Know
(1) Creation of jobs in export sector	44%	34%	14%	8%
(2) Lower prices for consumers	40	33	20	7
(3) Achieving optimum international subdivision of production	39	38	14	9
(4) Wider choice for consumers	31	40	21	8
(5) More efficient U.S. companies	29	37	25	9
(6) Foreigners can buy U.S. products	21	40	28	11

Arguments Against Trade:	Very Good	Fairly Good	Poor	Don't Know
(1) More jobs retained by Americans	44%	30%	20%	6%
(2) Making the U.S. more self-sufficient	39	33	20	8
(3) Protect the dollar	30	30	25	15
(4) Higher profits for U.S. companies	25	30	35	10
(5) More U.S. products for American consumers to buy	20	28	43	9

These findings reveal that Americans now are almost as likely to associate competitive imports with lower prices in the positive sense as with lost jobs in a negative sense: Crosstabular analyses of the responses to these two items show that 27 percent of the public rates the lost jobs argument as more persuasive than the lower prices argument; 25 percent rates the latter argument as more persuasive than the former; 39 percent rates them as equally

effective;and nine percent gives a "don't know" response.(Appendix C.)

Roper surveys conducted in 1977 and 1979 showed that much larger proportions at those times rated the lost jobs argument as "good" than gave that rating to the lower prices argument (68% vs. 51% in late 1979, for example). Since then, a rising inflation rate and high prices have become much more widespread public concerns than the problem of unemployment, probably raising the salience of the lower prices argument.

Other survey evidence indicates, nevertheless , that a sizeable segment of the public does not perceive a connection between more competition from imports and lower consumer prices. A Harris poll conducted in December, 1978, found that 52 percent believed that "competition from foreign products" tends to increase inflation, compared to only 17 percent who believed such competition tends to hold down inflation. Another 17 percent believed imports had no effect on prices and 14 percent were not sure.

The Education Fund's survey indicates that the idea that "exports create jobs" may be just as persuasive as the argument "imports lose jobs." In fact, 27 percent of the public rates the first argument as more persuasive than the second, compared to 22 percent who rate them in the reverse order (40% rates them as equal and 9% gives "don't know" response). (Appendix C.)

Also judged to be very persuasive were two opposed basic arguments relating to the desired level of U.S. involvement in the world economy: Achieving the most efficient subdivision of production among different trading countries versus achieving U.S. self-sufficiency by reducing foreign trade.

Each of the five top arguments for and against trade described above were highly rated by every major population group (i.e., about one-third or more in each group rated each argument as "very good"). Other arguments rated highly by certain groups include the pro-trade reason "making U.S. companies more efficient" (38% of executives/professionals rated it "very good"), and

the anti-trade reason "protecting the value of the dollar" (36% of blue-collar workers, union members, and Blacks rated it "very good").

The population group ratings for each argument are summarized in the Appendix B, Tables 11 and 12. Among the noteworthy findings in those tables are these very high ratings:

Blacks -- 55 percent rated the "lower consumer price" pro-trade argument as "very good"

Executives/professionals -- 54 percent rated "creation of jobs in the export sector " as a "very good" argument and 52 percent rated "optimum international subdivision of production" as "very good"

About half of the grade school educated, those earning less than $15,000 annually, union members, and those 60 years or older rated the anti-trade argument "more jobs retained by Americans" as "very good."

Some of the groups which gave a relatively high rating to the pro-trade argument "achieving optimum international subdivision of production" gave a relatively low rating to the anti-trade argument "making the U.S. self-sufficient" -- executives/professionals, college educated, those earning $25,000 or more annually, Westerners and Republicans. Some other groups had the reverse tendency, finding the "self-sufficiency" argument more persuasive than "optimum subdivision of production" -- union members, the grade-school educated, those earning less than $7,000 annually and those living in the Northeast. (Appendix, Tables 11 and 12.)

Appendix A: The International Trade Poll Questionnaire

Introduction to Trade Questions

Now we are going to ask you a few questions about international trade, but before we do I'd like to explain a few words that many people don't understand. When a U.S. company sells its products to a company in another country, that is called international trade. When a U.S. company buys products from a company in another country, that is also called international trade. Selling products to a company in another country is called exporting, and the products sold are called exports. Buying products from a company in another country is called importing, and the products that are bought are called imports.

1. Thinking of what this country has and needs, produces and doesn't produce, buys and sells, which situation would you say best describes the United States at the present time? (HAND RESPONDENT CARD A)

CARD A

The United States is...
  a. completely self-sufficient
  b. nearly self-sufficient
  c. somewhat dependent on other countries
  d. largely dependent on other countries
  e. wholly dependent on other countries

2. Thinking about the standard of living in this country, the products we use in our homes, the clothing we wear, the food we eat, do you think Americans would be better off, worse off, or would our standard of living be about the same if we did not buy from and sell to other countries?

3. When it comes to what the United States buys from other countries and what the United States sells to them, which do you think has been happening during the past several years--has the U.S. been buying more than it has been selling, has it been selling more than it has buying, or have the amounts the U.S. has been buying and selling been about the same?

(IF "U.S. HAS BEEN BUYING MORE THAN IT HAS BEEN SELLING," ON QUESTION 3 ASK QUESTION 4)

4. Here are some of the reasons that have been given as to why other countries sell more products to the U.S. than the U.S. sells to other countries. (HAND RESPONDENT CARD B). Would you read down that list and tell me which ones you think are major reasons? First, because workers are paid less...

CARD B

a. Because workers are paid less in many other countries than in the U.S., they can make the same things cheaper than we can.

b. Because factories in many other countries use newer and better machinery than that in the U.S., they can make the same things cheaper than we can.

c. Because many other governments help their businesses financially they can make the same things cheaper than American firms can.

d. Other countries make it hard to sell American products there, while the U.S. does not make it hard for other countries to sell their products here.

e. American businesses do not try very hard to sell their products overseas.

f. U.S. government regulations prevent American businesses from selling more overseas.

g. The increased cost and the large amount of oil we import means that we have to export a lot of other products just to make our exports and imports equal.

5. Now, I'd like to ask you a question concerning U.S. imports of oil during the next several years. Do you think the government should try to increase the amount of oil the U.S. buys from other countries, should decrease the amount it buys, or do you think it should try to keep the amount of oil imported into the U.S. at about the present level?

6. Concerning U.S. imports of products other than oil--do you think we should increase our imports of non-oil products, reduce them, or keep them at about the present level?

7. Now a question about U.S. exports. Do you think we should try to increase our exports (that is the amount of products we sell to other countries), reduce our exports, or try to keep exports at about the present level?

8. Thinking in terms of the amount of products that the U.S. imports and exports--do you think it is best for the U.S. to import more from other countries than we export to them, or best for the U.S. to export more than it imports, or do you think it is best if the amounts we import and export are equal? Or doesn't it matter?

9. Here are some arguments that have been made in favor of international trade in products other than oil. For each one, please tell me if you think it is a very good argument, a fairly good argument, or a poor argument. (REFER TO FIRST ARGUMENT ON CARD C) -- do you think that is a very good argument, a fairly good argument, or a poor argument? Next...

CARD C

a. Some foreign products cost less than American-made brands and Americans can buy them and save money.

b. Foreign competition makes U.S. businesses more efficient.

c. Buying foriegn countries' products means those countries earn money and can buy those U.S. products they want.

d. Selling U.S. products to other countries helps create American jobs in businesses that export.

e. International trade enables us to produce and sell what we make best and enables other countries to produce and sell what they make best.

f. Americans can have the choice of buying some products that aren't made in the U.S.

10. Now, here are some arguments against international trade in non-oil products. (REFER TO FIRST ARGUMENT ON CARD D) -- do you think that is a very good argument, a fairly good argument, or a poor argument? Next...

CARD D

a. Buying fewer imports from other countries means foreigners would have fewer U.S. dollars and that would protect the value of the dollar.

b. Keeping out foreign products would mean American companies would make higher profits.

c. Not selling U.S. products to foreigners would mean more U.S. products that Americans could buy.

d. Keeping foreign products out of the U.S. means more jobs for Americans.

e. Keeping out foreign products makes the United States more self-sufficient and that is good.

11. Sometimes countries place restrictions on imports coming into the country. Sometimes too, they place restrictions on exports going out of the country. Which statement on this card (HAND RESPONDENT CARD E) comes closest to your view of what U.S. policy should be?

CARD E

a. The U.S. should not have any restrictions on exports or imports

b. The U.S. should have restrictions on exports, but not on imports

c. The U.S. should have restrictions on imports, but not on exports

d. The U.S. should have restrictions on both imports and exports

(IF RESPONSE c OR d SELECTED ON QUESTION 11, ASK QUESTION 12):

12. Speaking of restrictions on imports only--do you think U.S. import restrictions should be increased, decreased, or kept about the same as they are now?

Appendix B

Table 1. Perception of U.S. Economic Dependence

	Dependent			Self-Sufficient			Don't
	Wholly/Largely	Somewhat	(Total)	Nearly	Completely	(Total)	Know
Total Public	17%	52%	(69%)	23%	6%	(29%)	2%
Age							
18-29	20	51	(71)	24	4	(28)	1
30-44	19	53	(72)	21	6	(27)	1
45-59	15	52	(67)	22	8	(30)	3
60 and over	10	53	(63)	25	8	(33)	4
Education							
College	22	53	(75)	20	4	(24)	1
High School	16	53	(69)	24	6	(30)	1
Grade School	10	49	(59)	25	11	(36)	5
Occupation							
Executive/Professional	22	54	(76)	21	3	(24)	-
White Collar	18	54	(72)	23	4	(27)	1
Blue Collar	16	49	(65)	24	9	(33)	2
Union Member	16	50	(66)	26	7	(33)	1
Race							
Black	9	54	(63)	25	11	(36)	2
White	18	52	(70)	23	5	(28)	2
Region							
Northeast	15	48	(63)	24	8	(32)	5
South	17	52	(69)	22	7	(29)	2
Midwest	13	55	(68)	25	6	(31)	1
West	23	52	(75)	21	3	(24)	1
Sex							
Male	18	51	(69)	22	7	(29)	2
Female	15	53	(68)	24	6	(30)	2
Community Size							
Major Metropolitan Area (1.4 million or more)	14	44	(58)	29	9	(38)	4
Cities (150,000-1.3 million)	17	55	(72)	21	5	(26)	2
Towns (35,000-149,000)	19	59	(78)	17	4	(21)	1
Rural Areas	20	59	(79)	16	3	(19)	2

Table 2. Perceptions of Dependency for Specific Products (Harris Surveys)

".....Do you think the U.S. depends on the rest of the world a lot, a little, or not at all for...(SPECIFIC ITEMS READ FROM LIST)?"

".....Does the rest of the world depend on the United States a lot, a little, or not at all for...(ITEMS READ FROM LIST AGAIN)?"

U.S. Dependency on Rest of World: Nov. 1978 (Dec. 1974 Results in Parentheses)

	A Lot	A Little	Not at All	Not Sure
Gasoline and oil	79% (71%)	16% (23%)	3% (4%)	2% (2%)
Markets to sell manufactured products	48 (41)	41 (44)	5 (10)	6 (5)
Manufactured products	39 (21)	49 (53)	9 (21)	3 (5)
Raw materials for manufacturing	36 (30)	50 (53)	8 (12)	6 (5)
Money for investment and construction	21 (8)	46 (30)	24 (53)	9 (9)
Technology	14 (9)	56 (40)	22 (40)	8 (11)
Developing industrial know-how	11 (10)	58 (36)	25 (50)	5 (5)
Food supplies	10 (6)	57 (52)	30 (40)	2 (2)

World Dependency on United States: Nov. 1978 (Dec. 1974 Results in Parentheses)

	A Lot	A Little	Not at All	Not Sure
Food supplies	81% (84%)	17% (13%)	1% (1%)	1% (2%)
Developing industrial know-how	74 (77)	19 (16)	2 (3)	5 (4)
Technology	67 (72)	24 (19)	3 (2)	6 (7)
Money for investment and construction	67 (76)	23 (16)	4 (3)	6 (5)
Markets to sell manufactured products	62 (73)	30 (22)	3 (1)	5 (4)
Manufactured products	54 (67)	39 (27)	4 (2)	3 (4)
Raw materials for manufacturing	53 (60)	39 (33)	4 (3)	4 (5)
Gasoline and oil	15 (21)	51 (38)	30 (37)	4 (5)

Table 3. Awareness of U.S. Trade Imbalance

"When it comes to what the United States buys from other countries and what the United States sells to them, which do you think has been happening during the past several years--has the U.S. been buying more than it has been selling, has it been selling more than it has been buying, or have the amounts the U.S. has been buying and selling been about the same?"

	Buying More Than Selling	Other Responses, Don't Know
Total Public	57%	43%
Education		
College	67	33
High School	58	42
Grade School	43	57
Occupation		
Executive/Professional	68	32
White Collar	57	43
Blue Collar	57	43
Union Member	62	38
Income		
$25,000 and over	67	33
$15,000 - $24,999	59	41
$ 7,000 - $14,999	56	44
less than $ 7,000	43	57
Race		
Black	37	63
White	60	40
Region		
Northeast	52	48
South	52	48
Midwest	61	39
West	69	31
Sex		
Male	65	35
Female	50	50
Party Affiliation		
Democrat	56	44
Republican	64	36
Political Philosophy		
Liberal	54	46
Moderate	58	42
Conservative	60	40

Table 4. Reasons for U.S. Trade Imbalance

"Here are some of the reasons that have been given as to why other countries sell more products to the U.S. than the U.S. sells to other countries. (CARD SHOWN TO RESPONDENT) Would you read down that list and call off the ones you think are major reasons?"

(Question asked of Respondents Aware of U.S. Trade Deficit, Comprising 57 percent of Total Sample)

	Cited as a Major Reason
Because workers are paid less in many other countries than in the U.S., they can make the same things cheaper then we can.	80%
Other countries make it hard to sell American products there, while the U.S. does not make it hard for other countries to sell their products here.	36
The increased cost and the large amount of oil we import means that we have to export a lot of other products just to make our exports and imports equal.	31
Foreign manufacturers are making products that are more attractive to buyers than the products U.S. manufacturers are making.	30
Because many other governments help their businesses financially they can make the same things cheaper than American firms can.	25
Because factories in many other countries use newer and better machinery than that in the U.S., they can make the same things cheaper than we can.	13
U.S. Government regulations prevent American businesses from selling more overseas.	13
American businesses do not try very hard to sell their products overseas.	8
None cited, Don't know	2
	238% *

*More than 100% due to multiple responses

Table 5. Attitude Toward U.S. Foreign Trade

	Effects of No Trade			
	U.S. Worse Off	About the Same	U.S. Better Off	Don't Know
Total Public	44%	28%	21%	7%
Education				
College	57	23	16	4
High School	41	31	22	6
Grade School	32	29	27	12
Occupation				
Executive/Professional	55	26	16	3
White Collar	51	27	16	6
Blue Collar	37	32	25	6
Union Member	45	32	20	3
Income				
$25,000 and over	55	24	18	3
$15,000 - $24,999	48	27	19	6
$ 7,000 - $14,999	40	27	25	8
less than $ 7,000	29	35	24	12
Race				
Black	27	42	23	8
White	46	26	21	7
Region				
Northeast	45	27	20	8
South	41	28	25	6
Midwest	41	29	21	9
West	53	27	16	4
Sex				
Male	48	27	21	4
Female	40	29	22	9

Table 5.
(cont'd)

	Effects of No Trade			
	U.S. Worse Off	About the Same	U.S. Better Off	Don't Know
Party Affiliation				
Democrat	43	29	22	6
Republican	47	29	19	5
Political Philosophy				
Liberal	50	27	17	6
Moderate	40	28	26	6
Conservative	46	28	20	6
Perception of U.S. Economic Dependence				
U.S. largely dependent	59	16	21	4
U.S. somewhat dependent	48	26	21	5
U.S. nearly self-sufficient	34	38	20	8
U.S. completely self-sufficient	22	40	32	6

Table 6. Preferred Level of U.S. Exports

	Increase	Decrease	Keep at Present Level	Qualified (Volunteered)	Don't Know
Total Public	45%	14%	23%	11%	7%
Education					
College	56	11	17	11	5
High School	44	15	25	10	6
Grade School	33	16	28	11	12
Occupation					
Executive/Professional	61	12	15	11	1
White Collar	46	14	23	11	6
Blue Collar	44	14	26	10	6
Union Member	51	13	23	9	4
Income					
$25,000 and over	56	11	22	8	3
$15,000 - $24,999	48	12	21	11	7
$ 7,000 - $14,999	43	14	25	11	7
less than $ 7,000	30	19	26	14	11
Race					
Black	22	20	28	20	10
White	47	13	23	10	7
Region					
Northeast	52	11	23	7	7
South	37	17	24	14	8
Midwest	40	12	26	13	9
West	59	14	17	6	4
Sex					
Male	52	13	20	10	5
Female	39	14	26	11	10
Party Affiliation					
Democrat	44	15	23	11	7
Republican	47	14	24	9	6
Political Philosophy					
Liberal	46	11	27	10	6
Moderate	42	14	24	12	8
Conservative	48	15	21	10	6

Table 7. Preferences on Import and Export Restrictions

"Sometimes countries place restrictions on imports coming into the country. Sometimes too, they place restricitons on exports going out of the country. Which statement on this card (RESPONDENT SHOWN CARD) comes closest to your view of what U.S. policy should be?"

The U.S. should not have any restrictions on exports or imports	6%
The U.S. should have restrictions on exports, but not on imports	4
The U.S. should have restrictions on imports, but not on exports	14
The U.S. should have restrictions on both imports and exports	67
Don't know	9
	100%

(IF FAVORED "restrictions on imports" or "didn't know," RESPONDENT WAS ASKED):

"Speaking of restrictions on imports only--do you think U.S. import restrictions should be increased, decreased, or kept about the same as they are now?"

Increase import restrictions	28%
Keep same	31%
Decrease import restrictions	14
Don't know	17
	90%

Table 8. Preferences on Import Restrictions

	Favor Import Restrictions				Oppose Import Restrictions
	Increase Restrictions	Keep Same	Decrease Restrictions	Don't Know	
Total Public	28%	37%	14%	17%	10%
Education					
College	30	32	14	14	10
High School	28	32	15	16	9
Grade School	24	30	15	22	9
Occupation					
Executive/Professional	35	27	16	12	10
White Collar	26	34	14	18	8
Blue Collar	30	30	16	13	11
Union Member	35	28	15	12	10
Income					
$25,000 and over	34	33	12	11	10
$15,000 - $24,999	26	32	16	17	9
$ 7,000 - $14,999	27	30	15	18	10
less than $ 7,000	27	29	13	19	12
Race					
Black	27	29	13	16	15
White	28	31	15	17	9
Region					
Northeast	29	26	17	19	9
South	25	31	15	17	12
Midwest	28	33	14	16	9
West	32	37	10	13	8
Sex					
Male	33	31	15	11	10
Female	23	31	14	23	9
Party Affiliation					
Democrat	26	32	16	17	9
Republican	30	31	13	14	12
Political Philosophy					
Liberal	27	34	12	17	10
Moderate	28	33	15	16	8
Conservative	28	29	16	16	11

Table 9. Arguments in Favor of International Trade

"Here are some arguments that have been made in favor of international trade in products other than oil. (RESPONDENT SHOWN CARD) For each one, please tell me if you think it is a very good argument, a fairly good argument, or a poor argument..."

(Order of presentation on card: #2,5,6,1,3,4)	Rated "Very Good Argument"
(1) "Selling U.S. products to other countries helps create American jobs in businesses that export those goods."	44%
(2) "Some foreign products cost less than American-made brands and Americans can buy them and save money."	40
(3) "International trade enables us to produce and sell what we make best and enables other countries to produce and sell what they make best."	39
(4) "Americans can have the choice of buying some products that aren't made in the U.S."	31
(5) "Foreign competition makes U.S. businesses more efficient."	29
(6) "Buying foreign countries' products means those countries earn money and can buy those U.S. products they want."	21

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Table 10. Arguments Against International Trade

"Now, here are some arguments against international trade in non-oil products. (RESPONDENT SHOWN CARD) First,....do you think that is a very good argument, a fairly good argument, or a poor argument?" (ASK ABOUT EACH ITEM)

(Order of presentation on card: #3,4,5,1,2)

		Rated "Very Good Argument"
(1)	"Keeping foreign products out of the U.S. means more jobs for Americans."	44%
(2)	"Keeping out foreign products makes the United States more self-sufficient and that is good."	39
(3)	"Buying fewer imports from other countries means foreigners would have fewer U.S. dollars and that would protect the value of the dollar."	30
(4)	"Keeping out foreign products would mean American companies would make higher profits."	25
(5)	"Not selling U.S. products to foreigners would mean more U.S. products that Americans could buy."	20

Table 11. Group Ratings of Pro-Trade Arguments
(Percent Rating Each Argument as "Very Good")

Pro-Trade Arguments

	(1) Create Jobs in Export Sector	(2) Lower Consumer Prices	(3) Int'l Subdivision of Production	(4) Wider Consumer Choice	(5) More Efficient U.S. Companies	(6) Foreigners Can Buy U.S. Products
Total Public	44%	40%	39%	31%	29%	21%
Education						
College	45	45	43	32	32	22
High School	45	38	39	31	28	20
Grade School	43	38	34	29	28	22
Age						
18 - 29	47	39	38	33	30	18
30 - 44	44	43	37	29	27	19
45 - 59	40	40	39	28	28	24
60 and over	47	40	43	34	32	25
Occupation						
Executive/Professional	54	48	52	33	38	28
White Collar	40	42	37	29	25	18
Blue Collar	42	37	35	29	28	18
Union Member	43	38	33	28	33	18
Income						
$25,000 and over	50	46	42	32	30	21
$15,000 - $24,999	42	37	39	31	29	20
$ 7,000 - $14,999	43	41	40	32	30	20
less than $ 7,000	45	41	34	30	28	24
Race						
Black	39	55	31	28	32	23
White	45	39	40	32	29	21

Table 11.
(cont'd)

	Pro-Trade Arguments					
	(1) Create Jobs in Export Sector	(2) Lower Consumer Prices	(3) Int'l Subdivision of Production	(4) Wider Consumer Choice	(5) More Efficient U.S. Companies	(6) Foreigners Can Buy US Products
<u>Region</u>						
Northeast	40	38	31	24	26	15
South	48	43	42	35	30	23
Midwest	42	42	38	30	28	22
West	48	35	45	35	34	23
<u>Sex</u>						
Male	50	43	42	30	34	23
Female	40	38	36	32	25	19
<u>Party Affiliation</u>						
Democrat	44	41	38	31	29	21
Republican	45	37	43	32	30	24
<u>Political Philosophy</u>						
Liberal	47	40	41	34	33	24
Moderate	41	39	36	29	25	17
Conservative	47	42	41	32	31	24
<u>Community Size</u>						
Major Metropolitan Area (1.4 million or more)	40	43	35	29	30	20
Cities (150,000 - 1.3 million)	46	37	38	29	28	19
Towns (35,000 - 149,000)	48	40	44	36	29	22
Rural Areas	46	42	47	32	35	29

Table 12. Group Ratings of Anti-Trade Arguments
(Percent Rating Each Argument as "Very Good")

Anti-Trade Arguments

	(1) Retain American Jobs	(2) Make U.S. More Self-Sufficient	(3) Protect Dollar	(4) Higher Profits for U.S. Companies	(5) More U.S. Products for American Consumers
Total Public	44%	39%	30%	25%	20%
Education					
College	37	31	25	22	16
High School	45	42	33	25	20
Grade School	51	43	32	30	23
Age					
18 - 29	41	39	30	26	21
30 - 44	41	38	30	25	18
45 - 59	45	39	28	23	20
60 and over	50	37	32	27	20
Occupation					
Executive/Professional	35	29	27	23	15
White Collar	38	35	26	21	16
Blue Collar	51	44	36	27	24
Union Member	51	43	36	24	17
Income					
$25,000 and over	39	33	29	21	15
$15,000 - $24,999	39	36	27	22	17
$ 7,000 - $14,999	50	44	33	29	23
less than $ 7,000	51	43	33	31	25
Race					
Black	46	32	36	31	23
White	44	39	30	25	19

Table 12.
(cont'd)

Anti-Trade Arguments

	(1) Retain American Jobs	(2) Make U.S. More Self-Sufficient	(3) Protect Dollar	(4) Higher Profits for U.S. Companies	(5) More U.S. Products for American Consumers
Region					
Northeast	48%	41%	26%	21%	17%
South	48	43	34	31	24
Midwest	43	36	33	25	20
West	33	30	24	21	15
Sex					
Male	44	39	32	24	19
Female	44	39	28	27	21
Party Affiliation					
Democrat	45	39	32	27	22
Republican	37	34	29	21	16
Political Philosophy					
Liberal	40	35	26	22	19
Moderate	47	41	29	27	20
Conservative	44	38	34	26	20
Community Size					
Major Metropolitan Area (1.4 million or more)	40	32	26	20	17
Cities (150,000 - 1.3 million)	50	42	30	27	20
Towns (35,000 - 149,000)	42	41	36	30	24
Rural Areas	42	46	34	29	21

Appendix C

Crosstabular Analysis of the Arguments

Argument #1	Argument #2	Argument # 1 considered to be better than # 2	Argument # 2 considered to be better than # 1	Both about same	Don't know responses #1 and/or #2
(1) Lower prices	Lost jobs	25%	27%	39%	9%
(2) More jobs in export sector	Lost jobs	27	22	40	11
(3) Subdivision of labor	U.S. self-sufficiency	28	25	35	12

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE SENATE COMMITTEE ON FINANCE
REGARDING S. 2773, A BILL TO ESTABLISH A NATIONAL
EXPORT POLICY FOR THE UNITED STATES

September 10, 1980

Farm Bureau, representing over 3 million member families appreciates this opportunity to comment on S. 2773. This is, of course, a very comprehensive bill touching on many aspects of national export policy.

We would like to offer comments on Title VII which has several provisions that bear directly on agricultural exports. These provisions are:

(1) Part I - Commodity Credit Corporation financing for agricultural exports.

(2) Part II - Export-Import Bank Credits for agricultural commodity exports, and

(3) Part III - International Wheat Exporting Commission.

COMMODITY CREDIT CORPORATION FINANCING

Farm Bureau gave strong support to the Agricultural Trade Act of 1978 which, among other things, had export credit provisions that if effectively implemented would enable additional U.S. farm exports to be financed in world markets under terms and conditions of sale just as attractive as those offered by our competitors in those markets. Unfortunately, certain credit provisions of the 1978 Trade Act have not been effectively implemented.

A part of this problem is addressed by Sec. 20, Part I of Title VII of H. R. 2773. This provision would establish an Agricultural Export Credit Revolving Fund which would considerably enhance farm export prospects and remove a great deal of the uncertainty of whether export financing would be made available year in and year out for use in obtaining additional agricultural export sales. Since CCC credit export financing is not subsidized and, in fact, yields a return to the government above the cost of money to the Treasury, a revolving fund, once established, should be self-sustaining.

CCC credits are one of the most effective tools that can be used to quickly stimulate sluggish exports. There are many countries, especially developing countries, that do not always have "cash-on-the-barrel head" to pay for their commodity needs. However, they can, and will, turn our way if export financing is made available. Losses in the CCC credit program have been virtually nil.

At our annual meeting in January, 1980, Farm Bureau adopted policy that "recommends legislation to establish a revolving fund for the Commodity Credit Corporation's extension of credit terms in international commercial trade in U.S. commodities." We are pleased to see that such a provision is a part of S. 2773, and we strongly support it.

EXPORT-IMPORT BANK CREDITS

In past years the Export-Import Bank has provided some export financing for agricultural commodities, including financing for cotton and breeding animals. In recent years such export financing has been terminated.

We believe that an inequity exists when a foreign importer of U.S. industrial items can obtain Export-Import Bank financing at an 8 percent interest rate while a foreign importer of farm commodities, under current U.S. export policies, cannot obtain any Export-Import Bank financing and must turn to CCC for financing, where funds are inadequate and interest rates are about 13 percent.

Farm Bureau strongly urges your support of Part II of Title VII, which directs Export-Import Bank financing to have a relationship to the ratio of the dollar value of U.S. agricultural exports to the dollar value of total U.S. exports. Passage and implementation of this provision would mean a more equitable allocation of the Export-Import Bank's export-financing resources.

INTERNATIONAL WHEAT EXPORTING COMMISSION

Part III of Title VII would establish an International Wheat Exporting Commission. As we understand this provision, it would empower the Commission to attempt to set a minimum world market price for wheat each year, prescribe a market share for each member country, "protect purchasers of wheat against wide price fluctuations," and control exports by the issuance of licenses.

Farm Bureau vigorously opposes the provision for the following reasons:

(1) The trading of farm commodities--and the prices, terms, and conditions of such trade--should not be dependent on, or influenced by, political decisions of the governments. Farmers became very upset--as did our trading partners--over the soybean embargo of 1973, and the grain embargo of 1980. This provision would, in effect, freely permit the Commission to restrict or even embargo, exports for political reasons. We believe that prices, terms of trade, and market shares should be based on economic considerations rather than political decisions.

(2) The United States, as the most efficient producer of wheat in the world, has nothing to gain by dividing up the world wheat trade into market shares. Neither is it in the American wheat farmers' or consumers' interests to hold a price umbrella over the heads of less efficient competitors by agreeing to minimum price levels. It is, however, in the interest of American wheat farmers and consumers to carve out our share of the world market by efficient production and a market-oriented export sales policy, combined with a strong market development effort to service our overseas markets. Exports of grain are a significant portion of total U.S. exports and any policy that limits grain exports is a detriment to the total U.S. economy.

(3) We oppose any system that would require export licenses for general export destinations. Such a requirement can limit, or even effectively embargo, wheat. This can only lead to market sharing and increased political interference in the marketing of wheat; the final result of which would be to reduce the incomes of American wheat farmers.

The government has a role--a very important one--in expanding exports of farm commodities. That role involves such matters as negotiations with regard to international trade restrictions and trading rules, grain inspection, cooperative market development, operation of trade and operation of the P.L. 480 and CCC credit programs. In our view, the government should not have a role in pricing, merchandising, or setting the terms and conditions of export sales other than to assure that the market is kept free of anticompetitive practices.

We recommend deletion of Part III of Title VII of S. 2773.

Mr. Chairman, these are Farm Bureau's views on Title VII, Agricultural Exports of S. 2773. We will appreciate the consideration of our views as this proposed legislation is discussed.