CHAIRMAN WEIDENBAUM: Thank you. Commissioner Wessel will begin the question period.

COMMISSIONER WESSEL: Excuse me, thank you, Mr. Chairman. And I appreciate your appearances here today.

When the American people think about the trade deficit, they don't necessarily think about exchange rates and sustainability, vulnerability, et cetera. What they think about are wages and their jobs. And in some of the materials that the panel has sent to us, they talked about that up to a quarter of the fallen relative earnings of less skilled Americans was due to trade and that there are large implications in terms of the distribution of the job impacts from the trade deficits.

At our August hearing and in previous comments by Chairman Greenspan and former Secretary of the Treasury Rubin, they talked about the question of whether the trade deficits are sustainable.

My question is in terms of the way the American people look at these trade deficits and what occurs to them, what impact it has on them, what are your views about where they will fair? What are the distribution of the income changes, the job changes, and what impact would there be if in fact we find out that the trade deficit is not sustainable?

CHAIRMAN WEIDENBAUM: The member of the panel, Dr. Collins?

MS. COLLINS: Let me -- your question raises a large number of issues -- let me make two comments in response. One of them is that there is a widespread view that because the trade deficit is very visible that some of the things that have happened at the same time that trade deficits have increased have therefore been caused by trade deficits. My view of extensive empirical analyses as well as some theoretical looks at this question is that in fact a number of other things, in particular, technology changes are at the heart of part of the trade changes as well as some of the other things that you're talking about.

Now, I think that there is a very difficult issue in terms of making those points generally, and the reason essentially is that many of the benefits are very widespread, but the costs are very highly concentrated.

And, so the point that I made at the end of my comments is that I think that there are reasons to be concerned about individuals who are bearing the costs associated with, for example, displacement and that the ways to address that though are not related to trade policy. They're related to policies that are directly focused on those groups or individuals who have been adversely affected.

As far as the effects on wages, I mean, many of the concerns of some years ago I think are literally less salient today, because what we've seen is that as the U.S. economy's strength has continued, that many of the benefits have been much more widespread. And, in particular, average wage performance in recent years has increased pretty significantly. And, so I think a strong economy in which growth and job creation continue is the best message to give American people about their concerns about employment prospects, et cetera.

CHAIRMAN WEIDENBAUM: Professor Feketekuty.

MR. FEKETEKUTY: The basic point I would make is that it does create a burden on U.S. trade policy, because it makes it difficult for the United States to play the kind of leadership role it should be playing. The trade deficit creates a general public impression that we're in trouble, that we have a problem. It therefore undermines our ability to pursue a sound trade policy and to provide effective leadership in trade.

Secondly, I would argue that while the impact on the wages of the unskilled workers in basic industries is marginal, the public tends to blame most of the impact of technological change on trade.

Even though the public perception of the impact is much larger than it probably is in reality, in trade policy, perceptions have an effect. The bottom line is that the trade deficit burdens U.S. trade policy.

CHAIRMAN WEIDENBAUM: If I can follow up Commissioner Wessel’s point, and my question really focuses mainly on the work of Mr. Beach and Dr. Collins, have you had the opportunity in your econometric analysis of looking at imports and exports separately? And, if so, to what extent has the growth of our exports been associated with the growth patterns -- economic growth patterns of our trading partners? And to what extent have our imports grown because of the growth of our own economy? Can you sort that out?

MR. BEACH: Mr. Chairman, let me venture a little bit on that, because I hope we can develop this point as we go forward today, since I think it’s a basic point behind all of our discussion.

Over the last 18 months, we’ve been spending a lot of time in California -- it’s a lovely place to be -- working with organizations out there, businesses out there, to better understand how the Asian financial crisis, which now is lapsing I hope into the Asian financial recovery, affected the economies there.

In the course of doing that, we discovered quite interesting things about the current trading situation. First of all, the long-term direction of commodity prices is extremely important to understanding how employment is changing in trade related businesses. I think the Asian financial crisis really emphasized that, but look at the cotton exports coming out of the United States. Cotton prices around the world are dropping dramatically and have been dropping dramatically for decades. Oil is the same way.

So, we're caught, in some respects, in long-term secular changes that are going on, have been going on for some time, and we keep those in mind when we talk about employment is recomposing itself.

There are employment gains from imports. We've been looking at industries that are specifically sensitive to the import side, and we see substantial gains in employment there. In fact, we're seeing some good wage growth there, as well. These are jobs coming in, being created on the import side to sell these imports, to service these imports, to service the financial side of these imports, and the wage growth is substantial.

In a couple of my simulations, I in fact note the employment side related to imports and note how that is sustaining higher disposable income in households above that, which is related to the export side.

CHAIRMAN WEIDENBAUM: Dr. Collins?

MS. COLLINS: I'll respond, as well.

Again, two points. I think that it is a little difficult to decompose the two as directly as you suggested, and let me give an example for why. As we anticipate further recovery in the rest of the world, including not only the countries that experienced currency crisis but also in Europe and hopefully in Japan, that strengthening and demand would be expected not only to increase demand for U.S. goods, which hopefully would increase export growth -- and, yes, export growth from the U.S. did decline as the rest of the world's economies weakened -- but it would also be expected to affect international capital flows.

And, in particular, one would expect some reallocation and shifting away from some of the safe haven assets in the U.S., and, as a result, one would expect and would come out of the models, you would see some dollar depreciation. The relative price adjustment would have effects on both imports and exports, of course.

And, so I think that many of the exogenous or the changes, such as you suggest, would end up in a model actually affecting both exports and imports. And, so one has to be careful about separating them out.

One additional point that I'd like to make though is that there's often a sense that it's the import competing sectors of the U.S. where most of the job displacement is concentrated. And in fact some of the econometric evidence that I've seen suggests that in fact if one looks at import competing industries as a whole -- that means not focusing on individual industries, such as textiles and apparel -- what one sees is that on average the rate of job displacement from import competing industries is no larger than the rate of job displacement from export competing industries.

We have a country in which there is significant job turmoil and job changes, et cetera, and in fact that job displacements are dispersed throughout the U.S. economy and that the sense that they concentrated in only imported competing industries in some of the empirical analysis I've seen is in fact not borne out by the data.

Apparel and textiles, for example, is an industry which does have very high displacements rates, but there are other industries that do not.

CHAIRMAN WEIDENBAUM: Dr. Preeg?

MR. PREEG: To try to get back to Mr. Wessel's original question, how do you explain this to workers and is it in our interest, I think it's important to distinguish between the debate over whether we should have an open, liberal trade policy, a separate issue, and the problem that we face with a large and now record trade deficit for almost 20 years.

I am in favor of the first and concerned about the second open, liberal trade policy through NAFTA, et cetera, means exports and imports both go up. One line of argument in favor of such growth in two-way trade is that export jobs are higher skill, higher pay. There is a need for adjustment by some workers in import competing industries. But is a set of questions over whether we should have a liberal trade policy.

Within the context of having open trade, and in recent years a full employment economy to boot, we still have a quite distinct set of questions about the impact of the chronic trade deficit situation. And should the deficit be a concern to workers?

And on that, I'd make two points. Certainly, it's a concern, because it means essentially we’re living beyond our means. We have a current account deficit, three to four percent of GDP. We are borrowing that from foreigners year after year to subsidize or pay for additional consumption and to some extent investment. And that should be of concern to our workers, because the foreign debt is going to be hanging over our heads for years or decades to come. That’s the point I made earlier.

The other question is if we have a big deficit, what will it mean to get rid of it? Is that going to impact on workers? And, here, I just take issue with one point Gesa made. He talked about not having been willing to throttle -- that was his choice of word -- our economy to deal with the trade deficit.

MR. FEKETEKUTY: No, I said we wouldn’t, we shouldn’t.

MR. PREEG: No, but you used the word “throttle,” and I'm saying that you don't necessarily have to throttle the economy. In fact, what we mean by adjustment at this stage, if it's three percent of GDP, is that we've got to a shift resources three percent out of consumption and to some extent out of investment and into the export sector, the net export sector, meaning more exports and in fact less imports. And if we can do that adjustment smoothly within the economy, we don't have to throttle it. We can have full employment right through, although obviously we're going to be shifting resources, and that can cause some adjustment problems in particular industries.

The real question -- if you conclude that the deficit is not in our interest and we must bring it down, is how to do it? A "soft landing" is the way of defining a shift of three percent of GDP into the net export sector in a way that has minimal disruptive effects and transitional costs.

The exchange rate has a role as do interest rates, and this can affect workers, but I would think American workers would also conclude that we've got to do it, because we don't want to prolong these deficits and live off borrowed funds abroad indefinitely.

Thank you.

CHAIRMAN WEIDENBAUM: Thank you.

Mr. Papadimitriou.

VICE CHAIRMAN PAPADIMITRIOU: Dr. Collins, from your commentary, I didn't get a sense whether you believe that the trade deficit is sustainable or unsustainable and if it is sustainable, then we should not worry about whatever that deficit might be. If it is unsustainable, what are we then to do?

MS. COLLINS: My comment -- the point I

intended to make -- let me clarify -- was that my reading of the forecast looking forward are that would I anticipate, best guess scenario, is one in which for a few years the U.S. trade deficit may actually get somewhat worse before it improves. Certainly, the U.S. cannot maintain a significant trade deficit forever, and so that's where this issue of the adjustment comes into play. And the question then is what the adjustment is likely to look like.

My reading of the models and the analyses that I've seen suggest that what has been called a soft landing is more likely than I think Dr. Preeg believes it is. I think it's impossible to rule out the possibility that there is some kind of a major change which would create a more difficult adjustment process.

But, so my point is that if the U.S. continues to implement sound macroeconomic policies, which include foresight in terms of its long-run budgetary obligations, Social Security, and those kinds of issues, and continues the kind of macroeconomic policies it has, it actually has quite a bit of freedom and leverage if it were to happen that something unforeseen occurred that created a much different outturn.

So, is the situation sustainable? Well,

the scenarios in which it maybe gets a little worse for a few years before some adjustment takes place I think is one that is very believable and conceivable and works. Is it necessarily what we will see? Of course, no one can say that.

So, that's perhaps a less simple answer than I would like to be able to offer, but I hope that that clarifies the remarks that I made.

CHAIRMAN WEIDENBAUM: Thank you. Commissioner Rumsfeld?

COMMISSIONER RUMSFELD: Without trying to predict what's going to occur in the future, I would think it would make some difference as to whether the deficit was for the purpose of investment or consumption when you come to the question of sustainability. And I noticed that in the responses, we seem not to be disaggregating those two issues.

One would think, at least I would assume, that we would be able to sustain over a long period a deficit, if it were essentially going for investment where it might be somewhat more difficult if it were going for consumption. Is that true?

MS. COLLINS: Absolutely. In the comment that I distributed, I did disaggregate and address that issue somewhat. I did not do so in my oral remarks. If one look at recent U.S. data, what you see is I guess two things.

One is on the investment side. After some declines in U.S. investments as a share of its total output, U.S. investment rates have been increasing. And I take that as good news. I think that's associated to some degree with the improvement in productivity that we've seen and that we all hope will continue.

At the same time, there certainly in recent years has been an increase in private consumption that's associated with a decline in personal savings, and we know that that's been offset by increases from savings from other parts of the economy, in particular, the government and corporate sectors. So, overall, the U.S. savings performance looks good with a major concern about what's happening to households.

So, in some ways, my reading of that is that there are many things to watch and to be cognizant of. If we knew how to raise the personal savings rate, there are a number of things perhaps we could do to address that, but that's a very difficult question.

So, the increase in investment which has occurred, I think we should see as good news. I think the personal consumption boom is a reason to monitor and to perhaps have concerns down the road.

CHAIRMAN WEIDENBAUM: Mr. Preeg.

MR. PREEG: A two-hander, because I really don't agree with some of the line of assessment here, particularly that we can establish causality between whether investment and consumption are going up or down within the U.S. economy and the fact that we have a large or a growing external deficit.

It's a complicated macroeconomic policy question, and one of my attachments is a recent piece in the Financial Times that addressed the issue. **[See Insert 2]** Investment has been going up over the last five years as a share of GDP is a fact. But my judgment is that we're having an investment-driven economic growth. It is unrelated to whether the foreign deficit has gone up or down.

The real question is how to establish causality. When the current account deficit goes up, -- which by definition means increased borrowing -- does this lead to increased consumption or increased investment or both, and in what proportions.

If it were all investment and there are Economists who believe this -- I quote this year's CEA report of the Clinton Administration which strongly implies following this line. I don't believe that this conclusion holds up. Based on the limited facts available, I believe that about 80 percent of the borrowing each year goes to immediate consumption rather than incremental investment. And if this is so, there is a real question of sustainability in that certainly at some point there will be too much debt for us to sustain.

That is the key point, and I would hope the Commission would come to a relatively clear conclusion on this issue.

[Insert 2]

Financial Times

The deficit trap

by Ernest H. Preeg*

The U.S. current account deficit could reach a record $350 billion this year, April 25, 2000, the eighteenth deficit in a row. As a consequence, the United States has shifted from a net creditor nation of $350 billion in 1980 to a net debtor of $800 billion in 1996 and $1.5 trillion in 1998, headed for $2 trillion early in the next decade. This foreign debt equates to almost 20 percent of gross domestic product now, projected to 30 percent by 2005.

An important question is whether these large external deficits – which are principally trade deficits – are a good or bad thing for the United States. Many and perhaps most observers believe the deficits are not something to worry about and could in fact be beneficial to the United States. I disagree.

The disagreement hinges largely on whether the growing foreign indebtedness is used to finance incremental U.S. productive investment or immediate consumption. The non-worriers believe that all or most of the deficit reflects additional investment whereas my conclusion is that about 80 percent goes to immediate consumption.

The classic statement in support of incremental new investment was made by Herbert Stein in The Wall Street Journal ten years ago ("Don't Worry About the Trade Deficit", May 16, 1989): "The U.S. has a trade deficit because people in the rest of the world invest their savings here…. As a result of the capital flow…the stock of productive capital in the U.S. is…higher than it would otherwise have been…. This inflow of capital has been mainly of benefit to American workers who as a result of it work with a larger capital stock and have higher productivity and real incomes”.

In February 1999, the Annual Report of President Clinton’s Council of Economic Advisors came to a similar conclusion: “Since 1993…current account deficits have been driven by increases in investment, with foreign financing taking the form of both direct and portfolio investment”.

These assessments, unfortunately, are analytically flawed. It is true that an increase in the trade deficit, by definition, goes hand in hand with an increase in foreign investment in U.S. assets. The dollars accumulated from the trade deficit have to be invested somewhere, including in bank accounts and U.S. Treasuries.

The key question, however, is not whether foreign investment increases but rather whether such foreign investment leads to a higher level of aggregate investment in the U.S. economy or to a switch by Americans from domestic investment to domestic consumption. The reality is that the latter, switching effect, is probably dominant.

For example, the Asian financial crisis of 1997-98 caused an increase in the U.S. trade deficit on the order of $100 billion. U.S. exports fell as Asian economies declined and U.S. imports grew from the lower, more competitive Asian exchange rates. The resulting $100 billion deterioration in the trade account, in keeping with the inexorable definition cited above, corresponded with $100 billion of additional foreign investment.

The impact of the additional foreign investment on aggregate U.S. investment and consumption, including the critical switching effect, is nevertheless not self-evident and depends on various forces in play to bring about the macroeconomic adjustment. The decline in the U.S. export sector and cheaper imports from a strengthened dollar could together shift the aggregates toward greater personal consumption. A somewhat lower interest rate from the dampening effect of the growing trade deficit on inflation would tend to stimulate both investment and consumption.

Higher stock market prices from foreign investors would stimulate consumption through the "wealth effect".

There is no available analysis that shows clearly whether investment or consumption would be stimulated disproportionately as a result of the various macro economic forces engaged, and the best that can be assumed is that the proportional effects are more or less neutral. However, U.S. personal consumption, in absolute terms, is more than four times larger than gross private investment ($5.8 versus $1.4 trillion in 1998), and hence the conclusion drawn here that about 80 percent of the increase of the trade deficit is likely to be translated into additional private consumption, and only 20 percent into incremental investment.

A similar macro-policy assessment, including the switching effect, can be made if a larger current account deficit is initially triggered by the capital rather than the trade account.

The non-worriers make one other spurious argument in support of incremental investment during the 1990s. They point out that the investment share of U.S. gross domestic product has increased by two percent from 1993 to 1998 while the consumption share has declined by one percent, with the additional foreign investment recorded during these years given credit for much of this rise in investment share. There is no justification, however, for assigning such causality. The U.S. economy has indeed experienced an extraordinary investment-led growth in 1990s, but it is far more likely to have been driven by new technology application and industrial restructuring within the U.S. economy than by the growing trade deficit. If, without an Asian financial crisis, the trade deficit had not increased by a $100 billion, there would still have been investment driven growth in the U.S. economy, but the increase in the investment share of GDP would have been somewhat smaller, and the drop in the consumption share would have been a little larger.

The foregoing is the principal analytic basis for my worry about continuing large U.S. trade deficits. Interest and dividend payments on accumulating net foreign debt are already about $100 billion per year, and this figure could more than double by 2005. These debt servicing payments, of course, would continue to be made by the children and grandchildren of those Americans now on a consumption binge, thanks to almost 20 years of unprecedented foreign borrowing.

This concern about a generational income transfer abroad, moreover, raises an additional worrisome prospect. The deficit on current course is simply not sustainable, and the longer it prevails, the more likely will be a disruptive and costly adjustment, for both the U.S. and the global economies. It makes more sense to take the appropriate steps to reduce the deficit now rather than later. Regrettably, as long as the Stein/Clinton assessment prevails that the trade deficit is nothing to worry about, any official steps will be hesitant at best.

*Ernest H. Preeg is a senior fellow at the Hudson Institute in Washington, where he directs a project on the chronic U.S. current account deficit and a new economic architecture.

COMMISSIONER RUMSFELD: Mr. Chairman, may I ask one other question?

I read things from time to time that suggest that the data is not only not perfect but in some cases not really very useful and possibly misleading. Could whoever would like to comment on how comfortable you are with the elements that make up the trade deficit and their accuracy or lace of accuracy or precision?

MR. BEACH: Well, I suppose I should say something first to give my colleagues a moment to reflect on this.

You can't work with data on the international scene, Mr. Rumsfeld, without a high degree of either tolerance for missing data, out-of-period data, changes in data -- I mentioned only what's coming out of Russia -- or sort of a naivety about the world.

We have what we have, and we work with that. OECD data -- the data certainly on the 18 major countries of the OECD are pretty good, and I use that exclusively in my model. That also covers most of the trading partners of the U.S. So, when we're dealing with trade numbers to know what's happening in the European countries, in Canada, in Australia, in New Zealand, Japan, they're data is good. They're based on the same accounting system we have, basically the same period. They report on a daily basis what's happening in their markets -- the capital and equity markets, and so forth. I'm fairly happy with that.

You should hear the testimony or you should read the work of some of the people who have worked on the BEA accounting system, and I think the major improvements have been made there. So, we understand better internally what's happening, certainly with the standard industrial classification changes and so forth.

So, I'm happy with the data that I have; wish it was better, wish it was better. But for the major countries, we're in pretty good shape.

If I could just address -- use that as a way to address something else about the sustainability of the net exports or the trade deficit. We're calling for those numbers, the current account balance to be significantly negative for the next four or five years. At the same time, we're calling for fairly steady growth in the overall general economy, because of the strong growth on the investment side.

But the critical factor here in this model and I think in most of the large ones, is what's happening to the recovery in Asia and what's happening in Europe. If you get a good recovery in Japan, Europe pulls together around the euro and moves forward, it is possible to see these trade deficits being sustainable for a significant amount of time.

There's a wall out there, and that wall is financing publicly provided pensions in the OECD countries. Only Great Britain really faces the 21st century without significant pension unfunded liability; Australia, perhaps, as well. We don't know yet. But most of the countries that are in the OECD have significant borrowing requirements beginning about 2010.

And, at that point, I would think that these particular deficit numbers would be decidedly unsustainable. It raises a different dimension to this question but certainly one that this Commission is -- in fact, all that are working in public policy need to bring into the debate.

CHAIRMAN WEIDENBAUM: Thank you.

Commissioner D'Amato?

COMMISSIONER D'AMATO: Thank you, Mr. Chairman.

I would also like to thank the panel for coming today. I really appreciate this testimony.

I want to focus on Mr. Preeg's testimony. I want to say that, Mr. Preeg, I found your testimony -- the written material you provided us very provocative and thoughtful. And you raised issues that we don't normally get in testimony from economists, because you try to connect the big dots between politics and economics.

I'm particularly intrigued with your worry number three: foreign government leverage against the United States. One could speculate, Mr. Secretary of Defense, that the relevancy of the military playing field may be coming less of a priority in the world and the economic playing field more a priority, simply because we're such a Super Power that in order to compete with us another power's got to look for another way to compete, and we hear some commentary by Chinese officials about financial pressures and that sort of thing.

My question concerns the willingness of foreign powers to compete with us in this area and how large an accumulation of dollars that they hoard, based on these big sustaining deficits, is required before our vulnerability to financial pressure or blackmail or attack becomes too acute?

Specifically, let me ask you this question about the accumulation of dollars -- private versus central bank holdings. Mr. Preeg, you suggest that from the period 1990 to '96 the total of foreign central bank holdings of dollars went from $486 to $947 billion, which equated to 90 percent of the U.S. current account deficits. This increase seems to indicate that the demand for U.S. dollars was not simply a private market phenomenon.

Does this large increase in foreign official holdings of dollars indicate that foreign governments are manipulating the foreign exchange value of the dollar to gain a trade advantage? And is such foreign government intervention a cause or a part of the U.S. trade deficit?

MR. PREEG: Let me try to separate two questions you raised, one about whether other governments manipulate exchange rates to their trade advantage, and the other a more political question: Do some of them now have excessive dollars that might be something we should worry about?

On the first question, I certainly agree with your choice of verb. That's the IMF article IV verb, do governments, or members manipulate their exchange rates to commercial benefit. And there are a couple of pieces attached to my statement where I see clearly in the case of Japan, for example, during the 1990's, that based on the IMF criteria, it has been manipulating its exchange rate to mercantilist purpose and effect. **[See Inserts 3 and 4]**

Certainly, the cumulative impact during the six years, ’90 to ’96, where 90 percent of the dollars that accumulated abroad from our current account deficits were in effect taken off the market and put in central banks, was to keep the dollar significantly higher than it would have been just from market forces and with a lag effect time that this increased our trade deficit as a result.

There is thus first the relationship in terms of whether governments manipulate exchange rates which, in turn, is related to something explained in yet another attachment here. It’s a basic question about what people refer to as a new financial architecture, which isn't so much about bigger and perhaps better IMF loans but rather the fact that we're in a floating exchange rate relationship with most of our trading partners. It's a managed floating rate, but how do we manage it and how do we intervene in markets and what is a prudent level of reserve holdings? I believe these are important questions.

My conclusion is that we need less reserves with floating rate relationships, and with free floating, we wouldn't need any. Therefore, I would see Japan and some other countries -- South Korea at this stage and Europe -- I’ll come to China in a minute --

having excessive reserves, and that worries me not only because of the mercantilist effect, if they keep building them up, but also having these large reserves that they could use in some way to commercial or foreign policy advantage against us.

China is quite distinct, because it has a fixed

rate, but it's not a convertible, their currency. The Chinese have built up their reserves even faster in relation to the level of imports in recent years. They now have reserves more than 100 percent of annual imports, which is far above traditional World Bank or other indicators of a "prudent" level.

This is a major problem in defining the new financial architecture, which has an impact on our trade deficit.

A last comment; is that excessive dollar purchases were certainly major factors during the years '90 to '96 related to the uneven adjustment of national economics to globalization. It was not a factor, however, in '97 and '98 because of the Asian financial crisis. The dollar was stronger than the most mercantilist-oriented government could hope for during these last couple of years so no one had to buy dollars for that reason.

This year coming out of the crisis, Japan has again been buying a lot of dollars expressly to keep its currency from strengthening too quickly, even though it has a large trade surplus. South Korea, the same way, although hopefully not to continue much longer on this buying binge of dollars.

There definitely is a major question about exchange rate policy use for trade policy objectives and the building up of reserves to where they're excessive. This, in turn, should be a concern as to how they might be used in the future.

[Insert 3]

Journal of Commerce

"Japan's actions look and quack like mercantilism"

September 7, 1999

Letter to the Editor

Ronald Babula of the U.S. International Trade Commission, in his August 17 letter rejecting the notion of a mercantilist Japanese exchange rate policy, directs his attack at three recent opinion articles in The Journal of Commerce, but does not reference their author. I admit to being the author of all three articles and offer the following rebuttal to Babula's wrong-headed conclusion.

Article IV of the IMF Articles of Agreement states that members shall "avoid manipulating exchange rates…to gain an unfair competitive advantage", and surveillance procedures include "protracted large-scale intervention in one direction in the exchange market" as a development that might indicate such manipulation. This is the starting point for defining the use of exchange rates as a mercantilist instrument of trade policy.

From 1992 to 1996, the Bank of Japan made protracted large scale interventions in currency markets, increasing total reserves from $72 billion to $220 billion, which amounted to 65% of annual imports by 1996. During these same years, Japan had a large and protracted trade surplus and, if anything, the Central Bank should have been selling rather than buying foreign exchange so as to avoid an unfair competitive advantage on trade account.

In 1997-98, the dollar was exceptionally strong as a result of market forces related to the Asian financial crisis and there was a hiatus in Bank of Japan foreign exchange purchases. In 1999, however, there has been a strong resurgence, with $23 billion of reported purchases during June alone (Wall Street Journal, July 21). Japanese officials, moreover, have explicitly acknowledged that these purchases were intended to avoid a strengthening of the yen that would dampen export-led economic recovery. Meanwhile, Japanese trade remains in large surplus.

Since all these facts look and quack like the IMF definition of mercantilism, I conclude that Japanese exchange rate policy has indeed been mercantilist throughout most of the decade.

Babula cites two specific "problems" with my articles, but in both cases he misquotes me. He states that I wrongly "assume" 95% of Japanese "total" reserves are held in dollars, while in fact I have estimated elsewhere, based on knowledgeable sources, that in 1996 95% of Japanese foreign exchange reserves were in dollars. Recently, Japan has probably been buying more European currencies, but dollar holdings still predominate. In any event, my mercantilist conclusion is based on total foreign exchange purchases.

The other cited "problem" with my article is that public and private sector financial data do not support a positive correlation between Japanese official dollar purchases and a weak yen, but I never claimed such a correlation. I simply state that protracted large-scale purchases result in a weaker yen than would otherwise prevail, which is sufficient to draw a currency manipulation conclusion as defined by the IMF.

Finally, there is the relation between Babula's denial of Japanese currency manipulation and official U.S. policy. The Omnibus Trade and Competitiveness Act of 1988 requires semiannual reports by the U.S. Treasury as to whether other nations manipulate exchange rates to gain unfair competitive advantage in international trade. In all consequent Treasury reports, however, Japan has never been mentioned as a possible currency manipulator. On June 30, 1999, during confirmation hearings for Secretary of the Treasury-designate Lawrence Summers, Senator Paul

Sarbanes referred to recent reports of currency manipulation for competitive trade advantage, and asked if the U.S. Treasury had identified any trading partners engaged in currency manipulation. Summers responded that he had not received such reports and that no country has been officially identified as a currency manipulator.

Secretary Summers thus concurs with ITC supervisory trade analyst Babula that Japan has never used exchange rates as a mercantilist instrument of trade policy. U.S. policy is evidently consistent but, in analytic terms, it is also deeply flawed.

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[Insert 4]

May 27, 1999

Hudson Institute *American Outlook*
The New International Financial Architecture

By Ernest H. Preeg*

Exhaustive discussion over the past couple of years about a new international financial architecture has focused on better and possibly bigger International Monetary Fund (IMF) lending facilities for financially troubled emerging market economies such as Mexico, Thailand, Indonesia, South Korea, Russia, and Brazil. It will rise again to ministerial level at the World Bank/IMF meetings in Washington in September.

Unfortunately, this discussion is largely misdirected. A new financial architecture is emerging, but it principally involves a transition from the dollar-based system of the past half-century to a truly new framework of floating exchange rates and monetary unions, and in the process the IMF role should be reduced greatly. The most important policy challenge is to define currency relationships evolving among the dollar, the euro, and the yen, including how to deal with the unsustainably lopsided current account relationship of record U.S. deficits offset by large surpluses in the other two key currency areas.

The emerging new architecture is a result of rapid growth in international trade and investment since the mid-1980s and a parallel integration of world capital markets. As a consequence, government attempts to defend an exchange rate linked to the dollar have become very costly or unfeasible. Recent financial crises in Asia and elsewhere have all been triggered by futile government attempts to maintain a dollar-linked exchange rate, and the result for all six countries listed in the first paragraph has been a shift to a floating exchange rate policy.

The new architecture, in fact, consists of two strong tendencies, either toward floating rates or monetary union, which can be called the “two corners architecture” to reflect this bipolarity. The monetary union option has been adopted in Europe through the formation of the European Monetary Union (EMU) and is being discussed within the Western hemisphere in terms of “dollarization”, whereby other countries simply adopt the dollar as a replacement for their national currencies.

The initial thrust of the new architecture, however, apart from the EMU, is almost entirely toward the floating rate corner, qualified as a managed floating rate policy, and much depends on how “managed” is defined. In particular, central bank intervention in currency markets, which can have significant impact on exchange rates, needs more clearly defined guidelines and disciplines. Such intervention, in recent years, has been used by some others as an instrument of trade policy, whereby the central bank buys large amounts of dollars to keep its exchange rate low and thus to stimulate a trade surplus. This mercantilist objective was especially strong during 1990-96 when foreign central banks increased dollar holdings by $461 billion, equating to 90 percent of the U.S. current account deficit during those years. The result was a stronger U.S. dollar than would have occurred from market forces alone, and a possible doubling of the U.S. current account deficit by the end of the period. The financial crises of 1997-98 kept the dollar very strong on its own, but as recovery begins in 1999 a renewed interest in central bank purchases of dollars is evident in some countries.

At this transition stage for the new architecture, the relationship among the dollar, the euro, and the yen is a managed float with very different definitions of “managed”.

The United States follows a basically free float with minimal currency market intervention by the Federal

Reserve Board and the U.S. Treasury. The rare and highly publicized intervention to support the yen in June 1998 amounted to less than $1 billion.

Japan, in contrast, has consistently used exchange market intervention as an instrument of trade policy. The Bank of Japan buys large amounts of dollars when the yen strengthens to the point of restraining Japanese exports. Official reserves have consequently increased from $72 billion in 1992 to $220 billion in 1998. When the yen rose to 110 in January 1999, the Bank of Japan immediately bought $8 billion to push the rate back down.

The EMU doesn't yet have an exchange rate policy. As long as the euro is weak there is no interest in European Central Bank intervention, and the euro floats freely. But if the dollar rate should strengthen to 1.25 or more, while unemployment remains in double digits in key member states, pressures will quickly develop to buy dollars and avoid a decline in the European trade surplus.

Other major trading nations, including Canada, Mexico, Brazil, South Korea, Thailand and Indonesia, also have ill-defined floating rates. Interest rate policy is often used in conjunction with currency market intervention to influence the exchange rate. South

Korea, now on the post-crisis recovery path, has been able to bring interest rates down below pre-crisis levels while the central bank buys large amounts of dollars to keep the won weak and the trade surplus intact.

A big question mark country for the new architecture is China, with the yuan pegged to the dollar, but on a nonconvertible basis. The result has been a consistent Chinese trade surplus and a huge build-up of official reserves by the central bank to $149 billion, or more than 100 percent of annual imports. The implication is that the nonconvertible yen is undevalued, although China threatens to move in the other direction and devalue its currency further. At some point, the yuan needs to become convertible, and then the same “two corners” pressures will come into play. Hong Kong will also be affected because the Hong Kong dollar has been linked to both the U.S. dollar and the Chinese yuan, and if the latter were to become more flexible with convertibility, Hong Kong would have to choose whether to link to the U.S. dollar or the yuan.

In parallel with the broadening of the basic two-corner architecture, IMF loans would become less necessary or useful. Mexico, which floated its rate in 1995, then went on to float successfully through the financial crises of 1997-98 without recourse to the IMF or other large official borrowing. It is doubtful that other emerging market economies now with floating rates will again need the kind of large financial packages put together over the past four years. A major benefit of a floating rate policy, in fact, is the discipline it imposes on governments not to let fiscal, banking, and other policies drift dangerously out of line.

In terms of geographic scope of the emerging new financial architecture, the industrialized countries, which account for 65 percent of world trade, are now all clearly in one or the other corner, with monetary union in much of Europe and managed floating rates elsewhere. One consequence is that none of these countries has taken out an IMF loan in more than 20 years. As emerging market economies follow this path toward the two-corner orientation, the "IMF graduates" share of world trade should rise to 80 percent or more.

There will still be an IMF role as the international forum for developing guidelines and disciplines for the new system, and for providing technical assistance for banking sector and other reforms in developing countries. But IMF lending programs, in addition to being much smaller, will focus more and more on the poorer, mostly smaller countries on the periphery of the international trade and investment system. Moreover, this geographic shift increases the overlap between IMF and multilateral development bank programs, and strengthens the case for merging IMF and World Bank lending programs.

From the U.S. perspective, the definitive shift from a dollar-linked to a floating rate financial architecture is equally stark. Canada and Mexico, the United States' two largest trading partners, accounting for one third of total U.S. exports, have close to a free float policy. Adding in Europe and Japan brings the share of U.S. exports up to 65 percent, and floating rate emerging market economies increase the share to at least 75 percent. China/Hong Kong and Argentina, in fact, are the only remaining major trading partners with an exchange rate clearly pegged to the dollar.

It is only in the context of this greatly changed set of financial relationships, and in particular the systemic shift to managed floating rates, that the record U.S. trade and more broadly based current account deficits can be addressed. In January 1999, Secretary of the Treasury Robert Rubin stated for the first time that the U.S. deficit is not sustainable, and the reasons are clear. The eighteen-year chronic current account deficit has transformed the United States from a net creditor nation of $350 billion in 1980 to a net debtor of $1.2 trillion in 1997, headed for $2 trillion by 2000. This equates to about 20 percent of U.S. gross domestic product, projected to rise over 30 percent by 2005. With $300 billion of additional debit accumulating abroad each year from the current account deficit, sooner or later there will be offsetting downward market pressures on the dollar to reduce the external imbalance. A slowdown in the U.S. economy and/or a pickup of growth in Asia and Europe could trigger such a shift. In the current state of highly integrated financial markets, moreover, the shift could be abrupt, with substantial adverse impact on U.S. economic growth and stock markets. This is the "hard landing" scenario, and the policy question is what governments should or should not do within the new floating rate financial architecture to avoid a hard landing.

One thing the United States should not do is increase import protection to reduce the trade deficit because that would be self-defeating and lead to an even harder landing. The counterpart restraint in the financial field is for governments, and particularly the U.S., Japanese, and European governments, not to resist an early, orderly decline in the dollar as market forces dictate. As explained above, some other governments during the 1990s have used the exchange rate as an instrument of a mercantilist trade policy, and this should stop or be stringently constrained. More precisely, trading partners that have current account surpluses or only modest deficits – which at this point includes Japan, the European Union, China, and South Korea – should not be increasing foreign exchange reserves through central bank purchases of dollars. Indeed, under a floating rate financial architecture, a "prudent" level of foreign exchange reserves would be lower than before, and such countries with unusually high levels of reserves might, if anything, begin to reduce excessive reserve holdings.

These are the analytic and policy issues ministers should be addressing at the Bank/Fund meetings in September. A much smaller IMF lending program should be welcome, and the multilateral challenge of how to manage a soft landing for the dollar, including reasonable new disciplines on central bank intervention in currency markets, should be prominent on the agenda. Regrettably, however, such issues will likely be avoided, for two reasons.

First, purveyors of IMF loans would resist the notion of a greatly reduced financial program. A big architectural innovation of 1999 was creation of a new IMF contingent lending facility, which could result in more rather than less borrowing from the Fund by some countries. There is also a special problem with the Fund's largest borrower, Russia, currently in default to commercial lenders, and where the Fund has to offer additional loans in order for Russia to service existing IMF loans. Such linkage would render the Russian liabilities "non-performing assets" by commercial banking standards, but the IMF applies different standards.

And second and more important, there is widespread aversion to any discussion of whether the chronic U.S. current account deficit is sustainable and, if not, what to do about it. The U.S. deficit goes to the heart of the transition to a post-dollar, managed floating rate architecture, but any reduction in the deficit has to result in a reduction of surpluses elsewhere, which is politically unwelcome for most trading partners. Finance ministers continue to be more ostrich-like than forward thinking when it comes to the key components of the truly new financial architecture.

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CHAIRMAN WEIDENBAUM: Thank you.

Commissioner Krueger?

COMMISSIONER KRUEGER: Thank you very much.

I have two questions, actually, and they're distinct enough, I'd like to address them separately.

I think the first one is to Dr. Preeg, primarily, but I'd also be interested in anything the other panelists have to say. And I'm following up really on what Don Rumsfeld asked, because you were saying that you thought that something had to be done.

Now, one can talk about the exchange rate, one can talk about any number of things, but I think we would all agree, along with Dr. Collins, that if there is to be a reduction in the current account deficit, there has to be either an increase in savings or there has to be a decrease in investment. It has to be one or the other or some combination of both.

Your implication is that somehow this could be avoided. Now, I guess my question would be suppose in fact that you saw a small country with very profitable investments, but for some reason they were going to stay a rate of return above that in the rest of the world for a long, long time. Surely, an in-flow of capital would help finance those investments. It's sustainable, is it not? And the deficit has very little to do with it.

Would you cut that investment on the grounds that the country had a current account deficit? How would you -- if you really believe that something should be done, what would you do to increase savings, which, as Dr. Collins pointed out, is not something that very many of us think we know how to do?

MR. PREEG: I certainly didn’t mean to imply that we could do this without increasing savings. You have to maintain the identity. The equation has to be there. Whatever the adjustment is, savings and investment have to balance, and if we get rid of the current account deficit, which means savings from abroad, something has to adjust within our economy. The real question is how the adjustment takes place. If all of the current account deficit and new borrowing all went into incremental -- that’s the key word -- incremental investment -- then obviously we would have a problem cutting back because investment would come down. If most of it were used for consumption on the other hand, the adjustment would be quite different.

I would just make one other point. How the equation, the identity adjusts also has to do with what the causes are of the deficit in the first place and what the policy response might be. I see three causes. One is cyclical factors, which have been very important during the last couple of years for the trade deficit. That raises one set of factors and in these you sort of wipe them out or whatever you do.

The second is the question: Is there an underlying savings gap within the U.S. economy? Aside from the cyclical effects I believe that's part of it. The statistics are not good, but we need to do something internally to get our internal level of savings up.

The third area of causality concerns policies being used by other governments aside from the market forces, which essentially drive the cyclical and the internal savings investment structural balance, particularly the exchange rate policy. In some instances -- I would signal China in particular -- trade policy changes could also affect this equation aside from the market forces.

COMMISSIONER KRUEGER: But my question, I think, was a little more pointed than that.

Let's take your premise -- which I'm not sure I buy -- but let's take your premise that something, quote, "should be done" to reduce the current account deficit.

MR. PREEG: Right.

COMMISSIONER KRUEGER: Obviously, and I

think you said implicitly that you would not do anything on the investment side. I think you said that investment is a good thing, so implicitly you're saying you would somehow raise the U.S. savings rate, and my question is how?

MR. PREEG: Well, if it's the internal structural causality, there are a number of measures. We could change fiscal policy. Almost all entitlements have impact on savings, and how entitlements are structured can make a difference. Changing the bankruptcy law might make some difference around the edges.

But whatever we do to change the balance, I'm not saying it doesn't affect investment at all. If consumption is four times as large as investment and we have to shift three percent of GDP to the export sector, both consumption and investment would have to come down three percent.

There would thus have to be some reduction in investment, but it's not one-on-one between bringing down the current account deficit $300 billion, and bringing down investment $300 billion.

COMMISSIONER KRUEGER: So, what you are saying, then, is that you would basically have the U.S. Government go to fiscal surplus.

MR. PREEG: I didn't mention the Government. But Government consumption could also play a role.

COMMISSIONER KRUEGER: What policies can you use is what I'm getting at. If this is a problem, what are the policies you can use?

MR. PREEG: Well, as I have said, fiscal policy, entitlements, incentives within entitlements are other kinds of measures, such as bankruptcy.

COMMISSIONER KRUEGER: I have a second question, but Dr. Feketekuty had something he wanted to say on this one I think. Gesa had something he wanted to say.

MR. FEKETEKUTY: Just to add to what Ernie was saying, if you were somehow able to get foreign governments to accumulate dollars, the market would force an adjustment. More of that adjustment would occur on the investment side rather than the savings side.

The question, then, is what can we do to get the savings rate up. I wonder whether there are some tax policy changes that might encourage a shift from consumption to investment. We have many tax incentives that favor consumption in the tax code. We could remove some of these incentives.

As an economist, I’m skeptical of the idea that savings rates would not respond to a higher interest rate.

COMMISSIONER KRUEGER: Could I continue with my second question?

And this really goes to this question of official holdings of reserves and what that has to do with anything, because Dr. Preeg has presented us with some numbers arguing that official holdings have gone up, and we all know that especially when you’re dealing with a first difference, which is what these things are, that you could find all kinds of numbers that track all kinds of other ones.

But we’re talking about a current account deficit of about $300 billion, and according to your own numbers, foreign exchange daily transactions are $1.3 trillion. Now, the conventional wisdom out there and the kind of thing that was discussed after the Asia crisis was how dangerous all this private money was, because it was so liquid, and there was an implicit assumption that the public funds were in some sense less liable to various kinds of manipulative things.

So, the first part of the question is, do you really want to say that it’s the public holding of these funds is more dangerous than the private holdings?

And -- two other parts -- secondly, quite clearly, we had a tremendous out-flow of funds from Korea's South Thailand and so on in the Asian crisis. Then those countries imports cut back drastically, as they, a, tried to -- went into recession. So, their exports did not grow actually grow last year; it was a cut in imports. And with that, of course they built their reserves back up. Is this what you regard as exchange rate manipulation would be the second part of it?

And the third part of it, I guess, is the other way around. If indeed you think these countries are manipulating the exchange rate, how can it be then that in the 1970' and 1980's, according to your numbers, things were so different, because we had then more fixed exchange rates and countries in fact building up reserves relative to private holdings?

MR. PREEG: First point, the $1.3 or $1.5 trillion a day, much of that is back and forth. It's not quite comparable. But there's no question that --

COMMISSIONER KRUEGER: But we're talking about dangerous --

MR. PREEG: No, my first point concerns the forces affecting our overall exchange rate and balance of payments. Part of it is current account, and part of it is capital accounts, and in recent years the capital flows, particularly '97, '98, were probably dominant. But, still, current account deficits do count. If at the end of the year, there's an accumulation of three hundred billion dollars abroad that people have -- they have to invest them somewhere, this would put downward pressure on the dollar.

And my point about distinguishing what central banks do or governments do from private market forces is that those decisions are not market oriented. One can take the view, I basically do, that the best thing probably is to have freely floating rates and let the markets determine what are the exchange rates. And we may still have a trade deficit at the end of the day, because we have an internal savings gap, and that's our question to deal with.

However, when foreign governments take dollars off the market for whatever reasons, that's a non-market different factor, and it happened during these six years of the early '90s. We had an unprecedented experience -- never happened in the '70s or '80s -- that so many dollars were taken off the market by central banks, and I do relate this in the discussion to the very uneven adjustment to globalization where others had export-driven growth, and there was a strong temptation to buy dollars.

There was also the fact that trade doubled and for those who say reserves should equal 25 percent, at least, of imports, that meant -- ipso facto, governments had to have twice as many dollar reserves. That’s the World Bank criterion.

There are a number of reasons for the deficit. All I said is that if central banks take 90 percent of the current account deficit off the market, there will be a significant impact through a stronger dollar and with a time lag, a larger trade deficit.

One final question, do other governments manipulate? In other words, they didn’t increase reserves because they felt they had to have a higher prudent level, but they deliberately wanted to take dollars off the market in order to keep the yen or the won down and maintain export-driven growth. And we didn’t argue.

Article IV of the IMF says that members shall, quote, " Avoid manipulating exchange rates to gain an unfair competitive advantage." And the specified surveillance procedures state that one development that could be related is protracted large-scale intervention in one direction in exchange markets. That's a criterion as to whether they're manipulating, and obviously that would have the effect of keeping their currency down.

And related to this is the piece that came out yesterday in the Journal of Commerce -- to show that, clearly, Japan has been doing this. They've even been saying they've been doing it.

We've also had the Omnibus Trade and Competitiveness Act of 11 years ago. Our U.S. Treasury is required twice a year to report to the Congress whether any other country manipulates its exchange rate on these criteria, and not once in 11 years has the U.S. Treasury said that Japan has been manipulating on this basis.

This is a controversial policy issue, and there are members of Congress, obviously, who were more inclined to agree with me that maybe there has been some manipulation by Japan.

CHAIRMAN WEIDENBAUM: I have a list now, Commissioner's Angell, Hills, D'Amato, and Wessel.

COMMISSIONER HILLS: I just had a clarification here.

Dr. Preeg, help me here. This morning in the Wall Street Journal, it showed that the dollar had fluctuated from 137 down to 108 in the past 12 months. If I take a wider span of time, the dollar has vacillated from 147 down to -- I should ask the commissioner to my left who is the reigning expert on monetary range -- but I think about 80.

If these governments are manipulating the currencies for competitive reasons, have they been successful?

MR. PREEG: Well, up to a point. The yen was about 110 at the beginning of the year. It went to 130, and now it’s up to 109 or 10 again. They held it for a few months at 120 by buying large amounts of dollars. There was one report of $20 billion of purchase in June. At a certain point -- and they can go on year after year -- but at a certain point, it’s going to catch up with them, and that’s part of the difference, perhaps, between a soft and a hard landing scenario. If others keep trying to keep their currencies up, at a certain point, the markets can overreact -- maybe it's the $1.5 trillion a day -- much stronger than the mid-'80s when we went through a similar transition.

The adjustment, I call it a relatively hard adjustment in '85, '87, when the dollar came down by 40 percent. The managed soft landing was going to bring it down only 10 or 12 percent. But, within five weeks, with some intervention, it was already down 12 percent.

Then it went another 20 percent.

So, my answer is that governments try, and at times they can succeed for periods of time, but it can also catch up, and I think now we have to consider whether we're getting close to a point where the yen may go down more than it should just to balance out markets.

CHAIRMAN WEIDENBAUM: Thank you.

Commissioner Angell.

COMMISSIONER ANGELL: Mr. Chairman, I would like to make a comment, and then I'll get to my question, which I will ask twice.

Countries that attempt to manipulate exchange rates and engage in other mercantilist or protectionist policies largely harm themselves far more than they have the potential to harm us. So, I think that's a very important consideration.

COMMISSIONER LEWIS: Could you repeat that, please.

COMMISSIONER ANGELL: Countries that engage in protectionist, mercantilist, exchange rate manipulation programs, harm themselves and their growth rate and their well-being far more than they have the potential to harm us. We are harmed by our policy mistakes, not so much by other countries' mistakes.

Now, I would like to ask my question. Do each of you agree with the premise that it is futile to try to adjust the trade deficit without altering our saving imbalance?

As you know, we've, in the United States, always had a very large share of our GDP devoted to residential capital investment. Since 1990, non-residential capital investment has moved from nine percent of GDP to 13 percent of GDP. One of the most unusual changes ever witnessed in a modern economy, our saving rate has not kept pace.

Now, surely we all would agree that if we really wanted to increase the savings rate, that would not be hard to do. All we would have to do is to shift from an income tax system to a consumption tax system, and we could raise the savings rate dramatically. So, the fact that we don't raise the savings rate is really an indication that we don't want to raise the savings rate.

Now, if our savings shortfall continues to run at $20 billion a month and if we decided to take the trade deficit to zero, surely you would each of you agree that that would be futile, because taking the train down to zero while still spending at the rate we are out of income, would simply cause our growth rate to rise even higher. For the last five years, we will have grown -- this has a little forecast in it -- for the last five years, we will have grown at a real rate of four percent.

Taking the trade deficit to zero would add one percent or two percent or three percent to that growth rate depending upon how fast it would take the trade deficit to zero.

So, surely we would understand that it would be futile to try to reduce the trade deficit without either leaving this capital spending economy that is driving labor productivity higher or raising the savings rate.

So, I come back to my question, which I promised to ask twice. Do each of you agree that it would be futile to attempt to reduce the trade deficit while maintaining a savings imbalance of $20 to $25 billion per month?

CHAIRMAN WEIDENBAUM: Who will lead? Gesa?

MR. FEKETEKUTY: I'm not sure it would be futile but certainly undesirable. In other words, we could do it, but the consequences might not be desirable.

COMMISSIONER ANGELL: But if did it and we added one, two, three percent to a four percent real growth rate, then our growth rate would rise relative to the growth rate of the rest of the world. And so our imports would overwhelm us, right?

MR. FEKETEKUTY: As you well know, what would happen is inflation would go up and the Fed would tighten the money supply. And, so our interest rates would rise, and so we would not get that higher growth rate. What we would get is lower investment.

COMMISSIONER ANGELL: Well, but I do not agree that faster growth causes inflation. Only bad monetary policy causes inflation.

(Laughter.)

COMMISSIONER KRUEGER: Pardon me, but, Gesa, did you say -- just to repeat the question, because I think something got lost in translation -- did you say that you did believe you could cut the trade deficit without doing anything about the savings and such?

MR. FEKETEKUTY: Could I make one comment. While I agree with Ernie’s concern about the buildup of dollar balances by other reserve -- I mean countries, I don’t think the blame is entirely on foreign governments. U.S. policy bears part of the blame by pursuing policies which favor the use of dollars as a reserve currency.

We have to look at both sides. It's not

only the question of what foreign governments in accumulating dollars are doing but also what the U.S. is doing to encourage foreigners to hold dollars.

CHAIRMAN WEIDENBAUM: Mr. Beach.

MR. BEACH: Yes, I certainly agree. I'll just be very brief. As I mentioned earlier, Mr. Angell, on my concerns in this point in our history, I guess, goes beyond trade deficit to the publicly provided pensions, to our pension system. I'm not convinced that personalizing Social Security as the net national savings, but I am totally convinced that going to a consumption tax would move the savings rate very much higher. And if we can anything to use these $340 billion negative numbers to move forward the tax reform agenda, I say it's good for the country.

COMMISSIONER ANGELL: Thank you.

CHAIRMAN WEIDENBAUM: Dr. Collins?

MS. COLLINS: Just very briefly, absolutely, I agree with your comment, your question to us. A country that is on balance taking more resources for the rest of the world is by definition a country which has a savings investment imbalance.

Just let met take the opportunity to make two brief comments, which are related to Professor Krueger's questions earlier, which I see actually two pieces of the same question, which have to do with the adjustment question. Part of it is on the domestic or current account side and part of it is on the capital flow side.

On the first part of that, the scenarios that I call the orderly scenarios that seem quite likely to me -- of course one doesn't ever know 100 percent -- but they seem quite likely have the U.S. current account imbalance declining over time with increases in the gross national savings rate as well as in some cases some slight declines in the investment side.

And how is that brought about? It's brought about through a variety of mechanisms. Again, as the rest world economy strengthens, one would expect a number of things to happen there. Again, assuming continued sound macro policy in the United States, those would include some increase in demand for U.S. output.

They would also include some shift in demand for foreign assets, and those things would tend to depreciate the dollar. And as the dollar would depreciate, I actually do believe that changes in relative prices have been part of the reason for the personal consumption boom in the United States.

And, so one might expect, and some of these models bear it out, that you would see some gradual increases in that personal savings rate over time associated with that adjustment mechanism. And, so the orderly adjustment I see as certainly reflecting changes in saving and investment.

And, then, finally, on the capital side, it seems to me that the risks or the uncertainties really very much are associated with private capital flows, which are very hard to predict. The changes in the public flows, it seems to me, are much less likely to be what I called to be orderly and much less likely for concern down the road.

Thank you.

CHAIRMAN WEIDENBAUM: Thank you.

MR. PREEG: I would suggest you might want to rephrase the question, because I would say by definition it is impossible to adjust the trade deficit without change in the savings gap. It’s the definition that the savings gap equals the current account deficit.

The key difference is whether we adjust -- if it’s unsustainable and the deficit’s going to come down – the question is do we take measures ourselves -- call it soft landing -- to reduce the trade or eliminate the trade deficit -- by reducing the savings gap, or do we wait for markets to impose it through the hard landing impact on exchange rates, interest rates, et cetera.

But, without question, by definition, you cannot adjust the trade deficit without adjusting the savings gap.

CHAIRMAN WEIDENBAUM: Commissioner Hills?

COMMISSIONER HILLS: Dr. Collins, I was interested in your view that seems to be somewhat more optimistic, perhaps, than some of your colleagues on the panel. If I correctly understand you, one scenario that you see is that the trade deficit would grow over a period of time, maybe as much as five years, but not in a straight trajectory, and then the natural mechanisms of adjustment would take place, as they have in the past. Do I correctly understand you?

MS. COLLINS: Yes, that is -- and, again, the different model scenarios have somewhat different timing and somewhat different magnitudes, but, as I say, that is a scenario that I see as a believable scenario. Of course, one can never predict exactly what would happen, but, yes.

COMMISSIONER HILLS: And the holding of dollar reserves, dollars being the major reserve currency today, has actually been recommended by institutions like the IMF for liquidity in the face of increased globalization and $1.3 or $1.5 trillion dollars of private monies moving around which has created greater risk for financial disturbance such as we saw in Asia and Russia and Brazil. Many countries have tried to accumulate and have been encouraged to accumulate adequate surpluses to deal with that problem. Isn't that the case?

MS. COLLINS: Yes, very much so. In particular, in the aftermath of the currency crises, which affected many countries in Asia as well as elsewhere, many -- and I would include myself in this group -- have advocated that one piece of a prudent response is to hold a larger level of foreign exchange reserves. I think that is largely seen as a defensive response and not so much as a potentially aggressive response and not even so much as one that is directly related to trade flows.

But in some ways, one of the worst things that can befall an economy is to undergo an economic crisis, and so if one is trying to maintain or sustain positive growth rates, trying to avoid crises is perhaps one of the most important things for policymakers in developing a transition in other economies to keep pin mind.

And, so I see the increase or the move towards increasing reserves in many of those countries as in fact quite a positive development.

But having said that, one I think would expect that as the rest of the world strengthens, that the composition of those assets might become more diversified. At the moment, my reading of the data suggests that there is perhaps a larger share of dollar holding in those reserves than one might expect to happen down the road.

And, so part of that transition or the scenarios that some of the models I've talked about suggest is a reallocation and a shifting. Again, I don't see a reason to expect that not to happen in an orderly way. It's not clear to me why there's any reason to think that a country that as part of a prudent macro strategy is accumulating reserves would all of a sudden decide to make a dramatic shift from one currency holding to another. One would expect that to happen over time.

COMMISSIONER HILLS: Thank you.

CHAIRMAN WEIDENBAUM: Thank you.

Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Mr. Chairman.

I think this has been a very interesting discussion on dollar holdings. I think, Mr. Chairman, it might be useful for the Commission to have some more work done on the question of public and private dollar holdings and their implications. That would be interesting exploration for us.

But I'd like to shift to the other side of mercantilist behavior, which is basically trade flows and trade barriers. Clearly, our Asian partners have been involved in mercantilist behavior. Trying to reduce Asian trade barriers is probably the longest running show in Washington, and is alive and well today.

I've been involved in drafting all kinds of mechanisms to try and reduce those trade barriers with almost no success over the last 10, 15, 20 years.

The question I have is how do you reduce these trade barriers? You, in your testimony, Mr. Ambassador, talk about the need to reduce foreign trade barriers. Of course, we would like to reduce them, but you don't really come up with any mechanism where we can actually accomplish that.

I have two questions. Does anybody in the panel have any more ideas about how we can reduce foreign mercantilist behavior and erecting protectionist trade barriers while they invade our open market at will?

But the second thing is this: In our last hearing, one of the panelists suggested that the composition of our balance with China, our trade deficit with China, was a very large number attributable to foreign trade barriers -- I think $30 to $50 billion was something of that order.

Let me ask you, Mr. Ambassador. Do you have a sense of what portion of the trade imbalance with China is attributable to their trade barriers? And the second question is do we have any more ideas on any of the panelists as to how we can bring foreign -- particularly Asian trade barriers down?

MR. FEKETEKUTY: Thank you, sir. I’m not an ambassador, but --

CHAIRMAN WEIDENBAUM: There is hope.

(Laughter.)

MR. FEKETEKUTY: China is obviously not yet a market economy. While a large part of the trade balance is not necessarily the result of centralized governmental decision-making, it’s certainly decision-making by many different government entities and government-owned enterprises within China.

China is a country that's in the process of transition. What is the most important thing we can do right now? It's to do everything we can to encourage the market-oriented reforms in China, and one of those is to admit China to the WTO under the kind of agreement that seems to be close within reach. It seems to me that's probably the absolute best thing we can do with respect to China.

As far as the rest of Asia, the difficulty with the in trade barriers is that they're not necessarily barriers at the border. While barriers at the border remain important to developing countries, the problem in other countries is that they do not have the kind of transparent domestic regulatory systems that we do. Reforming those systems is not something you can do overnight.

What we need to do is to push and prod these countries to move towards objective, transparent, arms length methods of regulating their economies. As long as you have regulatory systems that are highly interventionist and discretionary, it provides all kinds of opportunities for mercantilist intervention by officials throughout the system, as well as opportunities for bribery and corruption.

It is in the interest of the countries themselves, as well as in our interest, to encourage them towards more transparent, objective, performance-based regulation. That is something you cannot do overnight. It requires patient, continuing prodding.

COMMISSIONER D'AMATO: Do you have a sense of the percentage of the Chinese trade that is attributable to non-trade barriers?

MR. FEKETEKUTY: No. In a sense, the whole deficit is the result of Chinese policy. I have asked the Chinese why it is that they have been accumulating these assets. I said, "Why aren't you using it for your own growth?"

Their answer was interesting. Their answer was, "We do not have a sufficient number of enterprises who can efficiently use these assets. We don't want to squander them, and what we need to do, we need to move our economy to where we have more market efficient enterprises who can efficiently use these."

They do not want to use them for consumption. In other words, they said, "We don't want to use these assets for just domestic consumption. We want to use it for investment in our economy, and we feel that not enough agents within our economy and not enough enterprises who can efficiently use them."

And I thought that was an interesting, coherent answer coming from the vice governor of the central bank of China.

Now, I think the answer, therefore, really is we need to help them to transform their -- to get rid of the state or enterprises, and we'll privatize them, remove the subsidies, and get to the point where they feel they have efficient agents who can make efficient investment decisions, and of course they'll open up to foreign investment, as well.

CHAIRMAN WEIDENBAUM: Commissioner Wessel?

COMMISSIONER WESSEL: I want to follow up on Commissioner D'Amato's question. Last week, I believe it was the International Trade Commission that released a report on China accession to the World Trade Organization, and as part of their finding, they indicated that they estimated that the trade deficit, the bilateral trade deficit, the current account deficit, would increase as a result of the current framework approach that is being negotiated.

With that in mind, is that an approach we should be pursuing or should we continue negotiations to find a more desirable outcome?

MR. FEKETEKUTY: I find it hard to see that we can get a more desirable outcome. I wonder about that result. I mean, I would have severe doubts. Given what the Chinese have put on the table, it would involve substantial reform and liberalization further in their economy in opening up.

I think all we can do really is push the

Chinese to move as fast as possible. I find in my trips to China there is no disagreement within China as to where they need to go. The whole argument is over how fast. And I think anything we can do to push the speed of adjustment within their economy is going to be in our interest.

MS. COLLINS: May I -- I agree with what has just been said. I'd just like to add one point, and that is that one needs to be very careful not to go from forecasts or projections of what might happen to the U.S. bilateral trade deficit with an individual country, to go from there to what might happen to the overall U.S. trade imbalance.

Again, the overall U.S. trade imbalance is related to the macroeconomic issues of saving investment we've been talking about, and it's much more difficult -- it's very unclear that the forecast that came out of that study for the bilateral deficit would have an obvious implication for the overall.

The movement towards integrating China with the world trading community in a more transparent way, it seems to me there are lots and lots of reasons to move forward on that. That is a medium- to long-term endeavor, not a short-term one, and it seems to me it needs to be evaluated in that light and not so much in a discussion of the overall U.S. trade imbalance.

CHAIRMAN WEIDENBAUM: Commissioner Lewis.

COMMISSIONER LEWIS: I'd like to ask -- I have several questions I'd like to ask you, but I'd like to ask you quickly one about China. They have had an enormous buildup of dollars, and they're saying they don't know how to invest it. Hasn't there been a concomitant, huge foreign investment in China during the very period of time that they've been building up the huge dollar investments?

MR. FEKETEKUTY: There has been.

COMMISSIONER LEWIS: So, there's obviously places to invest in China.

MR. FEKETEKUTY: Oh, yes, and those investments are taking -- I mean, there is a large amount of foreign investment, but I suppose the question is beyond that, the Chinese don't trust their own enterprises for making wise investment decisions.

COMMISSIONER LEWIS: Well, I want to come into the Chinese question from a different angle.

It's my understanding that the Chinese are not building up huge trade surpluses with Europe as they are with us, not because they're not selling to Europe but because they are buying from Europe much more than they're buying from us. Which means that it's almost like a matter of national policy of the Chinese to build up a huge trade surplus with us, because they wouldn't be building up a huge surplus with us, if they bought more from us, as they're buying more from Europe.

MR. FEKETEKUTY: I wonder about that. I mean, I'm not sure that that's a correct assumption; that they have a deliberate policy of building up a surplus with us. They do have a deliberate policy of diversifying their purchases and their investments.

COMMISSIONER LEWIS: It's my understanding they're buying much more from Europe than they're buying from us. I'd like to see those numbers, though.

MR. FEKETEKUTY: Yes, I mean, I haven't looked at those, but I don't get a sense that there's a deliberate policy on their part to build up a surplus with us and not with the Europeans.

COMMISSIONER LEWIS: Yes?

MR. PREEG: Well, the fact is that they have a huge trade surplus with us and they are balanced or even in deficit -- with Europe and other parts of the world. Whether there is a deliberate policy or not is a separate question, and of course China is not a market-oriented economy at this stage.

COMMISSIONER LEWIS: Things don't happen by accident in China.

MR. PREEG: That’s my impression there’s a lot of manipulation -- I’m going to use that term again -- but the question is how do we push China in the right direction? We are in this situation where they have a huge trade surplus with us and not with the rest of the world, and we should be talking about it very frankly, because that’s not good policy from their point of view or ours to have this deficit. And as they move toward a more market-oriented economy hopefully over time, and with WTO membership the commitments involved are a significant step in that direction.

They also should make their currency convertible on capital account, and some experts say that’s inevitable too. With their taking on WTO commitments the service sector and elsewhere it will be an extra push on this very important issue of currency convertibility.

But until they get a lot further along, we’ve got this major problem of the trade imbalances, and there’s no quick solution to it. I hope they understand that it’s going to cause a problem in their relations with us as long as trade is so widely out of balance.

COMMISSIONER LEWIS: I find your paper very provoking, and I’m wondering if you could give us a citation to the unrestricted war that you referred to of the two Chinese military strategists that talked about a financial war is one of the ways to compete in the future?

MR. PREEG: That was a front page story in the Washington Post during the last two or three weeks -- I don’t have the date, but I’m sure your staff can find it.

COMMISSIONER LEWIS: Thank you. And could we get a copy of the other thing that you held up, the recent studies coming out of London?

MR. PREEG: Which one?

COMMISSIONER LEWIS: Lombard.

MR. PREEG: Oh, this one.

COMMISSIONER LEWIS: Yes. Could we get a copy of that, and then we can make copies of it ourselves?

MR. PREEG: Yes, I guess so -- although this is a pricey report and there may be a copyright question . I have to reflect a little bit on that.

COMMISSIONER LEWIS: Thank you.

Okay, the question that I wanted to ask you was somebody at the last hearing said, "Trade policies don’t affect trade balances." Do you believe that?

MR. PREEG: Trade policies will have --

COMMISSIONER LEWIS: -- affect trade balances.

MR. PREEG: Well, they can, but they don’t have to.

COMMISSIONER LEWIS: No, they said they don’t. The comment was they don’t affect trade balances.

MR. PREEG: Well, it does for China, but if countries are freely floating with their exchange rates, there could be a rate movement that could be offsetting.

COMMISSIONER LEWIS: Do you believe that?

MS. COLLINS: I believe that trade policies can affect the distribution. It can affect particular industries or particular distributions by countries, but trade policies by themselves, I don’t believe do affect the overall trade balance for a country.

COMMISSIONER LEWIS: Mr. Beach, do you believe that?

MR. BEACH: No, quite frankly, I don’t. I would agree with Professor Collins on this point. I don’t think that the policies could affect those balances. It would be interesting to know who said that, and I’m sure we’ll learn.

COMMISSIONER LEWIS: Do you believe that trade policies don’t affect trade balances?

MR. FEKETEKUTY: Well, they can if they affect the structure of the economy.

COMMISSIONER LEWIS: Okay. So, you don't believe that they don't affect them.

MR. FEKETEKUTY: Yes, I think they can, yes.

COMMISSIONER LEWIS: Okay. Then I'd like to ask you one final question. We have a foreign trade policy in our country, don't we, whatever it might be?

As a nation constructs a foreign trade policy, what purposes should be served in constructing the foreign trade policy? What are the interests that we should be concerned about?

MR. FEKETEKUTY: Trade policy?

COMMISSIONER LEWIS: I'd like to ask each of you that question. Yes, what are the interests that we should be concerned about in constructing a foreign trade policy?

MR. BEACH: Well, I think we ought to make certain -- let me just venture here, just an obvious point -- that whatever our trade policy is, it's one that encourages what we do really best in this country to be done. And, so our comparative advantage is clearly focused and supportive.

In that sense, since you never really know what tomorrow's comparative advantage is going to be, you have to have a very hands-off, a very laissez-faire approach, a very positive approach. A mercantilist approach seems to be totally inappropriate to the kind of world in which we live. It must recognize the global reach of capital markets and the importance of that for disciplining capital controls, other countries that are just emerging and coming onto the field of giving up national monetary policies that do affect those trade policies.

Those are things that I would hope we would focus on in addition to those other elements that all policy has to relate to, and that is the health and well being and defense of the country, which, of course, it shapes that.

MR. FEKETEKUTY: Well, I agree with that, except there are other considerations you have to take into account. You want to make sure that the adjustment process is one that doesn't have undesirable distribution effects with a new economy. So, you want to move in the direction that Mr. Beach mentioned but at a speed and at a rate which doesn't create internal tensions.

And, thirdly, you want to do it in a way that maintains a domestic consensus in support of the overall thrust of the policy, and that means you've got to moderate that policy in order to maintain that consensus.

MS. COLLINS: I would agree with the broad statements that have been made, but let me just step back for a minute. It seems to me that one's objectives for trade policy are the broader objectives that one has for the overall economy.

On a macro front, those are maintaining and sustaining economic growth rates in an environment of low inflation, stable price stability, and then, again, I think there are important distributional concerns.

There are in some cases microeconomic considerations that countries have where there may be a particular reason to target a particular industry and to deal with that.

In that context, trade policy is one of a range of policies that are available, but it seems to me that one starts with the overarching objectives and looks at all of the policies together as a package and doesn't just say here's trade policy, what is this going to do, without considering the broader range of objectives.

COMMISSIONER LEWIS: Would anybody disagree with the fact that one of our goals in a trade policy would be to provide an environment in which American companies can compete throughout the world? That should be one of our objectives.

MS. COLLINS: Sure, absolutely.

COMMISSIONER LEWIS: And one of our objectives should be to provide low-priced goods for consumers in America.

MS. COLLINS: Yes, and I would characterize both of those as in some way supporting the broader objective of sustained economic growth.

COMMISSIONER LEWIS: One of our goals would be to provide competition for American companies so that they have to constantly refurbish and modernize their plants. Competition is healthy for any company.

MS. COLLINS: I guess I would suggest that that is an objective of the market, of the entrepreneurs to provide that competition.

COMMISSIONER LEWIS: Would one of the objectives be to provide jobs for American workers?

MS. COLLINS: Again, I guess I would perhaps phrase that differently. One of the objectives is certainly in the interest of living standards is to provide an environment in which economic growth and job creation can go forward.

MR. PREEG: Well, I think the objectives of free trade is very much in the U.S. interest. The gains from trade are real and the dynamic gains these days are larger than ever. The gains certainly would be maximized if we liberalize on a reciprocal basis with other countries. Our two largest trading partners are Canada and Mexico. Thanks to NAFTA we have full, free trade and investment with all the objectives you mentioned. So, I think that's where we should be going.

There should be limits on other governments manipulating trade and distorting it. That's why we have a countervailing duty law, for example, for subsidies. That's what I believe our basic focus should be in trade policy.

Now, to get back to trade deficit -- how does this work out in terms of overall balance? If we have floating exchange rates as we have with Canada and Mexico and some other trading partners, that does most of the balancing out. But at the end of the day, if we still have an internal savings gap, by definition, we're going to have a trade deficit, and we can't blame that on a free trade policy.

COMMISSIONER LEWIS: One prior presenter said that he doesn't think that a country should have a foreign trade policy.

MR. PREEG: Who said that? I didn't say that.

COMMISSIONER LEWIS: A prior presenter, not today. The presenter said, when I asked what should be the elements in a foreign trade policy, this person said, "I'll be radical and say I don't think the country should have a foreign trade policy."

And I said, "You mean total laissez-faire?" And he said, "Yes."

MR. PREEG: Well, again, it's a definitional problem. You have to have a trade policy.

COMMISSIONER LEWIS: Of course. Does anybody here think that if Nazi Germany were in existence today in 1999 that we wouldn't be trading with them?

CHAIRMAN WEIDENBAUM: Well, I'd like to leave that and move it along, if I may.

MR. PREEG: That's economic sanctions. I have another book on that one for you.

COMMISSIONER ANGELL: Mr. Chairman, I want to be sure I understand Mr. Preeg. I think I heard you say that it is a very bad thing when other countries try to manipulate their economy in mercantilist ways, but it's a very good thing when we try to manipulate out economy in mercantilist ways.

MR. PREEG: I never said we should try to manipulate our economy in mercantilist ways.

COMMISSIONER ANGELL: But what is trade policy that you have in mind if it is not the attempt to manipulate our economy so as to achieve a greater growth in our exports than in our imports?

I mean, it really -- I don't understand a world in which it's a bad thing if China or some other country attempts to manipulate through its trade policies, but it's okay for us to attempt to manipulate through our trade policies.

CHAIRMAN WEIDENBAUM: By the way, as someone who did draft a trade policy from one administration, if I may take a stab at answering Commissioner Angell.

One approach in trade policy is to foster the reduction of barriers to the flow of trade and investment and thus encourage a more productive, competitive economy.

COMMISSIONER ANGELL: And that would then lean more to a laissez-faire world trade system.

CHAIRMAN WEIDENBAUM: Guilty.

If we can move on. Commissioner Thurow.

COMMISSIONER THUROW: Let me ask about fears. We can certainly bring in these two Chinese generals that say the way to handle the United States is to declare economic warfare. Mr. Ishihara in his famous book of Japan, said, "No." He said we would pull the American chain, sell the Treasury bills, really show them who's boss. And I can certainly find French politicians who've made very similar speeches.

But I wonder whether it's really true. Suppose you've got a government -- any one of those three, let's say -- who owns a lot of Treasury bills, and they decide to pull the American chain, and they sell Treasury bills. What they get -- they used to have an American asset that paid interest, called the U.S. Treasury bill, and what they get is now a U.S. dollar, another American asset that doesn't pay interest. And, I don't really understand how our chain has been yanked.

I think these are all empty threats. I mean, they could do it. Alan Greenspan would have to change monetary policies a little bit here and there and those kind of things, but I don't see any reason why Mr. Rumsfeld, the Secretary of Defense, should worry about any of those threats, should he?

MR. PREEG: Should I say something since I more or less raised the issue?

First of all, it's in the definition. It's not that they sell Treasury for dollar bills. This is intervention in the other direction where they sell dollars for domestic currency.

COMMISSIONER THUROW: No, no. I'm not talking about the intervention. I'm talking about the worry you had here, the fear that we would get to the point where they could kind of use these for political or military reasons. The threat or the actuality --

MR. PREEG: Well, no. This is specifically the $150 billion in China's central bank or in Europe. It's limited to that. Would they shift to euros or would they sell --

COMMISSIONER THUROW: No, but they've got to sell Treasury bills to get dollars. They buy euros. I mean, I don't really see where the military or political blackmail is in that. It might be a little awkward, but --

MR. PREEG: Well, again, it's the fact that they have $150 billion. If they made a decision they were going to go down to 140, 130, 120, $10 billion each month, that would put downward pressure on the dollar, and if it were in a certain set of circumstances --

COMMISSIONER THUROW: I don't understand. It's the political blackmail.

But let me ask you about another threat. One of the ways to pay for a trade deficit is you borrow the money, and of course there the problem you have to worry about is what if the rest of the world at some point in time says, "We want our money back." And then you're telling people for however long in the future you're going to have to lower your standard of living to repay the principal and continue to pay the interest on these loans.

The other way to finance a trade deficit, of course, is they make equity investments in America to the equivalent of Mercedes buying Chrysler. And somebody among the four of you, and I've forgotten whom, said we wouldn't care if that happened.

Suppose I could organize the world so the entire trade deficit was financed by foreigners buying American companies? And, so every year, foreigners bought $350-whatever billion worth of American companies. Should we worry about that?

MR. BEACH: Well, politically, you might have a concern there.

COMMISSIONER THUROW: Well, politically, I'm sure that we do

MR. BEACH: I see a situation in which it would be very difficult, Mr. Thurow, for you to go to Boston and to look at the Harvard Commons or whatever place you happen to be and know that it's in German hands, French hands, Japanese hands. Those kinds of issues are crucial. It boggles the mind to think that all the U.S. companies could be owned by foreign countries. What would that mean in their context. But, yes, clearly, politically, it raises a serious question.

Economically, are the assets well used? Are we producing good wages? Do we have the required rate of return on capital being met? Is this the best, most efficient use? I mean, those can be evaluated in a separate sense.

COMMISSIONER THUROW: We do have a capital society, and I suppose at some level you're saying it doesn't make any difference to Americans whether Americans play a role as capitalists. We would be perfectly willing to sell our capitalist inheritance and just play the role of workers in the global economy, and we shouldn't worry about that.

MR. BEACH: It worries me politically.

COMMISSIONER THUROW: Just politically.

MR. BEACH: If I put on my other hat, it doesn't worry me that much.

COMMISSIONER THUROW: Let me ask another -- my final question.

CHAIRMAN WEIDENBAUM: Can I follow up your point? Has anyone had the occasion of doing some analysis of the purchasing and investment patterns of foreign companies that take over American companies or vice versa, American companies that take over foreign companies?

To be blunt, they do have a tendency to import more capital goods, more components from their home country than their domestic competitors? Anyone taken a look at that?

MS. COLLINS: I haven't seen evidence on that question specifically, but something that's related is some evidence I've seen that suggests that foreign-owned companies are similar to American-owned companies in the human capital training kinds of components that they provide and job creation kinds of issues. I'm not aware of some studies on that specific question.

COMMISSIONER THUROW: Let me ask you a final question.

CHAIRMAN WEIDENBAUM: By the way, the answer is yes.

COMMISSIONER THUROW: A long time ago, Professor Hauthakker doing econometrics -- and I think it's been validated ever since then -- came to the conclusion if you look at the income elasticity of the demand for imports, the income elasticity demand of Americans from imports from the rest of the world is much, much higher than the income elasticity of demand for foreigners for imports from America, which means if the whole world was growing at the same speed, let's say four percent a year, the United States trade deficit would get forever bigger unless something else adjusted.

MR. PREEG: Like the dollar.

COMMISSIONER THUROW: And my question is, is that a macro problem we should worry about?

MR. PREEG: The short answer if we're in a floating exchange rate world --

COMMISSIONER THUROW: Short answer, yes.

MR. PREEG: -- the implication is that the dollar would drift down in this situation.

COMMISSIONER THUROW: The dollar has to go down forever.

MR. PREEG: Based on these circumstances -- the Houthakker effect, definitely.

CHAIRMAN WEIDENBAUM: Commissioner Thurow, are you finished with your questions?

COMMISSIONER THUROW: I have one final question. And it has to do with this issue of distribution. I think the real implications are distribution, and, of course, as we all know, in the economic literature there's this big debate about whether the adverse distributional effects that we've been seeing -- low-income people with either their share or absolute wages goes down and the top 20 percent doing very well -- how much of it is due to trade, and how much of it is due to technology?

But I think that's a question where it's very hard to know. Let me give you an example. Suppose I have a new communication technology that allows me to make wiring harnesses wherever, -- Thailand, which means I move some jobs to Thailand because of technology, and the people who used to have those jobs being paid at a reasonably high wage now move into services where their wages are much lower.

Is that a trade effect or a technology effect?

MR. BEACH: A bit of both, isn't it.

COMMISSIONER THUROW: I think the answer is both, and see I think this whole argument about trying to divide these distributional things into trade and technology affects -- it can't be right, because you can't do that intrinsically, because the technology in fact is producing the globalization.

MR. BEACH: I'd encourage the Commission to look at the history of the shoe industry in this country. I think that's distant enough. We can see technology, and we can see trade in both. There's good data on that and good research to answer that question.

COMMISSIONER THUROW: We also have an antitrust case that destroyed our best firm in that industry.

MR. BEACH: Well, indeed, indeed.

MS. COLLINS: Can I make a very quick --

MR. FEKETEKUTY: To the extent you're getting more automation, that is something that we can divorce from trade. And, undoubtedly, automation and change in the production process itself, and the resulting movement from blue collar to white collar jobs is largely technology-driven and not trade-driven.

COMMISSIONER THUROW: Let me make one final comment here, because I think Professor Collins was being a little cavalier about the distributional issues. As I understand the data, and I've looked at it, some of it, recently, up through 1997, if you looked at men, the real wages of the median male worker and those below him were falling. And the fact is from 1989 to 1997, the wages for that median, full-time, male American worker were down four percent.

Now, most of us believe that probably in '98 and hopefully in '99 that those real wage declines will have stopped. But I think everybody also believes that the distributional effects are still very sharp in a sense. Even in 1988, 1989, if you looked at how much were the wages going up in the top 20 percent of the workforce for males and how much were wages going up in the bottom 20 percent, you'd see a big difference in favor of the top.

Now, then we can argue about what we should do about that, and it obviously isn't just trade policy. But I think you can't say that globalization has had no impact on that, because, here again, almost all of the studies that have looked at what's happened to low-wage workers, let's say high school dropouts -- and I remember a big one done not too long ago -- where they had 60 percent of the effect in California on high school dropouts coming from basically trade effects.

But you can't separate technology and trade would be my basic argument.

CHAIRMAN WEIDENBAUM: Dr. Collins wants to defend herself.

MS. COLLINS: Well, let me not phrase it that way. Let me agree very strongly with both of the two points you've made. I was very brief about the trade micro issues at the end, and perhaps didn't treat them fully. I do have some materials I've distributed that I hope treat them a little bit more fully.

But in that context, let me just say that while I agree with you that it's extremely difficult to know whether it's possible to partition them out, there are attempts to do that, and one can fault them on a variety of different mechanisms, but, given that, it seems to me that one of the real lessons we should take is if you step behind -- beyond this and look at the look bigger picture, we want to be really careful not to make the mistake of comparing where we are now, which includes some combination of international movements -- immigration as well as trade -- interacting with technology and other domestic factors, as well. We want to not suggest that there are alternative scenarios that could have existed that are actually unrealistic.

And, so it seems to me that the real lesson from that is not then to take guesstimates of what trade would or wouldn't do and to suggest that it could move us back to a world before the trade and technology and other factors happened, as well.

And, so the key issue then is coming up with a realistic counterfactual, and that's the real reason why I think the trade policies are not the best way to address the real distributional concerns that, I agree with you, the changes in the past two years have only been a drop in the bucket to address.

CHAIRMAN WEIDENBAUM: Thank you.

Commissioner Becker?

COMMISSIONER BECKER: Thank you, Mr.

Chairman.

Just a comment on this last thing that you're talking about. In all my experience, my life, I've never witnessed a transfer of jobs from out of this country to another country because of technology. What I've seen is that you move the technology with it from the United States. The United States has the technology, and you move it into the other country, and you train workers in the other country.

Very often, other workers from the other countries come into the United States and work with the existing workers until they become familiar with a job, and then they move the job and the technology to the other countries. There may be some examples that exist, but in 40 years of dealing with this and going through shutdowns and transfers of work, I've never seen it, not within our union or other unions either.

I would like to address your comments and your concerns about the increased trade deficit heightening the political concerns and subsequently the fight for protections for workers. I would submit -- and I have another question that I would like to ask Mr. Preeg at the end of this, I would tie them both together to a degree. We're a nation of laws, and we have trade laws. We do have some trade laws. The ones that I deal with and manufacturing workers deal with mostly are the dumping laws, section 201 and 301, and there are some others in there that I'm not familiar with.

The enforcement process is extremely costly. The steel industry estimated at one time that it took $1 million. Someone can run through a trade case and wind up spending close to $100 million in processing a trade case from beginning to end. Most companies are not in a position to do this. Certainly, a toy factory down the street that has to contend with violations of other trade laws can't do this. They don't have the resources to do this kind of thing.

And, so I would ask a question based on your comments. Do you have any kind of an estimate at all of what percentage of our trade deficit is caused by what is referred to as unfair trade, which incidentally is in violation of U.S. law, and therefore, illegal trade? Could you give an estimate of that?

Or maybe anyone else could answer this question keeping in mind that most companies, the vast majority of companies, can't even deal with the trade laws.

And, secondly, do you feel it would be advantageous to liberalize those trade laws so that it would be easier and less costly to process and that workers themselves could process unfair trade cases under section 201, 301, et cetera?

MR. FEKETEKUTY: I've always felt that we have been too restrictive in the use of 201, which is a safety valve, and the policymakers have to know when the shoe pinches, when people are hurt. This use of 201 can send signals to policymakers by policy decisions.

When a failure to control fiscal policy leads to tighten monetary policies and an opportunity of the dollar, the burden of preventing inflation is put on industries that produce tradable goods and services.

Since it is easier to import steel than purely domestic services as a product, industries such as the steel industry end up having to pay for a policy decision that had nothing to do with steel.

At that point, it is important for a signal to come back to those policymakers that macro policies are having a distributional effect in the economy. A 201 action is one such signal. I have thus always felt that we have been too restrictive in the use of import relief, denying import relief in situations where an industry is being hurt by wrong macroeconomic policies.

COMMISSIONER BECKER: But staying with the first question, where company after company could be wiped out of business, because they can't "compete," quotation marks, "can't compete," against foreign firms that are dumping, or selling products in the United States below the cost of production before they are produced by subsidized industries. If this is the law of the land, there has to be a way for American workers to exercise their rights and get the benefits of this law. It has to be available in some way, doesn't it? Or do we just want to give our jobs and our industries away?

MR. FEKETEKUTY: You have a legitimate point.

CHAIRMAN WEIDENBAUM: Dr. Preeg?

MR. PREEG: Well, unfair -- what is unfair? Certainly, anti-dumping and countervailing measures address unfair trading practices. You asked how much of the actual trade is subjected to these actions, and the answer is that it is quite small in the overall. So, I would say that a relatively small share of our trade deficit has been designated as unfair, where we countervail or apply anti-dumping duties.

Section 201 actions are not necessarily against unfair trading practices. There's simply a disruptive impact on American workers and firms from trade. It doesn't have to be based on unfair practices, but, again, a relatively small amount of trade is involved. I don't have a clear assessment of 201 actions -- so much is to try to show that injury is caused by trade, mainly or by whatever criterion, rather than by domestic competition.

I would just finish by saying several million American workers -- three, four, five million a year -- change jobs because of competition, and the number of these workers that have been found to have been harmed by imports is quite small, one or two percent of the total number of American workers that change jobs every year.

COMMISSIONER BECKER: The reason the focus has been on steel -- and you cite steel in your written testimony -- is because they're big and they're able -- the industry is strong enough to be able to fight back.

My emphasis is on those that are not big enough to be able to do this, that are just automatically wiped out.

But does anyone else have a thought as far as liberalizing the trade laws so that workers and their institutions and small companies could process these cases in an affordable way?

MR. BEACH: There is an obvious point here that I think we could all agree on, and that is that if we can bring together those people who have studied the degree to which part of the trade deficit is due to the illegal activity, we should come to a consensus as to what that number is. Let's proportion the problem.

My guess is it's between $6 and $15 billion of the current trade deficit, but estimates range all across the board. That's a substantial amount of money. And, so if it is the law of the land, access to the courts and the various other remedies needs to be expanded, if that's not being taken into account. Again, the costs of compliance are fairly high. Reduce those costs. Somehow make it possible for people to bring their suits.

But you need to have another panel on that.

COMMISSIONER BECKER: Let me go back to Mr. Preeg. In your written testimony, you make reference to a study that attaches a cost of some $800,000 for each steel worker job that would have been saved had legislation been passed to protect them from illegally-dumped steel.

If you use the figure -- and I underscore the words illegally-dumped steel -- that's been kicked around most often, the 10,000 steel worker jobs that were lost through illegally dumped steel, you come up with a figure of $8 billion just for the 10,000 workers.

If you expand that a little bit, though, because the legislation was not to return imports to a zero level, but simply to the pre-crisis or the normal level of import penetration, which was about 20 percent of total capacity in the United States. The $800,000 figure per steel worker then would be from that level of, say, 20 percent to the current level of up around close to 40 percent or higher of total capacity of the U.S. steel industry.

If you use that same figure, my arithmetic tells me that if that legislation would have protected the 150,000 steel worker jobs that the industry said were at risk at that level, we are talking $120 billion that would have been passed on. That’s an incredibly high figure.

And in that regard, I would ask whether that study is credible and whether such a cost could be passed on? And whether or not in that study that put those costs at that level, did they take into consideration the cost that would be attached to the government and to local taxing authorities that would have been lost tax revenue from the employed steel workers, and the social costs that would be attached in taking care of those families and the communities?

And, further, did it take into

consideration the lost earnings on the part of the steel companies and their dealings with their suppliers and the flow that would follow from that? Was all of that considered in the report?

MR. PREEG: I'll just cite the reference. This is Gary Hufbauer, the IIE economist, who came out with this study a few months ago. I'm sure it's readily available.

As for the $800,000 figure, Gary, himself, could explain it fully. But one of the ironies is that these losses from protection -- because protection can have quite a high cost in terms of increasing prices -- that most of the gains -- or losses to the U.S. households, as he phrases it, were not gains to American steel workers but to foreign exporters who got higher prices for their steel -- the remaining steel exports of the U.S. -- and they make large windfall profits at the expense of the U.S. economy.

COMMISSIONER BECKER: We lost 300,000 steel worker jobs to the '80s, 300,000 jobs during this period. I don't -- I've talked to people that tried to run the estimates of cost of what happened when entire communities were shut down, when the whole complete tax base was lost; incredible devastation to people. And I believe before we throw figures out like that -- and I want to see the figures; I want to see the study -- that we should weigh in this complete -- this total impact into this kind of cost.

MS. COLLINS: Can I address that point very briefly? It does seem to me that one of the key issues that arises not only with trade but with other dislocations, with other changes, like technology, is that the costs are often very heavily concentrated, and the benefits are quite dispersed and often much less visible.

I agree with you that often if a plant closes in a community or there's another major economic dislocation, that it has a profound number of effects in the way that our policies address those kinds of issues at the moment. Perhaps, it does not take into account the full ramifications of those things.

Some of my colleagues at the Brookings Institution have proposed and suggested ideas of various types of what you might you think of as kind of an insurance -- community insurance kinds of schemes. I can't go into the details here, and I'm not an expert on the specifics of them, but the point, I think, is, again, that if one's concern is that there may be larger community effects if there is a major employment dislocation in a particular community, the right way or the most effective way to address those is to look specifically at trying to provide other mechanisms for that community, perhaps, through some insurance scheme.

The remedies that would look directly at a particular kind of trade interaction seem to be very ineffective ways to do that, and in that context, let me just reiterate a point I made earlier, which is that what the empirical evidence that I'm aware of suggests is that in fact dislocations are not more concentrated in the import competing sectors than in other parts of the U.S. economy.

And, so my personal view is that one should be concerned about the fact that there are displacements which often have severe and very long-term, in some cases, effects, not only on individuals but at times on communities, and that's a very reason for policies to be concerned, but I'm not at all convinced, in fact, I'm quite unconvinced, that trade policy remedies are good ways to address those concerns.

COMMISSIONER BECKER: Staying with that for just one second, because I like a lot of the things that I'm hearing in explanation, but I almost got the feeling in reading your testimony that this was a benefit, that this was a benefit to the working people and the population in general, if we would lose these jobs, we would benefit at the rate of $800,000 per worker. And if we add on to that, would this same figure apply? If we lost 100,000 auto workers on top of it or another 100,000 rubber workers, would each lost job save $800,000? I mean, can we believe then that the economy or the working families of America are benefiting as a result of these kind of job losses?

MR. PREEG: Again, it's a of traditional analysis of what is the cost of protection. If quota protection is given, which is what was involved here, what is the cost to the overall U.S. economy, this was related to how many jobs would be saved by cutting back imports by x percent and how that would play out on the economy in terms of the higher price of imports and other effects?

So, that's as far as this study goes, which has been done for other sectors, as well, over the years. But I'm not sure -- I really don't have an answer to your broader question.

MS. COLLINS: Can I jump back in for a moment? And that is a very important context to place this in is the economic growth and job creation in the U.S. economy at the moment. And, basically, the environment that we're seeing is one in which employment growth has continued to be very robust.

Now, of course what that means is that, again, if individuals are displaced from their jobs, they're specifically the ones where the cost of the adjustments are concentrated. Again, I think there are major reasons for concern there, but one doesn't want to suggest that what's happening in particular sectors or industries or communities from a macro stand point means that the overall U.S. job growth has not continued.

CHAIRMAN WEIDENBAUM: I just make a very modest point here that when you analyze the impact of trade on a producing industry, such as steel, the analysis really isn't complete until you look on the impact on the various American industries that use that product.

I don't have an answer as to what the net is, but if you look at whether it's adverse in terms of imports or positive in terms of import restraint, if you look at the effect on, say, the steel-producing industry, you also have to look at what happens to the American companies that buy and use steel, and what happens to their employees.

Now, as I said, I don't have the answer --

COMMISSIONER BECKER: And that's what we're looking for.

CHAIRMAN WEIDENBAUM: But I think the

question has to be a comprehensive one, because I can appreciate your concern with the steel-producing industry, but -- and I think we all share it -- but we also have, as nationally focused, a concern with the steel-using industries.

COMMISSIONER BECKER: Don't misunderstand me. I'm not just addressing this to steel. I'm addressing this to industrial workers and general manufacturing. Every job that we produce in the United States -- every industrial job that we have in the United States could actually be performed cheaper overseas, when you figure the social cost, of what I call social costs, to employers in the United States for having to provide all the necessary environmental controls and benefits, makes it virtually impossible if we're targeted.

Now, admittedly, they attacked on steel and not other industries. It was illegal, but it was only because you had a strong wealthy steel industry that could fight it back through the trade lawyers and be able to handle all of this. Most industries are not. They're vulnerable and they're wiped out. I'm not really referring just to steel, but the policy would apply all the way, I think, all the way through.

Sure it may be cheaper for steel importers or rubber importers or auto importers to buy foreign products coming into the United States. But there is a cost that reaches down into the community with the destruction of the community base where they can't even provide essential, life-giving services in a community and destroys it.

That is what happens when you lose that, and I'm just saying, is that cost figured in here?

CHAIRMAN WEIDENBAUM: To continue the analysis, there was a -- we had a semiconductor import restriction, and, yes, that for a while helped the American companies that produce semiconductors. The problem is once that decision was made to restrain the imports of semiconductors, they didn't stop to figure out what about the industries like the computer manufacturers that use the semiconductors.

And during that period of import restraint the American producers of computers lost serious market share to foreign producers of computers who weren't subject to the restraint on a key input, i.e. the semiconductors.

MR. BECKER: But, Mr. Chairman, I said at the beginning we are a nation of laws, and we do have trade laws. But only the very wealthy can afford to use these trade laws. We consider anything that's an illegal trading practice in the United States as unfair trade.

However, in actuality, we are talking about illegal practices under our current laws that only a few can afford to take legal action against, and that is really what I'm trying to direct this to. I don't want to belabor this here. We'll argue when we go to lunch, Murray.

(Laughter.)

I have one last question, if I could, and I'd like to direct it to Mr. Beach, because you talked about the difficulty of forecasting with economic models. That's a new word for me in this whole process -- the difficulties with economic models. And I admire your candor in saying how difficult it is.

But one of the effects of the last increase in the deficit, which was in June -- the fact is it came out the day of our last hearing of this committee -- and it was quoted by The Wall Street Journal and The Washington Post in various ways, but the one quote that sticks in my mind is that this June figure, an increase of roughly $4 billion in one month, was remarkable in that the majority of trade economists had predicted a decrease for the month of June because they were following record months of May and April before them.

And my question to you, is this economic forecasting so imprecise that the majority of economists would not only not predict the record increase of $4 billion in one month, but, in fact, had predicted a decrease? What weight are we to put on economic forecasting?

MR. BEACH: What a lousy way to end my testimony.

(Laughter.)

The story comes to mind of -- that many in this room will also appreciate of several years ago, I believe in a room very much like this -- it could have been this room -- the Congressional Budget Office predicted that there would be budget deficits as far as the eye could see. And that eye went out, by the way, out to 2075. Today it is surpluses as far as the eye can see, out to 2075.

What we're dealing with in economic modeling is historical data. And to the extent that history -- and history is really many, many months now behind us, not just yesterday, many months -- to the extent that history reflects your understanding of the near-term future -- in other words, there will be a Japan, and Japan will have these kinds of financial structures, and there will be organized labor, and there will be, you know, all of those things -- then you can rely on the economic models to give you an indication of the direction in which a change in policy will take the economy.

Point, precise, estimates -- well, frankly, it’s making sausage. You can go and watch it, if you like the process. You may have done it yourself at some time, but I would not recommend that it be a common practice, particularly prior to lunch.

MR. BECKER: I really raised that last question more as an end yes than I did as a --

(Laughter.)

Thank you.

CHAIRMAN WEIDENBAUM: Thank you.

Commissioner Krueger?

MS. KRUEGER: Yes. Let me just ask one last question from my end. This follows on the discussion in trade policy, because you can talk about trade policy in the broad as being anything that improves productivity, etcetera, etcetera, and, therefore, makes all firms able to pay higher real wages, you know, and still compete, etcetera.

But there is also a narrow definition of trade policy which normally entails things that you could do to effect imports and exports more directly.

And since there are constraints in what one can do on the export side -- and let me just simply the question and ask each of the panelists very quickly -- suppose that somehow or other Congress were to pass a law which either by quantitative restrictions, or by raising tariffs uniformly and across the board, reduced imports by $300 billion in the first round. Do you believe that would cut the trade deficit? And if so, by how much?

MR. PREEG: The immediate effect would relate to the underlying savings gap. With flexible exchange rates, the dollar be lower -- and trade would come down. We would have lower imports and lower exports. So I guess my answer is: no.

MS. COLLINS: Again, unless there is a good reason to expect that that change would influence the national savings or investment rates, there is not a reason to expect that the broad external balance would be affected.

MR. BEACH: No. I would agree and add another point. That the focus on the trade deficit I think is unfortunate. You may have put your finger on it. Because when you do that, you raise the cost to consumers, you reduce their choice over products, you decrease their well-being, their lifestyle, everything else.

There is a reason why we have imports being preferred over other products. It could be because of price, it could be quality, and so forth. And the signaling is what is important when government intervenes, puts a tariff in place. It causes a great deal of problems in other areas.

MR. FEKETEKUTY: I guess the question is: what do you hold constant? You can, first of all, assume no foreign reaction, right? Number one. If you then wanted to use the quotas, well, obviously you can get the deficit down. The problem is that a lot of your exports now depend on imports, right?

A lot of your exports use foreign inputs. So it would automatically immediately affect your exports. But, you know, without foreign reaction, you can certainly make foreign goods more expensive relative to domestic goods. I mean, and that certainly would have an effect on the balance but certainly not one for one.

But then when we factor in the fact that the foreigners would not stand idle, there would be a response, I'm not sure how much of an impact you could have.

CHAIRMAN WEIDENBAUM: Let me toss out a statistical observation and see if there's any reaction on the part of the panelists. Earlier we were discussing the Asian trade restraints vis-a-vis the United States. How much does a calculation of the per capita Japanese imports from the U.S. -- this was from 1996, I believe -- per capita Japanese imports from the U.S., and per capita U.S. imports from Japan. And to my surprise, showing my ignorance of this area, U.S. per capita imports from Japan were significantly smaller than per capita Japanese imports from the U.S.

Does anyone have any comment on that? Do we take it seriously? Do we draw any conclusion? The average Japanese apparently has a greater propensity to buy American stuff than we buy theirs.

MR. BEACH: It may say something, Mr. Chairman, about American products. It may say something about the preferences of Japanese at the point in time that you took the measurement.

I think if you went around the world and looked at countries that are developing, developed -- Japan being well developed; I'm not pointing to them but to others -- and say, "What is the percentage of U.S. imports versus the percentage of imports of their products?" we would clearly find the U.S. is the net exporter into that country because it is capital equipment that they're buying. It's the basic infrastructures, the new technology, and that may be what your number shows.

MR. FEKETEKUTY: Our key arguments with Japan have been over their reluctance to buy high value U.S. manufactured products such as capital equipment, auto parts, and so on. They tried to buy unprocessed basic materials and food products.

CHAIRMAN WEIDENBAUM: Dr. Preeg?

MR. PREEG: Well, I'm not sure. Did you include services in that? Because we have a big surplus in --

CHAIRMAN WEIDENBAUM: Yes.

MR. PREEG: -- Japanese coming to golf

courses and resorts in the U.S. more than we go there. That might be part of the explanation.

But I still -- I see structural impediments in the Japanese market through the decades, particularly on manufactured imports. That's where the big difference has gone the other way. But you still end up with a Japan which has had a large current account surplus and trade surplus.

It's almost fundamental to Japanese policy at this stage to attain minimum economic growth through a trade surplus throughout this decade. That's the trade deficit problem despite the composition of imports and exports both ways.

CHAIRMAN WEIDENBAUM: Well, it was just a statistical artifact. I picked Japan because it has a comparable level of industrialization. That's why I didn't pick China, and one country that we have a large continuing trade deficit with.

And it just struck me, to what extent does our large population make -- generate -- tend to generate bilateral trade deficits with countries of comparable levels of industrialization?

At this point, I have to call time out on my own question. We've just hit the witching hour.

I certainly want to thank all of the

panelists, as well as the Commissioners, for a very lively morning. We stand recessed until 2:30 p.m.

(Whereupon, at 12:28 p.m., the proceedings in the foregoing matter went off the record.)