S. HRG. 105–926

CAUSES OF THE TRADE DEFICIT AND ITS IMPLICATIONS FOR THE U.S. ECONOMY

HEARING

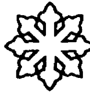
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

JUNE 11, 1998



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

55–877—CC WASHINGTON : 1998

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-058372-1

5361-23

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CAUSES OF THE TRADE DEFICIT AND ITS IMPLICATIONS FOR THE U.S. ECONOMY

THURSDAY, JUNE 11, 1998

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD-215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Chafee, Grassley, D'Amato, Murkowski, Moynihan, Conrad, Graham, Moseley-Braun, and Bryan.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

Today marks the beginning of a comprehensive review of our trade policy, one that I expect to pursue this year and next as a means of reconnecting our trade policy with the American people.

My goal is to lay the foundation for trade legislation to be considered in the next Congress that will establish a new American agenda on trade.

Since World War II, we have maintained a strong bipartisan consensus in favor of trade liberalization. As this past fall's debate over fast-track legislation made clear, that consensus has broken down. The result has been a political climate in which many view trade with skepticism or outright hostility.

In my view, unless we address the concerns of the American public over trade, the current hostility may foster a new isolationism, the urge to throw up a protective wall around us to stave off the economic changes at loose in the world. That would have devastating economic consequences.

Ultimately, there is no protection in protectionism. The way forward lies, instead, in rebuilding a domestic political consensus in support of opening markets abroad and encouraging competitiveness at home. That is a goal of the trade policy review we will begin today.

The first step in that process will be a series of Finance Committee hearings designed to assess the impact of trade and trade agreements on the economic future of the American people.

To supplement the work of the Finance Committee hearings, I intend to turn to those agencies with expertise in economics and trade policy, such as the International Trade Commission, and,

where necessary, to resources outside government to ensure that the committee gets the answers it needs to fulfill its responsibilities.

At the outset, I will focus the committee's review on the broad policy questions raised by this past fall's debate such as: what drives the increasing globalization of markets, and what are the implications for the American economy; how do our existing trade agreements serve our economic interest, and, where broken, how should these trade arrangements be fixed; what domestic policy changes are needed to ensure American competitiveness in a global economy, such as the fundamental reform of our Tax Code; what impact does increasing international trade have on labor, environmental, and health and safety standards both here and abroad?

In later stages of the review, I intend to focus on our relationships with particular trading partners, the competitiveness of particular sectors of the economy such as agriculture, manufacturing and services, and on the operation of our existing trade laws.

That hard work begins today with our hearing on the causes and consequences of the trade deficit. I do not need to inform the members of the committee about the dramatic shift that has taken place in our trade position over the last 20 years.

The last time we ran a current account surplus for a full year was in the early 1980's, and our net international investment position has eroded steadily during that time to the point that we are now the world's largest debtor Nation.

While the deficit is substantially smaller now as a percentage of gross domestic product than it was in the mid-1980's, it is once again expanding rapidly as a result of economic developments in Asia.

That erosion has caused considerable debate over what drives that deficit, whether it is largely a function of our own domestic economic policy or the result of foreign unfair trade barriers and the manipulation of exchange rates.

We are fortunate to have with us today three extremely distinguished panels of witnesses to help explain the deficit and what it means for our economic future.

Kent?

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. Thank you very much for holding this hearing. I think it is critically important. I welcome your announcement that we are going to have a series of hearings, because I think this goes right to the heart of the economic challenge facing our country.

I think most of us would agree that free trade is a correct principle. The devil is in the details. Representing the State of North Dakota and being next to our neighbor to the north, Canada, we have had a chance to experience how the details of a so-called free trade agreement can very adversely affect a State.

Once the Canadian Free Trade Agreement was passed, Canada went from zero percent of the U.S. durham market to 20 percent of the U.S. durham market, virtually overnight, not because they were more competitive, but because of a loophole that was in the

Canadian Free Trade Agreement that was never revealed to Congress.

In fact, we only learned of what was negotiated away when we had a Binational Panel ruling that went to the negotiating notes that had never been given to Congress and found that our then trade ambassador, Clayton Yeuter, had agreed to a formula that was grossly unfair to U.S. producers.

The consequences have been severe for our State. The State University has indicated that, because of these unfair trade practices that were allowed in this secretly negotiated deal, North Dakota loses about $500 million as a result.

Now, not only have we seen it in a specific agreement like the Canadian Free Trade Agreement, we have also seen the defects of NAFTA. In the NAFTA agreement, members will remember, we negotiated a 10 percent reduction in the tariffs. Very soon thereafter, Mexico had a 50 percent devaluation.

As a result, we were worse off in terms of a trade relationship than when we started. As a result, we went from a $2 billion trade surplus with Mexico to a $16 billion trade deficit. If that is a success, I would hate to see a failure.

Right now our State, North Dakota, is going through a severe agricultural crisis. We have just had the Secretary of Agriculture to North Dakota, and he formed a crisis response team that told us that we are in danger of losing one-third of our farmers next year. One out of every three, Mr. Chairman. That is a crisis. We are bedeviled by a double-whammy of low prices, coupled with a severe outbreak of disease.

Part of the reason we have got low prices, is because we have got our chief competitors, who are heavily subsidizing their producers, in fact, at a level 10 times what we do for ours. Ten times. On export subsidy, they are subsidizing their producers at a rate of 100 times what we do for ours. The outcome is predictable: their market share has increased, ours has declined.

Over and over, we have seen this pattern repeated as the United States has been taken advantage of in trade negotiations and trade discussions. The result is, we are the largest debtor Nation in the world, and that has serious economic consequences.

Mr. Chairman, that is why these hearings are so important, and I, again, thank you for holding them.

The CHAIRMAN. Thank you, Senator Conrad.

Senator Chafee?

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you very much, Mr. Chairman. I want to thank you for holding today's hearing on the important subject of the trade deficit. I believe there is an enormous amount of misinformation and misunderstanding about the trade deficit of our country. One need only to look at the recent debates in the Senate to find proof of that.

For example, one suggestion is the notion that, for every billion dollars in imports, some 20,000 jobs are lost. This formula seems to be based on the well-known and accepted statistic that every billion in exports supports roughly 20,000 jobs.

But economists agree that you simply cannot reverse that export formula. Why? Because with imports, other questions arise, questions such as, is there direct important substitution? Is it a substitution for something that did exist in our country?

For example, let us take a look at coffee. We import $2.6 billion in coffee. But we cannot say we, therefore, have lost 52,000 U.S. jobs, for we do not grow coffee in this country.

So I think it makes sense to go back to basics, as you are doing here today, Mr. Chairman, and take a look at the deficit to understand why it may exist and what it means.

The panels that are assembled today before us are made up of distinguished experts in this area, and I am especially interested in hearing from two of our top economic officers in our country, the Secretary of the Treasury and the Chair of the Council of Economic Advisors. They are going to help us understand the true nature and implications of the trade deficit.

So I believe this hearing can help clear away some of the misconceptions about trade and its impact on our economy, and I hope that the information we hear today will be shared with our colleagues during the next Senate debate on trade legislation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Chafee.

Senator Bryan?

Senator BRYAN. Mr. Chairman, I will waive my opening statement, but I will have some questions for the panels.

The CHAIRMAN. Thank you very much. Time is of the essence, and I appreciate that.

We will now hear from our distinguished colleague, the junior Senator from North Dakota, Byron Dorgan. Senator Dorgan has been one of the primary proponents of examining the causes and consequences of the deficit.

I share his concern that we gain a better understanding of what is driving the trade deficit in light of the trade numbers we have seen in recent months.

I appreciate, also, Senator Dorgan's efforts to assure that this important issue is addressed, and his interest in being with us today.

Senator Dorgan?

STATEMENT OF HON. BYRON DORGAN, A U.S. SENATOR FROM THE STATE OF NORTH DAKOTA

Senator DORGAN. Mr. Chairman, thank you very much for holding the hearing. I will be brief. I know you have a long schedule.

But let me begin by going through a series of charts. And if I might turn them so that some in the room can seen them as well as those at the dais, it will, I think, set the stage for what I am about to talk about.

First, is the U.S. merchandise trade deficit. You can see the flood of red ink. If you are over 21 years old, you have never lived in this country at a time in which we have not had a trade deficit. It is 32 out of the last 33 years, 22 consecutive years, of merchandise trade deficits.

If we could have the next chart. That is not a record, it seems to me, that is a record of success. Second, is the American goods

deficit is getting worse. These are the average monthly deficits. You will see that this year, the average monthly deficit is worse than every other year, and that has been the case every single year.

The next chart will show, for the past 13 years, a couple of countries. China, in the past 13 years, has grown in its merchandise trade deficit with us from $10 million to $50 billion.

The next chart will show Japan. If you take a look at our trade relationship with Japan, you will see an abiding, consistent trade deficit with Japan. I believe that is the last chart. I simply wanted to show the flood of red ink dealing with trade policy.

Now, I think it is wonderful to have distinguished economists testify today. I would encourage you, however, to invite some farmers and some businessmen, some oil drillers, and others who really know about trade policy.

It is safe to say that there has never been an economist, a politician, or a journalist that has lost a job because of bad trade policy. But I would invite, also, in future hearings some folks who know firsthand about how trade policy affects them and their lives.

There are really two views about this trade policy. One, was in the Boston Globe in an op-ed piece yesterday by a writer who says, "Our trade deficit is not a sign of disaster, but of strength," and goes on to say, "America's balance of trade is not a real economic event, it is only an accounting fiction."

A piece in the New York Times by a former member of the administration said, "What are we worried about? We are importing tomatoes from Mexico and buying toys from China. But then we are exporting automobiles and jet aircraft, so what is the big deal?"

It is true, in fact, we import tomatoes from Mexico, but the largest imports from Mexico are auto parts, automobiles, and electronics. In fact, we now import more automobiles from Mexico than we export to the entire rest of the world.

I am wondering whether the writer, one of the country's distinguished economists, could have confused tomatoes with Toyotas, or might want to alert customs that those big red vegetables have combustion engines.

But there is a lot of confusion about trade, so let me talk about the other view. Mr. Greenspan, whom I rarely quote, yesterday, was testifying before Congress and talked about trade deficits ballooning to record levels that are "unsustainable and pose unknown consequences and possible dangers."

Buster Thoreaux. "If there is one thing we know about international trade, it is that no country, not even one as big as the United States, can run a trade deficit forever."

I have said before, and feel strongly, that our trade policies in this country that create these deficits or result in these deficits are both soft-headed and weak-kneed.

By that, I mean soft-headed, one, they are, in most cases, a result of trade agreements that we have negotiated badly. Some 60 or 70 years ago, Will Rogers said, "The United States has never lost a war and never won a conference." He surely must have been talking about trade.

We negotiate, inappropriately, trade agreements with other countries, believing that most of it is foreign policy rather than hard-

nosed economic policy, not understanding that our competitors in this world these days are tough, shrewd, competent, able competitors. Our trade policy must be tough, hard-nosed, economic policy, not soft-headed foreign policy.

So, one, badly negotiated trade agreements. We ought to do better than that. Senator Conrad talked about NAFTA. I wish I had 15 minutes today to talk just about NAFTA and how incompetently that was negotiated, at least from the standpoint of farmers in our part of the country. I mean, incompetently negotiated.

Two, trade agreements are rarely enforced. In fact, they are so rarely enforced that you cannot find a record of what the agreements are. The U.S. Chamber of Commerce in Japan tried to accumulate the trade agreements we have with Japan and tried to get U.S. Government sources to accumulate it for them, and the agencies and the government really could not find a record of the trade agreements.

So, if you do not have a record of the agreements, how on earth would you enforce them? Of course, they are rarely enforced, and, when enforced, enforced in very weak terms.

Finally, we have trade agreements that do not recognize currency fluctuations. When the Japanese yen fluctuates 40 or 50 percent, which makes our exports much more expensive and their imports much less expensive and you see this flood of red ink, it seems to me that if you were a producer rather than a journalist, a producer rather than an economist, or a producer rather than a legislator, you would understand and demand that no trade agreement can be effective if you have wild fluctuations in currency values.

But let me just conclude with a couple of other points. About two weeks ago, a ship pulled up to the dock in California with European barley. We raise plenty of barley in this country.

The Europeans subsidized that feed barley, which does not have much value in the first place, probably $2 a bushel. They subsidized it to the tune of $1.10 a bushel, and then shipped it into Stockton, California, into this country. It was legal under GATT.

Let me say that again. You can take a $2 product raised in Europe, pay the shipping costs, send it to this country, and subsidize to $1.10 a bushel, and it is legal under GATT. That describes the bankruptcy of a trade agreement that says that kind of behavior is legal.

If any of us think that this trade policy has the respect of producers in this country, who every day go to work and try and confront those kinds of issues raised by that kind of behavior, we are dead wrong. We need to fix this, and we can do it if we work together.

I am not suggesting that expanded, open, and free trade is not important. It is. I advocate it. I demand, however, on behalf of the producers of this country, that it be fair trade. You cannot look at those charts, in my judgment, and see the accumulation of red ink and not understand that it hurts this country.

Finally, let me conclude by saying, the economists who will testify today will likely have different views of these issues. Some will say, in fact, gee, things are going so swimmingly, in fact, all these red marks are signs of economic health. I taught economics very briefly in college. I was able to overcome that. [Laughter.] And I think go on to some other things.

I do not dismiss economists. I think they contribute a great deal to our country. But I must say this. The most basic text of economic learning tell us that our gross national product is composed of four things: consumption, investment, government, and net exports.

If net exports show a deficit, it detracts from our economy, not adds to it. There is no debating that, in my judgment. We will find people who come here and describe all kinds of excuses about why we are here and why we ought not do anything, and why those who come and raise some concerns about it are xenophobic protectionist stooges who just do not understand and just cannot see over the horizon. That is all nonsense.

This is a problem, and this country would do something that is responsible on behalf of producers if it recognizes it is a problem and begins, thoughtfully, to address it. No, not to start a trade war, but just to serve notice to our trade partners around this world that times are different.

We are going to stand up for our interests, the interests of our producers, and demand fair and reciprocal trade policies. When we do not get them, then others must pay a price for that, but this country must begin standing up for its economic interests.

The word protectionist is used in the article that I started with today and it is bantered around. Anybody who has any different thoughts about trade is immediately branded a protectionist.

I am only interested in expanded trade opportunities that are fair to this country. I am not interested in continuing 25 or 50 years of trade policy that really, in effect, is foreign policy and that undermines and weakens our country.

Mr. Chairman, thank you for holding the hearing. I have introduced the bill that would create a commission to develop strategies to deal with this issue, and that is, I think, part of the reason for this hearing. I thank you for being willing to explore what I think is a controversial, but nonetheless a very important, issue for this country.

The CHAIRMAN. Thank you very much, Senator Dorgan, for being here today. The purpose of these hearings are to try to determine exactly where we are, what needs to be done. Certainly, agriculture is one of the most critical areas and we intend to spend a great deal of time on that matter.

Thank you very much.

Senator DORGAN. Thank you.

[A statement submitted by Senator Dorgan appears in the appendix.]

The CHAIRMAN. I would now turn to our second panel, which includes my good friend and colleague, Secretary of Treasury Robert Rubin, as well as the Chair of the Council of Economic Advisors, Janet Yellen.

Secretary Rubin, of course, is the administration's principal spokesperson on economic policy matters. Before becoming Treasury Secretary, he served as Chair of the National Economic Council and Co-chair of Goldman Sachs.

Chair Yellen, prior to assuming her current position, was most recently a Governor of the Federal Reserve. Before that, she enjoyed a distinguished career as a professor of economics, specializ-

ing in the international arena, and most recently as a Bernard Roka Professor of International Business and Trade at the School of Business at the University of California at Berkeley.

Senator MURKOWSKI. Mr. Chairman?

The CHAIRMAN. Yes, Frank?

OPENING STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM ALASKA

Senator MURKOWSKI. If I may just compliment you on holding these hearings. I believe Secretary Rubin is either lost in traffic, or slow in coming.

But, if I may proceed very briefly, to compliment you on the significance of this hearing, the timeliness of it, and the importance of it, because an awful lot is taken for granted in the area of trade.

I intend to pursue with Secretary Rubin, who has just arrived, the question of the role of the Secretary of Treasury in regard to the stabilization of the yen. The yen is at 141, almost 142. The Japanese stock market is at a 52-week low; the Taiwanese stock market is at a 52-week low.

Furthermore, Mr. Chairman, I think it is rather enlightening to reflect on some of our trade policies associated with sanctions, because I am under the advice that 65 percent of the world's population is current subject to our U.S. sanctions.

What that does to our international competitiveness, Mr. Chairman, is pretty obvious. It certainly provides opportunities for our trading partners to have a little better position, whether it be the Japanese, the South Koreans, the French, or whatever, as we exclude ourselves by our own sanction policies from a significant portion of the world's market.

When you think of the magnitude of excluding ourselves from 65 percent of the world's population by trade sanctions, it suggests that we review this. I am particularly pleased that Senator Lugar is proceeding with hearings and an examination of this policy.

So, I will look forward to the Treasury Secretary commenting on some of the points that I have made and, particularly, when do we step in, or do we step in, and stabilize the yen or some other currency.

Finally, Mr. Chairman, as we look at our trade deficit of $199 billion, it is rather interesting to reflect that most of it is made up of two countries, China and Japan.

The third major factor, is the trade deficit as a consequence of the contribution of dependence on imported petroleum. Thirty-one percent. Thirty-one percent of our trade deficit is as a consequence of our dependence, and there are the figures over there, on imported petroleum, which means we send our dollars and our jobs overseas.

This administration has been very reluctant to encourage development on Federal lands, particularly in my State of Alaska, where, for the last 20 years, we have supplied this Nation with about 20 percent of the total crude oil produced. So, if you want to address that with relief, Mr. Chairman, you might start with the old adage that charity begins at home.

With that profound observation, I am finished.

The CHAIRMAN. Thank you, Senator Murkowski.

Again, I am happy to welcome the Secretary of Treasury, Mr. Rubin. He is accompanied, of course, by Larry Summers, the distinguished Deputy Secretary of Treasury. As I said earlier, it is a great pleasure to have these three distinguished people here.

Your full statements will be included as if read. I would ask that you summarize them. Welcome. It is good to have you here.

Senator Rubin, I mean, Secretary. I just promoted you. [Laughter.]

STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY OF THE TREASURY, WASHINGTON, DC, ACCOMPANIED BY DR. LAWRENCE H. SUMMERS, DEPUTY SECRETARY, U.S. TREASURY

Secretary RUBIN. Well, you changed me, Mr. Chairman, but I will note to Senator D'Amato that you so referred to me.

The CHAIRMAN. No, do not do that, please.

Secretary RUBIN. In any event, let me start by saying that I think this hearing is a very good idea. I think it gives us an opportunity to discuss a whole range of issues that revolve around the trade deficit that are very important to our country.

Let me start, if I may, by putting the trade deficit in context. As you know, Mr. Chairman, this is the strongest economy amongst the major industrialized world today: we have 4.3 percent unemployment, created roughly 16 million new jobs over the past five and a half years, low inflation, and rising real wages, all of which I think is very important to keep in mind as we talk about the trade deficit.

At the same time, we do have an expanding trade deficit. However, having said that, also, as a percentage of GDP, as a percentage of the economy, it is substantially lower than it was in the mid-1980's.

In the mid-1980's, it was about 3.5 percent of GDP. It is about 2.5 percent of GDP this year, and private forecasters are estimating somewhere between 2.5 to 3 percent of GDP next year.

There are many reasons behind the increasing trade deficit, and I know Chairman Yellen is going to be talking about savings, a very important factor. But it is our view that the single most important factor is the relative strength of the U.S. economy compared to virtually all of our significant trading partners.

Within the context of the United States' economy, the driving force has been domestic demand, although exports have also increased at a rather nice pace, but foreign demand, as a general proposition, has not increased nearly as rapidly as domestic demand.

First quarter data indicates that the countries that have been most affected by the recent instability in Asia, Thailand, Malaysia, Indonesia, the Philippines, Singapore, and Korea are in a pace to fall somewhere on an annualized basis between $17 billion and $24 billion in terms of our exports to them versus where we were before the crisis began. Of course, the concern is that if that contraction in this part of the world increases, then those numbers become substantially larger.

If you add Japan to those figures, the number is somewhere between $23 billion and $29 billion on an annualized basis, and, once again, that could become larger if the contraction increases.

Most of the industrialized nations have also been growing less rapidly than we have, but I think, most troublingly, and Senator Murkowski referred to this, is the situation in Japan.

That economy still fails to show signs of recovery, and I do not think there is any question but that the weakness of the Japanese economy and the correlated weakness in their currency are having substantial adverse impacts on the Eastern Asian countries, which, in turn, affects us.

Obviously, the worse the conditions become in Japan, the worse it impacts on East Asia. We, that is to say, the United States and the IMF, the OECD, and the G-7—and in our case this has been going on for close to 2 years now—have strongly and actively urged the Japanese government to undertake the necessary steps to increase domestic demand-led growth, particularly fiscal stimulus dealing with the problems in their banking sector, deregulation, and opening markets.

We have also consistently, particularly over the last several months, expressed a sharing, if you will, of the concern that they have expressed about the weakness of their currency. I think it would be fair to say that we have expressed a growing concern, as they have expressed a growing concern, about the weakness of their currency.

It is our view that the weakness of the yen reflects the economic conditions in Japan. Senator Murkowski, in response to your, I think, very important comments, the fundamental remedy to the problem of the yen is for the Japanese government to take the kinds of measures that are necessary to stimulate domestic demand-led growth in Japan.

On the whole, the trade deficit of the United States, as a consequence, is viewed as a reflection of the strength of our economy, not a weakness. It is our view that, even with this trade deficit, the most likely scenario in the foreseeable future is a continuation of solid growth, low inflation, low unemployment.

One thing that is absolutely clear, is that the trade deficit has not undermined performance in this economy. Having said that, let me focus on the effects of the trade deficit for a moment, Mr. Chairman, because I think that is an extremely important and somewhat complicated issue. Let me do it in the context of two dynamics. On the one hand, the trade deficit means that we are attracting foreign capital, and that does create claims, both debt and equity claims, that are some point are going to have to be repaid.

On the other hand, if that capital is used, not for consumption but for investment, and if it is used wisely, then we can get more growth in this country out of the foreign capital that has come in than the claims that we will have to repay so that, on balance, it will be good for our economy.

I think the evidence suggests at the present time that, in fact, that is exactly how that imbalance of capital coming in is being used and that, therefore, this capital coming in is contributing constructively to our economy, even when taking into account the fact that it will have to be repaid at some point in the future.

Having said that, it also does create vulnerabilities. Increased trade deficits create vulnerability to a change in sentiment in the international capital markets with respect to the United States,

and, second, they do give rise to sectoral dislocations in our economy. Amongst other things, all of this gives rise or underscores the importance of having strong economic policies at home.

More broadly, Mr. Chairman, I do not think there is any question, at least in our view, that trade contributes very substantially to the economic well-being of our country. Millions of Americans owe their jobs, directly or indirectly, to trade, and all of us have both lower prices and greater choice because of the international competition that trade fosters.

Moreover, trade with developing countries now accounts for somewhat over 40 percent of our total exports. It is sometimes said that we cannot trade effectively with low-wage countries, and I think the evidence I have just put forth suggests exactly the opposite.

While it is true that low-wage countries are able to produce a range of low-wage, low-skilled items at lower cost than our country, which, I might add, is to the benefit of American consumers, this is not true across the board because in many low-wage, low-skilled products we still have an advantage due to American productivity and other factors.

Moreover, the developing countries buy American goods, airplanes, construction equipment, entertainment products, high-tech goods, and the result is that, as long as we remain a highly productive and competitive economy, we can, and we will, export effectively to low-wage countries, and increasing trade with low-wage countries will benefit our economy.

Just for one moment, to put the same thing into conceptual perspective, trade is not a zero sum game. A nation does not win by exporting and lose by importing. If a nation produces its relatively most competitive goods and services and then exchanges them with other nations to obtain the goods and services it produces relatively less competitively, the nation will be better off with than without trade.

Having said that, it is also true that, while the great preponderance of Americans will benefit from trade, some industries will be buffeted by foreign competition, which means there will be dislocations for some, though I think it should be observed that technology contributes far more to those dislocations than trade.

The answer, in our view, is not to try to halt the technology or to try to halt trade, which contributes so much to so many, but, rather, to make sure that all of our people are equipped to compete in the global economy, to help the dislocated re-enter the economy quickly and successfully, and to have an appropriate safety net, where needed.

Let me say that I do think, for those of us who believe strongly in trade liberalization and its benefits to our economy, I think one thing that we must do is focus on how to continue to provide assistance to those who are dislocated so they can re-enter the economy effectively.

In terms of promoting exports and also minimizing the trade deficit, it seems to us, in terms of national economic policy, there need to be three pieces: first, an aggressive program of opening markets, as we have done through NAFTA, the WTO agreement, and scores of trade agreements, including strong enforcement of our trade

laws; second, promoting growth and development in the developing world, which I said a moment ago, accounts for something over 40 percent of our exports; third, promoting financial stability and, particularly where there is financial instability, working to restore financial stability.

Let me say with respect to trade policy, Mr. Chairman, the President, as you know, is committed to fast track, and the question is when that can be most effectively reintroduced. He has also said recently that, in the context of pursuing fast track, we need to "harmonize our goals of increasing trade and improving the environment and working conditions."

Give me one more moment and I will finish. In the context of financial stability, Mr. Chairman, we live in an uncertain world. The global financial markets have brought great benefits to our country and nations around the globe.

However, they do carry the risks of financial instability, and I believe that it is absolutely critical that the Congress, as rapidly as possible, approve funding of the IMF and approve our contribution to the International Monetary Fund so that the international community will have the resources to deal with severe problems, should they develop.

As I have said, and Chairman Greenspan has said at numerous hearings, the probability of another major crisis is low, but, if such a crisis should happen, its effects on country could be severe. It is not sensible for our economy to take the risk of not having an IMF that is sufficiently funded to deal with a significant crisis.

I might add that the IMF is at historically low levels of funding right now, and there is no cost to the American taxpayers of providing the funding that we have requested. With your leadership, Mr. Chairman, the Senate has adopted the legislation with a vote of 84 to 16, and it is now imperative that the House follow suit as rapidly as possible.

The only final comment I would like to make, Mr. Chairman, that is a complement to everything I have talked about with respect to international economic policy, it is also absolutely critical that we be productive and competitive in the global economy here at home. That requires fiscal responsibility to keep interest rates down, increase savings for investment, and investing in our people through education, training, and the like.

If we pull all of this together, a forward-looking international economy policy and a domestic economic policy focused on competitiveness and fiscal responsibility, then we are well positioned for success in the global economy.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Secretary Rubin. Secretary Summers is not going to make any statement?

Secretary RUBIN. Secretary Summers will be responding to questions along with me, and I know Chairman Yellen has comments to make.

The CHAIRMAN. Well, we are delighted to have you here. Please proceed.

[The prepared statement of Secretary Rubin appears in the appendix.]

STATEMENT OF HON. JANET L. YELLEN, CHAIR, COUNCIL OF ECONOMIC ADVISORS, WASHINGTON, DC

Ms. YELLEN. Thank you, Mr. Chairman, members of the committee. I appreciate the opportunity to discuss the trade deficit with you today.

The trade deficit is an important economic statistic, but its interpretation is subject to substantial confusion. A country's trade balance is, often wrongly, used as a measure of its success in market opening policies or as a measure of the benefits of its engagement in international trade.

So the central point I would like to make today, is that the benefits of increased international trade are reflected in higher real income and not in a smaller trade deficit.

In part, our trade deficit reflects the fact that our fast-growing economy is pulling in a lot of imports. At the same time, it reflects the fact that the United States is attracting substantial international capital flows because the United States is viewed by foreigners as a good place to invest.

Those capital flows have financed increases in plant and equipment investment that have exceeded even the growth in national saving due to deficit reduction since the beginning of the Clinton Administration.

One of the most important insights of economics is that international trade increases the real incomes of all countries that engage in it. Secretary Rubin emphasized this, and I would like to reemphasize it: trade is not a zero sum game in which the gains of some countries come at the expense of other countries. On the contrary, it is a positive sum game in which all sides gain.

The benefits from trade are not simply theoretical. Large economics literature has found that those countries that are open to trade tend to grow faster and have higher levels of per capita income than countries that close themselves off from international competition and trade. In fact, one estimate is that the globalization of the U.S. economy has added around $1,500 to per capita income over the last 40 years.

Now, it is often suggested that a major benefit of trade liberalization is job creation. When our economy is operating below its potential, as it was in 1993, export growth can produce job gains, helping the economy move back toward full employment.

But, in the long term, increases in exports ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and lower prices.

Perhaps the greatest source of confusion about trade relates to the interpretation of causes of trade or current account deficits and surpluses. A trade deficit occurs, by definition, when a country's total spending exceeds it production.

When that happens, the shortfall is made up by importing more than is exported. So when the United States runs a trade deficit, foreigners buy less than a dollar's worth of U.S. goods for every dollar they earn through their export sales to us.

The natural question, of course, is what do foreigners do with the dollars they do not use to buy U.S. goods? In practice, the excess dollars are invested in U.S. assets. Indeed, it is the desire of foreigners to purchase those attractive U.S. assets, to lend us the

money needed to finance a trade deficit that makes it possible to run such a deficit. Countries can only run those deficits if foreigners want to add to their holdings of our country's assets.

The relationship between spending, production, and the trade deficit can be expressed another way. I will not bore you with the details, but it turns out that, in an accounting sense, a country's current account balance, which is a more comprehensive measure than the trade balance, is equal to the difference between national saving and national investment.

When the demand for investment in the United States exceeds our pool of national savings, that gap, that difference, is made up by borrowing from foreigners. The United States first experienced large current account deficits during the mid-1980's, when investment fell as a share of national income, but net national saving feel even faster. The trade deficit shrank briefly as investment collapsed in the 1990–1991 recession, but we have seen it reemerge in the current expansion.

The good news in this expansion, is that investment has been booming. But national saving has not kept pace, despite the dramatic improvement due to the elimination of the Federal budget deficit.

As Secretary Rubin emphasized, when a trade deficit is used to finance productive investment, as in the United States now, it can be viewed as largely benign because the extra investment raises productivity and that results in future national income that is more than enough higher to enable us to pay off that foreign borrowing.

So, we would be worse off as a Nation if, over the last few years, we had been forced to curtail our investment. Our ability to attract funds from abroad is, I believe, a well-deserved vote of confidence in the ability of our high-performing economy to put those funds to good use.

Let me return for a minute to the more immediate causes of our rising trade deficit. Increasing trade deficits often accompany strong economic growth of the kind we have seen over the last few years, both because expanding domestic demand pulls in imports and because growing economies tend to have appreciating currencies.

More recently, the East Asian crisis has boosted the deficit as the affected countries have cut back sharply on imports of goods from the United States. Fortunately, this slow down in exports to East Asia comes at a time when domestic demand growth is extremely robust and labor markets have become increasingly tight.

The consensus among forecasters is that the East Asian crisis could serve as a kind of break that subdues growth toward a more sustainable pace, permitting continued job growth with a more moderate path for interest rates and stronger investment spending than we would otherwise enjoy. Of course, we have the side benefit that the decline in import prices is a dampening influence on inflation.

I will just take one more minute and conclude. I do not want to leave you with the impression that there are no reasons to be concerned about a large trade deficit. First, even in the absence of any negative impact on overall output or employment, there have been sectors that have been adversely impacted. Before 1997, there were

many U.S. producers that enjoyed rapid growth in their exports to East Asia, and they will see, and have already seen, a decline in those exports.

The second reason for concern about the trade deficit follows, in part, from the first. That is, if the rising trade deficit undermines support for internationalist principles and for market opening policies like those that have been outlined by Secretary Rubin in his testimony, including support for the IMF and for fast track, if that widening U.S. trade deficit were to create the false impression that the United States stands to lose rather than gain from continued engagement in international markets and trade, that would be a very costly development, indeed.

The CHAIRMAN. Thank you very much, Chair Yellen.

[The prepared statement of Ms. Yellen appears in the appendix.]

The CHAIRMAN. Yesterday, Alan Greenspan, I think, appeared before one of our committees, where he made the comment that the Asian crisis already has deeply affected the U.S. economy, hurting farmers and businesses that export to Asia and causing the trade deficit to balloon to record levels that are "unsustainable and pose unknown consequences and possible dangers. The trade deficit will only get worse, since the worst of that crisis, clearly, is not over in Asia."

Now, I know the importance you attach to IMF and in helping it out. I have generally been supportive of that effort. But I am concerned about this statement that says that the trade deficit is ballooning to record levels that are "unsustainable and pose unknown consequences and possible dangers."

I would ask you, Mr. Secretary and Madam Yellen, what should the administration and ourselves be doing? What are these dangers, and how can we ameliorate, somehow, these problems?

Secretary RUBIN. Let me give you a brief response, if I may, Mr. Chairman, and then suggest that Chairman Yellen or Dr. Summers might, as distinguished economists, want to respond.

I think that I would interpret the Chairman's comments, although I have not discussed them with him, as referring to long-term sustainability. As I said in my remarks, as long as your trade deficit represents savings from abroad that are coming to this country, and I think Chairman Yellen referred to this, and then being used constructively here in investment, if it is being well-used, it actually, on balance, should be contributing to our growth.

Now, it is true, over a long period of time this can create greater problems as your foreign-held assets, relative to your GDP, grow and grow and grow, if that, in fact, is the effect of this.

So over a long period of time you could have an unsustainable situation, but in a shorter period of time, a period of several years—I will speak now for myself and you can get other responses—I think that the real key is what is being used, what is this inflow of savings being used for? If it is being used for productive investment, that is positive.

On the other hand, there are, as I said in my remarks, two sets of things we should be worried about. One, is that sentiments could change abroad with respect to the attractiveness of our economy.

If that were to happen, if we ceased to be viewed as an attractive place for capital to come and capital sought to leave this country,

then that could drive interest rates up and have all kinds of adverse impacts.

So, I think one thing that we, the administration, and you, the Finance Committee, and the Congress all need to do is to maintain a healthy macroeconomic and other policy environment in this country so we continue to be an attractive place for savings from abroad to come and stay. I think that is the key.

I think the second, would be to deal with the sectoral dislocations that occur as a consequence, and they inevitably will occur.

The CHAIRMAN. Chairman Yellen?

Ms. YELLEN. I would certainly agree with Secretary Rubin's analysis of this. I would add that I think part of the increase in the trade deficit and the current account deficit that we have seen, and are likely to continue to see over the next couple of years, part of it, I believe, is temporary and has to do with slow growth abroad and the crisis in East Asia. So, hopefully we will see some diminution of those rising trade deficits/current accounts surpluses if recovery occurs abroad.

I would add that, from a policy standpoint, of course, we want to do everything possible—Secretary Rubin emphasized this in his remarks—to promote recovery abroad, both in the East Asian countries that have been affected by the crisis, and similarly in Japan, that really needs to grow more rapidly and serve as an engine of growth, both for the Asian region and also for the world as a whole.

The CHAIRMAN. Everyone talks about the importance of Japan, particularly with respect to Asian flu, the need for it to take measures to get its economy growing. Yet, it seems, to the contrary, things are not going well there. If things do not go well in Japan, things will not go well in Asia.

What do we do about that? I think it is a matter of utmost importance.

Secretary RUBIN. Mr. Chairman, I think it is exceedingly troubling. We would agree with your characterization of the utmost importance. It is a matter of public record, so I am not saying it is not public, that President Clinton, over the last 18 months, has spoken with the Prime Minister about this several times.

We have very actively urged the Japanese government to deal with the issues of fiscal stimulus, and now, most particularly with the problems and issues around the financial sector and the banks, as well as deregulation of opening markets.

We have worked with the G-7, with the OECD, with the IMF, and others to continue to discuss these matters with the Japanese government. In the final analysis, although others may have a different view they would like to express, I think the most constructive and the only role that we can really play is to continue to very actively work to persuade the Japanese government to face these very difficult issues they have to deal with.

Dr. Summers, as you may know, is very much involved with this.

The CHAIRMAN. Could I just make an observation. It concerns me. We see the yen, in its relationship to the dollar, moving the wrong direction. There are those who say that the dollar is only going to get stronger. That means Japan is depending more and more on exports and that is the opposite of what Asia needs. Some

people say that the administration is willing to see the dollar even strengthened further. Do you have any comments on that?

Secretary RUBIN. Yes, I have seen that, Mr. Chairman. Every time that I have seen it, we have said to those who have printed that, that exactly the opposite is the case, that we are greatly concerned about the weakness of the yen. But, in a fundamental sense, the ultimate answer to this lies in the Japanese economy.

But it is the administration's position to be very concerned about the weakness of the Japanese economy and to be very concerned about the weakness of the Japanese currency. But the answers to those issues lie within Japan in terms of actual policy measures that need to be taken.

The CHAIRMAN. Larry, I know you have been on the front line. Do you have any comment?

Dr. SUMMERS. I would just say this, Mr. Chairman. I think we share, and I think increasingly other countries in Europe and in Asia have come to share, an enormous sense of concern about developments in Japan. I think many in Japan are coming to share that concern much more than would have been the case 6 months ago.

That is, I think, a reflection of, in Japan, what weakness in their economy means for their capacity to do the things they need to do as a country, prepare for an aging society, and so forth.

I think there is a very clear recognition that weakness in Japan, as you suggested, Mr. Chairman, has spill-over consequences for the rest of Asia. These are very much active subjects of discussion.

In a flexible exchange rate regime, which is the type of regime that we have, the value of currencies over time are set by the perceptions of people who trade a trillion dollars a day as to where the fundamentals of economies are.

So, while our concerns are relevant and we have tried to be very clear about our concerns, we continue, in cooperation with others, to watch developments in these markets very closely.

What is ultimately most important for the value of any exchange rate, is the economic policy fundamentals in the country that determines it.

The CHAIRMAN. I would like to ask Chairman Yellen one further question, then I will turn to the next questioner.

Chairman Yellen, do you agree, or Mr. Secretary, with the recent Census Bureau estimates set out in the June 8th edition of the Journal of Economists that we are under-reporting our exports by as much as $62 billion, and that our current account deficit may be one-third lower than the recent Commerce Department statistics suggest?

Ms. YELLEN. Mr. Chairman, that is something that we have been recently briefed on by the Bureau of the Census. My understanding is that they have developed these estimates in conjunction with their efforts to encourage more U.S. exports to record their exports electronically so that the statistics can be more accurate, and numbers in that range have been given by the Census Bureau.

I think a conservative estimate, in their view, of the under-reporting of exports would be in the $20 to 40 billion range. It is conceivable, according to their estimates, that the under-reporting could be, as you indicated, in the $60 to 70 billion range. This

comes about because about 97 percent of U.S. imports are recorded electronically, the rest are submitted on paper and entered by hand.

In the case of exports, though, only about 70 percent are recorded electronically, and there can be delays and other problems in tabulating and recording these exports. So I believe what you have indicated is correct and it could lead to over-reporting of the trade deficit.

With respect to the current account deficit, I would simply add that there could be misreporting or under-reporting in other areas as well. Investment income is a notorious area in which statistics could be inaccurate.

So, in terms of drawing a bottom-line conclusion on that, I would hesitate, but certainly, you have indicated about exports, those lead to over-reporting of the trade deficit.

The CHAIRMAN. Well, my time is up.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. I thank the witnesses for being here today.

I must say, as I listen to this discussion, the message going forward here disturbs me because it sounds to me very much like the message is, well, trade deficits really do not matter, in fact, maybe they are positive. I personally do not believe that.

It reminds me a little of the discussions we used to have about budget deficits. People would say, very often economists, that the budget deficits did not matter. Well, of course they mattered. They mattered because they put pressure on interest rates and slowed economic growth. Trade deficits matter because they have got to be repaid. They represent the claim on the future.

The only way that I know that trade deficits can be repaid is, at some point in the future, you reduce consumption and increase savings. That means a reduced standard of living at the time that it occurs.

Now, Mr. Secretary, you have acknowledged that these deficits have to be repaid, the debt that is building has to be repaid. We are now the world's largest debtor Nation. Not so recently, we were the world's largest creditor Nation.

When you acknowledge that these deficits and debt has to be repaid, how is that to occur?

Secretary RUBIN. I agree, by the way, absolutely about budget deficits. But on the trade deficit question, Senator, the comment I made was that if we have a trade deficit, say we have in influx of capital today of a dollar and then we have to pay interest over 10 years and have to pay it back 10 years from now, but if that dollar is invested productively in this country and the result is the GDP 10 years now is $2 higher than it otherwise would have been, one of those dollars would go back to pay that dollar and the other dollar would be net benefit to this country.

So I think it really depends on what this is used for. In the mid-1980's, as you know, the trade deficits we used largely for consumption. That was not good. The evidence suggests now it is being used for investment.

Having said all of that, there are still all the vulnerabilities, which I mentioned in my testimony. That is the general framework.

Senator CONRAD. Can I go back to my question, and that is, how are these deficits to be repaid? Am I correct that, to repay them, requires at some point that we reduce consumption from what it would otherwise be and increase savings?

Secretary RUBIN. Yes. But the from what otherwise would be would be higher than it would have been without the investment in the first place.

Senator CONRAD. Well, I understand the theory. The theory is that we are productively investing those dollars that we are receiving today.

Secretary RUBIN. Yes. That is right.

Senator CONRAD. The question is, is that the case or are those flows being consumed? Now, you indicated in the 1980's, the evidence was they were being consumed.

Secretary RUBIN. Right.

Senator CONRAD. You indicate the evidence today is that those flows are being productively invested. What are the indications of that?

Secretary RUBIN. Investment today, as a percentage of GDP, is, I think, the highest we have had in our history, though I am not sure about that. Chairman Yellen or Dr. Summers?

Dr. SUMMERS. Equipment investment, Senator, is at the highest share of GNP that it has ever been in our history. If you look at this period of recovery, business fixed investment as a whole has risen very substantially greater, at a faster rate, than the GDP.

Indeed, there were some recent statistics that came out suggesting that the capital stock, which is sort of the measure of capacity, had grown more rapidly in the last year than at any point in several decades.

I think your concern with the trade deficit is very much warranted, that what in some ways would be best is if we had a high level of investment in America that was financed from a high level of saving in America.

I do not think we do ourselves a favor if we forego attractive investment opportunities because we have to borrow the money, but the priority goes very much, for the long-run health of our economy, to improving national savings. I think we can take some satisfaction from the fact that the national savings rate is almost three times as high this year as it was in 1992, but we have clearly got a great deal more to do. The budget surplus is an important step. I think, with the Chairman's leadership, the very important steps to expand personal savings through IRAs are constructive steps.

Obviously, the next place where, on a very large scale, we as a country will confront this issue is as we think through the dilemmas associated with Social Security reform. It is exactly the importance of saving that is behind the President's emphasis on saving Social Security first.

Senator CONRAD. Well, let me just say that I agree very much with your statement. I mean, it would be even better if we were financing these high levels of investments with increased domestic

savings. The fact is, the piper must be paid at some point. When you borrow money, when you build debt, it has to be repaid.

At some point in the future, and I understand the argument that if it is productively invested we will have more to pay it back with in the future, but the fact is, at that point in the future am I not correct that it will require a reduction in consumption in this country in order to repay it?

Secretary RUBIN. Well, but you would still be at a higher level of consumption than you would have been without having the investment in the first place.

Senator CONRAD. Well, I understand that. If, and there is a big if in there.

Secretary RUBIN. If it is productively used.

Senator CONRAD. The if, is if it is being productively invested.

Secretary RUBIN. Correct.

Senator CONRAD. I think the fact is, as Secretary Summers indicated, we would be better off if these high levels of investment were financed by high levels of domestic savings.

Secretary RUBIN. Oh, yes. Yes.

Senator CONRAD. I do not think we would have a disagreement.

Secretary RUBIN. No, no. We would agree with that.

The CHAIRMAN. Senator Chafee, before I refer to you, Senator Moynihan, would you care to make any comments at this time?

Senator MOYNIHAN. I would care to make my apologies, Mr. Chairman.

The CHAIRMAN. I know you had to be late, and we appreciate your being here now.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Gentlemen and Ms. Yellen, I would like to say that this is a hard sell. Obviously, it is much easier to call alarm to imports and their effect than it is to point out the benefits that might be obtained.

Let me just give you an illustration in my State. We have suffered from textile imports and, although, as nationally, our unemployment rate is low, nonetheless, we all feel the concern over the textile imports.

At the same time, in my State, as it is across the Nation, I suppose, for every citizen in our State, they own at least one pair, and perhaps more pairs, of so-called tennis shoes or sneakers made in Taiwan, Malaysia, or Korea and they get them cheaper than if they were made in the U.S. That is why they are buying these goods that are made in Taiwan, Korea, and so forth.

But it is hard to call attention to that. People just expect that the low price is there, and they do not make the relationship that this is a benefit from imports that they are getting.

Also, I might say that you rarely hear anybody declaim, that comes before this committee, deploring the effect of imports and the deficit we are running about the surplus we are running, say, with Australia or the Netherlands. That is not considered evil and in some fashion, that is praiseworthy, whereas, the high imports from China, Japan, or wherever it might be are considered very detrimental to our country.

So it seems to me that we have been through this. We go through this when we do NAFTA, or whatever it might be, GATT, and the

benefits of trade. But I think it behooves you, as spokespersons for the administration and for the Nation on this subject, to continue to make your views known. I think you have done a good job here today.

It is a very complicated subject. It is much easier to point out the difficulties that come with high imports than it is vice versa. It previously was mentioned here, I think Senator Murkowski mentioned, about these sanctions. Particularly, we are in a situation where, in some areas of the world, there is no flexibility at all in the sanctions. Many of these sanctions originated up here in the Congress, so we are not guilt-free in this.

But I certainly want to applaud the efforts, as I understand it, that Senator Lugar is making to examine these sanctions. If we are going to have sanctions, I personally am skeptical of sanctions. I think, where you have got multinational imposition of sanctions they do some good. I think in South Africa they did some good. But I have trouble finding many other places in the world where U.S. sanctions have done much good.

But I look forward to what Senator Lugar is undertaking, as I understand it, and want to be helpful to him. Thank you very much.

The CHAIRMAN. Thank you, Senator Chafee.

Senator Bryan?

Senator BRYAN. Thank you very much, Mr. Chairman. After hearing Senator Dorgan's opening statements, which I know, Mr. Secretary, you were not here, but Ms. Yellen was here, and then hearing the testimony of each of you, I get a sense that there are two ships passing in the night.

Senator Dorgan laid out a very strong indictment in terms of our current trade deficit. You all have responded, at least in part, that the economy is doing well, and that is absolutely the case. We have the strongest economy in the world. We have created all kinds of new jobs, inflation is low, employment is high, interest rates are under control. It is a very sanguine assessment.

In part, Mr. Secretary, you have indicated that our trade deficit is exacerbated by the circumstances in the Far East. I think that is undoubtedly the case. But it strikes me, and I am not an economist, that there is an intractable structural problem here.

A decade ago when I held a previous position and had occasion to visit the Far East on behalf of my State a couple of times, the yen was appreciating in value. We still had a trade deficit at that point. So, both when the yen has been appreciating and depreciating, we have had this trade deficit. It strikes me that there is something that is fundamentally wrong.

Can I ask you to focus on that? It strikes me that, even if we did not have this Asian crisis, that we would still have a very, very serious trade deficit. As Senator Conrad and others have pointed out, ultimately we have to pay the piper. Let me get your response to that, if I may.

Secretary RUBIN. Well, yes. However, had it not been for the slow growth in the rest of the world and the Asian crisis compared to our very rapid growth, which is good for us, we do not want to slow our economy down, the trade deficit as a percentage of GDP would now be much lower than it was in the mid-1980's.

I think in the mid-1980's it was 3.5 percent, and I think, Chairman Yellen, correct me if I am wrong, it is about 2 percent now, but it probably would have been appreciably under 2 percent, so it actually was heading very much in the right direction.

Second, I think there is this whole question of, how do we react to the fact that we have a trade deficit in the first place, which is the conversation we had with Senator Conrad before. I will not repeat all of that, but I think that was a good framework for thinking about it.

Dr. SUMMERS. If I could perhaps add to what the Secretary said.

Senator BRYAN. Certainly.

Dr. SUMMERS. I think the Secretary is right in asserting that a large part of the very recent deterioration can be ascribed to the Asian crisis. But I think your question is a very important one, which is, in good times, in bad times, however these cyclical fluctuations work out, there is a tendency for our trade with Asia not to be what we think it should be.

I think that points to the importance as a Nation of us having a very active structural set of policies directed at market opening in the products where we are particularly competitive.

I think, to use a bit of the lingo, if you look in Asia, penetration ratios, particularly in manufactured goods, are low relative to those of many other economies around the world.

I think that is why we have had a very activist policy towards Japan, including the discussion, where appropriate, of possible 301 actions that has led to a number of substantial agreements and had led to a substantial increase in the trade with Japan in the sectors we had negotiated about relative to the sectors where we had not negotiated about.

That is why, as part of the task of fixing these economies, the IMF programs include quite far-reaching structural conditions as well as the usual macroeconomic stuff. For example, an end to directed lending industrial policies from the commercial banking systems, which have been an important source of the distortions in those economies that have worked to their detriment.

That is why we have tried to focus on some of the other barriers, for example, by new policies, something we have worked hard on at the Treasury, that counter other countries' tied aid with tied aid subsidies from us that have resulted in an agreement that has backed that off and produced a more level playing field for American exporters.

Or what I think was a significant accomplishment this year, we got an OECD convention that makes the payment of bribes criminal and no longer tax deductible, which restriction had put our business at a disadvantage relative to others'.

So, I think there are a whole set of things that we need to do structurally that are directed at promoting our exports into those economies because it is a problem quite apart from the cyclical concern, and, in particular, in these IMF conditions in these countries, we are drawing the two problems together and taking advantage of the opportunity the problem creates to make long-run progress.

Senator BRYAN. Any evidence that currency manipulation is exacerbating this problem at all, and if so, what should we do?

Secretary RUBIN. Let me speak from my experience, and see if others have an additional view.

Senator BRYAN. Sure.

Secretary RUBIN. I used to run a currency trading operation. It is actually something I know a little about in a firsthand sense. I do not think that a country could successfully manipulate, if you really mean manipulate.

I mean, you can try to sustain an unsustainable level for a while. That usually has a rather unfortunate ending. But I do not think that you could manipulate a currency for a substantial period of time successfully, and I, at least, do not recollect ever having seen any evidence of it. But, I do not know. Others may feel differently.

Dr. SUMMERS. I think, Mr. Secretary, that there was a period in the late 1980's and early 1990's when it could fairly have been said that, with relatively closed capital accounts, a number of Asian countries, because they had closed capital accounts, were holding their currencies down, basically, for commercial advantage.

I think the legislation that Congress passed, and the procedures involving designating manipulators, and so forth, acted as a substantial deterrent to that.

I think if you look at Asia today, the problem is not that the countries are strategically reducing the value of their currencies, the problem is that, faced with a confidence crisis, they are difficulty avoiding devaluations that are very painful for them and their citizens. So, I think that could, at some point, be a problem in the future, but that is not the problem of the hour right now.

Secretary RUBIN. Those devaluations, you know, are a key problem because they have large external hard currency debts that they now are finding extremely difficult to repay.

Senator BRYAN. Thank you very much, and thank you, Mr. Chairman.

The CHAIRMAN. Senator Murkowski.

Senator MURKOWSKI. Thank you very much, Mr. Chairman. There is cause for alarm if you look at the direction. In reality, the trade deficit in goods was $199 billion last year, an increase of 4 percent. The first 3 months of this year, the deficit increased 14.5 percent to $57 billion. Significant.

Relief example, Japan. We encouraged them to open up their markets, housing markets, as an example, but they refused to eliminate the tariffs on wood products from the APEC countries. So, our ability to penetrate that and get them more transparent is not working.

Further, to exacerbate the increased trade imbalance is the significance of our dependence on imported oil, which, as I indicated, is 52 percent. Nobody pays much attention to it, but the Clinton Administration suggests that it is going to be 70 percent the year 2000. So, if those are factual generalities, it is going to get worse.

Question relative to the role of the Secretary of Treasury and the experience you had in Mexico, and your success and my projected failure of your process. Again, I will commend you for your foresight, because you were right and I was wrong.

But are you doing anything internationally to help stabilize the yen now, and do you intend to, at some point, in the sense that the

yen seems to be the focus of Asian difficulties now? Then I have two other questions.

Secretary RUBIN. This is my view, and I think it would be fair to say that it is our view. I think, Senator Murkowski, you have raised what may be the single most fundamental question about what is happening right now, and that is this whole question of the Japanese economy and their currency.

I think the question is, what can you realistically do, or what is it that will affect that economy and that currency and will cause that currency not only to stabilize, but to appreciate?

While it is true that you can talk about intervention, which is really the only instrument available from outside of the country, I am confident that you will find that most people who are steeped in the questions of foreign exchange trading will say that intervention can be useful at times, it can have effects at times, but that, fundamentally, over any period of time, that currencies will fall on fundamentals.

That is why I said before, in response to your opening remark, that the fundamental key to the yen, and we absolutely totally agree with you about the concern, we share that concern to a very high degree, is what happened inside Japan.

For the last year and a half, or maybe it is a little longer than that now, we have been very, very actively involved, privately and publicly, and also with the rest of the world, expressing our concerns to Japan.

I think what Dr. Summers said is right. Over the past few months, this concern about Japan, the yen, and the problems in Japan really have become a worldwide concern. We meet with the Finance Ministry, with leaders, and so forth, and this almost always comes up now.

Senator MURKOWSKI. But you have not done anything yet to stabilize it other than——

Secretary RUBIN. Well, when you say we have not done anything, Senator, I think the question is, what can we do.

Senator MURKOWSKI. Right.

Secretary RUBIN. I think, if the premise that I stated is correct, which is that intervention is a temporary tool and not a fundamental solution, then, sure, you could try to intervene if that seemed appropriate, and we have said many times we intervene when it is appropriate, do not when it is not appropriate.

But, if that is not going to fundamentally change anything for any period of time, then the whole answer lies in Japan doing what it needs to do, and we have exerted enormous energy in that direction.

Senator MURKOWSKI. All right. Let me take you one step further down the path.

Secretary RUBIN. I think it is very important to say, this has now become a worldwide concern.

Senator MURKOWSKI. Right. But what triggers reaction? Because if you look at what we hear, that somewhere in the neighborhood of $750 billion in the Japanese banks consist of nonperforming loans, and I do not know what China is, China is estimated that 47 percent of their portfolios are nonperforming, and Murkowski's law on nonperforming loans, as a commercial banker, is things are

much worse than they appear to be in the general conformance of the terminology.

In many cases, you are broke and do not know it because your capital accounts simply cannot take the hit associated with the charge-offs. As we look at our own experience with the S&Ls, we took the hit. What did it cost us, $300–$400 billion? But we took it.

I am suggesting to you that, at some point in time, our economists need to focus in on whether the capital base of some of these banks is big enough to realistically recover. I would suggest that it is not. We can get carried away on the significance of having a favorable balance of payments, but Japan has one overall and it is in the tank.

Secretary RUBIN. That is right. I say, Senator Murkowski, we have been very focused. I think Murkowski's law, unfortunately, not speaking about Japan for a moment, but I think, on the whole, is correct. We have been very focused in our conversations with the Japanese on doing precisely what you said, which is facing and dealing with the problems in their banks. But it is their banking system, and it is their regulators, and it is their government.

Senator MURKOWSKI. Right. Larry?

Secretary RUBIN. I think you have got this analysis right. The question is, how bad does it have to get before they take the hit and before they do what they need to do.

Senator MURKOWSKI. Right.

Secretary RUBIN. The role that we can play, and I think have played, is to very actively discuss this with them, and also with the rest of the world, express this concern about the effects of what they are doing on the rest of the world, including East Asia.

Dr. SUMMERS. I would like to add two points to that. First, I think you are absolutely right on the centrality of their addressing their banking system. In many ways, the challenge, to continue your analogy with our situation, is to take the kinds of steps that we took in the late 1980's that involved facing up to the problem, closing institutions that were under while protecting depositors, and critically liquefying the bad assets, putting them on the market, letting the market find its level so the situation could start to return. That is what we did. That, frankly, is not what we did in the period up until then. We had a period in which we did not fully face the problem, and the problem grew.

Senator MURKOWSKI. Right. And it cost more.

Dr. SUMMERS. The challenge for Japan, really, is to address the problems in the way we did in the late 1980's and early 1990's rather than the way they did earlier.

I do think it is important, because people tend to group these situations together, to distinguish Japan in one very important respect from many of the others. Japan has many, many serious problems, as we have been discussing, but it also does have more than $200 billion in hard currency reserves.

So the situation in Japan is not a situation of international liquidity and hard currency liquidity in the way that the situation was in Mexico, or has that element in Asia. What is crucial, and this is something that we pursue at the technical level as well as at the political level, is the Japan take-steps.

As you know, the Prime Minister has recognized the problem and Japan has made commitments of substantial public funds, nearly 30 trillion yen, which is several hundred billion dollars. But the question is, what kind of framework and with what energy those problems will be addressed. That is absolutely critical.

Senator MURKOWSKI. Well, under their system, who takes the fall, too?

Mr. Chairman, let me just, in conclusion, point out what I think is rather interesting for this committee to reflect on, because in the 1980's we heard economists report from time to time that the reason we had a huge trade deficit was because we had a large budget deficit. We were told to eliminate, you remember, the budget deficit and the trade deficit would disappear. Well, today we have a budget surplus and a record trade deficit.

I am questioning the realities of 1998 to suggest that the budget deficit we have really has nothing to do with the trade deficit. The trade deficits result from foreign trade barriers, exchange rates, varying rates of economic growth. What I think, and Senator Chafee brought it up as well, is the terrible dilemma we have with our sanctions that have complicated this.

The CHAIRMAN. I would just like to inject one question. This matter of Japan is of such importance. Did this matter come up in the Group of Eight? Was any effort made to resolve the problem and get some kind of a solution there?

Dr. SUMMERS. If you look at the statement of the G–8 leaders, there was a quite pointed reference to the situation in Japan that referenced, in particular, the theme that Senator Murkowski was stressing, having to do with resolving bad asset problems in the banks.

It is something that has been discussed in the Group of Eight for some time, and has been very much an important part of the bilateral discussions that President Clinton and Prime Minister Hashimoto have had. I think it is fair to say that the very senior political discussions have gotten into quite a bit of detail on these financial questions.

The CHAIRMAN. It just seems to me this is a global problem, basically, and to make those meetings really relevant, this is a matter that ought to have the highest priority.

Senator Grassley?

Senator GRASSLEY. Senator Murkowski did not ask me, but if you look at Japan, and it is a long-term solution to this problem we are talking about, but there is nothing that is going to help in Japan more than a competitive political system with at least two strong parties, and reducing, subsequently, the power of the faceless bureaucrat. I see that as a basis for all of the problems in Japan.

Mr. Chairman, I want to put my entire statement in the record, but I would like to refer to a couple of points that I was going to make before I ask a question of Secretary Rubin, and that is, the significance of the hearings that you are having.

Anyone who watched the debate last year on fast track will appreciate the value of this hearing, and that is that, even though the Senate strongly endorsed fast-track authority, the opponents of free trade really clouded the debate with these emotional arguments about the trade deficit and ignored the facts all the time.

These facts coming out at this hearing are very important, and most of these facts have already been stated. But one of the most misused statistics by opponents of free trade in that debate last year was the trade deficit allegedly causing all these job losses, low growth rates, or declined the manufacturing sector.

As a practical matter, the trade deficit ranks right after El Ni$o as a cause of every problem that America has faced. The sad commentary is, and I think my good colleague here from Rhode Island referred to the fact, that the public generally believes these arguments, even though they are not based on fact.

Those of us who are in public office need to begin to build a case for free trade from the ground up. Hopefully, that is what these series of hearings will do. We need to talk about the tremendous benefits of freeing up trade.

But we also cannot ignore the arguments of those that are against freeing trade, or even the arguments why we need freer trade, especially when so many of those arguments can be easily refuted, the arguments of the opponents of free trade. If we can have an open and comprehensive debate on these issues, I think we win.

The most interesting thing that we can do to increase the exports, in my judgment, and to send a clear signal that the United States is in the game of promoting free trade once again, is for us to give the President fast-track authority.

Now, I know that probably is not going to happen, but we ought to do all we can to make it happen. Those who use the trade deficit as an excuse for not supporting fast track miss the point. There is not going to be any substantial progress made on addressing the trade deficit or on reforming our trade policies until the President is at the table, wherever that table is in the world, negotiating new trade agreements. We can only be hurt if we are left out.

In fact, there are many instances, and I cannot go into them now. Well, just last week, Europe is negotiating with Mexico now on a free trade agreement because they do not want to be left out. If that happens, we are going to be left out.

Secretary Rubin, there is going to be a witness on the next panel that I believe is going to express the view that the trade deficit is such a problem, that he will be advocating devaluing the dollar relative to other major currencies in order to address the problem. What is your view of this potential remedy to the trade deficit, and what would be the possible side effects if that were to take place?

Secretary RUBIN. Let me comment very briefly, if I may, Senator, and then ask Cl airman Yellen maybe if she would. I do not think it makes sense, and I have said this many times, to use the dollar as an instrument of trade policy. What we would be doing is reducing, in effect, the terms of exchange in which we are obtaining foreign goods and services in exchange for our goods and services. I think the right thing to do about the trade deficit is exactly what we all have been doing, including what you have just referred to, which is to try to open markets abroad, stimulate growth abroad.

I think the IMF is critically important, with respect to these countries, to get into problems of financial instability. Then I think we have to be productive at home and increase our savings rate.

It seems to me that that is the right answer with respect to the trade deficit. Janet?

Ms. YELLEN. Well, I fully agree. I think, if you just look at how our economy is doing, when we have a 4.3 percent unemployment rate and labor markets are as tight as they are now and real wages are rising and people, if we look at the statistics that directly reflect on how individuals and families and households are doing in their everyday lives, well, we can see pols show very high consumer confidence and there is every reason for it to be high, with greater sense that people can get jobs, that their real wages are rising, that their living standards are improving.

Those are the things that directly reflect how they are doing and not the trade deficit. Of course, as I have indicated earlier, this is really a reflection of strong investment now in our economy.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman. I also wish to express my appreciation for the panel. I would like to turn to page six of the Secretary's statement where he states that a forward-looking international economic policy to derive the full potential from trade and best promote our export of goods and services has three components: first, continuing an aggressive effort to open markets, and through strong enforcement of our trade laws."

I am concerned about that second component of the first component, and that is the strong enforcement of our trade laws, because there is a pervasive feeling, and I think this is particularly true in American agriculture, that we have not had strong enforcement.

Two illustrations of that in American agriculture are the fact that the person who was most responsible for this hearing today, Senator Dorgan, comes from a State in which agriculture is the principal segment of the economy, and second, politically, that significant components of agriculture abandoned the free trade movement in 1997.

In my own State, six to eight members of our Congressional delegation who had voted for NAFTA would have voted against fast track, and they were almost all from agricultural areas of Florida.

It is estimated that, within the House, there were some 25 primarily agricultural members who were no votes on fast track, the principal reason being their concern about the adequacy of enforcement of our trade laws.

So, with that background, what do you think fuels this perception of inadequate enforcement, if it is a perceptive problem, or substantively, what are the real issues of enforcement and how can we attack those as a component of both a political strategy to expand trade and to realize the goal of reducing our trade deficits by increasing our exports?

Secretary RUBIN. Senator, let me comment on two pieces, if I may. The enforcement of our trade laws is something that we have been very focused on from the very beginning of the administration.

As you may remember, I guess, in 1993 and 1994, I have forgotten precisely when it was, we had some very significant differences with the Japanese, for example, at the annual summits. I believe

it is correct to say that this was the first time that a President really has allowed some discord to be expressed at a summit over these trade issues.

We have had a commitment to strong enforcement. The person responsible, as you know, or the agency responsible, is the USTR and they are not here today. So, I cannot deal with the specifics of the agricultural trade agreements. I just do not know them. But I do know that there has been a consistent policy perspective of strong enforcement, and I think the best thing we can do, Senator, is to get you a more detailed response from USTR.

But I think your point is well taken. I think if we are going to have the support of trade liberalization and fast track that we need, there also has to be not only a reality, but a perception, that our trade laws are being strongly enforced. So, I think that point is absolutely correct.

Senator GRAHAM. I would look forward to getting that further detail of what the administration, including the USTR, feel to be the necessary steps in order to adequately enforce our trade law. If there is some role for the Congress in that, we would appreciate identification.

The third of the components that you identified, Mr. Secretary, was to address financial instability by developing an architecture of the international financial system that is as modern as the market.

The subsequent remarks focus, appropriately, on the need to adequately fund the existing IMF, but I wish you would comment on what you think the IMF which is as modern as the market would look like. What are the reforms that we should be attempting to secure?

Secretary RUBIN. As you correctly say, Senator, the immediate focus is to have sufficient resources so we can deal with what lies before us right now. But, in a broader sense, and it does not necessarily all relate to the IMF. In fact, a certain part of it will, a certain part of it will not, I suppose.

But it comes in three pieces: one, greater transparency in disclosure, and actually steps have already been taken, and are being taken, in that respect, so there are actually changes going on; second, steps to strengthen the financial sectors in developing countries, since that is where so many of these problems come from or they are exacerbated.

There is a lot of work going on right now around the world developing standards, and there is a lot of thought being given in the international arena as to how to better incentivize, if you will, or promote effective supervisory regimes in these developing countries.

Then the third piece of it, is to create mechanisms—and this will take time, this is a very complicated subject—such that the private sector, the creditors, the investors, will more fully bear the consequences of their decisions, though I did think you see a beginning of that in the Korean bank resolution.

But that is a broad framework of the work that is being done, and I think you will see the results of that work their way into the system over time, and some of it will take a fair bit of time because of the complexities.

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Senator GRAHAM. But is it your feeling that we should separate those more fundamental reforms from the immediate issue of refunding the IMF as it exists?

Secretary RUBIN. I believe, Senator, there are changes that we can make with respect to the IMF now, so the answer to your question is yes, in large measure, it is imperative that we provide the funding now to deal with the problems immediately in front of us and not hold up that funding over changes that will take a longer period of time to put in place.

Senator GRAHAM. I agree with you. I would suggest that one of the ways that would give comfort to the process of funding the status quo, albeit a status quo that many of us have some dissatisfactions with, and I gather from your answer including yourself, to a strong case of what is happening with U.S. and other world leadership to achieve those reforms at the same time that we are providing substantial new resources to the existing international financial system.

Secretary RUBIN. I think that is a very good suggestion. Let me just say, I would not characterize it quite as funding the status quo, because it is funding the IMF, but the IMF is undertaking a good bit of change, much of which has been a function of U.S. leadership.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. I would like to join my colleagues in thanking you for holding this hearing, and thanking the witnesses for their testimony. It has been very illuminating. But I want to share a concern, to take a page from a Senator from Iowa.

I was out on the campaign trail talking about all the good news and kind of giving the speech that the Honorable Yellen just gave a minute ago about what good times we are enjoying, economic times, and how we are really on a par with the rest of the world in terms of, our trade deficit really was not causing us that big of a problem because it created all these new jobs, and, you know, the speech.

Having given the speech, however, I was in a group of blue collar workers in southern Illinois and I noticed a kind of silence in the room when I finished speaking, and it was almost as though nobody in that room really had experienced all this good news.

These workers were very concerned, working-class people. They were very concerned that all this expansion of trade and job creation had nothing to do with them and, as much to the point, had probably nothing to do with their children either. This was a real concern in that room.

That relates to this subject, in that one of the things that I think ought to concern our economic analysis has to do with the issue of the effects of the downward pressure on wages that the trade deficits cause. The downward pressure on wages caused by the trade deficit clearly has a negative effect on savings, national savings, the ability of people to save.

So the stagnating wages, the income inequality, all of those things that working-class Americans, particularly those who work in traditional manufacturing jobs, that they are experiencing, has a real relationship to this conversation.

So the question becomes, assuming that we are going to say, well, the trade deficits do not really matter, we do not really have to do anything, what do we do to improve the quality of life for those people, to give them some hope that they can maintain a standard of living that we all associate with the American dream, give them some hope that their kids will have that opportunity, and that they are not being shut out as a result of all of this global conversation.

Let me just say as an aside, I was really taken by the debate that we had here. This sounds like a digression, but it is not. We had a big debate not too long ago, and we are maybe still having it, about the awarding of some additional H-1 visas.

The high-tech community has been coming in to Congress asking for the ability to import some more workers in the high-tech area because they cannot find enough people who are qualified to do the work from our American work force, which should be stunning. I mean, it is stunning to me.

I am not a xenophobe, by any means, but it is just stunning that you have got to go outside of this great country and import workers because you cannot find them to do your high-tech widgets. But, that is clearly the case.

So we are, I think, ignoring the human side of this whole equation, ignoring the lack of investment in human capital, lack of investment in education, the lack of concern for the national savings rates among working-class people. I fear, frankly, that we ignore that part of this equation to our peril. I would like your comment on that.

Ms. YELLEN. If I might just start off. I think that you have raised a very important set of issues. I think the perception certainly is common among households that trade may have something to do with the trends that you have mentioned. We have seen, certainly since the late 1970's, an increase in income inequality in this country.

I believe it has been stabilized and possibly is beginning to be reversed recently, but simply looking at the wage gap of skilled versus unskilled workers, or even the progress in real terms that has been made by less skilled workers since the late 1970's, there is reason for concern and it is very natural that you should see that expressed by your constituents.

Now, there has been a great deal of thinking and research about what is responsible for that trend. While it is natural to say, it is competition, particularly from low-wage countries, from less-skilled workers, the research that has been done suggests that it is not the major cause of the problem.

I think the major thing that is responsible for these trends are pervasive technological changes that are raising the demand for skilled labor in comparison with less skilled workers.

The trends that you see are apparent throughout the economy, not just in sectors that are impacted by trade, but also in sectors that are entirely sheltered from trade. And, while it is natural to blame it on trade, I do not think that that is the major cause of this important phenomenon.

When you mention education and training, that is essential. This increase in the gap between skilled and unskilled wages is a meas-

ure of the market's reward to skill, or the rate of return to education.

That is why the administration's policy is so heavily focused on giving our workers the skills they need to succeed in this economy to benefit from trade and to benefit from the technological changes that are raising the rewards to skills.

Senator MOSELEY-BRAUN. Thank you.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I think we have more than exploited our panelists. I think they might have complaints that they could lodge against us.

Just to make one comment outside this box, you might say. There is always this measure of free-floating anxiety in any society. Just yesterday, Alan Greenspan said, we have the best economy he has seen in 50 years of watching it every day. Are people happy? They are not.

At the moment, when we have every reason to think that the increase in trade has been extraordinary and central to the increase of the growth of our economy, you cannot get a simple extension of the fast track through the House of Representatives, something Cordell Hull could do in 1934.

I see Murray Weidenbaum back there smiling and saying, you will not find an answer. Schumpeter might help you, Stiglitz can sort of help you, Milton Friedman might help you, but, on the whole, it is going to happen anyway no matter how well you do.

Secretary RUBIN. You are suggesting Freud would be more—— [Laughter.]

Senator MOYNIHAN. Yes. No matter how well you do. It might sometimes be best to just accept that as a given of the economists' condition.

But one question, and only that. Is it not the case that a large part of the trade deficit is a form of importing capital because we do not have a sufficient savings rate? I see Dr. Yellen.

Ms. YELLEN. Yes, indeed. The current account deficit measures the gap between a country's investment and saving. Our investment is strong. It has been very strong, it has increased. Our savings has increased too because of conquering, finally, the Federal budget deficit. But private saving is not strong, it is rather weak, and the gap has grown.

Senator MOYNIHAN. And would you not suggest that it would be a good thing to pay down some of our debt?

Ms. YELLEN. I think, certainly thinking about ways in which the Federal Government, particularly as we embark on restructuring Social Security, could contribute possibly to raising the national savings rate, is appropriate.

Senator MOYNIHAN. Just pay down the debt. Just pay off all those bonds that Rubin has. [Laughter.]

Secretary RUBIN. Some were there before we came around.

Senator MOYNIHAN. I just think it is a fact that the trade deficit represents a form of capital importation.

Ms. YELLEN. It does.

Senator MOYNIHAN. When you get that clear, you have other things that come to mind.

Senator MOSELEY-BRAUN. Mr. Chairman, not to keep the witnesses too long, but Senator Moynihan just raised a question. If it is all right, before you dismiss the witnesses, if I can follow Senator Moynihan with a little, tiny question.

The CHAIRMAN. I would ask you to keep it brief.

Senator MOSELEY-BRAUN. It will be very short.

The CHAIRMAN. All right. Please proceed.

Senator MOSELEY-BRAUN. Oh, are you finished?

Senator MOYNIHAN. I am finished. I just want Rubin to sell all of those bonds. [Laughter.]

Senator MOSELEY-BRAUN. And I do not want to do a Chicken Little kind of question here, but the euro, when and if it really takes off, to what extent will that be a problem for us?

Secretary RUBIN. I think you will need another hearing, Senator. No, you are right to raise the question. Let me give you a one-sentence answer. The one-sentence answer is, if it is good for Europe, it is good for us.

But I think you are correctly raising the question of, what are the various issues that could exist within the context of its effect on Europe. I think that is a very complex and appropriate question.

Senator MOSELEY-BRAUN. Thank you.

Secretary RUBIN. Mr. Chairman, can I make just one comment, because I think there is something that happened that could mislead markets, and I do not want that to happen. All right?

The CHAIRMAN. Please proceed.

Secretary RUBIN. With respect to Senator Murkowski, we discussed Japan, the yen, and I think, appropriately, at great length. It was right to be at length, because this is so fundamental. I do not want anyone to infer, though, that we were suggesting that in all cases intervention is not an appropriate strategy for short-term effects.

We have often said in the past, Mr. Chairman, that we will intervene when appropriate and not intervene when it is not appropriate, but it is always a tool that is available for the kinds of impacts it could have.

Senator MOYNIHAN. And you will always know when it is appropriate and when it is inappropriate.

Secretary RUBIN. We will, and we will absolutely announce it ex post. [Laughter.]

The CHAIRMAN. Well, I want to thank the distinguished panel for being here today. It has been a long session, and I appreciate your patience. We will permit questions to be submitted until tomorrow evening to be answered in writing. So thank you.

Senator MOYNIHAN. Thank you very much, all.

Secretary RUBIN. Thank you, Senator.

The CHAIRMAN. This will be a serious series of hearings on trade, because I think nothing is more important than developing a new consensus. Thank you very much.

Secretary RUBIN. Thank you, Mr. Chairman.

The CHAIRMAN. I would now like to introduce the third panel. I am going to be very brief in the introductions, because all of these gentlemen are well known. We will have Dr. Robert Scott, who is a well-known economist with the Economic Policy Institute.

We are delighted to welcome Dr. Murray Weidenbaum, who is currently chairman of the Center for the Study of American Business.

We are pleased to hear from Dr. Robert Lawrence, the Albert L. Williams Professor of Trade and Investment of the John F. Kennedy School of Government at Harvard.

And, finally, we welcome, indeed, Mr. Daniel Griswold, the associate director of the Center for Trade Policy Studies at the Cato Institute.

Gentlemen, we are delighted to have each of you here. We would, of course, include your full statement as if read and ask you to summarize.

We will start with you, Dr. Scott.

STATEMENT OF DR. ROBERT E. SCOTT, ECONOMIST, ECONOMIC POLICY INSTITUTE, WASHINGTON, DC

Dr. SCOTT. Thank you, Mr. Chairman and members of the committee, for giving me the opportunity to testify here this morning. Make no mistake about it, our trade deficit is a problem. It is destroying jobs, depressing wages, hurting our competitiveness, and contributing to the stagnation of real incomes that has plagued our economy for the past two decades.

The trade deficit results, in part, from the use of the U.S. as a market of last resort for exports from around the world, and also from several macroeconomic problems. Both kinds of problems can, and should, be addressed with new trade and international policies.

As you have heard this morning, many attempts have been made to create economic excuses for trade deficits. I frequently heard claims that trade deficits do not matter. This lays a fair claim that it is both wrong and dangerous to the health of our economy, as I will show a little bit later in my testimony.

I will very briefly summarize the negative consequences of trade deficits, to save time for other issues. First, there are three major consequences of trade deficits: first, trade deficits have eliminated millions of high-wage manufacturing jobs in the United States; second, they have also put downward pressure on the wages of production workers, not only by eliminating good jobs, but also pushing down the prices of domestic products and by decreasing labor's bargaining power with multinational firms; finally, trade deficits have reduced investment in research and development and, thereby, undermined productivity growth and contributed to the stagnation of incomes which have plagued our economy for at least two decades.

I want to turn, next, to the causes of these, what I call, structural trade deficits. Many economists have emphasized the importance of so-called fundamental accounting identities.

For example, the economic report of the President this year notes that, by definition, any excess of national investment over national savings must be financed through an inflow of foreign capital, as we heard this morning. This, of course, generates an offsetting current account deficit. In this view, a low level of national savings must necessarily result in a trade deficit.

However, just because trade is influenced by macroeconomic forces such as the savings rate and currency values, it does not follow that trade policy cannot influence the level of the trade level.

There are at least two issues we have to think about: first, what determines these macroeconomic flows, and, second, how can public policies, both at home and abroad, affect trade balances?

These accounting identities we have been talking about do not, and cannot, explain the causal relationship between savings and investment. Do low savings rates cause trade deficits, as we have heard this morning, or does causation run in the other direction?

A trade deficit, as Senator Moseley-Braun pointed out, reduces the incomes of domestic workers, pushing many into lower income brackets. Families with lower incomes generally save less. They find it much harder to save. Therefore, trade deficits can, and do, reduce national savings.

In addition, the council's report also points out that, in the last two decades, our trade deficit has been closely tied to movements of the dollar and it links these movements to macroeconomic problems.

However, our trade deficits and our exchange rates are also heavily influenced by other countries' economic policies. For example, in 1994, China devalued its currency by 30 percent against the dollar. Since that time, it has continued to purchase dollars and has piled up a huge reserve of over $140 billion in foreign currencies. Since then, our bilateral deficit with China has been increasing at an enormous rate of about 25 percent a year.

Japan has also intervened heavily in foreign exchange markets, with similar consequences. In 1996, there were more than $125 billion in official capital inflows, official government purchases of U.S. assets, and those contributed to the decline in the value of the yen, which has lost about 50 percent of its value.

Of course, as we have heard this morning, there are many other ways in which governments also intervene to increase our trade deficit. There are many countries that have substantial restrictions on trade flows.

China certainly has been using heavy restrictions on imports, in particular. They also use offsets and technology transfers to capture market share from U.S. firms in high-tech products, such as automobiles, computer products, and aircraft.

In fact, I have estimated that over 148,000 jobs in aerospace and related industries alone are at risk in the next two decades because of these particular discriminatory policies in China.

In summary, the U.S. trade deficit has been increased by both mercantilist macroeconomic policies of foreign governments, as well as interventions and distortions in individual product markets.

These problems have been exacerbated, as we have heard, through the Asian financial crisis and by financial market deregulation in the last several decades. These deficits have contributed to a widening of income inequality in the U.S., and to the stagnation of income and productivity growth here in our country.

Turning now to policy implications, I am going to very briefly summarize five ideas that we might pursue for reducing these trade deficits. First of all, as was mentioned earlier, I think we

need to devalue the dollar, not in general, but against the yen and the Chinese wan, because of the interventions I mentioned earlier.

Briefly, I will just finish my summary. Second, we need to coordinate macro policies with Japan and Europe to encourage those countries to reflate their economies. Third, we need to attack trade barriers to U.S. exports.

Fourth, I think we should promote labor rights and environmental standards. Fifth, I think we need to develop a plan for addressing these critical trade problems, as suggested by Senator Dorgan earlier this morning.

To conclude, I think we have a breathing space at this moment to develop plans and policies that will enable us to address our trade problems when the next crisis hits us, as it inevitably will.

Effective planning can help us nurture a consensus on the desirable future directions for our trade policy. This consensus must be achieved before we can move ahead. A continuation of the trade policies of the past is no longer a viable option. Thank you.

The CHAIRMAN. Thank you, Dr. Scott.

[The prepared statement of Dr. Scott appears in the appendix.]

The CHAIRMAN. Dr. Weidenbaum, it is always a pleasure to welcome you.

Senator MOSELEY-BRAUN. Mr. Chairman, before Dr. Weidenbaum starts, because I will have to go vote, I have an issue with the Chair. I was just writing you and the Ranking Member a note, in fact, regarding the confirmations that are coming up, and that is after this panel.

I would like to raise it before we go vote, because I could have an issue and there could be a problem in regards to the confirmation panel. I wanted to raise it with the Chairman before we adjourn or recess.

The CHAIRMAN. Why do we not discuss that later. We will proceed with this.

Senator MOSELEY-BRAUN. All right. Thank you, sir.

Senator MOYNIHAN. A very special welcome.

STATEMENT OF DR. MURRAY WEIDENBAUM, CHAIRMAN, CENTER FOR THE STUDY OF AMERICAN BUSINESS, FORMER CHAIR, COUNCIL OF ECONOMIC ADVISORS, ST. LOUIS, MO

Dr. WEIDENBAUM. Thank you, Senator. That is very greatly appreciated.

The trade deficit is the most misleading indicator in our statistical tool kit. Bad news for the economy is good news for the trade deficit, and vice versa. That is not theory, it is practice. In 1992, we were in a recession. The trade deficit came down. The next year, the economy revived and the trade deficit rose.

Our trade with South Korea furnishes a current example. In 1996, we enjoyed a trade surplus with them. In 1997, their economy went into the tank. Korea got rid of its trade deficit with us overnight. We now have a trade deficit with them. Reducing our imports from Korea would make it more difficult for them to get back to normal.

I think we pay too much attention to the trade deficit with Japan. Here is a neglected set of numbers. The average Japanese spends more on U.S. products than the average American spends

on Japanese products, $535 to $432. We have a larger population, is the reason for our imports being greater than our exports there.

The trade deficit is a symptom of a basic imbalance. You have heard that from the previous panel. We invest more than we save. We can reduce the trade deficit constructively, but not by barriers to imports or subsidies to exports.

By the way, we do a lot of that. We are not an island of free trade in a world of protectionism. I would be glad to cite, for the record, chapter and verse on that. Yes, we need to encourage Americans to save more, to provide at home the funds needed to finance economic growth.

Frankly, you folks here are part of the problem. So many of the complications in the Internal Revenue Code arise when the taxpayer dares to save and invest. Yes, you have helped deal with that with some current reforms, but there is a lot more I think that needs to be done.

However, the trade deficits remind us that economic progress produces losers as well as winners. The challenge, is to help those hurt without undermining the progress.

A constructive response means making the U.S. a more attractive place to hire people to do business. Tax reform, regulatory reform, are important. We need to raise the skills of Americans who have difficulty finding good jobs, but it is silly to quiver at the sight of international competition. We are the pace-setters. Other nations are copying our economic system, business practices, culture, fashions, freedom.

American companies are the global leaders in aerospace and airlines, beverages and brokerage, chemicals, computers, and cars, electronics and entertainment, paper products and pharmaceuticals, soap and scientific equipment. In the years ahead, we will be benefitting from the upsurge of R&D during the 1980's and 1990's.

There is a new development. Since the early 1980's, most R&D is financed by the private sector. That makes it more likely that there will be a future flow in the U.S. of new and improved civilian products and production processes.

To sum up, the trade deficit should not be the focus of economic policy. It is a painful side effect. We should not be so preoccupied with it that we adopt policies that weaken the basic strength of our high-performance economy.

Senator MOYNIHAN. Mr. Chairman, may I just say, that was brilliant. Succinct and brilliant. You were necessarily distracted for a moment, but Dr. Weidenbaum began by saying, "The trade deficit is my favorite candidate for the most misleading indicator in our statistical tool kit. More often than not, bad news for the economy is good news for the trade deficit, and vice versa." Feel better? [Laughter.]

The CHAIRMAN. Much better. I was fascinated by the fact that the Japanese, individually, spend $535 compared with what for Americans?

Dr. WEIDENBAUM. $432.

The CHAIRMAN. $432.

Senator MOYNIHAN. Stunning.

The CHAIRMAN. It really is stunning. Very significant.

[The prepared statement of Dr. Weidenbaum appears in the appendix.]

The CHAIRMAN. Dr. Lawrence, please.

STATEMENT OF DR. ROBERT LAWRENCE, ALBERT L. WILLIAMS PROFESSOR OF TRADE AND INVESTMENT, JOHN F. KENNEDY SCHOOL OF GOVERNMENT AT HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. LAWRENCE. Thank you, Mr. Chairman. It is really a pleasure to testify here today, and I want to commend you for holding these hearings. I think that we need to understand what the trade deficit is, and it is critical that it not be used as a pretext, either for delaying fast track or for adopting protectionist measures.

Indeed, I want to argue that, over the next few years, our trade deficit will get larger, and, perhaps provocatively, that it should get larger. I mean it as a temporary adjustment, and I think we need it from the standpoint of the world economy.

Basically, what we know is, we have a crisis in Asia, and that is going to mean that the Asians can borrow less. That means that the world pool of savings is being increased. Some other parties have to be prepared to step forward and borrow that money and use it productively in order to sustain global economic growth.

So it is basically, in order to stabilize the world economy, that what we would like to see happen, or what I would like to see happen, is that a part of that excess in global savings be used in the United States. The key, is that those savings go to investment, to fund productive investments.

If that is what is happening as a result of the trade deficit, I would submit we have little to worry. If, on the other hand, we use those savings for consumption, then there is a greater cause for concern.

But there are other concerns which Americans express about the trade deficit, and I will deal briefly with two major concerns. The first has to do with employment, and the second has to do with the potential negative impact on our future living standards.

Now, I think these could be problems in some circumstances, but are not problems currently. First, there is this argument that, automatically, a deficit costs jobs.

Indeed, Senator Chafee quoted statistics which are often bandied about where people equate a certain value of trade with a certain job equivalent, and then claim automatically that the trade deficit has caused the loss in jobs.

The fact is, a trade deficit gives us the difference between America's spending and its production. So it is quite possible that our spending is growing very rapidly and our production is also growing. That means that we could get very rapid spending by Americans. They buy a lot domestically, they buy a lot from the rest of the world, so we get a trade deficit and we see employment creation at the same time.

Indeed, that is exactly what we have seen in the course of the 1980's, when 12 million jobs were created during the period when our trade deficit burgeoned, and in the 1990's, where we have seen a similar phenomenon.

A second concern, has to do with the deficits and increasing international indebtedness. There, I think Secretary Rubin got it exactly right earlier on when he pointed out, it does not matter or not whether you are borrowing, that is not the key question, it is, what are you doing with the money? If the borrowing is going to fund investment, then there is much less reason for concern.

Of course, it would be even better still if Americans would save more and could finance the borrowing themselves, but, given that we have not, we are better off borrowing for that purpose. Indeed, in my testimony, what I show is that in the 1980's, in effect, we had a deficit that was driven by a savings bust.

It was not an increase in investment as a share of our net national product. It was, rather, a decline in our National savings rates. Those 1980's deficits were, therefore, by this metric, a source of concern. In the 1990's, it is different. The deficits seem to have gone to fund investment, and that gives us less reason for concern.

I do acknowledge, and I think we need to accept, that as a result of international trade some jobs will be lost. But we need to also remember, before we quickly jump to the conclusion that a bigger trade deficit leads to a smaller manufacturing sector, that what the trade deficit allows us to do is stay in investment in this country.

What investment means, is more spending on plant and equipment. That means more jobs in construction and more jobs in the manufacturing sector that produces the equipment.

So we cannot simply assume that we could eliminate the trade deficit and hold everything else constant, because what we have to understand is, if we eliminate the trade deficit, we could see less investment in this country, and by that means reduce the number of manufacturing jobs.

I also think it is inappropriate to use the trade deficit as an indicator of unfair trade practices. I think there are problems in gaining access to foreign markets. We need to care about those. We need to take them very, very seriously. But we should not use the trade deficit as an indicator of whether we are successful or not.

I would submit that, if Japan balanced its trade simply by using more of the things it exports today at home, that would not mean a more open Japan. We would not like that. What we need to see, is a genuinely open market abroad. So that is what the thrust of our trade policy should be designed to do, open foreign markets.

The trade deficit is going to be misleading as an arbiter, and many people in this discussion already have referred to the trade deficit as if it measures whether our economy is relatively open compared to others or not.

What we have seen, is that we have had virtually balanced trade in the 1980's, virtually balanced current account in the 1990's, and at the same time we have had big deficits. Do we honestly believe that our economy, relative to others', has fluctuated and is becoming more or less open over those periods?

I was going to go into some policy implications, but I look forward to answering some questions on that. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Dr. Lawrence.

[The prepared statement of Dr. Lawrence appears in the appendix.]

The CHAIRMAN. Mr. Griswold?

Mr. GRISWOLD. Mr. Chairman, first, so I am not accused of malpractice, it should be Mr. Griswold.

STATEMENT OF DANIEL GRISWOLD, ASSOCIATE DIRECTOR OF THE CENTER FOR TRADE POLICY STUDIES, CATO INSTITUTE, WASHINGTON, DC

Mr. GRISWOLD. Mr. Chairman, thank you for allowing me to testify on this important subject. Perhaps no aspect of American trade is talked about more or understood less than the trade deficit.

It has been cited as conclusive proof of unfair trade barriers abroad or a lack of competitiveness among U.S. industries at home. It has been blamed for destroying jobs and dragging down economic growth. I welcome the opportunity to present a more charitable view of this much-abused trade number.

The U.S. trade deficit is the result of a net inflow of capital to the United States from the rest of the world. Because of our stable and relatively free domestic market, we remain the world's most popular destination for foreign investment. We have become a net importer of capital because Americans do not save enough to finance all of the available investment opportunities in our economy.

This inflow of capital from abroad allows us to pay for imports over and above what we export. In other words, the trade deficit is simply a mirror reflection of the larger macroeconomic reality that investment in the United States exceeds domestic savings. If we want to change the U.S. trade deficit, we must change the rate at which Americans save and invest. There is no alternative.

In a study published by the Cato Institute in April, I addressed four enduring myths about the U.S. trade deficit. Two of them relate to causes, two to consequences.

The first myth, is that the overall U.S. trade deficit is caused by unfair trade barriers abroad. Foreign barriers are certainly a problem, just as our own barriers to imports remain a problem. But trade restrictions do not determine the overall U.S. trade deficit, nor do they fully account for the differences in bilateral trade balances.

For example, the United States runs a large trade surplus with Brazil, a country with relatively high trade barriers, while we run deficits with Mexico and Canada, two countries far more open to U.S. exports.

The second myth, is that trade deficits are caused by a lack of U.S. industrial competitiveness. This myth has been refuted by the stellar performance of the American economy, which today is the envy of the world.

Since 1992, during a time when the U.S. trade deficit has tripled, U.S. industrial production has surged 24 percent and manufacturing output, 27 percent. The American people sell more goods and services in the global marketplace than people of any other country.

The third myth, is that trade deficits destroy jobs. Again, the performance of the U.S. economy in the last decade should lay that myth to rest. While the trade deficit has expanded, so have American payrolls.

Indeed, there is a strong correlation between rising trade deficits and falling rates of unemployment. The reason is simple: the same expanding economy that stimulates demand for labor also raises demand for imported goods and capital.

The final myth, is that trade deficits are a drag on the U.S. economy. With the slow-down in East Asia, this seems a reasonable claim. But the drag is not the deficit itself, but falling demand for our exports in the Far East. A trade deficit that reflects both rising exports and even more rapidly rising imports can be a sign of health. That has been the case in the United States for most of the past two decades.

Since 1980, the U.S. economy has grown an average of 3.1 percent in years in which the current account deficit has expanded from the previous year and an average of only 2.0 percent in years in which the deficit has shrunk. If trade deficits are bad for growth, why does the U.S. economy grow more than 50 percent faster when the trade deficit expands?

Frankly, we would have more reason to worry if the U.S. were experiencing a rising trade surplus. In Mexico in 1995, and more recently in South Korea and other East Asian countries, trade balances flipped overnight from deficit to surplus because of plunging domestic demand and the flight of foreign capital.

In Japan today, a soaring trade surplus has been accompanied by record high unemployment. It is no coincidence that America's smallest trade deficit in recent years occurred in 1991, in the trough of our last recession.

In some ways, I wish Senator Dorgan's chart was up here on the trade deficit. If you look, every time the trade deficit has improved, or even went into surplus, it was right, smack in the middle of their most recent recessions. So, basically, if you want to cure a trade deficit, nothing works better than a good recession.

What does all this mean for policy? First, there is no emergency. The trade deficit is not a sign of economic distress, but of rising domestic demand and investment. Second, the trade deficit is largely immune to change in trade policy. Imposing new trade barriers will only make Americans worse off, while leaving the trade deficit virtually unchanged.

In conclusion, I would urge Congress to ignore the trade deficit and focus, instead, on reducing and eliminating barriers to trade wherever they may exist.

Thank you for letting me speak, and I would be glad to answer any questions. Thank you.

Senator MURKOWSKI. Thank you, Mr. Griswold.

[The prepared statement of Mr. Griswold appears in the appendix.]

Senator MURKOWSKI. There are a number of questions that the professional staff has put together, and I will go through as many as I can.

First of all, let me ask you, Dr. Scott, relative to your suggestion that we devalue the dollar, and what was the yen 18 months ago, 80?

Dr. SCOTT. About 2 years ago. Yes, I think that is right.

Senator MURKOWSKI. All right. Something in that nature. We had a trade deficit then.

Dr. SCOTT. That is correct.

Senator MURKOWSKI. Why devalue now?

Dr. SCOTT. Well, certainly the trade deficit in the last 2 years has increased and it will increase much more rapidly in the next 2 years as a result of the yen's devaluation. It takes 18 to 24 months for a devaluation to have its full impact on the trade balance.

But, more importantly, I think trade is a long-run issue. We have had a structural trade deficit with Japan for two decades and, as I think Senator Dorgan pointed out this morning, since 1985, that deficit has not fallen below $40 billion.

I think this indicates that we certainly need to take steps to reduce that deficit. One way to do it is to devalue the dollar. I think that would also put pressure on Japan to take other steps to open its economy, as others have suggested here this morning.

Senator MURKOWSKI. The earlier panel that I had an opportunity to question, Secretary of Treasury Rubin and others, really did not have an opportunity to relate to the significance or connection of the role of our increased trade sanctions, which are obviously a political quasi-effort to try and bring conformancy to those that we are somewhat unhappy with, and the connection between the trade imbalance, which is an entirely different set of circumstances.

But, clearly, as we eliminate our participation for markets, it is my understanding that 65 percent of the world's population is now affected in some way by sanctions from the United States. How much of a factor is this in the complications, or is it independent? I would ask that of Dr. Weidenbaum, who obviously has been nodding his head in response to my leading question.

Dr. WEIDENBAUM. Thank you, Senator. Every study I have ever come across concludes that unilateral sanctions do not work. They do not achieve their objective and they hurt American industries who otherwise would be increasing their exports. So, it is clear to me that this multiplicity of sanctions is contributing to our trade deficit, and the economy would be better off by economizing on sanctions.

Senator MURKOWSKI. I have got a function that I am late to, and Senate Chafee has agreed to carry on until Senator Roth comes back. So, if you gentlemen would excuse me.

Senator Chafee?

Senator CHAFEE. Yes. Gentlemen, I am sorry that I was not here for your testimony, but I have looked it over.

Mr. Griswold, you say that the trade deficit reflects both rising exports and even more rapidly rising imports, can be a sign of health. Frankly, we would have more reason to worry if the U.S. were running a trade surplus. I am a free trader. Would we worry if we were running a surplus?

Mr. GRISWOLD. Well, I think we would have more cause to worry if we were moving towards the surplus in rapid fashion. In my testimony, I cited a number of examples of countries. For example, Mexico in 1995, and South Korea, and other East Asian countries recently, who flipped dramatically, overnight, literally, from a deficit position to a surplus position.

What that is a sign of, is plunging domestic demand and capital fight. We have heard several times today that the reason we have a trade deficit is because of a net inflow of capital into our country.

Well, a surplus can be a problem and a sign of distress when it is a sign of a net outflow of capital, as Mexico saw in 1995 and as East Asia has seen. So a surplus or a deficit are not necessarily good or bad in and of themselves. I would argue, they are basically neutral. But if we are moving rapidly towards a surplus, I think that can be a sign of distress.

As I mentioned, with Senator Dorgan's illustration of all of the recent trade deficits in the movement, every time the trade deficit "improves" in this country, it has been because of a recession that we are having. So, in that sense, that is why I pointed to that correspondence between recessions and a falling trade deficit.

Senator CHAFEE. Dr. Scott, presumably you would not have too much trouble with us running a surplus.

Dr. SCOTT. No. I think that, in the long run, large and wealthy countries such as the U.S. should be running a trade surplus. If I might add a few comments on the previous question and remarks.

Certainly, there is a correlation in the U.S. between the business cycle and the trade balance. There is no question about that. But, as I remarked earlier, we have to move back from the correlations, the simple correlations, to look at causation.

I think the key issue to look at there is not the short-run trade balance, the year-to-year variation in the trade surplus or deficit, but the status of the economy over the last several decades. Over that period of time we have seen a steady increase in the trade deficit as a share of GDP, but at the same time we have seen——

Senator CHAFEE. The prior witnesses would argue that, as you have said, it is a steady increase in the trade deficit as a percentage of GDP.

Dr. SCOTT. That is right.

Senator CHAFEE. Well, I do not think that is accurate. According to the prior panel, and I remember Secretary Rubin specifically said—were you here when he was testifying?

Dr. SCOTT. Certainly.

Senator CHAFEE. He said, and I cannot put my finger on it, maybe it was in answer to a question, that the deficit, as a percentage of GDP, is constantly declining. What about that, Dr. Lawrence, have you got some facts there?

Dr. LAWRENCE. Yes, Senator. The current account, as a share of our net national product, was a deficit of 3.8 percent of GDP in 1987, and it is 2.2 in 1997, so it is about half the size relative to the size of the economy. We do not want to be confused by either inflation or the fact that our economy is growing. It seems to me that we have had fluctuations in our trade balance.

In our current account, we have a virtual balance in 1981, we got a big deficit in the 1980's, we went to virtual balance, indeed, in the national income accounts there is a small surplus in 1991, and now we have got the emergence of a large deficit again.

Senator CHAFEE. Do you agree with that, Dr. Scott? Are these figures wrong, in your opinion?

Dr. SCOTT. No, the figures are not wrong. The time frame, I think, is incorrect. I would add two points. One, we had a strong surplus in the U.S. in the 1950's. In the 1960's and 1970's, we moved to trade balance, roughly. In the 1980's, we moved to a substantial trade deficit. And here I can bring up my second point,

that the trade deficit in 1987 was certainly heavily influenced by the over-valuation of the dollar.

The remarkable thing today, is that the U.S. currency has lost most of the value it had in the mid-1980's, and yet we still have a substantial trade deficit as a share of GDP.

So, looked at it over the last four decades, we move from a surplus to a relatively rapidly growing deficit today. There is no disagreement that the deficit is going to grow much more rapidly in the next several years.

Senator CHAFEE. Senator Moynihan, do you have some questions?

Senator MOYNIHAN. Well, I do not have questions, I just have exclamatory thanks to our panelists. They have clarified this subject. I know that they all do not agree. But Murray Weidenbaum is one of the—in Japan, where they know how to run these things, he would be called a national treasure, probably.

But you were voting, Senator Chafee, when Dr. Weidenbaum said that, "The trade deficit is my favorite candidate for the most misleading indicator in our statistical tool kit. More often than not, bad news for the economy is good news for the trade deficit, and vice versa." He pointed out that the average Japanese spends more on U.S. products, $538 a year, than the average American spends on Japanese products, $432. There are more of us, so the trade volume is different.

But I did not hear Dr. Lawrence, as I had to vote. I read Mr. Griswold's statement, and, of course, Dr. Weidenbaum. You do, the three of you, agree that the trade deficit basically reflects too low a level of domestic saving?

Mr. GRISWOLD. Yes, sir.

Senator MOYNIHAN. And you, sir?

Mr. GRISWOLD. Yes. Or to put a positive spin on it, we have a lot of investment going on.

Senator MOYNIHAN. You need more investment than you are saving for.

Mr. GRISWOLD. Over and above what we save, yes.

Senator MOYNIHAN. Dr. Lawrence? I am sorry, sir.

Dr. LAWRENCE. Yes. Although I would distinguish, one of the things I tried to bring out in my testimony is that, if we look at the world economy over the next year, we know the Asians are going to be unable to absorb a whole lot of global savings. They are not going to be borrowing, they are going to have to be adjusting their positions.

So, from a world standpoint, there is going to be an excess supply of savings. It is very critical that we, and other countries, mop up those savings so we do not plummet the whole world economy into a recession. So, in that context, I would argue that the key is for us to invest it and for others to spend the money which is now available in productive investment.

But, given that, currently I do not think there is a problem in the next year or two. We have a chronic long-run problem of inadequate savings. I think, in the long run, our goal should be to move towards balance and towards surplus by generating our own savings.

Senator MOYNIHAN. Could I ask, does the profession have much to say about savings? I mean, they do not seem to respond to textbooks.

Dr. LAWRENCE. Well, Senator, the textbook, unfortunately, tells us, in my reading of it, that the impact of increased incentive to save is ambiguous. That is what the textbooks tell us.

Senator MOYNIHAN. Keynes argued that, as income goes up, savings would go up.

Dr. LAWRENCE. That is a short-run relationship.

Senator MOYNIHAN. Yes. But I think we have since learned from Friedman and such that, no, no, you will learn that you need two cars and one will not do any more.

Dr. LAWRENCE. Well, if you are a fully employed economy, you need to change the balance between current consumption and future consumption to create an incentive for people to want to shift into consume more in the future.

The problem is, if you have a higher rate of return on your savings, you make people richer. A response to being richer may be to spend more today. So, there are these offsetting effects.

Senator MOYNIHAN. Keynes originally thought the response to being richer would be to save more. That might have been true in the 1930's.

Mr. Chairman, I think we have had a wonderful panel and I think we should——

The CHAIRMAN. Proceed?

Senator MOYNIHAN. Well, I just think we should tell some of our colleagues. We should send this testimony around. It is clarifying. Liberating.

The CHAIRMAN. Well, I appreciate the panel being here today. I regret that it came up so late. I know that is not the first time that has happened to you, nor the last.

I just have one question I would like to ask.

Senator CHAFEE. Mr. Chairman, I have to go, but I want to thank the panel, likewise. I appreciate their being here. Thank you.

The CHAIRMAN. I have just one question, and I may submit some others in writing. But I would like to ask, what can we do to improve savings in this country?

Dr. WEIDENBAUM. I think one of the things that the Senate Finance Committee could do, is to take a look at the Tax Code from the viewpoint of the average individual who is filling out a tax return and look at all of the disincentives that are in the Tax Code that face the individual who dares to save, and, worse yet, to invest his or her savings.

You have made progress, certainly. I think the Roth IRAs are a good example. But, on balance, you still have a Tax Code that discourages saving and investment from the viewpoint of the individual taxpayer.

The CHAIRMAN. Yes. Dr. Scott?

Dr. SCOTT. I would, again, hearken back to the incomes question. I am an unreconstructed Keynesian and I do think that raising incomes can increase savings, particularly at the bottom end of the income distribution.

I would point out that, since 1979, as I showed in my testimony, production and nonsupervisory workers have experienced declining

real wages, declining wages in real terms, on a steady trend, to the point that their real wages are now about 15 percent below where they were in 1979.

If we can find some way to raise the wages of production workers, who make up, by the way, three-quarters of the labor force in our economy, then we can certainly increase savings in that way.

Might I add a second point, which is, I think we also have a problem with savings imbalances in the world economy. The U.S., as a whole, savings 17 or 18 percent, I think, of GDP. In total, Europeans save around 20 percent, and many of the Asian economies save on the order of 30 percent of their GDP. I think that is a major imbalance and we need to address that through coordination mechanisms as well.

The CHAIRMAN. Yes. Dr. Lawrence, please.

Dr. LAWRENCE. I think we need to look at private incentives to save. But I think we also need to think deeply about the government savings, that is to say, the budget deficit. I think we have made major progress in the budget deficit in bringing it into rough balance today.

I think the single most important contribution the government can make over the medium term is generating surpluses. That is the way to increase national savings. If it is really a goal, the private sector is elusive in its response mechanisms, so I think it would be the public sector that could take the lead.

The CHAIRMAN. Some would say the public is pretty elusive too.

Dr. LAWRENCE. Well, that has been true.

The CHAIRMAN. Mr. Griswold?

Mr. GRISWOLD. Mr. Chairman, I would just add that one policy move would be to try shift the Social Security system away from a pay-as-you-go to an investment system, and that would create a new pool of savings that, instead of going immediately to consumption, would go into the stock market and enlarge the pool of savings available for investment.

The CHAIRMAN. Well, time is running out.

Senator MOYNIHAN. I might say, that is a proposal that a number of us have made to bring the payroll tax down to pay-as-you-go and have the 2 percent reduction be available for your savings plan.

Mr. GRISWOLD. Yes.

Senator MOYNIHAN. Which would suit your purpose of increasing savings.

Mr. GRISWOLD. It would be a very good start.

The CHAIRMAN. A number of us are very interested in these private saving accounts, and we will be making some proposals in that area.

Senator D'Amato, did you have any questions?

Senator D'AMATO. No, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very much for being here. This has been an excellent panel, and I think most helpful in our efforts in shaping a new American trade policy. Thank you very much.

[Whereupon, at 12:37 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. ALFONSE D'AMATO

Mr. Chairman, thank you for holding this very important hearing today. The current U.S. trade deficit is alarming. For the first quarter of 1998, it was $137 billion. And the deficit in March was $20.2 billion in the services sector.

Mr. Chairman, we will hear testimony today that the trade deficit is not something to be afraid of. We will be told that the trade deficit is particularly high for some very specific reasons, like the Asian economic crisis, the fluctuations in the cost of oil, and other macroeconomic occurrences in the economy which should not be of great concern to the United States.

However, Mr. Chairman I am more concerned now than ever before with the continuing increase in the trade deficit. The numbers are growing at an unmanageable rate. Perhaps one of the reasons for this steep increase is that U.S. goods and services are not being afforded a fair and equitable opportunity to compete in many of the world's markets.

For example, Mr. Chairman, the Japanese government continues to manipulate the way foreign goods are distributed, marketed, and displayed in retail outlets throughout their country. One of the most blatant examples of this predatory market manipulation can be seen in the case of Kodak film.

The Japanese government has erected a series of walls and hurdles that make it impossible for a foreign company to compete on an equal playing field. In effect, the Japanese government simply "privatized" protection, delegating the function of blocking foreign penetration of the market to private industry groupings, and painstakingly guiding the restructuring of those groupings to maximize the degree of protection achieved. Plain and simple, Fuji has used Japan's lax anti-trust laws and closed market system to erect barriers to free and open competition.

Market access, Mr. Chairman, is of paramount importance to maintaining free and open trade. American companies must have the opportunity to bring their products to market. Without truly free access to consumers, U.S. goods and services will never get a fair opportunity to compete, and the United States' trade deficit will surely spiral out of control.

One specific example, as it relates to Canada, is the wool-apparel tariff preference level. Using this loophole in the NAFTA rule of origin requirements is letting Canada flood the U.S. market with wool apparel made from foreign, non-NAFTA fabric from countries like China, Turkey and Korea. And these foreign fabric products are getting the same special, low NAFTA duties as if they were true NAFTA products. Thousands of U.S. jobs have been lost as a result. It seems to me that the Administration has an obligation, when it comes to fast track authority, to assure Congress that only strong agreements absent any loopholes will be negotiated.

The United States has fought hard to open markets throughout the world to U.S. Products. Unfortunately, there remains much to be done when it comes to expanding market access for American goods and services. One additional area of particular concern to me is cross-border, Canadian-U.S. dairy trade. The Canadians have made it impossible for the United States to gain market access for our dairy products by erecting huge tariff barriers. These practices have priced U.S. dairy goods out of reach to Canadian consumers.

Mr. Chairman, I realize that in return for this trade deficit, the United States is running a current account surplus and exporting capital to so many of the world's economies. While that helps the American financial sector and leads to productive economic growth, we must not allow this prosperity to blind us to effects of an uncontrolled, unmanaged trade deficit.

The trade deficit is an indicator of our nation's economy. It is like an engine warning light on a car. When it blinks uncontrolled, we must pay attention and correct the problems we are facing. This hearing will shed light on that important indicator and will allow this committee to adequately address the reasons that that indicator is "flashing."

I look forward to working with the Chairman over the course of these important hearings and successfully addressing the problems this country is facing as it relates to increasing trade deficits and closed markets.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

Mr. Chairman, thank you for holding this hearing. Anybody who watched the Senate debate the fast track legislation last fall, will appreciate the value of this hearing. Although the Senate strongly endorsed fast track in a bipartisan manner, the opponents of free trade attempted to cloud the debate, with emotional arguments that ignored the facts. This hearing, and the others planned by Chairman Roth, will finally allow the facts to come out.

One of the most misused statistics opponents of free trade is the trade deficit. The trade deficit is alleged to cause job loss, low growth rates, and the decline of the manufacturing sector. In fact, the trade deficit ranks just behind El Nino as the cause of everything that is wrong with America.

Unfortunately, for the opponents of free trade, the facts don't support their arguments. Also unfortunately, for those of us who favor expanding trade, the American public generally believes our opponents arguments, even though they are not base in fact. That's why this hearing is so important. Those of us in public office need to begin to build the case for free trade from the ground up. We must continue to talk about the tremendous benefits of trade. Such as its contribution to increased employment, higher wages and low inflation.

But we also can't ignore the arguments against trade. Especially when so many of those arguments can be easily refuted if they are debated in an open, comprehensive manner.

I'm confident that the distinguished group of witnesses here today will dispel some of the myths associated with the trade deficit. I would just note that in my own studying of this issue, I have found very little correlation between the size of the trade deficit and the unemployment rate, as an example. In fact the last time we ran a trade surplus, 1975, the unemployment rate was over 8.5%.

Recently, with record trade deficits, we've enjoyed the lowest unemployment rate in a generation. So although trade is often the scape goat when a factory shuts down or moves offshore, the facts fail to support the proposition that the trade deficit significantly affects employment levels.

And the most important thing we can do to increase exports is give the president fast track authority. Those who use the trade deficit as an excuse for not supporting fast track miss the point. No substantial progress will be made on addressing the trade deficit, or on reforming our trade policies until the president has the authority to negotiate new trade agreements.

Withholding fast track authority is a prescription for failed trade policies. Hopefully, this hearing will begin a process of rebuilding the public's support of trade in order to create an environment where it is politically popular, once again, to support free trade policies.

So thank you, Mr. Chairman, for holding this series of hearings. That's not to say the trade deficit is a good thing. In fact, it is a strong indicator that Americans don't save enough of what they earn. The low savings rate forces American companies to import capital to continue to invest in their business, which in turn, increases our trade deficit. But this problem should be addressed by balancing the federal budget and through vehicles like the Roth IRA and other tax incentives to save money. Not through trade policy.

With that said, there is one area where the federal government has an important role in reducing the trade deficit. Both Congress and the administration must work tirelessly to break down trade barriers wherever they exist. The *1998 National Trade Estimate Report on Foreign Trade Barriers* lists over 400 pages of trade barriers to U.S. exports.

We have a lot of work to do to create an environment where American workers and farmers are able to compete fairly in every market in the world. So let's focus our energy on increasing exports and we'll see the trade deficit reduced.

PREPARED STATEMENT OF DANIEL T. GRISWOLD

Mr. Chairman and members of the Senate Finance Committee: Thank you for allowing me to testify on the causes and consequences of the U.S. trade deficit.

The economic crisis in East Asia has thrust America's trade deficit back into the news. Perhaps no aspect of American trade is talked about more and understood less than the trade deficit. It has been cited as conclusive proof of unfair trade barriers abroad or a lack of competitiveness among U.S. industries at home. It has been blamed for destroying jobs and dragging down economic growth. I welcome the opportunity to present a more charitable view of this much abused trade number.

The U.S. trade deficit is the result of a net inflow of capital to the United States from the rest of the world. Because of our stable and relatively free domestic market, we remain the world's most popular destination for foreign investment. We have become a net importer of capital because Americans do not save enough to finance all the available investment opportunities in our economy. This inflow of capital from abroad allows us to pay for imports over and above what we export.

In other words, the trade deficit is simply a mirror reflection of the larger macroeconomic reality that investment in the United States exceeds domestic savings. If we want to change the U.S. trade deficit we must change the rate at which Americans save and invest.

In my study published by the Cato Institute in April, I address four enduring myths about the U.S. trade deficit. Two of them relate to causes, two to consequences.

The first myth is that the overall U.S. trade deficit is caused by unfair trade barriers abroad. Foreign barriers are certainly a problem, just as our own barriers to imports remain a problem. But trade restrictions do not determine the overall U.S. trade deficit, nor do they fully account for the differences in bilateral trade balances. For example, the United States runs a large trade surplus with Brazil, a country with a number of unfair trade barriers, while we run deficits with Mexico and Canada, two countries virtually open to U.S. exports.

The second myth is that trade deficits are caused by a lack of U.S. industrial competitiveness. This myth has been refuted by the stellar performance of the American economy, which today is the envy of the world. Since 1992, the U.S. trade deficit has tripled. During that same time, U.S. industrial production has surged 24 percent and manufacturing output 27 percent. The American people sell more goods and services in the global marketplace than people of any other country.

A third myth is that trade deficits destroy jobs. Again, the performance of the U.S. economy in the last decade should lay that myth to rest. While the trade deficit has expanded, so have American payrolls. Indeed, there is a strong correlation between rising trade deficits and falling rates of unemployment. The reason is simple: The same expanding economy that stokes demand for labor also raises demand for imports of goods and capital.

The final myth is that trade deficits are a drag on the U.S. economy. With the slowdown in East Asia, this seems a reasonable assertion. But the drag is not the trade deficit itself, but falling demand for our exports in the Far East. A trade deficit that reflects both rising exports and even more rapidly rising imports can be a sign of health. That has been exactly the case in the United States for most of past two decades. Since 1980, the U.S economy has grown an average of 3.1 percent in years in which the current account deficit has expanded from the previous year, and an average of 2.0 percent in years in which the current account deficit has shrunk. If trade deficits dampen growth, why does the U.S. economy grow more than 50 percent faster when the trade deficit expands?

Frankly, we would have more reason to worry if the U.S. were running a trade surplus. In Mexico in 1995 and more recently in South Korea, trade balances flipped dramatically from deficit to surplus because of plunging domestic demand and the flight of foreign capital. It's no coincidence that America's smallest trade deficit in recent years occurred in 1991—in the trough of our last recession.

What does all this mean for policy? First, there is no emergency. The trade deficit is not a sign of economic distress, but of rising domestic demand and investment. Second, the trade deficit is largely immune to changes in trade policy. If Congress wants to reduce the trade deficit, it must seek to increase the amount Americans save or reduce the amount of domestic investment.

Trade barriers aimed at allegedly unfair trading nations, or at imports generally, will only deprive foreign producers of the dollars they would earn by importing to the United States. With fewer dollars in circulation abroad, the value of the dollar would rise, making it more difficult for U.S. exporters to sell abroad. Exports would fall along with imports, damaging the efficiency of the U.S. economy while leaving the trade deficit virtually unchanged.

In conclusion, I would urge Congress to ignore the trade deficit and focus instead on reducing and eliminating barriers to trade, whether abroad or at home.
Thank you.

America's Maligned and Misunderstood Trade Deficit

by Daniel T. Griswold

Executive Summary

America's annual trade deficit, already large by historical standards, could reach a new record in 1998, fueling protectionist sentiment in Congress. Political fallout from the trade deficit numbers could impede efforts to reduce barriers to trade in the United States and abroad.

Contrary to the popular conception, the trade deficit is not caused by unfair trade practices abroad or declining industrial competitiveness at home. Trade deficits reflect the flow of capital across international borders, flows that are determined by national rates of savings and investment. That renders trade policy an ineffective tool for reducing a nation's trade deficit.

A survey of America's major trading partners reveals no relationship between bilateral trade balances and openness to U.S. exports. For example, the United States runs a bilateral surplus with Brazil, which is relatively protectionist, while we run deficits with Canada and Mexico, which are almost totally open to U.S. exports thanks to the North American Free Trade Agreement.

There is no connection between trade deficits and industrial decline. Between 1992 and 1997, the U.S. trade deficit almost tripled, while at the same time U.S. industrial production increased by 24 percent and manufacturing output by 27 percent. Trade deficits do not cost jobs. In fact, rising trade deficits correlate with falling unemployment rates. The U.S. economy has actually grown faster in years in which the trade deficit has risen than in years in which the deficit has shrunk. Trade deficits may even be good news for the economy because they signal global investor confidence in the United States and rising purchasing power of domestic consumers.

What matters to the economy is not the difference between imports and exports but the extent to which Americans are free to benefit from the efficiencies, opportunities, and consumer choice created in an economy open to world trade.

Daniel T. Griswold is associate director of the Cato Institute's Center for Trade Policy Studies.

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If the past is any guide, the growing trade gap will fuel anguish in the news media and protectionist sentiments in Congress.

Introduction

One of the most politically volatile consequences of the financial and economic turmoil in the Pacific Rim will be a rising U.S. trade deficit in 1998. Plunging growth rates in the region will mean less demand for U.S. exports, while falling foreign currency values will make Asia's exports to the United States more affordable, spurring demand by American consumers. The result, widely predicted by economists, will be a mercantilist's nightmare: a growing gap between the value of the goods and services we import and the value of what we export. The U.S. merchandise trade deficit in 1998 could approach $250 billion, breaking the record of $198.7 billion just set in 1997.[1] If the past is any guide, the growing trade gap will fuel anguish in the news media and protectionist sentiments in Congress.

Whenever the government announces a record, or just a rising, deficit, the media routinely declare the "bad news" that the trade gap has "worsened"—no matter how good the accompanying economic news may be on inflation, employment, and growth. Media reports were typically gloomy in February when the Commerce Department reported a $114 billion trade deficit for 1997, the largest trade gap since 1988. On February 19, the day of the report, Dan Rather announced on *CBS News* that "the government says the 1997 U.S. trade deficit was the worst in nine years."[2] The same day, Lou Dobbs, host of CNN's *Moneyline* program, said, "We begin tonight with today's troubling report on trade, a report that showed the nation's trade deficit soared by 24 percent in December."[3] The next day, the *Wall Street Journal* added darkly that "1998 could shape up to be an even more dismal year for trade than 1997."[4]

Not to be left out, on March 23, 1998, the U.S. Senate voted to spend $2 million to fund an Emergency Trade Deficit Review Commission. The 12-member commission would be given 18 months to study the causes of the U.S. merchandise and current account deficits and recommend policy changes, with special focus on the bilateral deficits with China and Japan.[5]

No aspect of international trade is talked about more and understood less than America's perennial trade deficit. Critics of free trade, and most Americans for that matter, believe the trade deficit is prima facie evidence that American companies are failing to compete in global markets or that U.S. exporters face "unfair" trade barriers abroad, or both. The obvious implication is that, if other nations were to open their markets as wide as we have supposedly opened ours, or if American companies became more competitive against foreign rivals, we could export more relative to imports, thus reducing the trade deficit.

The popular thinking on trade deficits is simple, appealing—and wrong. Trade deficits are not determined by the microeconomics of trade policy or industrial competitiveness. They reflect underlying macroeconomic factors, specifically investment flows and, ultimately, the national rates of savings and investment that determine those flows. The recent experience of the United States and its trading partners confirms this conclusion.

Understanding the trade deficit has profound implications for our national debate about trade. We cannot reduce the U.S. trade deficit by restricting imports to the American market or by persuading or bullying other governments to lower barriers to their markets. We cannot reduce the trade deficit through government-directed industrial policy, managed trade, or export subsidies aimed at boosting national "competitiveness" (however one defines the concept). And, contrary to the headlines, trade deficits are not necessarily bad news for the U.S. economy. They may even be good news.

Current Accounts, Current Controversies

Americans have run an annual trade deficit in goods and services with the rest of world in every year since 1976. That unbroken string of deficits has colored much of the trade debate in the United States in the last two decades.

Beginning in the early 1980s, annual U.S.

trade deficits reached unprecedented levels. After decades of postwar surpluses, the U.S. trade deficit topped $100 billion in 1984 and peaked at a record $153 billion in fiscal year 1987. The trade deficit shrank to a low of $31 billion in 1991, but it has grown again to more than $100 billion a year since 1994,[6] reaching $113.7 billion in 1997. (The $198.7 billion deficit in goods last year was offset by an $85 billion surplus in services.)[7]

Throughout the 1980s and 1990s, trade deficits have spawned worry about "unfair" foreign trade barriers, lost jobs, and America's ability to compete in the global marketplace. Indeed, the trade deficit was partly to blame for a wave of angst in the late 1980s over American "decline." Best-selling books such as Paul Kennedy's *The Rise and Fall of the Great Powers* and Clyde Prestowitz's *Trading Places: How We Allowed Japan to Take the Lead* caught the mood of the time.

In the mid-1980s lawmakers on Capitol Hill responded to the trade-deficit anxiety with protectionist-leaning proposals. In 1986 the House approved by a two-to-one margin an amendment offered by Rep. Richard Gephardt (D-Mo.) that would allow the imposition of import quotas against countries that were running large bilateral trade surpluses with the United States. (Japan, Taiwan, and West Germany were considered the most likely targets at the time.) The amendment passed the House again in 1987, by a narrow margin, although it was ultimately excluded from the 1988 Omnibus Trade and Competitiveness Act in favor of the "Super 301" law threatening retaliation against countries engaged in allegedly unfair trade practices.[8]

In November 1991 Gephardt tried again, proposing an amendment that would activate Section 301 sanctions against any nation whose bilateral trade surplus with the United States accounted for more than 15 percent of the total U.S. trade deficit. "Like the original Gephardt amendment of 1986–88, this proposal exploited two widely shared beliefs: that nations ought normally to balance their trade bilaterally, and that deficits were caused, in important part, by the surplus country's barriers to imports," observed trade scholar I. M. Destler.[9]

The trade deficit has continued to haunt U.S. trade policy in the 1990s. In the debate in the fall of 1997 over renewal of fast-track trade authority, opponents of the measure cited the continuing overall U.S. trade deficit as evidence that trade harms the U.S. economy and destroys jobs. To discredit the North American Free Trade Agreement, and by association all free-trade agreements, opponents of fast-track authority hammered away at the bilateral trade deficits the United States runs with both of its NAFTA partners, Mexico and Canada.

The deficit with Mexico drew the most fire because America's bilateral balance with Mexico had been in surplus before 1995. In September 1997 Steve Beckman, an economist for the United Auto Workers labor union, testified before the Subcommittee on Trade of the House Ways and Means Committee that bilateral trade deficits with Canada and Mexico had created a "trade debacle" costing the U.S. economy more than 400,000 jobs.[10]

Bilateral trade deficits continue to complicate America's commercial relations with a number of major trading partners, chief among them Japan and China. In 1997 the United States recorded a $55.7 billion bilateral trade deficit with Japan and a $49.7 billion deficit with China, by far our two largest bilateral imbalances.[11] The deficit with China appears even more threatening to some trade critics because it has grown so rapidly in recent years, more than quadrupling from $11.5 billion in 1990.[12] Our bilateral deficit with China has been used to argue against renewal of China's Most Favored Nation status and against admitting it to the World Trade Organization. America's bilateral trade deficit with Japan has probably been the single biggest source of trade friction between the two countries.

If the overall U.S. trade deficit rises in 1998 as predicted, it could spur a whole new round of attacks on free trade, prompting government intervention to curb imports and spur exports.

Understanding the Trade Deficit

The trade deficit has been at the heart of

Throughout the 1980s and 1990s, trade deficits have spawned worry about "unfair" foreign trade barriers, lost jobs, and America's ability to compete in the global marketplace.

one of the oldest debates in economics. The mercantilist approach to trade that dominated thinking in the 17th and 18th centuries stressed the need for nations to accumulate gold. By exporting more than they imported, nations could hoard the excess money, almost always gold or silver, generated by the trade surplus. A treasury bulging with precious metals was considered the true sign of a nation's wealth and might. The more metallic money a state possessed, the more able it would be to wage war if necessary.

Predictably, the obsession with running a positive "balance of trade" led to all sorts of protectionist measures and export subsidies. High tariffs and outright import bans were the rule among European nations before 1800.

Back to Smith and Hume

In arguing for free trade, the 18th-century classical liberals David Hume and Adam Smith attacked what Hume called "a strong Jealousy with regard to the balance of trade."[13] Hume reasoned that a nation's supply of gold was ultimately determined by its capacity to produce wealth, not the other way around. A nation that attempted to accumulate gold through a trade surplus, by either blocking imports or subsidizing exports, would soon find that its gold stocks were rising in relation to the total goods available for sale. That excess of money would cause a general rise in the price of domestic goods (i.e., inflation), making them less appealing to foreign buyers. As long as prices kept rising, demand for exports would fall until the inward flow of gold ceased. As Hume understood two centuries ago, any attempt to manufacture a trade surplus through trade policy was doomed to fail because the flow of money would be self-correcting.

Hume's contemporary and friend Adam Smith also dismissed worries about the trade deficit. "Nothing ... can be more absurd than this whole doctrine of the balance of trade," he wrote.[14] What mattered to Smith was not the difference between exports and imports but the gains from specialization that trade allows. Those productivity gains allow a nation's residents to produce goods and services of a higher total value—the only true measure of a nation's economic wealth. Any interference in the freedom to trade, no matter what its effect on the trade balance, diminishes that wealth. "A trade which is forced by means of bounties [subsidies] and [protected] monopolies may be, and commonly is, disadvantageous to the country in whose favor it is meant to be established.... But that trade which, without force or constraint, is naturally and regularly carried on between any two places, is always advantageous, though not always equally so, to both."[15] Smith and Hume's critique of the balance of trade doctrine remains valid two centuries later.

A nation's trade deficit is determined by the flow of investment funds into or out of the country. And those flows are determined by how much the people of a nation save and invest.

Investment Flows Drive the Deficit

The most important economic truth to grasp about the U.S. trade deficit is that it has virtually nothing to do with trade policy. A nation's trade deficit is determined by the flow of investment funds into or out of the country. And those flows are determined by how much the people of a nation save and invest—two variables that are only marginally affected by trade policy.

An understanding of the trade deficit begins with the balance of payments, the broadest accounting of a nation's international transactions. By definition, the balance of payments always equals zero—that is, what a country buys or gives away in the global market must equal what it sells or receives—because of the exchange nature of trade.[16] People, whether trading across a street or across an ocean, will generally not give up something without receiving something of comparable value in return. The double-entry nature of international bookkeeping means that, for a nation as a whole, the value of what it gives to the rest of the world will be matched by the value of what it receives.

The balance of payments accounts capture two sides of an equation: the current account and the capital account. The current account side of the ledger covers the flow of goods, services, investment income, and uncompensated transfers such as foreign aid and remittances across borders by private citizens. Within the current account, the trade balance includes

goods and services only, and the merchandise trade balance reflects goods only. On the other side, the capital account includes the buying and selling of investment assets such as real estate, stocks, bonds, and government securities.

If a country runs a capital account surplus of $100 billion, it will run a current account deficit of $100 billion to balance its payments. As economist Douglas Irwin explains, "If a country is buying more goods and services from the rest of the world than it is selling, the country must also be selling more assets to the rest of the world than it is buying."[17]

The necessary balance between the current account and the capital account implies a direct connection between the trade balance on the one hand and the savings and investment balance on the other. That relationship is captured in the simple formula:

Savings − Investment = Exports − Imports

Thus, a nation that saves more than it invests, such as Japan, will export its excess savings in the form of net foreign investment. In other words, it must run a capital account deficit. The money sent abroad as investment will return to the country as payments for its exports, which will be in excess of what the country imports, creating a corresponding trade surplus. A nation that invests more than it saves—the United States, for example—must import capital from abroad. In other words, it must run a capital account surplus. The imported capital allows the nation's citizens to consume more goods and services than they produce, importing the difference through a trade deficit.

In 1996 Americans invested $1,117 billion privately and another $224 billion through government, for a total of $1,341 billion in gross domestic investment. National savings, however, fell short of that amount, requiring Americans to import a net $133 billion in capital.[18] That same year Americans paid $1,238 billion to the rest of the world for imports of goods and services, net transfer payments, and income on foreign investments in the United States, while receiving $1,105 billion for exports and investment income. The result was a current account deficit of $133 billion, equal to the net inflow of foreign capital.[19]

The transmission belt that links the capital and current accounts is the exchange rate. As more net investment flows into the United States, demand rises for the dollars needed to buy U.S. assets. As the dollar grows stronger relative to other currencies, U.S. goods and services become more expensive to foreign consumers, reducing demand, while imports become more affordable to Americans. Falling exports and rising imports adjust the trade balance until it matches the net inflow of capital. In effect, foreign investors will outbid foreign consumers for limited U.S. dollars until the investors satisfy their demand for U.S. assets. Of course, most day-to-day currency transactions are not directly related to trade, but demand for U.S. goods, services, and assets affects demand for the dollars needed to buy them, thus influencing the value of the dollar in global currency markets.

Germany in the early 1990s offers a case study of how this mechanism works. West Germans routinely ran large current account (and trade) surpluses in the 1980s, but between 1990 and 1991 Germany's current account flipped from a surplus of 3.2 percent of gross domestic product to a deficit of 1.0 percent.[20] The reason for the reversal was not that German manufacturers suddenly lost their legendary efficiency, or that Germany's trading partners imposed new and unfair trade barriers on the night of December 31, 1990. What caused the switch was the huge increase in domestic investment needed to rebuild formerly communist eastern Germany. An increase in domestic investment repatriated a huge amount of German savings that had been flowing abroad, thus reducing the amount of German marks in the foreign currency markets and raising their value relative to other currencies. The stronger mark, in turn, raised the price of German exports and lowered the price of imports, evaporating Germany's trade surplus.

In an October 1997 study for the Economic Strategy Institute, economist Peter Morici

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All new tariff barriers would accomplish would be to reduce the volume of both imports and exports, leaving Americans poorer.

attempts to offer an alternative explanation for the trade deficit. A press release accompanying the study dismisses "the old chestnut that the current account is simply the other side of an immutable accounting identity."[71] As evidence, Morici cites the effect on the trade deficit caused by the purchase of U.S. assets, in particular Treasury bills, by foreign governments.

Morici's analysis is not a refutation of the accounting identity but a restatement of it. Whether the transaction involves a private foreign investor's buying shares in IBM or a foreign government's buying T-bills, it still counts as an inflow of foreign capital to the United States. Indeed, Morici's own regression analysis finds that changes in the U.S. trade balances are strongly correlated with private investment flows. "Overall variations in private sector behavior appear to be more important than direct measures of either U.S. or foreign government policies," he concluded. "Among private variables net foreign private investment (NFPI) seems to explain more of the variation in the trade and current accounts balances than the domestic private savings balance."[72] In other words, the old chestnut still rings true: investment flows drive the trade deficit.

Why Protectionism Cannot Cure the Trade Deficit

The causal link between investment flows, exchange rates, and the balance of trade explains why protectionism cannot cure a trade deficit. In his 1997 book, *One World, Ready or Not*, Washington journalist William Greider proposes an "emergency tariff" of 10 or 15 percent to reduce the U.S. trade deficit.[73] If Congress were to implement that awful idea, American imports would probably decline as intended. But fewer imports would mean fewer dollars flowing into the international currency markets, raising the value of the dollar relative to other currencies. The stronger dollar would make U.S. exports more expensive for foreign consumers and imports more attractive to Americans. Exports would fall and imports would rise until the trade balance matched the savings and investment balance.

Without a change in aggregate levels of savings and investment, the trade deficit would remain largely unaffected. All the new tariff barriers would accomplish would be to reduce the volume of both imports and exports, leaving Americans poorer by depriving them of additional gains from the specialization that accompanies expanding international trade.

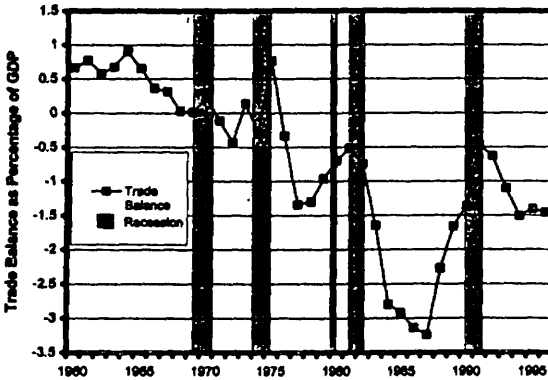
Government export subsidies would be equally ineffective in reducing the trade deficit. Partly in response to the Asian financial crisis, President Clinton proposed in his 1999 federal budget an increase in subsidies to U.S. exporters through the Export-Import Bank. By allowing certain exporters to lower their prices on sales abroad, the subsidies would stimulate foreign demand, but the greater demand for dollars needed to buy U.S. goods would bid up the dollar's value in foreign exchange markets. The stronger dollar, in turn, would raise the effective price of U.S. exports generally, offsetting any price advantage gained by the subsidies. Total exports, and hence the trade deficit, would remain unchanged. Subsidies only divert exports from less favored to more favored sectors.

In theory, trade policy can indirectly affect the trade deficit by influencing a nation's level of savings and investment. For example, a higher tariff would presumably raise government revenue through additional customs duties, thus reducing the budget deficit (or increasing the surplus) and reducing the need to borrow from abroad—resulting in a smaller trade deficit. But a tariff can also stimulate investment in the protected industry, increasing demand for foreign capital and leading to a larger trade deficit. After surveying the various theories, Labor Department economist Robert C. Shelburne concluded, "Trade policy is likely to have a marginal impact on savings or investment and thus only a marginal impact on the trade balance."[74] Even Morici concurs, noting that "changes in trade policies have had minimal effects on aggregate net exports in recent years."[75]

Another temptation is to intervene by intentionally devaluing the national currency in the foreign exchange market. A nation's central bank can put downward pressure on the value

Figure 1

The Trade Balance and U.S. Recessions



Sources: Trade balance data from Council of Economic Advisers, *Economic Report of the President 1997* (Washington: Government Printing Office, 1997), Table B-101, p. 414. Data on recessions from U.S. Department of Commerce, *Survey of Current Business* 78, no. 3 (March 1998): D-43.

of its own currency by creating an excess amount of that currency and using the excess to purchase foreign currencies. A falling currency can stimulate exports and dampen demand for imports, thus reducing a trade deficit. However, a cheaper currency also means that asset values in that country drop in foreign currency terms, attracting foreign investment flows that increase the capital account (and the corresponding current account deficit). And eventually the weaker currency feeds back into the domestic economy in the form of higher overall prices, that is, inflation. In the long run, higher domestic prices will offset any price advantage gained in the international marketplace by a "competitive devaluation."

Proven Trade-Deficit Cutter: A Recession

One way to reduce the trade deficit would be for Americans to save more. A larger pool of national savings would reduce demand for foreign capital; with less foreign capital flowing into the country, the gap between what we buy from abroad and what we sell would shrink.[3]

A related way to cut the trade deficit is for the government to borrow less. Reducing the government deficit (a form of "dissaving") releases more funds for domestic investment, reducing the demand for foreign capital. That explains the "twin deficits" phenomenon of the 1980s, when huge federal budget deficits claimed a rising share of national savings,

If the trade deficit really is one of our nation's most pressing problems, the surest and swiftest way to tackle it would be to engineer a deep recession.

Countries with which the United States runs large deficits are not characteristically more protectionist toward U.S. exports than are those with which we run a surplus.

requiring the importation of savings from abroad to meet domestic demand for investment. The inflow of foreign capital prompted by the budget deficit allowed Americans to buy even more goods and services than they sold in the international marketplace. As the federal budget deficit declined in the late 1980s, so too did America's trade deficit.

Another, less appealing way to reduce the trade deficit is to reduce investment. That occurs more or less naturally during times of recession, when business confidence falls and companies cut back on expansion plans. As Americans consume and invest less, demand for imports and foreign capital falls along with the trade deficit. That explains why the smallest U.S. trade deficit since the early 1980s occurred in 1991, in the midst of the most recent recession.[7] In fact, as Figure 1 illustrates, the U.S. current account balance tends to shrink during times of recession and grow during economic expansions. If the trade deficit really is one of our nation's most pressing problems, the surest and swiftest way to tackle it would be to engineer a deep recession.

That is exactly what happened to Mexico in 1995. In the aftershock of the peso crisis, Mexico's real GDP shrank in 1995 by 6.2 percent. Because of falling domestic demand, fleeing capital, and a plunging peso, Mexico's overall trade balance flipped from a deficit in 1994 to a surplus in 1995. Mexico's bilateral balance with the United States did the same, going from a deficit to a surplus. That supposed "trade debacle" for the United States had nothing to do with NAFTA or any other change in trade policy. It was caused by mismanagement on the part of Mexico's monetary authorities, and the chief victims of that mismanagement were Mexican workers. Perhaps NAFTA critics who believe our bilateral trade deficit with Mexico is such a terrible development would have preferred that the U.S. economy, not the Mexican economy, contract 6.2 percent in one year. Of course, American workers would have suffered, but it would have done wonders for our bilateral trade balance.

An understanding of the all-important role of investment flows should liberate trade policy from its obsessive focus on the current account balance. The trade deficit is not a function of trade policy, and therefore trade policy cannot be a tool for reducing the trade deficit.

Enduring Myths about the Trade Deficit

Misunderstanding of the U.S. trade deficit has spawned a number of myths about international trade and America's place in the global economy. Those myths have allowed trade deficits to be used to further a number of anti-trade and anti-market positions, including export subsidies, industrial policy, and sanctions against "unfair" trading partners. The following are among the most common and harmful myths surrounding the trade deficit.

Myth: "U.S. Exporters Face Unfair Trade Barriers"

Many Americans are convinced that a bilateral trade deficit proves that the foreign country's market is relatively closed to U.S. exports compared with the "open" U.S. market. America's large bilateral deficit with Japan is almost unanimously seen as a problem by U.S. policymakers who share that view, with blame for the deficits placed squarely on "unfair" foreign trade barriers.

A survey of America's major trading partners challenges that assumption. Countries with which the United States runs large deficits are not characteristically more protectionist toward U.S. exports than are those with which we run a surplus. Canada and Mexico, two countries that are very open to U.S. exports thanks in part to NAFTA, are both among the five countries with which the United States has the largest bilateral trade deficits. On the other side, America's third largest bilateral trade surplus is with Brazil, a country whose barriers to imports remain relatively high. Americans face a common external tariff when exporting to members of the European Union, yet some EU members (the Netherlands and Belgium) are among the top surplus trade partners, and others (Germany and Italy) are among the top

Table 1

America's Top 10 Bilateral Deficits and Surpluses 1997 (Billions of U.S. $)

U.S. Deficit		U.S. Surplus	
Japan	–$55.9	Netherlands	+$12.5
China	–$49.8	Australia	+$7.4
Germany	–$18.7	Brazil	+$6.3
Canada	–$17.9	Belgium	+$5.5
Mexico	–$14.4	Hong Kong	+$4.8
Taiwan	–$12.2	United Kingdom	+$3.8
Italy	–$10.4	Argentina	+$3.6
Malaysia	–$7.2	Egypt	+$3.2
Venezuela	–$6.8	Chile	+$2.1
Nigeria	–$5.5	South Korea	+$1.9

Source: U.S. Department of Commerce, Bureau of the Census, Foreign Trade Division, at www.census.gov/foreign-trade.

deficit partners. Trade policy cannot explain those differences (Table 1).

Blaming bilateral deficits exclusively on differences in trade policy once again misses the reality of investment flows. In Japan, high domestic savings rates provide a pool of capital that far exceeds domestic investment opportunities. Japan "exports" capital to the United States, which allows Americans to import more goods from Japan than we export. The main reason that America's bilateral trade deficit with Japan exploded in the 1980s is that the Japanese government lifted many of its capital controls with the passage of the Foreign Exchange and Foreign Trade Control Law in December 1980. That allowed a *tsunami* of Japanese savings to flow across the Pacific to the United States, where it could draw a more favorable rate of return.

Despite the common perception, Japan was actually more open to U.S. exports in the 1980s than in the 1960s and 1970s, when American bilateral trade deficits with Japan were much smaller. As Robert T. Parry, president and chief executive officer of the Federal Reserve Bank of San Francisco, explained:

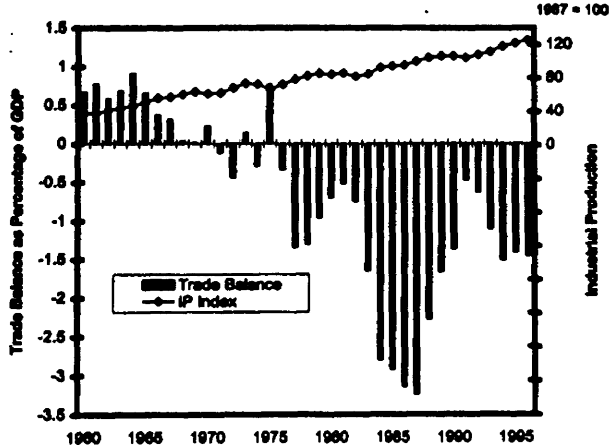
> Of all the U.S. trading partners, Japan continues to be singled out for having the most unfair trading practices. But it's doubtful that such policies have been a major cause of U.S. trade deficits. First of all, the Japanese market has become somewhat more open—not more closed—over the past decade. Second, Japan's share of changes in the total U.S. non-oil merchandise trade deficit has been proportional to its U.S. trade share. For example, in 1981, about 9 percent of our exports went to Japan, and about 20 percent of our imports came from Japan. That left us with a bilateral deficit of $16 billion. If the same shares prevailed in 1992, we would have had a bilateral deficit of $57 billion—which is in fact a little larger than the actual deficit of $51 billion. So I think there's not much evidence to say that restrictive trade practices have been the driving force behind changes in the U.S. trade deficit.[28]

The same cannot be said for our bilateral deficit with China. Despite substantial progress in the last 10 years, its barriers to imports remain relatively high. Those barriers partly explain the bilateral surplus China runs with the United States, but the primary explanation is more benign: We like to consume the products China sells. In 1995 the Council of Economic Advisers concluded, "China's persistent surplus with the United States in part reflects its specialization in inexpensive mass-market consumer goods. China similarly runs bilateral surpluses with Japan and Europe for this reason."[29]

If China were to further open its market, America's bilateral deficit with China would probably shrink, but our overall trade deficit—determined by aggregate savings and investment—would remain largely unaffected. A rising dollar caused by increased demand for U.S. exports to China would lead to larger bilateral deficits (or smaller surpluses) with other U.S. trading partners. If the United States were to impose higher tariffs aimed at imports from China (say, by revoking its Most Favored

Japan was actually more open to U.S. exports in the 1980s than in the 1960s and 1970s, when American bilateral trade deficits with Japan were much smaller.

Figure 2



Source: Council of Economic Advisers, *Economic Report of the President 1997* (Washington: Government Printing Office, 1997), Table B-60, p. 357, Table B-101, p. 414.

Since the Cuomo Commission report, the United States has enjoyed seven consecutive years of healthy, noninflationary growth along with historically large and rising trade deficits.

Nation status), that too might reduce the bilateral deficit, but not the overall U.S. trade deficit. Higher tariffs against Chinese imports would merely shift some of the bilateral trade deficit to other countries while raising prices for American consumers.

Myth: "America Is Losing Its Competitiveness"

In 1992 the Cuomo Commission on Competitiveness labeled the trade deficit one of America's 10 most urgent economic problems. "Because of American industry's declining competitiveness and our openness to the global economy, the economic demand spurred by the federal budget deficits in the early 1980s precipitated a huge flow of imports," the commission concluded in its report, which simply assumed a connection between trade deficits, openness, and competitiveness.[8]

The "competitiveness" myth has gone into remission in recent years. Since the Cuomo Commission report, the United States has enjoyed seven consecutive years of healthy,

noninflationary growth along with historically large and rising trade deficits. Meanwhile, Japan and Germany, the two export-driven juggernauts that were supposed to eclipse the United States as economic powers in the 1990s, have struggled with slow growth and rising unemployment.

America's experience in both the 1980s and the 1990s refutes any connection between trade deficits and a loss of industrial might. Figure 2 shows that industrial production in the United States has climbed steadily in the past two decades during a time of historically large U.S. trade deficits.

Between 1980 and 1987, when the U.S. current account deficit was rising to a peak of 3.6 percent of GDP, U.S. industrial production rose by 17 percent and total manufacturing output by 23 percent.[21] The same story has repeated itself in the 1990s. Between 1992 and 1997 the annual U.S. trade deficit almost tripled, from $39 billion to $114 billion.[22] Meanwhile, since 1992 total industrial production in the United States has surged by 24 percent and manufacturing production by 27 percent.[23] In Japan during the same period, industrial production has grown by only 8 percent, and in Germany growth has been less than 1 percent.[24] America runs substantial bilateral trade deficits with both countries.

America is the world's number-one trading nation in both imports and exports. Between 1992 and 1997, U.S. exports of goods and services surged from $617 billion to $932 billion. The reason the trade deficit has grown is that imports have increased even faster, from $657 billion to $1,046 billion.[25] By any definition, the ability of American industry to compete in the world has not suffered because of a rising trade deficit. The experience of the 1980s and 1990s points in quite the opposite direction.

Myth: "Trade Deficits Mean Lost Jobs"

A study by the Institute for Policy Studies in January 1998 predicts that the larger trade deficit caused by the East Asian financial meltdown will cost the U.S. economy more than 1 million jobs. Columnist Patrick Buchanan, when running unsuccessfully for the Republican presidential nomination in 1996, offered his own, back-of-the-envelope estimate of jobs lost because of the trade gap: "Our merchandise trade deficit was $175 billion (in 1995). For every $1 billion, you get 20,000 jobs. That's 3.5 million American workers who would have had good manufacturing jobs if we simply had a trade balance."[26] Both estimates are based on a fundamental misunderstanding of the relationship between trade and aggregate employment in the United States.

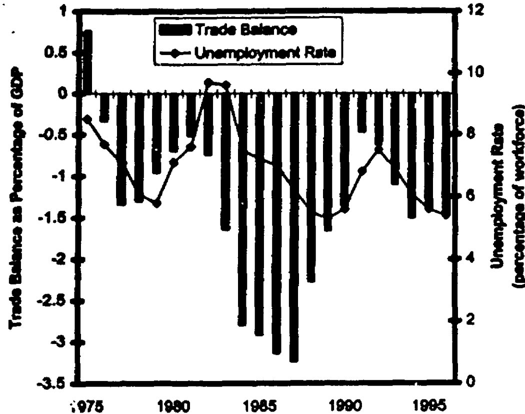
The total number of jobs in the United States is largely determined by fundamental macroeconomic factors such as labor-supply growth and monetary policy. Trade with other nations does not reduce the number of jobs, but it does quicken the pace at which production shifts from one sector to another. Trade, like new technology, lowers demand for some jobs while raising demand for others. Trade allows the United States to produce more Boeing jetliners, pharmaceuticals, software, and financial services for export, but trade also means we produce fewer shoes, T-shirts, Happy Meal toys, and computer memory chips. Meanwhile, total output and total employment keep growing.

In reality, larger trade deficits correlate positively with *falling* unemployment. Figure 3 illustrates how closely the unemployment rate corresponds with changes in the U.S. trade deficit. When the trade deficit expands, as it did in the 1980s, unemployment falls. When the deficit shrinks, as it did during the 1990–91 recession, the unemployment rate rises. As the trade deficit has expanded in the 1990s, the unemployment rate has fallen steadily. The unemployment rate fell in all but 2 of the most recent 14 years in which the trade deficit grew larger than it had been the previous year (1976–78, 1982–87, 1992–94, 1996–97).[27] As an expanding economy creates jobs, it also creates demand for imports and for capital from abroad.

There is no reason to believe that eliminating the trade deficit would create any gain in manufacturing jobs, never mind 3.5 million. With the U.S. economy already operating at a low level of unemployment, it is not clear

Meanwhile, Japan and Germany, the two export-driven juggernauts that were supposed to eclipse the United States as economic powers in the 1990s, have struggled with slow growth and rising unemployment.

Figure 3



Source: Council of Economic Advisers, *Economic Report of the President 1997* (Washington: Government Printing Office, 1997), Table B-40, p. 348, Table B-101, p. 414.

When the trade deficit expands, as it did in the 1980s, unemployment falls. When the deficit shrinks, as it did during the 1990-91 recession, the unemployment rate rises.

where 3.5 million new manufacturing workers would come from. And as we have already seen, a protective tariff to close the trade deficit would only succeed in reducing exports as well as imports, thus eliminating manufacturing jobs in the export sector. If Buchanan's calculations had any meaning, we should expect to see a fall in manufacturing employment during periods of rising trade deficits. Recent economic trends tell a different story. Since 1993 the U.S. merchandise trade deficit has grown from $132 billion to $198 billion.[8] In that same period the number of Americans employed in manufacturing has grown from 18,075,000 to 18,678,000—an increase of more than 600,000."

If anything, rising trade deficits signal more jobs, not fewer.

Myth: "The Trade Deficit Is a Drag on Economic Growth"

The Asian financial crisis is expected to shave a few tenths of a percentage point off the rate of growth of U.S. GDP in 1998, but to blame slower U.S. growth on an expanded trade deficit is to confuse cause and effect.

The real drag on U.S. economic growth is falling demand in East Asia for U.S. exports.

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At the same time, falling currency values in East Asia make the region's exports to the United States more attractive, leading to a larger U.S. trade deficit. A growing trade deficit is not the *cause* of slower U.S. growth; instead, slower growth and a bigger trade deficit are both *effects* of East Asia's economic slowdown.

In his study, Morici claims that "persistent trade deficits reduce long-term economic growth by shifting labor and capital from high-R&D to low-R&D activities." That claim is based partly on the fact that research and development expenditures, and wages, tend to be higher in trade-related (that is, exporting and import-competing) sectors than in non-trade-related sectors of the economy. The proper lesson to be drawn is not that trade deficits are bad for economic growth but that trade is good for growth. In other words, the true measure of the effect of trade on the economy is not exports *minus* imports but exports *plus* imports.

Far from being a drag, a trade deficit can be a good sign for an economy when it reflects growing demand for imports. When an economy expands, consumers are able to afford more goods, both domestic and imported. Returns on investment also increase, attracting foreign capital. The combination of inflowing capital and increased demand for imports tends to widen the trade deficit. That explains why every recent U.S. economic expansion has been accompanied by an expanding trade deficit.

Since 1980, in the six years in which the current account deficit has shrunk from the previous year as a percentage of GDP, the average growth rate of the U.S. economy has been 2.0 percent. In the 11 years in which the current account has grown larger as a percentage of GDP (i.e., "worsened"), the average growth rate of GDP has been 3.1 percent.[41] Those who maintain that the trade deficit is a drag on growth need to explain why our economy grows 50 percent faster in years in which the deficit expands.

Without a trade deficit, Americans would need to finance domestic investment exclusively from domestic savings. To bring investment in line with savings, domestic interest rates would need to rise, reducing investment and economic growth. As the Council of Economic Advisers recently concluded, the trade deficit has been a "safety valve" for the expanding U.S. economy. "Imports of goods have kept inflation low, while imports of capital have kept interest rates low, helping to sustain rapid income growth. In the strongly expanding full-employment economy that the United States now enjoys, it should be easier for Americans to see that trade deficits do not necessarily reduce output and employment."

The United States ran trade deficits throughout much of the 19th century during a period of dynamic growth and expansion. From independence until the 1880s, America was a net importer of capital from the rest of the world, in particular Great Britain. Foreign investors provided the capital to build the railroads and canals America needed for a continentwide economy. "In the 19th century, especially after the cotton boom of the 1830s, it was the current account that went into the red in order to balance the heavy inflow of funds to finance American enterprise. The United States had more profitable investment opportunities than it had domestic savings to finance them. The British, Germans, Dutch, and French stepped in and made themselves (and our American forebears) richer."

Today Americans run trade deficits with the rest of the world for much the same reason: America's relatively free and unregulated economy offers attractive investment opportunities. Attempts to reduce the trade deficit through government intervention would reduce our economic efficiency slowing investment and growth.

Exports Are Good, Imports Are Better

Underlying each of those myths, and much of the misunderstanding about trade deficits, is the assumption that exports are good and imports are bad. To anyone who accepts that premise, a trade deficit will by definition be a problem.

Pat Buchanan, during a 1996 campaign

Those who maintain that the trade deficit is a drag on growth need to explain why our economy grows 50 percent faster in years in which the deficit expands.

It is imports, not exports, that allow Americans to enjoy a higher standard of living. Exports without imports are like a job without a paycheck.

stop in Maryland, stated the case with characteristic bluntness: "This harbor in Baltimore is one of the biggest and busiest in the nation. There needs to be more American goods going out. We've got to start exporting more goods and stop exporting our factories and exporting our jobs."[44] Even many advocates of free trade implicitly agree with Buchanan. In his state of the union address in January, President Clinton urged Congress to pass fast-track trade legislation to "open more new markets" for U.S. exports and to "create more new jobs." Imports, in contrast, were painted as a threat. The president warned that, without U.S. aid through the International Monetary Fund, falling currencies in the Far East would mean "the price of their goods will drop, flooding our market and others with much cheaper goods, which makes it a lot tougher for our people to compete."[45]

By focusing exclusively on the danger of "cheaper goods" and not the benefits, the president chose to champion the cause of a small group of producers while ignoring the welfare of the large majority of consumers who will benefit from more affordable imports.

Imports bless Americans in a number of substantial ways. First, imports mean lower prices and wider choice for American consumers. By exerting downward pressure on prices, imports raise the real wages of American workers. Imports create price competition where a domestic monopoly or oligopoly might otherwise exist. They also spur domestic producers to control costs and raise quality in response to foreign competition.

Second, imports of intermediary inputs benefit American producers by keeping final prices down. One reason the U.S. computer industry is so successful and competitive is that it is able to import component parts, such as disk drives and D-RAM chips, at world-market prices. The largest categories of goods imported to the United States are not consumer goods but capital goods and industrial supplies and materials. Together they comprised more than half of the $803 billion in goods Americans imported in 1996.[46] Restricting imports hurts unprotected producers as well as consumers.

Third, imports of capital goods make Americans more productive. Higher productivity means a higher standard of living. Without imports, Americans would be deprived of the technology and know-how embodied in new, imported machinery.

Exports are not the reason we trade; they are the means by which we acquire imports. It is imports, not exports, that allow Americans to enjoy a higher standard of living. Exports without imports are like a job without a paycheck.

Conclusion

Misunderstanding of the trade deficit threatens to undermine the freedom to trade by encouraging faulty and damaging "solutions" to a problem that does not exist. Any attempt to fix the trade deficit through protectionism, export subsidies, or currency manipulation is bound to fail because none of those tools of intervention addresses the underlying causes of the trade deficit. The trade deficit will respond only to changes in a nation's net flow of foreign investment, which in turn is determined by its underlying rates of savings and investment.

America's $114 billion trade deficit in 1997, and the prospect of a larger deficit in 1998, are not a cause for worry. There is no "emergency" to justify spending $2 million for a special commission on the trade deficit. Our trade deficit reflects the benign fact that America remains an attractive haven for international investors. The trade deficit allows Americans to maintain a level of investment in our future productivity that would be impossible if we were required to rely solely on our current level of domestic savings.

None of the common concerns about the trade deficit holds up to empirical scrutiny. Trade deficits cannot be blamed for unemployment or slower growth, nor are they a sign of unfair trade practices abroad or declining industrial competitiveness at home. Trade deficits may even signify growing consumer demand and expanding investment opportunities.

What matters to a nation's economic health

is not the difference between exports and imports but the degree to which its citizens are free to trade and invest across international borders. When citizens are allowed to buy and sell goods, services, and investment assets freely in the international marketplace, a nation's productive resources will tend to flow to the best and highest use, raising the nation's overall standard of living.

In the final analysis, nations do not trade with each other; people do. Every international transaction that Americans engage in will, by definition, leave both parties to the transaction believing they are better off than before—otherwise the transaction would not occur. By this measure, the "balance of trade" is always positive, benefiting the nation as a whole.

Notes

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2. Quoted in "Reporters Assume Trade Gap Is Bad News," *MediaNomics*, February 1998, p. 3.

3. Transcript provided by the Media Research Center, Alexandria, Va.

4. Christina Duff, "U.S. Trade Gap Grew 24% in December: Deficit Could Worsen in '98 As Asia's Ills Spill Over, Some Analysts Warn," *Wall Street Journal*, February 20, 1998, p. A2.

5. "Senate approves Provision Creating Commission on the Trade Deficit," *Inside U.S. Trade*, March 27, 1998, p. 13.

6. Council of Economic Advisers, *Economic Report of the President 1998* (Washington: Government Printing Office, 1998), Table B-103, p. 398.

7. Richard W. Stevenson, "Trade Deficit for 1997 Hits 9-Year High," *New York Times*, February 20, 1998, p. C1.

8. I. M. Destler, *American Trade Politics* (Washington: Institute for International Economics, 1995), pp. 91-95.

9. Ibid., p. 269.

10. Steve Beckman, International Union, United Automobile, Aerospace and Agriculture Implement Workers of America, Statement before the Subcommittee on Trade of the House Committee on Ways and Means, September 11, 1997.

11. Duff.

12. International Monetary Fund, *Direction of Trade Statistics Yearbook* (Washington: IMF, 1997), p. 453.

13. David Hume, "Of the Balance of Trade" (1777), in *Essays: Moral, Political and Literary* (Indianapolis: Liberty Fund, 1987), p. 309.

14. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776; New York: Random House, 1937), p. 456.

15. Ibid.

16. In the official figures, the balance is not always zero. A government cannot keep track of every single international transaction its citizens engage in, as hard as its customs agents and financial regulators may try. That creates the need for a "Statistical Discrepancy" line in the accounts. In 1996 the statistical discrepancy in the U.S. balance of payments amounted to $46 billion. That may seem like a large amount, but it represents less than 1.5 percent of more than $3.1 trillion in total two-way transactions in 1996. For all practical purposes, the flow of money out of the United States in a given year equals the flow of money in.

17. Douglas A. Irwin, "Three Simple Principles of Trade Policy," American Enterprise Institute, Washington, 1996, p. 19.

18. Council of Economic Advisers, *Economic Report of the President 1998*, Table B-32, p. 319.

19. Ibid., Table B-24, p. 308.

20. International Monetary Fund, *International Financial Statistics Yearbook* (Washington: IMF, 1997), p. 142.

21. Economic Strategy Institute, "New ESI Study Finds Causes and Costs of Trade Deficit More Complex Than Traditional Economic Rhetoric," Press release, October 16, 1997.

22. Peter Morici, "The Trade Deficit: Where Does It Come From and What Does It Do?" Economic Strategy Institute, Washington, October 1997, p. 10.

23. William Greider, *One World, Ready or Not: The Manic Logic of Global Capitalism* (New York: Simon and Schuster, 1997), p. 189.

24. Robert C. Shelburne, "The Macroeconomics of Commercial Policy and the Trade Balance: A Policy Perspective," *International Trade Journal* 10, no. 1 (Spring 1996): 81.

25. Morici, p. 9.

26. Moving to an investment-based, personally managed retirement system in place of Social Security might be one way to boost private savings.

27. The current account balance in 1991 received an additional boost of about $40 billion in the positive direction because of transfer payments to the U.S. government from its Gulf War allies.

28. Robert T. Parry, "U.S. Trade Deficits and International Competitiveness," *Business Economics*, January 1994.

29. Council of Economic Advisers, *Economic Report of the President 1995* (Washington: Government Printing Office, 1995), p. 236.

30. Cuomo Commission on Competitiveness, *America's Agenda: Rebuilding Economic Strength* (Armonk, N.Y.: Sharp, 1992), p. 11.

31. Council of Economic Advisers, *Economic Report of the President 1998*, Table B-51, p. 340.

32. Ibid., Table B-103, p. 398.

33. Ibid., Table B-51, p. 340.

34. Joint Economic Committee of Congress, *Economic Indicators*, December 1997, p. 35.

35. Ibid.

36. Quoted in Wayne Leighton, "Playing with the Numbers: Why Protectionists Are Wrong about Trade," Issue Analysis, Citizens for a Sound Economy Foundation, Washington, September 18, 1997, p. 1. Buchanan made his remark on CNN on March 3, 1996.

37. See Council of Economic Advisers, *Economic Report of the President 1998*, Table B-103, for the annual trade deficit figures and Table B-42 for the annual unemployment rates.

38. Ibid., Table 103. The 1997 merchandise trade figure was released February 19, 1998, by the Bureau of Economic Analysis, http://www.census.gov/indicator/www/ustrade.html.

39. Council of Economic Advisers, *Economic Report of the President 1998*, Table B-46, p. 334.

40. Morici, p. 19.

41. For the current account as a percentage of GDP, see International Monetary Fund, *International Financial Statistics Yearbook*, p. 142. The U.S. current account deficit grew larger as a percentage of GDP in 1982 through 1987, 1992 through 1994, 1996, and 1997. It shrank in 1981, 1988 through 1991, and 1995. For real GDP growth by year, see Council of Economic Advisers, *Economic Report of the President 1998*, Table B-4, p. 285.

42. Ibid., p. 249.

43. Mark Thomas, "Who's Afraid of the Big Bad Trade Deficit?" in *Second Thoughts: Myths and Morals of U.S. Economic History*, ed. D. N. McCloskey (New York: Manhattan Institute, 1993), p. 90.

44. Quoted in Michael Abramowitz, "Baltimore Port Is Backdrop for Another Buchanan Attack on Trade Policies," *Washington Post*, March 3, 1996, p. A10.

45. See text of President Clinton's state of the union message, *Washington Post*, January 28, 1998, p. A24.

46. U.S. Department of Commerce, *Survey of Current Business* 77, no. 12 (December 1997): D-51.

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CATO INSTITUTE

[Submitted by Senator Dorgan]

EMERGENCY TRADE DEFICIT REVIEW COMMISSION

Mr. Chairman. For two decades, the twin deficits of trade and budget have plagued this nation. Finally, we have achieved some measure of success in bringing our unified federal budget under control. Yet, the economic future of our nation continues to be jeopardized by a serious trade deficit problem that has reached record proportions. Each month, new records are being set. While we congratulate ourselves for finally achieving a balanced unified budget, the trade deficit has been receiving very little attention by public policy makers.

Our nation's trade deficit is a deficit that this country must address. As Lester Thurow has stated, "if there is one thing we know about international trade, it is that no country, not even one as big as the United States, can run a trade deficit forever." While we have made real progress on the budget deficit, few recognize that the trade deficit represents an equally serious underlying economic problem in our country.

For each of the past five years, we have reduced the unified federal budget deficit to zero and is headed toward a surplus. At the same time, our merchandise trade deficit has been a record four years in a row. In 1997 the merchandise trade deficit reached the highest level in American history at $199 billion. During the first three months of this year, the trade deficit has set several new records: January, February and March were a record merchandise trade deficit for one quarter; two of the three months were record merchandise trade deficits; the goods and services deficit was a record for one quarter; and experts are forecasting that the current account deficit will also be a record for the quarter.

We need to solve these deficit problems, because together and individually they are threatening the economic security of Americans. Today the trade deficit is huge and growing, whether we choose to consider the merchandise deficit, the goods and services deficit, or the current account deficit. It is time for action.

I have made a number of attempts, with the assistance of others, to address this crucial problem legislatively. The amendment establishing an "Emergency Trade Deficit Review Commission," which is part of the legislative branch appropriations bill, will establish a commission to study the causes and consequences of our trade deficits and help us develop a competitive trade policy for the 21st century, which will not only increase production and manufacturing in our country, but also job opportunities and wages.

Just as balancing the budget has come to represent the need to take a more disciplined approach to deciding our national fiscal priorities, our goal in ending the trade deficit must be to develop a more disciplined approach in deciding and carrying out our nation's trade policies.

Our trade deficit is symptomatic of larger economic conditions and questions that must be addressed. My purpose in this legislation is not simply to get rid of the red figures at the bottom of our trade ledger. Instead, it is to help develop the national economic and trade strategies which will rebuild the American economy and make America the unquestioned leader in the global economy.

GROWTH OF TRADE DEFICIT

Many economists predicted that our trade deficit would disappear as we reduced our nation's budget deficit. That is not what is happening. Instead, as we have begun to gain control of our fiscal deficit, our trade deficit has continued to grow.

Last year, the United States experienced its twenty-second consecutive annual merchandise trade deficit. During these past two decades we have piled up a total merchandise trade deficit of $2 trillion.

The trend line in the growth of this deficit should be of great concern to the American people. Not only have we had four record-breaking trade deficits in a row, the economic forecasts indicate that the merchandise trade deficit will continue on its present path. In fact, at our present pace, it can be expected to double during the first decade of the new century.

THE CONSEQUENCES OF THE TRADE DEFICIT

As a result of our trade and budget deficits over the past two decades, the United States has shifted from being the world's largest creditor nation to the world's largest debtor nation. Our country has gone from a net creditor position of more than $250 billion in the early 1980s to a net debtor position of over three-quarters of a trillion dollars by the mid-1990s. The positive net international asset position that we had built up over the past 100 years was eliminated in a short six-year period during the 1980s.

The current account deficit indicates that there is a net outflow of dollars from the United States, dollars which must be replaced through foreign borrowing.

The most basic economic text teaches us that our Gross National Product is comprised of consumption, plus investment, plus government, plus net exports. Our negative net export position reduces our gross national product.

Thus, our trade deficit retards the growth of our nation's gross national product, increases the cost of servicing a higher net foreign debt, makes the United States more dependent on international financial considerations, and erodes our economic base.

IMPORTANCE OF TRADE DEFICIT

The persistence and growth of our trade deficit is not just a concern of academics and ivory tower economists. It is a question of fair trade and fair competition. It is an issue of American jobs and the purchasing power of American wage earners. It is a matter of what opportunities we will have for our future.

Today the bulk of the products that we import are not labor-intensive goods. Instead our merchandise trade deficit consists primarily of high-value manufactured items. Autos, office equipment, electronic goods, and telecommunications equipment make up three-fourths of those imports.

Imports of manufactured goods have increased from 11 percent

of the total U.S. manufacturing gross product to more than 50 percent. This means that rather than expanding our own manufacturing base in this country, we are importing more of our manufactured goods from abroad. It means that we are shipping jobs and new plants overseas.

Neither the American consumer nor the American economy is making any long-term gains by the continuing trade deficit. Instead, it represents an erosion of both our sovereignty and our economy.

CAUSES OF TRADE DEFICITS

Our merchandise trade deficit is a result of a series of trade imbalances with a handful of countries. Six countries comprise 92 percent of the U.S. merchandise trade deficit. These include Japan, China, Canada, Mexico, Germany, and Taiwan. Over one-half this trade deficit is with only two countries: Japan and China.

Our trade relationships are most accurately described as unilateral free trade. As a nation we have opened our borders wide open to almost anything and everything that can be produced anywhere. Unfortunately we pay little attention to the conditions under which these goods have been produced or if the competition is fair.

While the United States has one of the most open borders and open economies in the world, this nation faces significant barriers in shipping American goods abroad. As a result, these negative trade balances do not reflect the actual competitiveness or the productivity of the American economy. Yet, there is no question that we are one of the most competitive economies in the world.

Instead, most of our bilateral trade deficits effectively illustrate the barriers that continue to exist despite hundreds of new trade agreements in recent years. To a very large measure the trade deficit is structural in nature. As documented annually in the reports of the Office of the U.S. Trade Representative, reciprocal market access remains an elusive goal.

ENDING THE TRADE DEFICIT

As a nation we need to bring the same attention and the same commitment to working on the trade deficit that we have given to reducing our budget deficit.

It has been a quarter of a century since the last comprehensive review of national trade and investment policies was conducted by a presidential commission. Since that time we have witnessed massive worldwide economic and political changes. These changes have profoundly affected world trading relationships.

The cold war has ended. It is no longer necessary or even prudent for U.S. trade policy to take a back seat to our foreign policy objectives.

Regional trade relationships including the European Union and the North American Free Trade Agreement are redefining political, economic, and trading geography. The Uruguay Round of negotiations under the General Agreement on Tariffs and Trade has resulted in the creation of the World Trade Organization.

Globalization is part and parcel of the increased mobility of capital and technology that is reshaping comparative and competitive advantages among the nations of the world. It is part of the growth of multinational corporations. It is also part of the trend of outsourcing production across national boundaries.

Unilateral free trade no longer serves the interests of the American people, if it ever did. We need fair rules and reciprocal market access if our competitive economy is to thrive within a global system. I am not calling for trade restrictions. Rather I am calling for expanded trade, but with rules that are fair.

EMERGENCY COMMISSION

The United States is once again at a critical juncture in trade policy development. The persistence and growth of the trade deficit must be reversed. We must identify the causes and consequences of our trade deficit.

Rather than allowing our trade deficit to double during the next decade, we need to develop a comprehensive trade policy for the twenty-first century. That is why I introduced a bill with Senator Byrd to establish an Emergency Commission to End the Trade Deficit, and why we added an amendment to the Legislative Appropriations Bill to accomplish the same goal.

The purpose of the commission is to study the causes and consequences of the United States merchandise and current account deficits and to make recommendation for trade policy for the twenty-first century.

The bill directs the Commission to develop the necessary strategies to achieve a trade balance that fully reflects the competitiveness and productivity of the U.S. economy while improving the standard of living for the people of this country.

The Commission would look at five broad areas:

1. - The manner in which the government of the United States establishes and administers the nation's fundamental trade policies and objectives.

2. - The causes and consequences of the persistence and growth of the overall trade deficit, as well as our bilateral trade deficits.

3. - The relationship of U.S. trade deficits to the competitive and comparative advantages within the global economy.

4. - The relationship between investment flows, both into and out of the United States, and the trade deficit.

This Commission would consist of a blue-ribbon panel of leaders from a broad spectrum of the economic life of our nation. The members would be appointed by the leadership of Congress. They would be given the responsibility to study the situation, gather necessary data, conduct at least five public hearings, and evaluate strategies to end the trade deficit and make America more competitive in the global marketplace.

The Commission would be required to present its final report not later than eighteen months following the enactment of this bill. The final report would outline its findings and conclusions, and provide a detailed plan for reducing our nation's trade deficits together with recommendations on administrative and legislative actions that may be required to achieve that goal.

The Commission's report would be submitted to the President and the Congress for review, consideration, and implementation. To facilitate the Commission's report through Congress, this bill would have the House Ways and Means Committee and the Senate Finance Committee conduct hearings on the report within six months after it is submitted to Congress.

TIME FOR CHANGE

Today it is apparent that we do not have a consensus about where we should go with our national trade policies. We are not even sure whether we have the necessary tools to effectively achieve our trade goals.

Most important, we do not have a good set of alternatives and strategies to place before the American people so that they can effectively participate in making the decisions that are shaping their future.

It is time to develop a new trade strategy for the twenty-first century. We can get started on this path by making our first goal to end the trade deficit. Once we have set that goal, then we need the strategies to get there. That is why I believe it is time for such a commission.

The amendment establishing the Trade Deficit Review Commission has passed the Senate once, as part of the Supplemental Appropriations bill. The conference committee declined to include the amendment, but stated its preference that the amendment be included in the appropriations for fiscal 1999. By attaching the amendment to the legislative branch appropriations bill, we have complied with the directive of the conference committee.

I would appreciate the support of the members of this committee in the effort to explore the reasons for our trade deficits and to find solutions to a critical national problem.

Thank you.

PREPARED STATEMENT OF HON. ORRIN G. HATCH

Mr. Chairman, I welcome the distinguished panels of economists along with our colleague, Senator Dorgan, and Secretary Rubin. Their insights on the causes and consequences of the trade deficit is critical to the many trade-related decisions that will face this Congress during the balance of this session and, I suspect, even more so in the new 106th Congress.

I am of the school that believes the trade deficit gets a bad rap. The deficit's causes and effects are badly misconceived for the most part. Let me explain.

The trade balance—which is to say the existence of a surplus or deficit—is caused more by macroeconomic rather than microeconomic problems, such as denied access to foreign markets and related trade barriers.

The exchange rate for the dollar against other currencies is a case in point. The rate reflects the global demand for dollars, much of which is made by those who seek to use our dollars as instruments for trade-related purchases. The impact on the value of the dollar should not be misunderstood in this sense; it has a vast effect on the supply and value of the currency that we use domestically every day in our financial activities. obviously, as demand drives up the value of the dollar, it raises the cost of our exports, which in turn adversely affects the trade balance.

Managing this deficit, incidentally, has led to what we now increasingly refer to as the problem of "twin deficits," the budget and trade deficits, which are both financed extensively through foreign sources, and which depress the national saving rate while simultaneously increasing capital outflows in the form of interest payments. All of this contributes to trade deficits.

We acknowledge that we are a consumer economy, and more income will lead to more consumption, including increased purchases of foreign goods and services.

In fewer words still: the current trade deficit is the aggregate outcome of the decisions made by individuals, households, businesses, and even governments within the framework of a relatively strong economy. In the current global framework, this deficit trend is accentuated by the contrasting deterioration of other economies in Asia and Latin America, as well as in parts of Europe.

Now some would say that a different monetary and fiscal policy mix could reduce the trade deficit. I would argue that this change carries many potential pitfalls. For example, a conscious decision to obstruct consumer imports could have important consequences for our economy. Domestic supply of substitute goods could be stressed to the point that price inflation could occur, which in turn leads to higher interest rates. Imagine the impact on the stock market, auto sales, home starts, and the dozens of other benefits of prosperity that we are now enjoying—not to mention the threat to ever increasing investments by retirement plans in the U.S. equity markets.

Still other adversities would occur from tinkering with the open trade doctrine that we now employ. For example, import reductions could lead to increased employment in inefficient business sectors at the expense of high-growth or efficient business enterprises. This "crowding-out" effect occurs when the market demands increased supply of goods formerly provided in large part from imports, such as television sets.

But we must deal with the impact of trade deficits on jobs. I would suggest the same misconceptions apply here, too. To be sure, there are job losses as well as employment gains that derive from trade activity. Lower skilled and, contrary to some beliefs, even higher skilled jobs do migrate overseas. The big draw is often labor costs, but it is also lower environmental standards, proximity to foreign markets, circumventing high tariff walls, and available foreign investment, among many other attractions. For this reason, we have robust trade adjustment assistance programs in place to facilitate workers, transitions into other jobs.

The important point here is that job losses occur more because of market demand, both foreign and domestic, than because of the trade deficit per se. Accordingly, few jobs survive for very long simply because foreign competition is kept out of the domestic market. In fact, the opposite effect sets in: countries which have relatively closed markets rarely progress at the same rate as open market countries. Closed markets can shut out modern technology and innovativeness.

And if you still doubt this effect, allow me to point to the current state of the Japanese economy: a country with relatively closed markets and a very understated consumer potential. In denying Japanese consumers the benefits of competitive foreign goods and services, the Japanese Government created an excessively export-dependent economy which artificially placed continuing upward pressure on domestic prices. When competition with Japanese goods in foreign markets cut profits, the banking system's ability to support export industries faltered. Today, the Japanese yen is at all-time lows against the dollar. This suggests an opportunity to refuel ex-

ports while reforming the domestic economy through tax cuts, which would stimulate consumption of domestic and imported goods. The effect would also rehabilitate the Nikkei which is recording disastrously low stock prices sapping away the household wealth which the typical Japanese family has long committed to equity investments. Again, the Japanese economy enjoys a very substantial trade surplus, not deficit with the United States.

Mr. Chairman, I know that other arguments will be made on both sides of the issue by our distinguished panelists, and I am eager to hear them. But, I believe that the real strength of U.S. trade policy remains its openness, not some arbitrary balance of trade. Open trade breeds growth, innovativeness, higher paying jobs, productivity, lower unemployment, and many other domestic efficiencies that lead to U.S. leadership in world markets. That should be the ultimate goal of our national trade strategy.

Testimony for Presentation to the Senate Finance Committee Hearings on the "Causes of the US Trade Deficit and its Implications for the U.S. Economy." June 12, 1998.

America's Trade Deficit: Blessing or Curse?

by

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The East Asian crisis will have a significant impact on the US trade balance. According to projections by the OECD, for example, over the next two years, the most inclusive measure of the trade deficit, the balance on current account (which includes trade in goods, services, net factor incomes and unilateral transfers) will grow by about $100 billion dollars generating a trade deficit in excess of $300 billion. These projections have been greeted with alarm because in 1997 the US current account deficit of $166 billion in 1997 was already close to record levels. Deficits of this size will increase the difficulties faced by the Administration in obtaining Fast-Track Authority to negotiate further trade liberalization and protectionist pressures in the US could mount.

But the instinctive diagnosis that trade deficits of this magnitude must be a problem is not necessarily correct. Efforts to suppress the deficit by erecting new barriers to the US market could be disastrous because both the world and the US could be much better off if the deficit is allowed to grow.

The key to this conclusion is understanding the central role which the US trade deficit must play in stabilizing the world economy. Currently, a major challenge for the East Asian

countries is restoring international creditworthiness. Whatever the reasons for their problems, the questions raised about all these countries' financial systems will slow their ability to borrow in the immediate future. In response to the crisis, trade balances in these countries have shifted towards surplus. As their currencies have plunged, and their growth rates fallen, imports have plummeted. Over time, the depressed real exchange rates will also stimulate their exports. According to the OECD, by 1999 the current account of the affected countries will increase by $70 billion.

The counterpart to this adjustment process must be larger current account deficits (or smaller surpluses) elsewhere. *If the Asians draw less on the global pool of savings, other countries should draw more to prevent a global downward spiral in demand.* An important part of the adjustment will have to take place in the United States, in part because Asian currencies have all declined against the dollar and in part because growth in the US remains robust. Without such adjustments, the world economy could slip into a recession with particularly devastating implications for employment in the United States.

Even acknowledging these global responsibilities, many Americans complain that the US is being called on to do more than its fair share. Why should America be the global buyer (and borrower) of last resort? Americans point fingers particularly at Japan and to a lesser extent at Europe, which despite their greater lending to Asia, are projected to play much smaller roles as counterparts to the East Asian shift towards surplus. Implicit in this view, however, is the idea that trade deficits are necessarily bad, a view that is so ingrained in our language that a movement towards larger trade deficits is commonly described as a "deterioration" while a movement towards surplus as an "improvement."

More specifically, trade deficits are viewed as bad for two major reasons: the first is that they allegedly cost jobs. In 1996, each $1 billion value-added in US manufacturing was associated with 14,000 jobs. It is quite common for people to extrapolate using such numbers, that an additional trade deficit of $100 billion must entail the loss of 1.4 million jobs. The second concern is that trade deficits lead to greater international liabilities. Since the US is already the world's largest net debtor country, additional borrowing is allegedly imprudent because the obligations will either have to be serviced or repaid.

But these concerns could be wrong. To see this it is necessary to remember that there are three equivalent definitions of the current account. The most common and obvious definition is that the current account is equal to the difference between exports of goods, services and gifts to foreigners and imports of goods, services and gifts from foreigners. If the US has a deficit, it will be buying more from foreigners than they buy from it. But according to the second definition, the current account must also be equal to the difference between national income and expenditure. If the US has a current account deficit, its national spending (on both consumption and investment) exceeds its income and it must either be borrowing from foreigners or selling off foreign assets. The third definition is that the current account equals the difference between national saving and investment. If the US has a current account deficit, its domestic investing exceeds national saving (which is the sum of private saving and the government saving (or deficits).

Employment. Recognizing that the current account equals the difference between income and expenditures is useful in thinking about the links between the current account and employment. A current account deficit will emerge as long as spending exceeds income. *But the same deficit could occur in the face of very different spending and investment levels.* Those who believe that trade deficits are necessarily associated with a drop in employment have in mind a current account deficit in which income (and thus employment) is actually falling faster than spending. But they ignore the possibility that spending could exceed income and yet both could be rising. In other words, the current account deficit and employment could both actually be growing! Trade deficits need not cost jobs.

Borrowing. Recognizing that the current account equals the difference between national investment and saving is also useful in thinking about the links between the current account deficit and international indebtedness. Is it good or bad to get into debt? The answer depends on what you are doing with the money. A current account deficit will emerge as long as investment exceeds saving. *But the same deficit could be associated with very different levels of saving and investment.* Those who believe that increased international indebtedness reduces incomes in the future have in mind a current account deficit in which domestic saving falls and the country is

borrowing to consume. But they ignore the possibility that a deficit could actually raise incomes in the future if productive domestic investment is boosted by international borrowing.

As Table 1 indicates, these are not simply theoretical niceties. They are illustrated well by two recent episodes in which the US current account moved from a surplus to deficit of around $170 billion. The first was between 1981 and 1987, and the second, between 1991 and 1997.

The first issue relates to employment growth. It is striking that during both the episodes of growing current account deficits employment actually expanded strongly. The unemployment rate fell by 1.4 percentage points during this phase of the Reagan years and 1.8 percentage points during the Clinton years. In both periods employment increased by around 12 million. In both the 80s and the 90s, as the US economy recovered, spending increased more rapidly than production. Basically, in both periods, the deficit reflected the strength of US spending, rather than a fall in US incomes. Americans were buying more, both from US producers and from producers in other countries. During the Bush years, by contrast, when the economy fell into recession, unemployment increased and the current account deficit shrank. This implies that US spending fell more rapidly than income. *Thus what we have seen is larger deficits associated with falling unemployment rates and smaller deficits associated with rising unemployment rates.*

The second issue relates to the rise in US international indebtedness. Was the US borrowing to offset less domestic saving or to finance more domestic investment? Viewed from this perspective, the deficits of the 80s and the 90s are conspicuously different. In Table 1, I report measures of net national saving and net domestic investment as a share of US Net National Product (NNP). I include the numbers on the trade deficit actually net foreign investment which is the measure of the current account as defined for national income accounts purposes.

In the 80s, the deficit in Net Foreign Investment clearly reflected a savings bust. The familiar part of this story is the increase in the US government deficit which grew by one percent of NNP between 1981 and 1987 – reflecting the federal government deficit which increased from 2.1 to 3.1 percent of NNP. *Less familiar perhaps, but even more important quantitatively was the plunge in the private saving rate by a full 3 percentage points of NNP.* There clearly was no investment boom. Net domestic investment actually fell by 0.85 percentage points. Under these

circumstances, the foreign borrowing appears not to have been devoted to investment which will help raise US incomes in the future but rather to consumption.

In the 90s, the spending patterns driving the deficit have been noticeably different. The most striking differences are the dramatic increase in net national saving because of the declining Federal government deficit (by 3.4 percent of GNP) and the increase in net domestic investment by a similar order or magnitude. *This looks more like an investment boom deficit rather than a savings bust,which may help explain why it has not given rise to as much concern.*

Our praise for this recent performance should be tempered by acknowledging that in the 90s -- perhaps in response to the dramatic rise in national wealth because of the booming stock market -- the personal saving rate has continued to fall. We should also note that both net national saving and net national investment remain much lower shares of income than they averaged in the 1960s and 1970s and that we know from the size of the so-called statistical discrepancy that the data contain sizable measurement errors -- although they seem to be of similar sign and magnitude in both episodes. Nonetheless, these data do underscore the central point that current account deficits are not always reasons for concern. First, as long as income (and thus production) is growing strongly there need be no rise in the overall unemployment rate even if spending is growing more rapidly than income. And second, as long as spending falls heavily on productive investment there need be no concern over the rise in international indebtedness.

Manufacturing. Briefly, I would like to address two other concerns about the trade deficit. The first is that it has led to a shrinking of the manufacturing sector of the economy. This is a view that needs to be qualified, particularly since currently the US economy is at, or close to, full employment. If we simply shifted our spending away from imports towards domestic goods, we would create an excess demand for workers in the economy as a whole. The result could be inflation and if workers moved into manufacturing, a shortage of workers to provide us with the services and other non-traded goods we currently buy. Given full employment, in addition to switching spending, therefore, we would have to reduce spending, either by consuming less (saving more) or investing less. If we invested less, the result would be fewer jobs in our machinery, equipment and construction sectors. Those who claim that a

smaller trade deficit would increase manufacturing employment often forget that without increased domestic saving, a smaller trade deficit would not fully translate into more manufacturing jobs because investment would have to be reduced. Moreover, even granting that the entire manufacturing trade deficit could result in an increase in manufacturing output of equal value, we would see the total share of US employment in manufacturing increase by about seven percent i.e. from just over fourteen to just over fifteen percent. This would be a one time gain, and thereafter, the long runs trends which are reducing manufacturing as a share of total US employment would continue.

Unfair Trade? I have emphasized the interpretation of trade balances as indicators as spending patterns. I would also like to stress what aggregate trade balances are not, and that is evidence of whether trade is fair or not. The level of a nation's trade balance tells us little about whether its markets are open or closed. Some countries with open markets, for example, Germany prior to unification, run large trade surpluses. Other countries with very closed markets, for example, Mexico in the early 1980s, run large trade deficits. Indeed, Japan actually had much smaller trade surpluses as a share of GNP when it was more closed in the 1950s and 1960s than it does today. Trade balances reflect spending patterns rather than trade barriers. Japan has a large trade surplus today, for example, because it is spending less than its income -- in particular, since it is in recession, its investment spending has plummeted. Suppose Japan increased its domestic spending and eliminated its trade surplus. Would that mean that its market was more open? The answer is no. Japan could balance its trade simply by consuming more of its exports at home. Moreover, even if its trade surplus was eliminated through an increased volume of imports, this could be the result of increased Japanese spending rather than an increased market share for foreign goods.

Consider the recent US trade balance in this light. In 1987 the US had a current account deficit of $168 billion, in 1991, the current account was virtually in balance. Would we really want to say that during this period of just four short years, foreign markets suddenly become relatively more open? Since our current account has declined since 1991 with virtually all parts of the world, would we really want to argue there has been a global conspiracy and that the playing field has now been tilted in the opposite direction? These major shifts with many

disparate partners indicates strong aggregate factors, in particular spending patterns and exchange rates rather than trade barriers.

This does not mean, however, that our trade policies should not be directed towards increasing our access to foreign markets. There is considerable evidence, for example, that despite its low tariffs and official policies of free trade and investment, foreign entry into Japan remains extremely difficult. Indeed, Japan is distinguished by its low share of manufactured imports, low degree of intra-industry trade, low share of sales by foreign firms based in Japan, and the high level of markups on foreign products which serve as the functional equivalent of high tariffs. The problems experienced by foreign firms and products relate to the "invisible barriers" presented by private sector practices such as keiretsu, (Japanese corporate groups) and public policies such as the weak enforcement of anti-trust policies. Any agreement with Japan which deals only with the formal border barriers will not ensure access for foreign firms and products.

The fundamental problem in US Japan relations then, relates to access. Simply put, the US market is relatively easy to enter, the Japanese market is not. And this would be a problem even if our trade was balanced. More generally, most important goal of US trade policy should be to increase access for foreign products and investment. It should not be to achieve a particular level of the trade balance.

Concluding Comments. Achieving open foreign markets rather than balancing trade should be the goal of trade policy. The level of the current account matters less than the reasons we have it. The key to ensuring that the current account deficit which is emerging in response to the Asian crisis is benign, is generating strong investment growth in the US. The lower long term interest rates and strong stock market we have seen in early 1998 should help stimulate such a response. As long as the economy can absorb additional resources in a non-inflationary manner through the current account, the Federal Reserve can avoid raising interest rates.

All this does not mean that no Americans will lose jobs to Asian competition. While the growth in US spending will stimulate demand for workers both at home and abroad, there will also be some expenditure-switching in which foreign goods are bought and domestic goods are not. In particular, in some manufacturing sectors of the economy, there could be painful

adjustments. The best help we can give to these workers is the possibility of finding work in other parts of an economy in which growth is robust. As my colleagues and I have described in our book *Globaphobia: Confronting Fears About Open Trade* recently published by the Brookings Institution there is also a need for improved training and adjustment assistance.

But the bottom line is this: If domestic savings are insufficient to fund profitable investment opportunities in the US, we are better off borrowing from abroad and running a deficit than avoiding the deficit and losing the opportunity to improve our well-being. If the prospects for investment in the US are (temporarily) better than those in Asia, a larger US current account deficit may not only be necessary to maintain global incomes but also a desirable allocation of global resources.

Over the long run, of course, US incomes would be even higher if we save the money ourselves, rather than borrowing it from foreigners. The best way to reduce our current account is not to cut down on investment but to raise our national saving. In view of the difficulty of designing effective policies to stimulate private saving, it might be desirable for the federal government to run budget surpluses in the years to come.

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Table 1: US Net National Saving and Investment
(As a percent of Net National Product)

	Trade Deficit (Current Account)	Net National Saving	Net Private Saving	Net Public Saving (govt deficit)	Net Domestic Investment	Statistical Discrepancy	Employment (millions)
1981	0.27	9.58	9.66	-0.09	9.89	0.55	100.40
1987	-3.77	5.64	6.73	-1.09	9.04	-0.37	112.44
1991	0.14	4.85	7.15	-2.30	4.90	0.19	117.72
1997	-2.22	7.30	6.20	1.10	8.33	-1.19	129.56
<u>Change</u>							
1997/91	-2.36	2.45	-0.94	3.39	3.42	-1.38	11.84
1987/81	-4.04	-3.94	-2.94	-1.00	-0.85	-0.92	12.04

Source: Economic Report of the President Tables B-32 and B-36
Survey of Current Business.
Note: Trade deficit = Net Foreign Investment.

EMBARGOED UNTIL 10 A.M. EDT
Text as Prepared for Delivery
June 11, 1998

TREASURY SECRETARY ROBERT E. RUBIN
SENATE FINANCE COMMITTEE

Mr. Chairman, members of this Committee, I think that your hearing today on the trade deficit provides all of us a most useful opportunity to discuss many issues of great public importance.

To begin, I would like to place the issue of the trade deficit in the broader macroeconomic context. The United States has the strongest economy among the major industrialized countries in the world today. Unemployment is 4.3 percent and it has been under 6 percent for nearly four years. The economy has generated 16 million new jobs over the last five years, inflation has remained low and real wages are rising.

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At the same time, we have an expanding trade deficit. The current account deficit -- the broadest measure of the trade balance -- is rising, but it is worth noting that, relative to the overall size of the economy the present deficit is considerably smaller than the deficits of the mid-1980s. We estimate it equaled around 2.5 percent of GDP in the first quarter, compared to 3.5 percent of GDP in the mid-1980s. Private forecasters estimate that it will be between 2.5 and 3 percent of GDP in 1999.

The reasons behind the rising trade deficit are many, and Chairman Yellen will discuss how the savings rate affects the deficit, but the most important is that the U.S. economy is considerably stronger than the economies of almost all of our significant partners. The driving force behind the U.S. economy's current strength has been domestic demand, while, even though exports have been performing well, foreign demand for our exports has been notably weak. This has been particularly true in Asia, which has accounted for one-third of our total exports. First quarter data indicate that U.S. exports to the countries most affected by recent instability in Asia -- Thailand, Malaysia, Indonesia, the Phillippines, Singapore, and Korea -- are currently on pace to fall between $17 billion and $21 billion (annualized) since the crisis began, depending on how one does the seasonal adjustment, and the decline could be larger if further contraction occurs. If you include Japan, the figure is between $23 and $29 billion.

That takes us to the industrialized nations, most of whose economies have also been relatively weak compared to ours. Most troubling, the Japanese economy still fails to show signs of recovery, and Japan's economic difficulties and weak currency are having substantial adverse impact on the East Asian countries. Obviously, the worse these conditions in Japan, the greater that adverse impact on the region. We, the IMF, the OECD, and the G-7 -- in our case for well over a year -- have strongly urged the Japanese government to undertake the necessary steps to stimulate domestic demand-led growth, including fiscal stimulus, an effective program to address the problems of the banking sector, and deregulation and market opening. In this regard, we have in the past several months said on many occasions that we share the Japanese government's growing concern about the weakness of the yen, because of its implications for economic recovery in Asia and Japan's growing external surplus. In turn, the weakness of the yen reflects the economic conditions in Japan, and can only be remedied by restoring economic strength in Japan.

In short, Mr. Chairman, the recent rise in our trade deficit, and the trade deficits of the last few years, reflect the strength, not the weakness of the U.S. economy. Even with the rise in the trade deficit, we estimate the most likely scenario for the U.S. economy for the period ahead is sustained growth, low inflation, and low unemployment.

Let me now begin a discussion of the impact of the trade deficit on our economy. One thing that is clear is that the trade deficit has not undermined our strong economic performance. Having said that, let me focus on two dynamics regarding the trade deficit. On the one hand, it means we are attracting foreign investment, which does create claims from abroad that, at some point, have to be repaid. On the other hand, if we use that investment in areas that promote higher productivity in the long term, it will result in higher growth, and, on balance, increase, not drain, future income, assuming the return to the economy on the investment exceeds the foreign obligations. Currently, the United States is experiencing record levels of business investment, and thus, the probability is strong that higher productivity gains and growth will occur in the United States. It is also important to note that increased trade deficits and increased claims against our country, even if the capital inflows on balance promote long term growth, do create greater vulnerabilities to changes in global financial markets' views toward investment in the United States and they give rise to greater sectoral dislocations in our economy. All of this underscores the importance of having strong economic policies at home.

Mr. Chairman, trade contributes importantly to the economic health of this country. Millions of Americans owe their jobs directly or indirectly to trade, and all of us benefit through the lower prices and greater choice that international competition fosters. Our economic well-being truly is inextricably linked to the

rest of the world.

Moreover, trade with developing countries, which absorb 43 percent of our exports, is increasingly important to the United States. Trade deficits with low wage countries, such as most developing countries, are often seen by Americans as evidence that the United States cannot compete with low wage nations. While low wage countries are able to produce a range of low-wage, low-skill items at lower cost than U.S. firms -- to the benefit of U.S. consumers -- this is not true across the board because the productivity of American workers allows them to compete, even given their higher wages. Moreover, the developing countries buy American goods such as airplanes, construction equipment, entertainment products, and hi-tech goods produced by high-wage, high-skill American jobs. Indeed, studies have shown that over the last several years, six out of ten of the jobs created have been high-wage jobs. As a highly productive and competitive economy, the United States can -- and does -- export to low wage countries, and increasing trade with these countries benefits our economy.

To put the same thing in conceptual perspective, trade is not a zero sum game. A nation does not "win" by exporting, and "lose" by importing. If a nation produces its relatively most competitive goods and services and then exchanges with other nations to obtain the relatively less competitive goods and services, the nation will be better off than it would be without trade.

In the natural course of trade, some industries will be buffeted by foreign competition. That means there will be dislocations for some, although I think it is worth observing that technology contributes far more to dislocations than trade. Thus, while trade benefits most, there is a risk to some. The answer to these problems is not to try to halt the inevitable tide of technology or globalization that has benefited so many. Instead, the answer is to equip all of our people to compete in the global economy, very much including those outside the economic mainstream in inner cities and distressed rural áreas, through education and training; to help the dislocated re-enter the economic quickly and successfully through adjustment programs such as the North American Development Bank; and to have an appropriate social safety net where needed. Having said that, we all need to continue to focus on how best to help those who are hurt by the dynamic changes in our economy including trade and technology that greatly benefits the whole.

A forward-looking international economic policy to derive the full potential from trade and to best promote our exports of goods and services includes three components: First, continuing an aggressive effort to open markets and liberalize trade, as this Administration has done through Nafta, the WTO agreement, scores of other trade agreements and through strong enforcement of our trade laws. We estimate that U.S. exports have accounted for one-third of our nation's real growth during the recent economic expansion. The President has made clear he

is committed to working with Congress to secure fast track negotiating authority so that we can pursue a trade policy that creates jobs and promotes higher standards of living and that, as the President said recently, will "harmonize our goals of increasing trade and improving the environment and working conditions."

Second, is promoting growth and reform in developing countries. By helping them continue on the path of reform, we help to build markets that already have been buying 40 percent of our exports.

Third, is to address financial instability, both when it occurs, and in the long term, by developing an architecture of the international financial system that is as modern as the market.

The IMF is critical both to promoting growth in developing countries and addressing financial instability. Those who are most concerned about the trade deficit ought to be among the strongest advocates of IMF funding. As its core mission, the IMF works to promote or reestablish financial stability and economic growth, helping to create the conditions where other countries have the economic strength to buy our goods, as well as solid currencies that do not provide undue competitive pressure for our goods and services in countries around the world. The IMF is especially critical to our economic well-being in

countries experiencing severe financial instability and economic difficulty, both by helping those countries and by preventing contagion to other developing nations. Moreover, IMF programs, including the recent Asia reform programs, have long included significant trade liberalization measures which have the effect of opening foreign markets to U.S. goods and services.

Yet, as a result of the recent situation in Asia, the IMF's normal financial resources are approaching a historically low level, and the IMF does not have sufficient funds to deal with a truly major crisis, for instance if the Asian crisis were to worsen or if a new crisis were to develop. The probability of such events occurring is low, but if they occurred, the effect on our economy would be severe and we should not take the risk that such events could start to unfold and the IMF not have the capacity to try to cope effectively.

Mr. Chairman, with the help of your leadership, the Senate approved funding for the IMF by a vote of 84 to 16. We urge the House to follow suit as quickly as possible. The full IMF funding is needed now, to protect our economic and national security interests.

The key to prospering in the global economy is to maximize our productivity and competitiveness. That requires fiscal responsibility to keep interests rate down and maximize savings for investment, and investing in our

people through education, training and other areas critical to future productivity. If we put all of these pieces together -- fully funding the IMF to promote financial stability, continuing to open markets to U.S. goods and services, promoting growth and reform in developing countries, and maintaining our strategy of fiscal discipline and investment in people -- all of which constitutes the basic economic strategy for the past five and a half years -- we have a recipe for economic growth, and for containing the trade deficit to a sustainable level over time. Thank you very much.

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U.S. Trade Deficits:
Causes, Consequences and Policy Implications

Testimony given before the
Senate Finance Committee

June 11, 1998

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Mr. Chairman and members of the Committee, thank you for the opportunity to testify here this morning. Make no mistake about it, the trade deficit is a problem. It is destroying jobs, depressing wages, hurting our competitiveness and contributing to the stagnation of real incomes that has plagued our economy for the past two decades. The trade deficit results from the use of the U.S. as a "market of last resort" for exports from around the world, and from several macroeconomic problems. Both kinds of problems can and should be addressed with new trade and international policies.

Many attempts have been made to create economic excuses for the trade deficit. A frequently heard claim is that trade deficits do not matter, while others argue that "the trade balance is generally determined by macroeconomic factors."[1] Both views suggest that trade deficits will be largely unresponsive to trade policies, and may be safely ignored, as long as the nation is following sound macroeconomic policies.

These laissez-faire views are both wrong, and dangerous to the health of our economy. One major source of confusion is the use of simple correlations, or economic identities, in the place of meaningful economic analysis of the causes of our trade problems. The most recent *Economic Report of the President* makes this mistake in several places, as shown below. The Report emphasizes the accounting relationship between savings and investment without sufficiently examining the cause of changes in these variables. Improvements in our trade balance, through increased exports, can increase income and hence raise national savings, thereby reducing our reliance on imported capital while creating better jobs in the economy at the same time. If, on the other hand, we ignore the trade deficit, our incomes will continue to stagnate and the risks of an economic collapse will grow in the future.

Consequences of Trade Deficits

Trade deficits have harmed the domestic economy in at least three direct ways. First, the steady growth in our trade deficits over the past two decades has eliminated millions of U.S. manufacturing jobs. Between 1979 and 1994, trade

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[1]Council of Economic Advisors. *1998. Economic Report of the President.* Washington, D.C.: U.S. Government Printing Office. February. p. 246.

eliminated 2.4 million jobs in the U.S.[2] Growing trade deficits were responsible for most of these job losses, which were concentrated in manufacturing, because most trade involves the sale of manufactured goods. NAFTA added to the flow of jobs out of the U.S. by encouraging firms to move production to Mexico and Canada. Our trade deficit with both countries increased from $16 billion in 1993 to $48 billion in 1996 (in constant 1987 dollars). The U.S. lost 395,000 jobs as a result of the NAFTA deficits.[3]

The Asia financial crises are expected to increase the trade deficit by $100 billion, or more over the next two years. Deficits are already growing with Korea, and with Japan. The Japanese economy is contracting sharply as a result of the crisis, and U.S. exports to both countries have fallen sharply. The expected increase in the U.S. trade deficit could eliminate an additional one million jobs in the U.S. over the next 18 months, if the Fed does not act quickly to lower interest rates and keep unemployment here from rising.[4] Even if the Fed does lower interest rates enough to keep unemployment constant, 600,000 jobs will shift from the high-wage manufacturing to lower-paying service sector.

Second, trade deficits have also had a depressing effect on wages, in several ways. The jobs lost through trade do not raise the unemployment rate, in the long-run. Macroeconomic policies such as interest rates and government spending have much greater influence on the total level of employment and output than does trade. But trade does effect the *composition* of employment. Workers not employed in manufacturing find jobs elsewhere in the long run, usually in service industries where wages are much lower.

The growth in imports, especially from low wage countries, also puts downward pressure on the wages of U.S. workers. If the prices of these products

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[2]Scott, Robert E.,Thea Lee and John Schmitt. 1997. "Trading Away Good Jobs: An Examination of Employment and Wages in the U.S., 1979-94," Briefing paper. Washington, D.C.: Economic Policy Institute. October.

[3]Scott, Robert E. and Jesse Rothstein. "NAFTA and the States: Job Destruction is Widespread," Issue Brief. Washington, D.C.: Economic Policy Institute. September.

[4]Scott, Robert E. and Jesse Rothstein. 1998. *American Jobs and the Asian Crisis*. Washington, D.C. Economic Policy Institute. Issues Brief. January.

fall, then this puts downward pressure on prices in the U.S. Domestic firms are then forced to cut wages or otherwise reduce their own labor costs in response.[5]

For the past two decades, our living standards have stagnated, and the level of income inequality in our society has increased dramatically. As a result, the real wages of production and supervisory workers have declined steadily since 1979, as shown in Figure 1.

Many economists who are proponents of free trade have now concluded that trade is responsible for 20 to 25 percent of the increase in income inequality over the past two decades.[6] Our own research suggests that trade is responsible for 15% to 25% of the increase in income inequality which occurred between 1979 and 1994.[7] However, existing research can only explain about half of the change in income inequality. Therefore, trade is responsible for about 40% of the *explainable* share of increased income inequality.

There are several other ways in which trade and trade deficits depress wages that are not included in the preceding estimates. One of the most important is through foreign direct investment. When U.S. firms move plants to low wage countries, as they have done at an increasing rate in recent years, they clearly eliminate good jobs and increase the trade deficit. These moves also have a chilling affect on the labor market. The mere threat of plant closure is often enough to extract wage cuts from workers. This tactic has also been used with increasing frequency in the 1990s and is effective even when plants don't move.

The third problem with trade deficits is their corrosive effect on our long-term trade competitiveness. When the U.S. dollar and our trade deficit soared in

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[5]Note that the *Economic Report of the President* (*op cit,* 243) mentions this problem, but claims that the "prices of such imports actually rose." This statement appears to reflect a flawed 1994 study that has since been repudiated. See John Schmitt and Lawrence Mishel. 1996. "Did International Trade Lower Less-Skilled Wages During the 1980s? Standard Trade Theory and Evidence." Washington, D.C.: Economic Policy Institute. Technical Paper No. 213. July.

[6]See, for example, Tyson, Laura. 1997. "Inequality Amid Prosperity," *The Washington Post.* July 9.

[7]Mishel, Lawrence, Jared Bernstein and John Schmitt. 1997. *The State of Working America, 1996-97.* Armonk, NY: M.E. Sharpe. p. 20.

the early 1980s, many domestic firms and industries in sectors such as steel and semiconductors were decimated. Once closed, many plants in such industries failed to re-open, even after the dollar depreciated later in the 1980s.

Dr. Peter Morici, in an important new study for the Economic Strategy Institute, has identified another major reason why deficits have such corrosive, permanent effects on our competitiveness. Morici found that eliminating the U.S. trade deficit would increase U.S. spending on R&D by an estimated 3 per cent. This would in turn increase productivity growth by about "0.5 to 0.6 percentage points per year."[8] This single shift, alone, would have a massive impact on U.S. living standards, by allowing firms to raise wages for all workers.

To summarize, trade deficits have eliminated millions of high-wage U.S. manufacturing jobs. They have also put downward pressure on the wages of production workers, not only by eliminating good jobs, but also by pushing down the prices of domestic products and by decreasing labor's bargaining power with multinational firms. Finally, trade deficits have reduced investment in research and development, thereby undermining productivity growth and contributing to the stagnation of incomes which has plagued our economy since the 1970s.

There is also another way in which trade deficits could destabilize our domestic economy at some point in the future, causing an economic collapse even deeper than the downturns that have resulted from the Asian financial crisis. Over the past two decades the U.S. has accumulated over $2 trillion in trade deficits. We have used foreign capital inflows to finance these deficits. As a result, we have now become the world's largest debtor nation. In a forthcoming report from the Center for Economic Policy Analysis at the New School for Social Research, Dr. Robert Blecker of EPI predicts that the net indebtedness of the U.S. will exceed $2.1 trillion within four years.[9]

Our trade deficit and foreign debt have yet to reach critical levels.

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[8]Morici, Peter. 1997. "The Trade Deficit: Where Does it Come From and What Does it Do?" Washington, D.C.: The Economic Strategy Institute. October. P. 20.

[9]See also: Blecker, Robert A. 1998. "International Capital Mobility, Macroeconomic Imbalances, and the Risk of Global Contraction." Washington, D.C.: Economic Policy Institute. Technical Paper.

However, the U.S. current account deficit is expected to increase by $100 billion, or more, as a result of the Asian crisis, within the next two years. If the crisis deepens, perhaps triggered by further devaluations by China or Japan, then the current account deficit could reach $350 billion or more.

At $350, the deficit will come perilously close to five percent of GDP, a widely accepted trigger point for currency instability. A deficit of this size could trigger concern among foreign investors about our ability to borrow sufficient funds to finance this level of spending. A sharp outflow of short-term capital would result, causing the dollar to collapse, at a minimum. Short-term interest rates could also increase dramatically, as they have throughout Asia, pushing the economy into a deep recession, or worse.

As long as foreigners are willing to hold an ever increasing supply of dollars, then we can avoid this "hard landing" scenario. However, structural changes in the not-to-distant future (such as the successful creation of the Euro) could weaken dollar demand and lead to a crisis, if our trade problems persist and deepen in the future.

Persistent trade (current account) deficits are a fundamental risk factor in this potential shock to our economy. Lester Thurow has referred to the U.S. deficits as the key "fault line" in the international economy.[10] In his view, the Asian financial crises are only a mild precursor to the devastation that will result if the U.S. deficits are reduced through a financial crisis. In the long-run, the only way to avoid such a collapse is to reduce the trade deficit, to at least sustainable levels, through some other means, such as more effective trade policies.

The Causes of Structural Trade Deficits

Many economists have emphasized the importance of fundamental accounting identities in explaining trade flows. For example, the *Economic Report of the President* notes that by definition, any excess of national investment over national savings must be financed through an inflow of foreign capital, which must, in turn be matched by an offsetting deficit in our current account, the

[10]Thurow, Lester. 1998. "Asia: The Collapse and the Cure." *New York Review of Books.* Feb. 5.

broadest measure of our trade balance. In this view, a low level of national savings must necessarily result in a trade deficit.

However, just because trade is influenced by macroeconomic forces such as savings rates and currency values, it does not follow that trade policy cannot influence the level of the trade deficit. There are at least two key issues which must be considered. First, what determines the macroeconomic flows that affect trade, and second, how can public policies at home and abroad affect our trade balances?

Accounting identities do not, and cannot, explain the causal relationships between savings, investment and trade flows. Do low savings rates cause trade deficits, or does causation run in the other direction? A trade deficit reduces the incomes of domestic workers, pushing many into lower income brackets. Families with lower incomes generally find it much harder to save. Therefore, increasing trade deficits can and do reduce national savings.

The CEA report also notes that since 1980, the size of our trade deficit has been closely correlated with movements in the exchange value of the U.S. dollar. As the dollar appreciated in the early 1980s, the trade deficit expanded, and the deficit shrank as the dollar fell later in the decade. The CEA emphasizes the influence of macroeconomic factors, such as U.S. monetary policy, in determining exchange rates. However, our exchange rates and trade deficits with several key countries are also heavily influenced other countries economic policies.

For example, in 1994 China devalued its currency by 30% against the dollar. Since that time it has continued to purchase dollars and by 1997 it had accumulated total reserves of $143 billion.[11] Since then, our bilateral deficit has increased by 25% or more per year. China's mercantilist policies contributed significantly to the trade problems of other countries in South Asia, many of which were swept into the financial crisis which began in mid-1977.

Japan has also intervened heavily in foreign exchange markets, with similar consequences. In 1995, Secretary Rubin reached an agreement with Japanese Vice-Minister of Finance for International Affairs Eisuke Sakakibara to devalue

[11] *IMF Financial Statistics*, May 1998.

the Yen.[12] In 1996, more than $125 billion in official capital (asset) purchases flowed into the U.S., much of it from Japan. The Yen has lost 50% of its value since 1995, and our bilateral trade deficit widened rapidly last year, as a result.

Exchange rate intervention is not our only trade problem, by any means. Over the longer term, since 1982, the Yen has doubled in value, and yet our bilateral deficit has never fallen below $19 billion since then, and the deficit has exceeded $40 billion in every year since 1985. Japan maintains numerous structural barriers to U.S. imports. For example, Japan condones restrictive practices that have limited U.S. penetration of their domestic markets for film, auto parts, flat glass and many other products.

China maintains even heavier import restrictions than Japan. These barriers have generated our most imbalanced bilateral trade relationship: our imports from China in 1997 were $63 billion while exports were only $13 billion, a five to one ratio, leading to a $50 billion bilateral deficit. China also uses discriminatory offset and technology transfer policies to capture market share and move rapidly upscale into high-tech products such as automobiles, computer products and aircraft. Over 148,000 jobs in aerospace and related industries, alone, could be lost over the next two decades because of offsets policies and other types of outsourcing.[13]

Many other countries in Europe, Asia and Africa and Latin America use protected home markets as a base to support industries that dump excess output in the U.S. market, especially in capital-intensive sectors such as steel and semiconductors. Government subsidies also distort trade flows, especially in high-tech industries.

For the past eighteen months, the dollar has also been appreciating because

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[12]Johnson, Chalmers. 1998. "Asia's Financial Meltdown: What Caused It and What Does It Mean?" Prepared remarks delivered at the Economic Strategy Institute. March 24.

[13]Scott, Robert E. 1998. "The Effects of Offsets, Outsourcing and Foreign Competition on Output and Employment in the U.S. Aerospace Industry" in "Policy Issues in Aerospace Offsets," eds. Wessner, Charles W. and Alan Wm. Wolff. Washington, D.C.: National Research Council. Forthcoming.

of significant private capital inflows into the U.S., because of relatively high rates of growth here, and in search of a "safe haven" from the Asian financial crises. These private flows have also contributed to the growth of our trade deficit, while also pushing asset prices (such as the stock market) to unsustainable levels. This experience shows that our trade balance can be destabilized by both public and private forces. It is also worth noting that the surge in private capital inflows was made possible, in part, by the liberalization of capital outflows from many developing countries, in the 1990s, often with IMF encouragement.

U.S. trade deficits have been increased by both mercantilist, macroeconomic policies of foreign governments as well as interventions and distortions in individual product markets. They have been exacerbated by the Asian financial crisis and financial market deregulation. The resulting deficits have contributed to widening income inequality and the stagnation of income and productivity growth in the U.S.

Policy Implications

The preceding analysis suggest that, at a minimum, the following steps should be taken:

- Devalue the dollar against key currencies such as the Yen and the Chinese Yuan. In the long-run, devaluation is not a desirable way to improve the trade balance because it reduces our living standards. However, we must end the practice of allowing and encouraging these particular countries to manipulate their currencies for mercantilist reasons. A substantial appreciation in the Yen will also bring additional pressure to bear on Japan to deregulate, reform and expand its domestic economy. These policies will require coordination with other countries, probably through the G-8 or a similar institution.

- Coordinate macroeconomic policies with Japan and Europe, and encourage those countries to reflate and stimulate their economies, thus building demand for our exports. Restructure the IMF so that its policies do more to promote growth, rather than austerity, in East Asia and other countries with banking and financial crises. At the same time, steps are needed to gradually deflate asset price bubbles in the U.S. while depreciating the

dollar against all currencies. The U.S. can no longer serve as the import market of last resort for the rest of the world.

- Attack barriers to U.S. exports and other policies and business practices that bring dumped and subsidized products into the U.S. market. In particular, China should not be allowed to enter the WTO until it removes all non-conforming barriers to imports, both formal and informal. In addition, the U.S. should substantially increase public investments in research and development needed to improve the competitiveness of U.S. industries, in part to offset the effects of similar policies used in other countries, especially in Japan and Europe. Additional resources for the enforcement of trade agreements and our trade remedy laws are also desperately needed.

- Promote international labor rights and environmental standards, through aggressive agreements that are enforceable with trade sanctions, in the WTO. These policies will raise wages and environmental quality in developing countries, and give consumers in these countries the resources to buy more products from the U.S. These policies will also foreclose the "low road" in international competition that has increased income inequality in the U.S., and in poor countries, while fueling a race to the bottom in the regulatory environment.

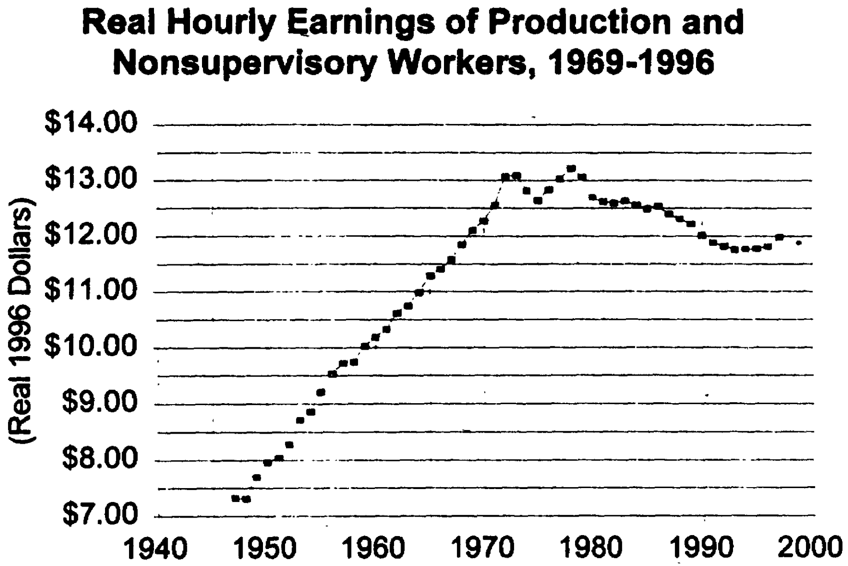
- Develop a plan for addressing the critical problems that both cause and result from trade deficits. Senator Dorgan has proposed a Congressional Commission to end the trade deficit, and I support that proposal. Issues to be addressed include mechanisms for coordinating with other nations to reduce macroeconomic imbalances; assessment of the impact of other countries' trade and industrial policies on U.S. competitiveness; and the development of new principles and approaches for addressing these problems through reform or replacement of the WTO.

A great deal of confusion and misinformation exists about the causes and consequences of our trade problems, and these issues are of critical national importance. Public outrage about the negative consequences of globalization is quite strong, both at home and abroad. In the U.S., these concerns resulted in the failure of Congress to approve the President's request for fast-track trade negotiating authority last year. While the public is highly supportive of the

administration overall at the moment, because of low unemployment rates, concerns over trade will grow quickly as the full impact of the Asian crisis is felt over the next 18 months, and as we move into the next downturn, whenever it comes.

We have a breathing space, at this moment, to develop plans and policies that will enable us to effectively address our trade problems when the next crisis hits. Effective planning can also nuture a consensus on desirable future directions for our trade policy. This consensus must be achieved before we can move ahead. A continuation of the trade policies of the past is no longer a viable option.

Figure 1



Source: EPI analysis of Bureau of Labor Statistics, "Employment and Earnings." April 1997.

THE U.S. TRADE DEFICIT: A MISLEADING ECONOMIC INDICATOR

by Murray Weidenbaum

Testimony before the
Senate Finance Committee
Washington, DC, June 11, 1998

The trade deficit is my favorite candidate for the most misleading indicator in our statistical tool kit. More often than not, bad news for the economy is good news for the trade deficit, and vice versa. In 1992 the economy was in recession and our trade deficit came down. The next year our economy revived, and the trade deficit rose.

More recently, our trade with South Korea furnishes a similar and more dramatic example of the relationship between trade and the overall economy. In 1996, the United States enjoyed a trade surplus with Korea (approximately $330 million a month). Korea's economy was expanding more rapidly than ours and our exports to that nation were a third larger than our imports.

In 1997, however, their currency and stock market crashed, and their economy declined sharply. Korea got rid of its trade deficit with us overnight (we now have a trade deficit with them, over $600 million in March 1998). Our imports are approximately the same as before, but our exports are only about one-half of their former level. All this happened without any change in trade policy. Trying now to reduce our imports from Korea would make it more difficult for that nation to return to normal.

I also believe that we pay too much attention to the much larger trade deficit with Japan. In good measure, it is a statistical artifact resulting from the fact that we have the largest population in the industrialized world. The average Japanese spends more on U.S. products ($538 in 1996) than the average American spends on Japanese products ($432 in 1996). But because we have a much larger population, our total exports to Japan are less than our imports from that country.

Please do not misinterpret my position. I believe that the trade deficit is a misleading indicator of economic success. But we should not ignore it. When we look beyond the short-run gyrations of the trade balance and the business cycle, there is a more fundamental and longer-run problem that does involve the trade deficit. It is a symptom of a more basic economic imbalance.

Stripping away the economic jargon, Americans invest more than we save. How do we finance our vast array of new and expanded factories, offices, and laboratories so essential to economic growth? By importing foreign capital. What do we do with the foreign money? We buy their goods and services — and the result is a substantial trade deficit.

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Yes, this explanation simplifies a complex economic reality, but I believe it is correct in its fundamentals. Moreover, this explanation points us in the right direction in terms of public policy: we can reduce the trade deficit in a constructive and sustainable manner — not by erecting barriers to imports or subsidizing exports — but by encouraging Americans to save more. That will provide at home more of the funds needed to finance economic growth.

Balancing the federal budget is an important step because it eliminates a major source of dissaving. The Treasury is no longer a net borrower, so more private saving is now available to finance private investment. More can be done.

Congress has already embarked on an effort to increase saving through tax reform. The Roth IRAs are a good case in point. Personally, I would go all the way and defer all saving from taxation. This means deregulating the saving process so that Uncle Sam no longer tells Americans how much to save or the exact form in which to save.

Most economic forecasters expect imports to increase much more rapidly than exports in 1998. Macroeconomic Advisers, the St. Louis-based economic forecasting group, estimates that the trade deficit will rise from $146 billion in 1997 to $214 billion in 1998. This is a factor in the standard expectation that the gross domestic product will grow a bit less rapidly this year than last.

However, it is useful to see international trade in the context of the overall economy. Imports are dwarfed by the total output of goods and services (see chart). Moreover, the positive effects of imports tend to be overlooked. It is more than a matter of benefiting American consumers by providing greater product variety at lower prices — and these are important positive effects. The more basic and beneficial impact of imports occurs because foreign competition spurs American companies to enhance their competitiveness by lowering costs, improving quality and, in other ways, enhancing productivity.

The trade deficits are also a reminder that economic progress can produce losers as well as winners, although not in equal proportions. The challenge to policymakers is how to help those who are hurt by progress without undermining that progress.

Any traveler beyond the borders of the continental United States quickly finds that our economy is the envy of the world. By any objective criteria, the United States is the pacesetter of our time. The citizens of other nations are trying to copy our economic system, business practices, culture, fashions, and freedom. They don't send their young people abroad to Tokyo University or Beijing University or Berlin University — but off to get an American MBA.

Concern for those not sharing in the general progress requires a constructive response. Pressures to "buy domestic" fly in the face of economic reality — given the fact that so many "foreign" products have U.S.-made components, and vice versa. We need to make the United States an even more attractive place to hire people and to do business. Tax reform and regulatory reform surely have important roles to play. The basic answer to low-priced import competition is not to "dumb-dumb" down jobs here but to raise the skill and performance level of Americans who have difficulty in finding good jobs.

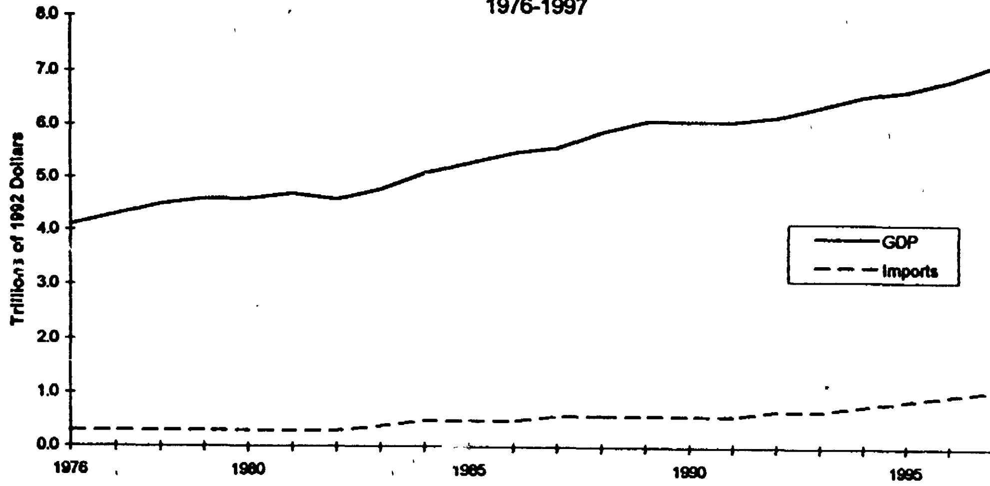
It is a silly spectacle for Americans to quiver at the sight of international competition. The U.S. economy is the strongest in the world and our long-term prospects are impressive. In a great many important industries, American firms are the global leaders. Our companies rank first in

sales volume in aerospace and airlines, beverages and brokerage, chemicals, computers and cars, electronics and entertainment, paper products and pharmaceuticals, soap and scientific equipment.

There is a special reason for optimism. In the decades ahead, we will be benefiting from a huge upsurge of industrial research and development during the 1980s and 1990s. A key but quiet crossover occurred in the early 1980s — for the first time, company-sponsored R&D was larger than government-financed R&D. Primary reliance on private R&D has continued ever since, making more likely an accelerated future flow of new and improved civilian products and production processes in the United States. To envision what this might mean, we can reflect on how the fax machine and the Internet have altered customary work practices in little more than a decade.

To sum up this statement in a nutshell: we should not be so preoccupied with the statistical excess of imports over exports that we adopt policies that weaken the basic strength of our high-performance economy. The trade deficit should not be the focus of economic policy; it mainly is just a side effect.

U.S. GROSS DOMESTIC PRODUCT AND IMPORTS,
1976-1997



SOURCE: U.S. Department of Commerce.

TESTIMONY OF DR. JANET YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
U.S. SENATE
COMMITTEE ON FINANCE

June 11, 1998

Mr. Chairman and members of the Committee. Thank you for the opportunity to discuss the trade deficit with you today.

The trade deficit is an important economic statistic, but its interpretation is subject to substantial confusion. A country's trade balance is often--wrongly--used as a measure of the success of its market-opening policies or the benefits of its engagement in international trade. The most important idea I would like to express to you today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. Indeed, the rising U.S. trade deficit in recent years mainly reflects the strength of the American economy, which has grown rapidly in comparison with the economies of many of our trade partners. In part, the trade deficit reflects the fact that our fast-growing economy is pulling in a lot of imports. But at the same time it also reflects the fact that the U.S. is attracting substantial international capital flows. These have financed increases in plant and equipment investment that have exceeded even the growth in national saving due to deficit reduction since the beginning of the Clinton Administration.

I. The Benefits of Trade

Going back to Adam Smith, one of the most important insights of economics is that international trade increases the real incomes of all countries that engage in it. Trade is not a zero-sum game in which the gains of some countries come only at the expense of other countries. To the contrary, trade is a positive-sum game in which both sides gain.

For a long time, arguments for trade were based on the principle of *comparative advantage*. When countries specialize in the economic activities for which they are particularly well-suited and rely on trade to acquire other goods, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that trade can also enhance productivity through the effects of greater market size, enhanced competition, and importation of new ideas and technologies.

These benefits from trade are not merely theoretical. A large and growing economics literature has found that those countries that are open to trade tend to grow faster and have higher

levels of per-capita income than countries that close themselves off from international competition and trade. One estimate is that the globalization of the U.S. economy over the last 40 years has added about $1500 to per-capita income.

Because policymakers in this country have long believed in the benefits of trade for all parties, the United States has long been the world's leading advocate for trade liberalization. U.S. tariffs are among the lowest in the world. While we benefit directly from our own low tariffs--through lower prices to consumers-- we would benefit even more if other countries were to lower their tariffs and other trade barriers. Since U.S. trade barriers are already so low, international trade agreements typically produce much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States.

It is often suggested that the major benefit of trade liberalization is job creation. When our economy is operating below its potential, with slack in the job market, export growth can produce job gains, helping the economy move toward full employment. As of January 1993, for example, the economy had substantial unemployment and excess capacity. One could say that the large increase in U.S. exports between 1993 and 1997--roughly 10% per year at an annual rate-- accounted for 38 percent of the increase in output, and a proportionate share of the almost 16 million jobs that were created over that period. In the long-term, however, increases in exports must ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and not from more jobs. Studies show that export jobs pay 13-18 percent more than other jobs. Indeed, export jobs are better even after adjusting for worker skills and firm-specific and industry-specific components to wages.

II. Macroeconomics and the Trade Deficit

Perhaps the greatest source of confusion about trade relates to the interpretation and causes of trade deficits and surpluses.

A trade deficit occurs, by definition, when a country's total domestic spending exceeds its total domestic production. When this occurs, the shortfall is made up by importing more goods than are exported. When the U.S. runs a trade deficit, foreigners buy less than a dollar's worth of U.S. goods for every dollar they earn from their export sales to us. The natural question is, what motivates foreigners to supply us with more goods than we supply to them in exchange? And what do foreigners do with the dollars that they don't use to buy U.S. goods? In practice, foreigners typically use the excess dollars to invest in interest-bearing U.S. assets. Indeed, it is the desire of foreigners to purchase attractive U.S. assets--to lend us the money needed to finance a trade deficit--that makes it possible to run such a deficit. Countries can run deficits only if foreigners want to add to their holdings of the deficit country's assets. In fact, one can as readily argue that the desire of foreigners to acquire attractive U.S. assets is responsible for the U.S. trade deficit as the reverse.

This relationship between spending, production, and the trade deficit can be expressed

another way. I will not bore you with the details but it turns out that in an accounting sense a country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. Conversely, when saving exceeds investment, the surplus is invested abroad. The United States first experienced large current account deficits during the mid-1980s, when net investment fell as a share of national income and net national saving fell even faster. The deficit shrank briefly as investment collapsed in the 1990-91 recession, but it has reemerged in the current expansion. The good news in this expansion is that investment has been booming. But saving does not appear to have kept pace, despite the improvement due to federal deficit reduction. (The interpretation of current trends in saving, investment, and the current account is complicated by the statistical discrepancy between GDP measured as the sum of all spending on output and as the sum of all income generated in producing that output.)

When a trade deficit is used to finance productive investment, as it is now, it can be viewed as largely benign, because the extra investment raises the productivity of our workforce, resulting in higher future national income. It is that return that should enable us to pay off the foreign borrowing we have undertaken to help finance our investments. We would be *worse off* as a nation, and our interest rates would have been higher if, over the last few years, we had been forced to curtail our investment. Our ability to attract funds from abroad is a vote of confidence in the ability of our high-performing economy to put these funds to good use.

Let me return now to the more immediate causes of our rising trade deficit. A key factor responsible for this trend is strong growth in the United States relative to some of our major trading partners. Our strong growth has resulted in a larger income-induced increase in American demand for foreign goods than in foreign demand for our goods and services. The second key factor is the dollar's appreciation, which has been substantial over the last three years. In a system of flexible exchange rates and high capital mobility, an appreciation in a currency reflects a desire by foreigners to hold that currency. Appreciations very often accompany strong economic expansions like the one the U.S. has experienced over this period, and in that sense the appreciation of the dollar is unsurprising given that the U.S. economy has grown much more rapidly than those of many of our trading partners over the past few years.

More recently we have seen a surge in the trade deficit that reflects the effects of the East Asian crisis. Sharp drops such as those seen in the value of the East Asian currencies lead to an increase in U.S. demand for the goods produced by these countries (which are now much cheaper to us than before). At the same time, the East Asian countries have cut back sharply on imports of goods from the U.S. both because our goods are effectively much more expensive for them, and also because their incomes have fallen substantially.

Our sales to these countries have fallen sharply. Data for the first three months of this

year show that our exports to the five most-affected countries are down between $17 billion and $21 billion (annualized) since the crisis began, depending on how one does the seasonal adjustment. Roughly two-thirds of the lost sales were to Korea. Exports to Japan are down another $6 to $8 billion over this period. Thus the total adverse movement across all six countries has been $23 to $29 billion. We expect the loss in sales to worsen during the remainder of the year, especially if Asian economies continue to contract. Furthermore, we have not yet seen the large increase in imports from the Asian countries that their devaluations are likely to produce.

It is often argued that the Asian crisis, by decreasing U.S. net exports, will diminish U.S. growth over the next year or longer. There is no denying that net exports are exerting, and will continue to exert, a drag on U.S. economic growth. Fortunately, however, the slowdown in exports to East Asia is affecting the U.S. economy at a time when domestic demand growth is extremely robust and labor markets have becoming increasingly tight. The consensus among forecasters is that the East Asian crisis could serve as the brake that subdues growth toward a more sustainable pace, preventing overheating, and permitting continued job growth with a more moderate path for interest rates and stronger investment spending than we would otherwise enjoy. There is the further side-benefit that the sharp declines in Asian currencies and the consequent decline in the dollar price of imports from that region will provide a dampening influence on inflation.

III. Are There Reasons for Concern?

My testimony so far has been that the trade deficit largely reflects the strength of the American economy. But I do not want to leave you with the impression that there are no reasons to be concerned about a large trade deficit.

First, even in the absence of any negative aggregate impact on output and employment due to a growing trade deficit, particular sectors have been adversely affected. Before 1997, many U.S. producers enjoyed rapid growth in their exports to East Asia. That has now disappeared. As I have already noted, exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. They can be expected to continue to fall in the remainder of this year. In addition, we will probably see increased imports from these countries, especially in such sectors as autos, steel, textiles and apparel, and semiconductors and other electronics. The crisis countries have no choice but to shift their trade balances into surplus, since they are no longer able to borrow from abroad to finance the trade deficits that most of them ran before the crisis. It is their inability to borrow in world capital markets that is responsible for the currency depreciations and income reductions that are in turn causing them to buy less from us and sell more to us.

The second reason for concern about our growing trade deficit follows in part from the first. Our rising trade deficit, particularly in such key areas of the economy as manufacturing and agriculture, could undermine support for internationalist principles and for market-opening policies like those outlined by Secretary Rubin in his testimony. If the widening U.S. trade deficit were to create the false impression that the U.S. stands to lose rather than to gain from continued engagement in international markets, then it would be a costly development indeed.

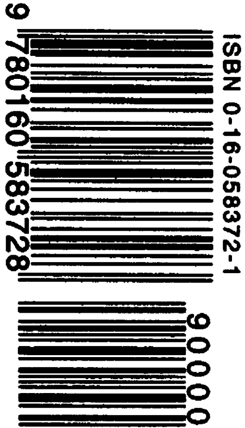


Exhibit: **Saving, Investment, and the Current Account Balance**

The current account deficit grew in the mid-1980s as saving fell faster than investment. In the 1990s, however, both investment and saving are increasing.

Percent of GDP

10
8
6
4
2
0
-2
-4
-6

Net national investment

Net national saving

Net national saving plus statistical discrepancy

Current account balance

1980 1982 1984 1986 1988 1990 1992 1994 1996

Source: Department of Commerce (Bureau of Economic Analysis).