

VICE CHAIRMAN PAPADIMITRIOU: Thank you very much.

Chairman Weidenbaum.

CHAIRMAN WEIDENBAUM: Thank you. I want to thank all of the panelists for their very helpful statements. My question is to Professor Galbraith. By the way, in our long relationship, I think this is the first time I'm looking down on you instead of looking up to you, but don't read too much into that.

My question relates to the three items you give in your written testimony accounting for the level of the trade deficit in the U.S. The first two are quite clear, the business cycle at home and abroad. It's the third one that I need some elucidation. Falling relative competitiveness of our traded goods sector. Could you briefly explain how this affects the level rather than the composition of our trade deficit and what's the factual support for this falling relative competitiveness?

PROFESSOR GALBRAITH: I am specifically thinking of a particular historical sequence of events and one that we're both familiar with because it occurred in the early 1980s when we were both working in this town.

At that time, in part due to very high levels of interest rates that were imposed in the fight against inflation and in part due to very high budget deficits, we had an immense increase in the real valuation of the dollar.

COMMISSIONER LEWIS: Excuse me, could you say that again?

PROFESSOR GALBRAITH: We had an immense increase in the real valuation of the dollar. The effect of that was quite dramatic on certain sectors in our manufactured goods industry. Throughout the Midwest -- and at the time I was working, as you know, for a Congressman from Milwaukee -- not the most advanced industrial sectors, but the tier just below that, the

heavy machinery producers, the industrial equipment producers, the heavy transportation equipment producers, suffered not only a decline in their ability to sell, but in fact, a decline in their survivability and many of them went bankrupt and out of business.

So when I'm referred to that episode, that's the kind of thing that I'm talking about specifically and that has a structural effect because once an industry does, in fact, disappear, you lose that piece of a manufacturing base, you've created a hurdle that you have to overcome before you have something comparable in its place. And I'm not saying that it can't be overcome because I do think after 1985 with the reversal in the high dollar policy there was substantial improvement.

But structural declines in competitiveness does occur in these circumstances.

VICE CHAIRMAN PAPADIMITRIOU: Thank you.

Commissioner Becker.

COMMISSIONER BECKER: Thank you. I have a question for Mr. Shaikh or Mr. Mulloy. Either one possibly could add to this. There's a perception in the United States amongst working people, particularly, and a lot of people who follow this that we're in the throes of de-industrializing our country. Massive job losses are incurring within a manufacturing section. We lost over 500,000 jobs by Department of Labor figures. Over half a million industrial jobs this year will be lost.

Last year we lost 336,000 industrial jobs and we've been on this trend for quite some time. At the same time we're running this record deficit that is expected to hit over \$300 billion this year. Yet, we've heard testimony from a lot of economists who claim that the deficit has no relationship at all to these job losses, that the deficit is because of a strong dollar or because of high investment in the United States or a lack of savings on the part of the people. Many of us believe that there is a linkage between this deficit and the job loss and

I would like you to comment on this, if you would, and give us your thoughts in this regard.

PROFESSOR SHAIKH: Thank you. The question of job loss raised by Mr. Becker is very crucial for me, because one of the implications of my argument is that since trade operates by competitive (i.e. absolute) advantage in which relatively high costs are a disadvantage, it is possible for trade to cause job loss.

There exists no natural mechanism which will automatically make trade balanced and, therefore, make everybody equally competitive. In fact, one of the ironies is that it is possible for trade, between unequal partners to cause job loss on both sides. Indeed, some studies of NAFTA have concluded exactly this.

It is, of course, true that those movements of the dollar which are independent of fundamentals can have a separate influence. For instance, in the 1980s, the dollar went up a lot, quite independently of costs

movements, and then it came down very rapidly in two years, back to its fundamentals.

Still, the central point I think is that if you look at the history of international competition from my vantage point, then it makes a great deal of sense that Japan and Korea and other countries entered the international sphere carefully and cautiously rather than simply opening themselves up to foreign trade. Indeed, there was a signal effort on the part of the government to insure that certain sectors were competitive before they were exposed to foreign trade. I think that is also what seems to underlie China's current trade strategy.

I would, therefore, be very surprised to hear that we would not do the same thing on our own behalf that we would not pay attention to the possibilities of job losses. I note that there were discussions of Article 12 in the earlier sessions this morning, but I think that one has to have a much stronger sense of how trade can affect jobs. Once one recognizes that there is no

guarantee those who lose jobs will get new one, then one must consider what needs to be done socially about either creating new jobs or exposing industries to foreign competition as they are able to compete, forcing them, perhaps, to get there, but nonetheless not just throwing them into the deep end of the pool.

PROFESSOR COOPER: I'd like to comment on the question, if I might. First, to scotch the notion that we deindustrializing. I have Current Economic Indicators, put out by the JEC, with me and it shows that industrial production in the United States has gone up nearly 40 percent since 1992. We've had a fabulous increase in manufacturing production. We have simply not deindustrialized. That's just not consistent with the facts. If you break it down between durables and non-durables, non-durables have gone up only 15 percent, but durables have gone up by 77 percent, a tremendous increase in U.S. industrial production.

Manufacturing employment has gone down, but those two issues should not be confused. I come from a farming background. U.S. agricultural production is fabulous. We now do it with 2.5 percent of the labor force. Productivity in farming grew so fabulously over the last 50 years that people could leave the farm for better employment.

I would suggest that the same process is occurring in manufacturing. And it's going to be difficult for some people just like it was for some farmers. Our productivity increases have been so great in recent years that we can simultaneously enjoy very nice increases in manufacturing output and still experience a decline in manufacturing employment. I wouldn't want to suggest that foreign trade plays no role in that process, but foreign trade is a sideshow in that process. The fundamental process is one of technological change, and technological improvement, I believe, will

continue to be the characteristic of the American economy for the next 20 years as it has been for the last 20.

COMMISSIONER BECKER: The shoe industry is gone in the United States

PROFESSOR COOPER: Absolutely.

COMMISSIONER BECKER: Completely. Productivity has nothing to do with it in the United States. The electronic industry has been devastated. We're hanging on with less than 300,000 textile workers when we had a million.

PROFESSOR COOPER: Absolutely. Carriages are no longer productive here.

COMMISSIONER BECKER: It has nothing to do with the productivity in the United States.

PROFESSOR COOPER: I disagree. It's entirely productivity. It's entirely productivity. I live in what used to be the shoe producing area of the country. We moved people out of shoes into more productive and more lucrative activities.

SECRETARY MULLOY: My own view would be that if, for example, Japan or some of these other Asian countries where we have these tremendous deficits year after year, and you project them from 1970 on to the present, if they were more open to U.S. manufactured exports, there would be more jobs in the manufacturing sector of country. It just seems to me that when you're running into export trade barriers and we're not talking about --

COMMISSIONER LEWIS: Export what? I couldn't hear that word.

SECRETARY MULLOY: When we're running into trade barriers to our exports, like Peter says, what it does it impacts the composition of what you make and where your jobs are going to grow in the country. And so that's why we think you've really got to focus in on how to get after some of these barriers. That's a matter that Ambassador Hills is very familiar with.

COMMISSIONER HILLS: But I don't come to the same conclusion. I really think that Professor Cooper has it right, if you look at the history of our country when we've moved out of sectors, people have moved up the economic scale and have enjoyed greater rewards. We don't make shoes any more, but we do make computers.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Rumsfeld?

COMMISSIONER RUMSFELD: Thank you, Mr. Chairman. Thank you very much, gentlemen, for your presentations.

Dr. Cooper, we've received different views on the subject you addressed over the course of the hearings we've had. And you have asked what is a key question. To the question is the deficit sustainable, you said why not?

You said it's only 6 percent of the world's savings outside the U.S. and it seems plausible that that would continue.

Is there some level that would be worrisome, if it were more than 6 percent? Is there some threshold? Obviously, it's a percentage as opposed to an absolute number that you use and I think probably properly so.

Do you get worried at some point?

PROFESSOR COOPER: I don't want to give a flat yes or no to your question. My main point would be that looking at the trade deficit or the current account deficit is looking at the wrong set of numbers. We really should be concerned with the innovativeness of the American economy, the flexibility of the American economy, and its capacity to produce higher standards of living for all of its people. If we can do that with a trade deficit equal to 3 percent of U.S. GDP, for example, by astute investment, I think the trade deficit is really pretty much of a sideshow.

We ought to keep our eye on the things that we're really interested in. That includes a whole range of things: the dignity of the worker, the standard of

living of Americans and the continued capacity of the U.S. economy to provide higher standards of living because we're concerned not only about ourselves but also about our children and our grandchildren.

COMMISSIONER RUMSFELD: One of the tasks that we've concluded is probably part of our charter is to provide information, I don't know if education is quite the right word, but to try to inform about what the deficit means and your point is that the trade deficit is probably more of a side show and that there are other pieces that are more important.

Let me ask a second question. You said to the question will it be sustainable that there is no way to know. And then you started walking through how things might occur. You left me, at least, with the impression that you don't anticipate a crisis. I'm not saying you're ruling it out, but the way you described it, was that there could be a series of seemingly incremental adjustments that could take place that would be a self-

correcting process, which at some point other countries would blink before we would.

Do you want to walk through that again, take each step as you think it would happen as some countries decide they don't want to have quite as much money in U.S. stocks or bonds as they do?

PROFESSOR COOPER: My starting point is that the principal cause of today's large trade deficit is willingness of the rest of the world to invest in the United States.

COMMISSIONER RUMSFELD: Right.

PROFESSOR COOPER: We live in a world of floating exchange rates. Inward investment causes the dollar to be as strong and that, in turn, encourages imports and discourages exports. Nothing in the numbers suggests that the trade deficit couldn't continue forever. But it might not. Anyone who looks at financial markets knows that sentiments can change quite quickly, so one can at least contemplate the possibility

that foreigners decide the U.S. economy is not such a great place to invest after all and cut back on their investments.

Under those circumstances the dollar will depreciate. I don't want to suggest that it will necessarily be a gradual process because again financial markets can move quickly, but I don't expect it to move very far very quickly. Just to take a round number because it's a round number, a 10 percent depreciation of the dollar will result in some really black headlines.

We've seen the press treatment of the Euro during its first year. The Euro dropped from \$1.17 at a start 11 months ago to \$1.02 today. In today's world I don't consider that a big deal, but we've got one negative headline after another and a lot of hand wringing. I have no doubt that if the dollar were to drop by that magnitude in the coming years there would be a lot of hang wringing going on too. But policy analysts have to stand back and ask what's the harm in it? There are some

disadvantages, but there are also some advantages and that's what I meant when I said I didn't see it as a big deal.

If the dollar drops too quickly or too far, the concern of foreigners will be much more acute than the concern of Americans. That's what I meant by the foreigners will blink first. We'll see what we have seen in the past, most notably in the case of Japan, that official investment in the United States will substitute for private investment in the United States. This is the point that Peter Morici made. They will add to their reserves. They'll invest mainly in U.S. Treasury securities. When that time comes, we can have a conversation with the Japanese. Japan is just one example, there may be other countries in similar situations -- about how rapidly they add to their reserves, because it does affect the exchange rate and it affects the adjustment process.

COMMISSIONER RUMSFELD: Could I push you just a little bit on this?

PROFESSOR COOPER: But I don't see a crisis coming out of it.

COMMISSIONER RUMSFELD: Fair enough. If a country loses some confidence in the U.S. and decides they have other things they'd prefer to do with their investments, they then would sell an investment which would lower their value one would think. And they'd end up with dollars and what do they do with the dollars?

PROFESSOR COOPER: Well, the assumption I'm going on is that they don't even have to sell an investment. We're now dependent on a continuing inflow of foreign capital.

COMMISSIONER RUMSFELD: So they slow the inflow.

PROFESSOR COOPER: So they just have to change the composition of the inflow.

COMMISSIONER RUMSFELD: I see.

PROFESSOR COOPER: Let's imagine that, contrary to all recent evidence, the Japanese economy really takes off. It looks like they're really restructuring things and all of the investment houses in London and Aberdeen and Zurich decide Japan is the place to bet now, the United States is last year's story. Japan is next year's story. So they put not 6 percent of worldwide savings into the U.S., but say 5 percent. That's still a lot, but it's not enough to sustain our current deficit. We would see downward pressure on the dollar under those circumstances. But the starting point in my example is that foreigners (and Americans) have invested Japan instead, so of course, there would also be upward pressure on the yen as a result. That is a major part of the adjustment process in today's world.

COMMISSIONER RUMSFELD: Which makes us more competitive --

PROFESSOR COOPER: And also would make U.S. assets more attractive. If they're a good deal at one

exchange rate, at 90 percent of that exchange rate, they're an even better deal.

COMMISSIONER RUMSFELD: Thank you very much.

SECRETARY MULLOY: I just wanted to respond to Ambassador Hills. The point when you mentioned computers, it's very interesting that last year we exported about \$7.4 billion worth of computers and this year at this same period we're exporting about \$7.3 billion, so that's down \$100 million. Computer accessories, last year we were at \$26 billion. This year we're up a little bit at \$27 billion, but it's interesting, computer accessories imports are \$52 billion, so we're importing twice as many computer accessories as we are exporting them. And in computers, we're importing more computers, \$7.6 billion than we are exporting. So I think it's important to realize that these represent very high-value added jobs and that it is impacting on us and I think a lot of these deficits

in these goods are focused on some of those Asian markets.

COMMISSIONER HILLS: I would like to comment that when you take last year, you're taking a year where we were facing the Asian financial crisis. I really think that I would say what economists say is that's really not a fair slice of the U.S. economy.

Most trade or a great deal of trade takes place in the same sector. It's not surprising to me at all that we import in the same sector that we export.

And in fact, many times and particularly in the high tech area our imports enable us to be more globally competitive with respect to our exports. It's hard to put single national ties on some. We need parts, and technology, I belong to the school of thought that says as much as you want to export, you also need to import to be globally competitive.

VICE CHAIRMAN PAPADIMITRIOU: Let me give Commissioner Thurow a chance and then you can --

COMMISSIONER THUROW: I want to ask a question of Patrick Mulloy. If you look at all the trade barriers in Asia, there's always a mystery. Why do they have a much bigger affect on the United States than they do in Europe? My impression is, and I haven't checked the data, that at the moment the Europeans are running a trade surplus with China while we run this huge trade deficit. You also have European countries like Italy that run a trade surplus with Japan while we run a big trade deficit with Japan.

Why do you think Europe has such a different pattern of relationships with Asia than we do?

SECRETARY MULLOY: One, I really don't think the European market is as open as the American market.

It's easier for foreigners to find distributors in the United States. For example, remember years ago, if you wanted to make a Buick you could have distributors that only sold Buicks, and there were some changes, I think by the Supreme Court and anti-trust cases that they said

you can't do that. They said you've got to open your distributorships and permit the dealers to sell other kinds of cars if they wanted. That was one thing that really helped Japan, for example, enter the American automobile market.

When we want to sell cars in Japan, our manufacturers have to build their own individual distributorships. So I think its things like that, some of those kinds of barriers that are still in place in Europe that aren't in place in --

COMMISSIONER THUROW: So you would say that the Europeans have a competitive set of barriers?

SECRETARY MULLOY: I think that they have barriers in place that make it harder for the Asians to export into those markets than they do in exporting into the American market. That would be one thought about why it's impacting us more than --

COMMISSIONER THUROW: One of the charges that is sometimes made is that the Chinese, since they

still have a heavily government-owned economy, are basically deliberately shifting their purchases toward Europe and away from the United States. Do you think that's true?

SECRETARY MULLOY: We took a look at China and most of their trade deficit appears to be with countries like Taiwan and Korea, and I think that's because people in those countries are investing and then transferring production and assembling into China which they can then export a lot of it, I guess, into the United States market.

We looked at that and that's what appears to be going on.

COMMISSIONER LEWIS: His question was Europe and China versus U.S. and China.

SECRETARY MULLOY: What I was saying, I think that overall Europe has a small --

COMMISSIONER THUROW: It has a small surplus with China if you believe the official data, no?

SECRETARY MULLOY: They have a small deficit, I believe.

COMMISSIONER THUROW: Small deficit.

SECRETARY MULLOY: Yes, not anything approaching our deficit which is over \$60 billion.

COMMISSIONER THUROW: But it would be your judgment that the Chinese haven't in some sense favored the Europeans and disfavored the Americans?

SECRETARY MULLOY: We're quite hopeful that our new market opening agreement with the Chinese is going to improve the situation

Secondly, we already have a commitment, I think, in our 1978 market access agreement that they're required to give us most-favored-nation treatment in China.

COMMISSIONER THUROW: But the problem is when governments own corporations you get all kinds of things under the table and it's very hard to know exactly what's going on.

It is very peculiar, if you look at the United States and Europe that we have such a different pattern of trade with China. That's not easy to explain, I don't think, based on economic fundamentals.

SECRETARY MULLOY: I won't quarrel with you, Dr. Thurow.

VICE CHAIRMAN PAPADIMITRIOU: Peter wants to respond to that. Peter?

PROFESSOR MORICI: From what I've read, I mean the Chinese do try to diversify their sources and if you're talking about airplanes there's a European source and an American source.

Patrick is quite correct, I mean the European market for a variety of reasons is less open than the U.S. market. Its competition policy is most directed at insuring integration and it doesn't have the level of antitrust enforcement that we enjoy.

To pick up on another point, I think it's silly to say the United States is deindustrializing. You

only have to read the data that the Joint Economic Committee sends out every month to know that it's not.

On the other hand, it is also silly to say that having a very large trade deficit doesn't affect the growth of that industrial production. So the question is: how does that reallocation of resources affect the incomes of people in the United States and the potential growth of the U.S. economy?

It does shift resources towards lower productivity industries. If we view ourselves as having a \$7.5 trillion economy and you lose half a percentage point of GDP, that translates into about a \$30 billion wage loss, or 80 percent of what we make. You can't get around that. If there are fewer employees in the automobile sector than there would have been without the trade deficit, then people are going to earn less money, because the automobile industry pays a lot. That doesn't

mean that we have a hat industry again or a footwear industry again.

Likewise, so many of our products in the export sector are so intense in technology that we're losing potential growth in GDP. We used to think of the U.S. economy as having a potential rate of growth of 4 percent or so during the Kennedy and early Johnson years. These days, the Federal Reserve doesn't view us as having that same trend, that potential rate of growth.

I think that part of it has been the consequences of this trade deficit for our investment in R & D. I think there are other causes as well.

SECRETARY MULLOY: If you want to have the exact figure, last year the Chinese had a deficit of about \$10 billion with Taiwan. This year it's going to be, from January to October, they're going to have a deficit of over \$12 billion with Taiwan, a deficit of over \$7.5 billion with Korea. But they're going to have strong surpluses with us and with the UK they're having

a surplus, but overall, I don't think Europe is in a major deficit situation with China.

COMMISSIONER THUROW: The last time I checked the data the Europeans had a small surplus if you add them all together.

COMMISSIONER THUROW: Yes.

COMMISSIONER ANGELL: Patrick Mulloy, I have a brief question for you and then I want to ask a question of Mr. Galbraith.

Suppose you had a country you would like to live in, and suppose this country A had a very high savings rate, was very protectionist, ran a very large balance of trade surplus, and every year becomes poorer in regard to their share of world wealth.

On the other hand, country B has a very low savings rate, a very high investment rate in capital goods, a high rate of return, and the world does seem to want to own either directly these capital goods in the U.S. or own indirectly through owning equities. Which

of the two countries would you prefer to be in? Would you prefer to be in the country that harms itself with protectionism and harms itself in some ways by having a higher saving rate than is needed, or would you rather have a somewhat undersaving and high growth rate of wealth.

SECRETARY MULLOY: Governor Angell, it sounds like you're describing Japan and the United States and, of course, I think right now I would much prefer to be here and living here than in Japan.

I think the question though that this Commission has been charged by Congress to look at is it sustainable when you look at it for the next generation? And what do these trends mean? Those are issues that you have to study, and the question is whether this can be sustained.

COMMISSIONER ANGELL: Well, yes, that is the question and I think that's a question that I want to ask Dr. Galbraith, but I want to remark in regard to Richard

Cooper who I agree with so much. It's hardly any use my asking him any questions, but the question of sustainability, I think, Richard Cooper has just right, and that is no one knows for sure how sustainable it is, but we have a world that has a very heavy appetite.

Richard, you suggested only 6 percent of the world's savings. My understanding is that 74 percent of the world's access savings is coming to the United States.

I think we need to be very happy that we have such high rates of return on capital as to foster that.

Now, Mr. Galbraith, I'm not going to use your words like demented and dangerous directions and all that, but your comments on monetary policy I find, I guess, amusing.

I would point out to you that Newt Vixell in the 1920s laid it out when he said there's a natural rate of interest in every country and that natural rate of

interest has to do with the saving rate. If you took that notion then you would expect a continued rise in real interest rates in the United States. And, Dr. Galbraith, aren't you happy that you live in a country with a Federal Reserve that manages things so well that the rise in real interest rates is primarily a reduction in the rate of inflation? Just think what it would be like over the last three years -- the rise in real interest rates is primarily a reduction in the rate of inflation. So do you really want the Federal Reserve to stop doing its monetary policy based upon, I hope, getting us closer to zero inflation than we even are?

Is that what you really want us to suggest?

PROFESSOR GALBRAITH: Commissioner Angell, I have also been in the business of observing monetary policy for a good many years and it is quite right that I've rarely been in the position of approving a Federal Reserve policy and certainly since the early 1980s it is my view that the real interest rate has been

unsustainably high, that it is very hard to go indefinitely with a real interest rate that is systematically higher than the real rate of growth. That involves a shifting of the ownership of capital assets which cannot go on forever.

I am very skeptical of the view -- the premise of your question -- the Federal Reserve's policy of maintaining this interest rate and indeed raising it in recent months has been one which has been based on an informed preemption of an inflationary threat. There has simply been no, in my judgment, credible evidence of any such inflationary threat. It's very easy afterwards to go back and say inflation didn't occur and, therefore, what we did must have worked, but it's equally possible that inflation would not have occurred if nothing had been done and that's the view I'd take. And I think the evidence for that view is at least as good as the evidence for the view that inflation would have accelerated if preemptive measures had not been taken.

It seems to me, therefore, that we're not living in an economy that is prone to very strong inflationary pressures for a number of reasons, having to do with a much weaker position of labor than was true at some periods in the historical past, having to do with a much weaker position of commodity producers in the world economy and having to do with a general climate of peace, since war and the disruptions that accompany war have been major inflationary forces in the past.

That being so, my argument would be that the Federal Reserve does need to pay a great deal more attention to the international implications of the actions that it's taking. I applauded very strenuously when in the face of the Asian crisis and I must say to my surprise because I really admire the boldness and speed with which the Federal Reserve acted to reduce interest rates three times in order to send a stabilizing signal to world capital markets. I'm worried about

undermining that position now at a time when the recovery of the developing world is by no means assured.

Let's get to a broader point which is really a difference of perspective on the same set of facts --

COMMISSIONER ANGELL: You're taking my time

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PROFESSOR GALBRAITH: Go ahead.

COMMISSIONER ANGELL: I'm sympathetic with your confusion in regard to why the Fed has done what it's done because I think by and large it has been a very confusing story. If interest rates and monetary policy are too restrained, then the rate of inflation in 2001 and in 2000 will be down too low. It may be going from 1 to 2 percent, getting the rate of inflation down. I would like to get it to zero, but I certainly believe the Federal Reserve is on the right track, but they haven't said so. They haven't really said that their objective is to get the inflation rate down, and so I understand why that might seem confusing.

PROFESSOR GALBRAITH: Let me, if I might, I don't want to hold up the Commission, but I do want to comment on Professor Cooper's point because we view the same facts from a very different perspective, it seems to me.

Professor Cooper talks about a crisis occurring should the rest of the world not continue to invest in us, I would say that the current investment of the rest of the world in the United States is a manifestation of an on-going crisis. The failure of the Japanese economy to grow over the last 10 years, a European unemployment rate which is still averaging about 10 percent and is 16 percent in Spain, the complete collapse of the economies of the former Soviet Union, the failure of the Central European economies for the most part to prosper and the very weak condition, generally speaking, of Latin America, compounded by the collapse of the Asian economies. If that isn't a serious situation in our export markets, I don't know what is and

I haven't even mentioned Africa. But we are an economy which exports advanced technologies, advanced products to the rest of the world, investment goods, largely. We, therefore, do well in international trade when the world economy is growing and when investment sectors are growing. We sell them aircraft. We sell them communications networks and computers, equipment and infrastructure and engineering products. I do not believe that there is a mechanism in place to bring the world economy out of the compounded set of problems affecting these markets. It seems to me we do have a major problem as things stand.

COMMISSIONER ANGELL: But I think it's important to realize that the real question about the dollar and its strength has more to do with what Americans do because American households' share of world wealth has risen so dramatically in the last 18 years.

We now have \$44 trillion of assets held by American households compared to \$6 trillion of liabilities. Your

father was exactly correct in his advice that a reserve currency country cannot really take a depreciation of its currency as a way out because we've got \$20 trillion of liquid assets of American households that might choose to go abroad. And so I would just commend the Administration for its strong dollar policy.

VICE CHAIRMAN PAPADIMITRIOU: Peter, you seem to be eager to say something.

PROFESSOR MORICI: Yes. Underlining what Jamie had to say, I think it is a very disturbing development that the whole world, it seems, wants to put its assets in the United States for the reasons he outlined. For example, it is not particularly good news that there is so little confidence in the future of the Euro that it lost so much of its value in less than one year. When the value of the whole is worth so much less than the sum of its parts simply because the currencies were put together -- I mean \$1.17 was the weighted average of the old currencies -- it reflects a lack of

confidence in the ability of the European Monetary Institute to manage monetary policy.

Certainly to some degree the United States will have a trade deficit owing to seignorage, because the world is replacing gold with dollars as its reserve asset, but we don't need to have a \$200 billion deficit to do that. A good deal of what's going on is that there are too many places in the world that used to be considered good places to invest and are now considered to be unsafe places to put your money. It's as if we were giants in a world of midgets.

COMMISSIONER ANGELL: But Peter, do you have a proposal that we ought to consider that would raise the saving rate in the United States so this huge capital investment spending would thereby be funded from U.S. sources? I mean, what is it? The trade deficit isn't going to go away, I presume, until we save a larger proportion of our capital spending.

PROFESSOR MORICI: The premise of that question is that U.S. budgetary decisions or U.S. savings decisions are the key variables that drive the rest of the system, as if they cannot be influenced by the rest of the system. In the few months after the Asian currency contagion, did Americans just get up and decide all of a sudden to save less so they'd have a larger trade deficit? No, there were a number of factors that happened. First of all, currencies came here, a flight to safety. At the same time, the portfolios of American households dramatically improved in value. The capital comes in, it drives up the stock market, everybody feels richer and they go out and buy Rolex watches.

It isn't as if our savings patterns are not influenced by behavior abroad, just as our savings patterns influence behavior abroad.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Lewis?

COMMISSIONER LEWIS: I have a question for you which I'm going to ask in the next go around, but I just wanted to tell you what it was: you said external factors can and have affected the size of U.S. trade deficits, and earlier people who made presentations to us essentially told us that the policies of those countries really can't affect our trade deficit, so I'd like you to go into that.

But I have a question for Professor Cooper. The question of investments is really very confusing to me because we're told that by having this great trade deficit that the rest of the world is really investing in the United States, which almost implies to me a conscious decision by people overseas to invest here.

Now obviously when they buy securities they're investing here, but when they sell to us and we have debt to them, I'm not sure I look at that as an investment. And yet we see American companies making massive investments overseas. To me, that's a real investment because we're

taking American dollars and making a conscious decision to invest in a shoe factory in China or a wafer factory in Indonesia, whatever it is. And there's been a massive outflow of U.S. dollars overseas by U.S. companies and those to me are really investments.

Now if the investment return in the United States yields 10 to 15 percent, and we're only paying 5 to 10 percent, are we investing that in the United States, or what is the rate of investment we're making overseas as being financed by the debts that's coming here from overseas? I'm confused by this whole concept of investment when I know that when a shoe factory is built in China, that's an investment.

PROFESSOR COOPER: Let me try to help. The first thing to say, is that international investment, like international trade, goes two ways. We import and we export and similarly Americans invest abroad and foreigners invest in the United States. Those processes are going on simultaneously and it's entirely true that

there are many Americans who are investing abroad. But the bottom line for 1998 and 1999 is that when you add up all the American investments abroad, they are overwhelmed in magnitude by foreign investments in this country.

COMMISSIONER LEWIS: When you say foreign investments, do you mean actually something other than buying securities or stocks or do you mean that included?

PROFESSOR COOPER: I'm including all foreign purchases of assets. It may surprise you to learn that the biggest destination in the world for foreign direct investment, that is, investing in operating businesses in the United States. The main investors are Europeans and Japanese, but some developing countries now are also making business investments in the United States, so-called direct investments. We are the biggest recipient of foreign direct investment. China is second, after the United States.

COMMISSIONER LEWIS: When you say that, do you mean investing dollars or stock exchange which really don't affect --

PROFESSOR COOPER: No, direct investment is defined as investment that involves management control.

COMMISSIONER LEWIS: No, I understand --

PROFESSOR COOPER: On top of that --

COMMISSIONER LEWIS: If Daimler Benz buys out Chrysler for stock, that's included in your statistics?

PROFESSOR COOPER: That's included. That's right.

COMMISSIONER LEWIS: Even though there's no change of dollars or currencies, just stock?

PROFESSOR COOPER: Yes, that's included in the numbers, although American acquisition of Daimler stock also represents outward investment by Americans.

COMMISSIONER LEWIS: Okay.

PROFESSOR COOPER: In addition foreigners purchase securities that don't involve management control, both stocks and bonds. It happens that foreigners tend to like bonds, whereas Americans tend to prefer stocks, as a sweeping generalization. But when you add it all up and net it all out, what you find is that foreign investment in the United States in recent years has overwhelmed in magnitude U.S. investments abroad, but both processes are going on at the same time.

And my basic argument is that in the world in which we live, with a floating dollar, if you have to identify the principal cause of the large deficit of the United States, it is the large net foreign investment in the United States, net of U.S. outflows.

Play the thought experiment of denying that. Suppose investors invested only half as much as they did, \$150 billion rather than \$300 billion. Our current account deficit would be \$150 billion. And the dollar would be weaker, relative to other currencies. So in

that sense the capitol inflows are the direct cause. Now just not to avoid any misunderstandings --

COMMISSIONER LEWIS: Excuse me one second.

You're saying in a sense that deficit causes a stronger dollar?

PROFESSOR COOPER: The foreign investment causes the stronger dollar which, in turn, causes the trade deficit. The foreign investment, by the way, is all-voluntary. Nobody is arm twisting them to invest in the United States. Our capital markets are open.

COMMISSIONER LEWIS: But the deficit causes them to invest in us which raises the value of the dollar?

PROFESSOR COOPER: No, no. Their desire to invest in the United States causes a stronger dollar which causes the deficit. That's the chain of causation.

It goes from foreign desire to invest in the United States, leading to a stronger dollar, leading to --

COMMISSIONER LEWIS: Isn't the investment the selling to us of goods which then gives them dollars which they can buy securities?

PROFESSOR COOPER: No, investment is the buying of assets in the United States, all kinds of assets -- real estate, plant, equity, stocks and bonds.

To avoid misunderstanding, I want to agree with what Jamie Galbraith said earlier, that one reason the U.S. has been as attractive as it has been, relatively speaking, in recent years is that other parts of the world have been flabby. As other parts of the world pick up economically, one would expect both their savings to increase, but also investment in those parts of the world to increase.

So I don't disagree with that proposition at all. But I just want to emphasize that 100 percent minus 6 percent is 94 percent. So most foreign savings is not invested in the United States. It is invested abroad.

As foreign economies pick up their savings will rise as well as their investment and the net affect is not clear.

COMMISSIONER LEWIS: If there's been such a flabby investment atmosphere in other countries, why has there been such a massive investment by U.S. companies in Asian facilities?

PROFESSOR COOPER: Well, you use the word "massive." These are all relative terms. U.S. investment in foreign countries has been tiny relative to foreign investment in foreign countries, and it's been small relative to foreign investment in the United States. It's true the numbers cumulate to hundreds of billions of dollars, but it's much smaller than foreign investment in the United States, so it's not "massive" in that sense. And, of course, it's much, much smaller than foreign investment abroad. Most investment is home investment in all countries.

COMMISSIONER LEWIS: Patrick, did you want to say something? I saw you raising your hand.

SECRETARY MULLOY: The only -- I have read some books that suggest that foreign takeovers of U.S. companies can have hidden costs. Daimler now owns Chrysler and the question is -- and if that's happening a lot, what are the implications for where the foreign management might want to have the higher value-added jobs located -- the one that involve the high technology? Does that have any long-term implications for the composition of what we'll be doing in the future as Americans?

I've read articles that raise that point, so I just wanted to throw it out.

COMMISSIONER LEWIS: Thank you. Thank you very much, Dr. Cooper.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Wessel?

COMMISSIONER WESSEL: I have two sets of questions. Mr. Shaikh, the first one for you is to

understand a bit, if I can, about labor inputs and the impacts on trade.

During last week's discussions in Seattle, the President made comments about the importance of labor rights and earlier there's, as you well know, long discussions during trade debates about the importance of labor issues and free labor markets as part of the impact of trade and what impact that will have.

In Mexico, for example, there is a joint wage setting process between the government and the major labor federation, the CTM, called El Pacto which occurs on an annual basis. And that places arbitrary limitations on the ability of wages to rise with productivity or by any other measures, as I understand it.

If you could, tell me what kind of impact you think those arbitrary limitations might have on trade flows and how important addressing free labor rights, free labor markets could be as part of

long-term trade policy advocacy?

PROFESSOR SHAIKH: Thank you. The question you pose is a very important one because if costs are central in driving international trade, then if we are not competitive we will tend to buy more from abroad than we can sell. It follows that we will have to borrow to cover the difference. International debt will be a reflex, so to speak of, a lack of competitiveness. I would agree that this is the principle for now which must be addressed. But since the trade balance is also affected by relative growth rates, it has been suggested in previous discussions that one of the ways to improve the balance of trade of the U.S. would be to raise growth rates abroad. Another way to improve the U.S. trade balance would be to raise wages and labor standards (and hence costs) abroad. This is a tricky issue. Considerations of this sort, as well as those involving around the WTO raise the issue of what precisely is the purpose of trade policy. Is it simply to allow exports

and imports or commodities to move freely and capital to move freely, or should it ultimately be about jobs and what about people and what about standards of living?

I think it's very important to push for the idea that people have a right to organize abroad. They have a right to wage increases that they can get in relation to their productivity. This has always been a principal component of U.S. history, a very proud component of U.S. history, and it certainly should be extended to the rest of the world.

The complication arises that historically countries like Japan and South Korea succeeded precisely by initially keeping wages relatively low and raising productivity very high. However, overtime workers were able to secure some of the benefits of that productivity growth which is one of the reasons that the Japanese and South Koreans are so much richer and more powerful now.

If you look at the relative unit labor costs of the U.S. compared to Japan and South Korea, you see

that the U.S. was initially quite high compared to them. Productivity kept growing in all three countries. But in Japan and South Korea, after a certain period when the benefits from trade began to have their impact, workers were able to raise their wages more rapidly than in the U.S. (starting from much lower levels). While this somewhat reduced the competitive advantage in these countries, it also had a material impact on the standard of living of the vast majority of their people.

If trade cannot benefit the majority of the people, then we have to ask why should we support it?

It should be able to feed back. It should be able to benefit most people.

The question then is there any way for the U.S. and for international organizations to foster a climate in which industries have a chance to get going and succeed in the world market, and yet also have a chance for the benefit of that to feed back on the

people, rather than flowing into pockets of the very wealthy or flowing out of the country altogether.

I think that it is absolutely essential to recognize that there is absolutely no automatic mechanism that will make trade balance, or provide benefits to all.

Anyone who has looked at the history of international trade across countries knows that we cannot read it from just a history of the U.S. We have to look at the whole world and over a long period of time. And then we can see that a country's trade balance can improve if foreigners grow more rapidly or if their wages rise more rapidly. And so we can see that there are circumstances in which both sides can benefit, if it's done properly.

COMMISSIONER WESSEL: Thank you.

Mr. Mulloy, a couple of questions for you if I could and I know that you're charged along with USTR staff on the question of monitoring and enforcement. We've seen, as I understand it, during this Administration some 250 or so trade agreements being

signed in addition to what is an annual inventory of trade barriers around the world collected in the National Trade Estimates. You have a fairly small elite staff but small nevertheless as well as limited resources.

What are the challenges that you face? How much do you believe addressing in a comprehensive and aggressive way do you think going after these trade barriers could yield in terms of our trade balance and what steps would you take to enhance our ability to confront this issue?

SECRETARY MULLOY: First, if I can just briefly comment on your prior question and then come right to this one. One of the reasons that you would want to press for core labor standards like the Administration did in the WTO Round is we're not telling them that they have to pay their workers a certain amount of money. All we're saying is permit your workers to organize and collectively bargain so that they can get a bigger share and so that maybe we have some domestic-

led growth in these economies rather than just export-led growth.

COMMISSIONER WESSEL: Let me just on that -- there are some, as you know, some who certainly want to impose higher standards. There are many who believe that labor as well as the environment are trade issues as well as intellectual property, investment, et cetera and they are simply seeking to have the rule of law, the concept of the rule of law equally applied across these issues such that if we were to engage in negotiations with Chile as we would expect them to address capital issues through the rule of law and enforcing their own laws that we would seek the same in those other domestic laws that they have on their books, rather than imposing U.S. OSHA minimum wage or other standards, so I understand what the President was seeking to do throughout the process.

SECRETARY MULLOY: Now on your talk about the monitoring and enforcement of trade agreements, it's almost astonishing to realize that up until about four

years ago there weren't units in the United States Government which had the responsibility to collect and monitor and enforce our trade agreements. So it's a new effort. I think it came about from -- people were asked for different trade agreements and we had no centralized collection of the agreements, so this Administration put in place that effort.

One of the problems we've had in the Commerce Department, in the monitoring and enforcement of these agreements, is the lack of resources. We have only 150 people broken down in our geographic units. We have tried to get additional resources. The President, in his recent budget requests, has tried to get additional resources for this effort. This year for the first time in many years we got a couple million more so we can actually hire more people.

But what we are finding is this is a very time-intensive effort. First, you get a problem and then you go through the agreements to see if the agreement

covers that market access problem. If it does, then you try and take it up with the other government. If it's like a NAFTA, then there's dispute settlement provided. If it's, for example, with Japan and you can't get them to resolve it in some way or another, then -- and you go to the WTO. USTR is the gatekeeper of what cases you take in the WTO. It's a very time consuming, difficult process and you have to have people who really understand the societies in which you face, the market barriers.

So I would hope that this is an area that we will be able to put some more resources and we're learning as we go along how best to do that and how to outreach to more and more companies to let them know we're there. And we're outreaching to some of the labor unions as well to let them know where they can come because they have some issues that they bring in as well.

COMMISSIONER WESSEL: So most of the problems that you're made aware is from private industry

indicating that they're having trouble getting access to
--

SECRETARY MULLOY: Most of -- that's the present, what we're finding. I think we need some more resources. We not only have to do the monitoring and enforcement with those 150 people, but we have to do all the policy papers for people who go into interagency meetings or meetings with foreign officials, et cetera, so it's a very -- compressed and we don't have enough time to do as much strategic thinking as we should be doing in this whole area.

The other point is on the WTO. I think Paula Stern mentioned this morning something about that they have some review groups. I think that's an area that the WTO has to strengthen as well to do these periodic reviews of each of the countries and what other people are saying, their experiences, what other governments, not just us, but other governments are

saying that they're doing to limit market access in those countries.

The third thing that we found, particularly with Japan, one of the reasons we tried so hard in those auto discussions to get some benchmarks in is because when you have agreements with the Japanese, it's very, very difficult to get any enforcement unless you have some benchmarks into them. Otherwise you can go around and around and around on these discussions, time after time and it doesn't -- we don't seem to be able to get the resolution that we need.

COMMISSIONER WESSEL: Did you have an estimate on the value of the barriers, what -- if we were to be fully effective, and I know that's a concept that's difficult to grasp, but fully effective in enforcement of existing trade agreements and addressing barriers, what kind of impact that might have?

SECRETARY MULLOY: I don't think we've done that type of calculation, Mr. Wessel.

COMMISSIONER WESSEL: Thank you.

VICE CHAIRMAN PAPADIMITRIOU: Thank you.

Professor Galbraith, if I may ask a question on something that no one seems to have asked and it is prominently included in your testimony. It has to do with your recommendation for a proposed financial or global financial authority. My question is that given the sophistication and the complexity of the financial markets, do you believe that such an institution could actually provide the stability that you seem to think once we had and now we don't?

PROFESSOR GALBRAITH: I believe that we need institutional reconstruction in this area. I would argue that the International Monetary Fund is, on the one hand, too small, and has a mandate that is on the other hand too broad to effectively advise the countries of the world on appropriate policies, and the result of that is that very small teams give very standardized advice

across a wide range of situations, often making the conditions worse, rather than better.

Now how one goes about addressing that is -- I'm not going to minimize the difficulty of that question. It seems to me though that if you look at the cases of effective transnational financial regulation they largely work best at the continental scale. The United States being a large, continental economy with an effective system of internal financial regulation. It seems to me that it is not beyond the bounds of reason to expect the Europeans to construct such institutions over the next several decades. I think they've gotten off to a very poor start, but they're going to have to change the rules under which they operate, because they cannot conceivably go through a generation of 15 percent unemployment in Southern Europe, it just isn't imaginable to me without fundamentally changing the character of the continent.

I do think that in the case of Asia where you're looking at a much more heterogeneous group of countries, the Japanese made a useful suggestion to begin the development of an Asian monetary fund into which they would have had to put a great many of their own resources and I think it was imprudent of us to reject that suggestion.

Now what one does when you put together pieces at the continental level at the global level to coordinate them, that's another set of issues, but that's where I would start.

I want to come back to a question, it's a point on Mexico.

VICE CHAIRMAN PAPADIMITRIOU: Go ahead.

PROFESSOR GALBRAITH: I do want to say a word in defense of the Pacto de Solidaridad which was an incomes policy aimed at internal stabilization in times of very great inflationary and other difficulties in Mexico. I've had occasion to do rather detailed work on

the change in inequality internally in the Mexican wage structure and although inequality was very high at the time of the Pacto, the Pacto did stabilize it. That is to say, it didn't work to the disadvantage of the lower income Mexican workers. What was really catastrophic in Mexico --

COMMISSIONER WESSEL: Relatively, in relationship to the economy itself?

PROFESSOR GALBRAITH: In the manufacturing sector.

COMMISSIONER WESSEL: Okay.

PROFESSOR GALBRAITH: Which is to say sectors which do export to us. What are really catastrophic on two counts have been the instability of the Mexican capital account and the tendency of the peso to depreciate catastrophically which has happened on several occasions, most recently at the beginning of 1995.

The problem there is two-fold from our standpoint. Mexican labor loses value, gains competitiveness, is reduced in price, relative to labor right across the border and in addition to that, the lowest-paid Mexican workers suffer the most because their commodity basket that they consume goes up in price and they are least able to defend their position on the wage front.

So it seems to me that financial stabilization is a far more important goal, from the standpoint of protecting American workers from cut rate competition, than going after the internal mechanisms which have, seem to me probably have been stabilizing as a whole, although perhaps not all that important.

VICE CHAIRMAN PAPADIMITRIOU: Thank you.
Chairman Weidenbaum.

CHAIRMAN WEIDENBAUM: I have a question for Secretary Mulloy. Today and earlier in our hearings we hear so much about Japanese trade barriers, so I did a

little calculation and let me try this calculation out on you and see what reaction you have.

I've taken Japanese imports from the U.S. per capita. Then I take U.S. imports from Japan per capita. And it turns out, in the last few years at least, the average Japanese imports more from the U.S. than the average American imports from Japan. Of course, we have more capita, more people, so when you multiply by our respective populations, you get the large trade imbalance that we regularly report.

But how come? When you do it on a per capita basis, you get a very different picture.

SECRETARY MULLOY: I think there are a couple of things you have to look at. You have to look at the composition in terms of whether it's higher value added, and what raw materials.

COMMISSIONER WEIDENBAUM: Oh yes, I assume that a small country like Japan that has a shortage of

raw materials is going to buy raw materials and ship finished goods. That doesn't surprise me.

SECRETARY MULLOY: I think the composition does impact in terms of what we make in this country and in terms of what we're buying and we don't make anymore because we have this deficit with Japan.

I don't know whether you'd want to look at that in terms of their worldwide situation. Japan is a major surplus country, not just with us, but with many other countries around the world and I would expect that that formula probably wouldn't work, say with their trade with Korea with which they're running a major with Europe and maybe -- you'd have to pick individual countries, I guess.

So I think you're making a fair point, but I think when you look at the total international trading system I think Japan stands out as a problem in terms of market access.

Let me just give you an example. An anecdote. I was over in Finland in Nokia Headquarters and they were showing us their worldwide markets and where they were producing and where they were selling, et cetera. And the fellow passed over Japan like oh, well, we -- nobody does well in that market. It confirmed what our own people tell us, that there's a real problem.

And let me just add one more thing and I raised this with Professor Cooper. I'm not sure, but I'm a lawyer and not an economist, but the money that's coming in here as investment, if that money was coming in to buy U.S. goods, rather than to invest, would that be better for our economy or not? I mean I'm not an economist so I don't know the answer to that, but it just seems to me one of the reasons that Japan, for example, or even now Europe. These countries are running major trade surpluses with the United States, so they have more money to invest in the United States.

COMMISSIONER WEIDENBAUM: A lot of the discussion which I find indeterminate is which is chicken and which is egg and I must say, just in my own view of the complicated modern economy, it's hard for me to think of one as the independent variable and the other is the dependent variable. I think the relationships are far more complicated and go in both directions.

PROFESSOR GALBRAITH: Right.

PROFESSOR MORICI: Commissioner Weidenbaum, you well know that *ceteris paribus*, the smaller an economy is, the more it trades. For example, the Canadians import far more per capita from the United States than we do from Canada, simply by virtue of size. So I don't know that comparisons between the largest country in the world and smaller countries, and the observation that these smaller countries always import more from us than we from them, casts particular light on the nature or the causes of the trade deficit or its consequences.

CHAIRMAN WEIDENBAUM: Professor Cooper, you also had a point to make?

PROFESSOR COOPER: I want to respond to the question of wouldn't it be better for Americans if foreigners bought goods, rather than assets? I'm sure the Commission has heard this before, but you haven't heard it this afternoon yet, that employment in the United States is basically a macroeconomic phenomenon.

In recent years, let's say the last three years, if foreign demand for American exports had been much higher than in fact it was, U.S. monetary policy would have been tighter. The big beneficiary of the Asian financial crisis was the U.S. housing industry. This crisis changed the composition of U.S. output, away from exports to construction. Lots of things were, of course, going on, but that is a first approximation. The Fed is charged with doing a job, keeping inflation down. One can debate whether the Fed deserves an A minus or a B but most people would credit it on the whole with doing a

good job. Jamie Galbraith would give them a lower grade than many other people would give them, but on the whole the Fed has done a good job. The Fed's job requires adjusting aggregate demand. We should do more through fiscal policy in my view, but executive-congressional cooperation has not been terrific in macroeconomic management in recent years, most of the burden is thrown on the Fed. There's no doubt in my mind that if U.S. exports had been \$100 billion higher in 1997 and 1998 and 1999, U.S. construction would have been lower. Construction would have been lower because our interest rates would have been higher and our interest rates would have been higher because the Fed would have acted to head off inflationary pressures.

So we have to keep that in mind when we ask about the influence of the trade balance on employment. We can't change the trade balance without changing other things. That's the key point.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Angell?

COMMISSIONER ANGELL: Yes, Professor Morici, some items I didn't quite understand. The one item I did understand I didn't agree with at the bottom of the page of your written testimony 1. You said it somewhat different than Dr. Cooper said it. You said that because foreign governments increased their purchase of U.S. securities the dollar was strong. I thought Professor Cooper and others were saying it somewhat differently, that if there had not been demand either from governments, corporations or households abroad for U.S., and here I'm going to paraphrase, the dollar would have been lower in value than it now is if there had not been that demand. But you really do think there was a conspiracy on the part of governments to buy U.S. Treasuries and thereby drive the exchange value of the dollar higher?

PROFESSOR MORICI: I would prefer to answer that rhetorical question at the end of my comment and to turn to Mr. Lewis' question, which directly relates to it.

COMMISSIONER ANGELL: Would you speak into the mike?

PROFESSOR MORICI: I would prefer to address that rhetorical question at the end of my comment and to turn to the question that Mr. Lewis has promised me, because it relates directly to it.

When we look at macroeconomic variables, there are really two kinds of variables, those that governments have control over and those that are induced or dependent variables, to use the Chairman's language. For example, the size of the budget deficit we can view as something the government can determine. It can decide how much to spend. It can decide how much to tax.

When we have a large budget deficit, we drive up interest rates. This attracts foreign private

investment. Foreign private investment is one part of the capital flows into the United States. Okay?

COMMISSIONER ANGELL: Yes.

PROFESSOR MORICI: The other part is the purchasing by central banks. These are public capital flows. I point out that the Treasury Department does not publish figures on individual central banks' purchases of U.S. securities. Rather for each country it publishes public versus private and then it tells you which countries purchase different kinds. It was apparent from looking at the IMF statistics that, during the period in which the budget deficit was falling, China, Japan, Hong Kong, Great Britain, and a few others were making large purchases of U.S. dollars for the purpose of just putting them up as reserves. These were official purchases.

An official purchase of a dollar has the same macroeconomic consequences as an increase of one dollar in the U.S. budget deficit. The model that economists use to evaluate --

COMMISSIONER ANGELL: The model that some economists use?

PROFESSOR MORICI: No, I'm talking about the Mundell-Fleming model, which is, for example, widely taught at American universities. It is basically an open country macroeconomic model. If you look at the multiplier for a government deficit, then you look at the multiplier for the purchase of official assets, it's the same. In other words, if the United States increases the deficit by a dollar or if a foreign government increases its purchases of dollars, it has the same effect in the model in terms of how it works its way through.

COMMISSIONER ANGELL: Perfect capital mobility.

PROFESSOR MORICI: Absolutely, but I mean --

COMMISSIONER ANGELL: What did you say?

PROFESSOR MORICI: When we talk about the savings rate driving the trade deficit, we're using that model. So I think it's only fair that I use your model,

Mr. Cooper, the model that is embraced by most conventional macroeconomists and that would attribute the trade deficit to the savings deficit and so on and so forth.

When foreign governments choose to purchase U.S. dollars in large quantities, it does have the effect of driving up interest rates, of making the U.S. dollar strong, and then having an effect on the trade deficit.

COMMISSIONER ANGELL: But my question was --

PROFESSOR MORICI: Was there a conspiracy?

I have no idea. I doubt it.

COMMISSIONER ANGELL: All right, so --

PROFESSOR MORICI: I doubt it. However, it did have the effect. It did have the effect of avoiding an appreciation of the yen and the depreciation of the dollar, and the Japanese did purchase substantial shares. It also had the effect of denying the pressure to appreciate the Chinese currency.

COMMISSIONER ANGELL: But you would agree, would you not, that many central banks, in countries where they are monetary authorities and countries where they're running a balance of trade surplus, do have an inflow of dollars and this inflow of dollars often shows up on the central bank's books. The central bank then decides whether to buy gold or buy U.S. dollars and quite commonly the choice of dollars has been predominant, hasn't it?

PROFESSOR MORICI: But they could choose not to make purchases at all and permit their exchange rates to adjust, which would then have consequences for the size of their budget surpluses and our budget deficits.

COMMISSIONER ANGELL: So the answer is you do think there was a scheming reason to purchase U.S. Treasuries?

Let me go to another --

PROFESSOR MORICI: Wait a minute. No, I don't think there was a scheming reason. I don't know

what their reason was. I'm saying these purchases do have that effect, just like a large budget deficit has that effect. Certainly we weren't scheming to have a large trade deficit when we had large budget deficits, but those purchases do have that effect. And they are not market-driven purchases. They're policy decisions. They're decisions by public officials to make those purchases, and they were very large purchases indeed.

COMMISSIONER ANGELL: Many of us would say that when Americans choose, because of higher wealth or whatever, to consume more and save less that in effect is a factor in both our under saving and also in our importing more. Would you agree?

PROFESSOR MORICI: Individuals making choices about how much they save are driven by factors in the marketplace -- rates of interest, household wealth, things of that nature. When a foreign central bank makes choices, it's a policy decision to intervene in exchange rate markets. There's a difference. One is

a public choice. The other is something induced by the whole panoply of forces that act on consumers and determine their behavior. There is a difference.

COMMISSIONER ANGELL: But monetary authorities and some central banks do prefer to stabilize exchange rates and such stabilization would involve an automatic purchase.

Now I want to ask another question that has to do with the currency depreciation or currency devaluation. If some think that other countries are doing something that causes the dollar to be stronger, then why couldn't the U.S. do something that causes the dollar to be weaker?

Would you agree that if the dollar were weaker, then American household wealth would fall, because Americans' household claims on world assets would shrink? And so we do know that if a dollar were depreciated, just as the Mexican peso being depreciated made the people of Mexico so poor they couldn't import

much, certainly that that would work, that is, we could resolve our balance of trade deficit quite easily if we were willing to make Americans poor by depreciating the dollar. And I think all of us know that that would -- or do we? Does anyone disagree that the U.S. balance of trade deficit under those conditions would fall?

PROFESSOR MORICI: If the foreign central banks from 1992 to 1996 had not chosen to purchase the dollars as they did, and if they had permitted exchange rates to readjust so that the dollar became weaker, then Americans would have been poorer, in the sense that their household wealth positions would have declined.

We have learned from history that, when that happens, they save more and in the process of saving more we would have a reduction in the trade deficit. That's the connection, sir, between policy and the trade deficit. It does run through savings. My point is, on the one hand, the United States can drive a budget deficit and lower overall U.S. savings. The United

States can drive that by spending too much money and taxing too little.

On the other hand, foreign governments can drive that by purchasing dollars in large quantities to elevate the value of the dollar. When they do that, they enhance the household wealth position of Americans and as a consequence Americans save less.

What I'm saying is that savings are an adjustment mechanism in the system. When the currency contagion hit in Asia, I doubt that Americans got up and decided to automatically change their savings pattern so dramatically. Rather, there were other things happening.

COMMISSIONER ANGELL: But when Asian currencies devalued they made the people of those countries poorer, but American dollars, of course, grew in value as they devalued. We became wealthier and so consequently why wouldn't we have saved less in households in such a condition of augmented wealth? I presume people save because they want to get wealthier

and I presume thereby that if they get wealthier than they expected to be, that the savings rate would be affected. But certainly I don't think anyone here is suggesting that the way to solve the balance of trade problem is to make Americans less wealthy.

PROFESSOR MORICI: I would suggest to you that permitting the dollar to decline, abstinence from intervention in exchange markets by the United States government and other governments, would be helpful in reducing the trade deficit. Or at least it would have during that period. We haven't had the level of intervention lately that we had during that period. It would also have the effect of making the Americans, on paper, less wealthy. But I would point out to you the real wealth of the nation is our ability to produce. Over the long term, by having a lower trade deficit, we would invest more in R & D, invest more in those things that we do so well, and we would raise our potential rate of growth significantly. In that way we would increase

our wealth over the long term. It's an unfortunate problem that we can mistake an immediate effect in the paper balance sheet situation of the American people with their long-term wealth prospects. Our real wealth is what we can make.

COMMISSIONER ANGELL: Of course.

VICE CHAIRMAN PAPADIMITRIOU: I wonder if we could move to another topic.

COMMISSIONER ANGELL: Of course, we've seen some very good evidence of capital investment increasing labor productivity, increasing our potential and thereby increasing well-being.

PROFESSOR MORICI: The last word, sir.

VICE CHAIRMAN PAPADIMITRIOU: May I move the discussion to perhaps another topic?

Commissioner Lewis.

COMMISSIONER LEWIS: I'd like to come back to the question that I asked you earlier. Part of it you answered by talking about the exchange rate impacts by

policy decisions of foreign governments. But when a country decides that they want to build more productive capacity than they can possibly consume in that country, isn't that essentially a policy decision by a foreign country that will impact their trade with us?

PROFESSOR MORICI: That's a more recent example of that kind of problem. In Asia, a great deal of excess capacity has been constructed, as a consequence of industrial policies, subsidies, credit steering, things of that nature. And the kinds of assets that have been assembled are not easily disassembled.

Now the --

COMMISSIONER LEWIS: There may be some other things that you want to mention also.

PROFESSOR MORICI: But that process essentially created a great deal of capacity, which was premised on exporting to the United States, and if you look at the period of, say 1990 or 1992 to the beginning

of 1997, exports from those small East Asian economies to the United States grew very dramatically.

Unfortunately, there's a limit to our ability to absorb those kinds of products, and if you look at the first six months of 1970, the exports ceased to grow.

COMMISSIONER LEWIS: 1970?

PROFESSOR MORICI: Excuse me, 1997. They ceased to grow. What that meant was the people that had the debt or the people that owed the debt, people with the excess capacity, started to sense that there was a problem. Not only that, but people within those economies started to sense that there was a problem. So they started dumping their currencies for dollars and that started the process going. But the debt crisis was the product of poor economic policy. It was the product of over-expansion of industrial policy and all of the sins we've heard about with regard to small country Asian capitalism.

COMMISSIONER LEWIS: So there's the building of overcapacity vis-à-vis their own domestic consumption. There's the policy of buying Treasuries to keep the dollar strong. Are there other ways that the policies of foreign governments can affect the trade balance besides those two that you're aware of?

PROFESSOR MORICI: Mr. Mulloy suggests trade barriers. I don't agree with that. My feeling is that trade barriers affect the structure of the deficit and how much exchange rates would have to adjust to bring the trade deficit back into balance. For example, suppose that nobody purchased any dollars between 1992 and 1996, of a government nature, that there were no public transactions, that it was all private. The fall in the value of the dollar relative to the yen would have to be much greater than necessary, because of the kinds of trade barriers we have in Japan. For example, consider the inability of the Japanese Fair Trade Commission to enforce its antitrust laws. Mr. Mulloy mentioned, for

example, our inability to enforce agreements. Take the Structural Impediments Initiative Report of 1991. The JFTC issued substantial regulations that would affect vertical restraints in Japan. And noted Japanese scholars to whom I could direct you have said they have not adequately enforced them. They have not adequately enforced them -- According to some of their own antitrust scholars, lawyers.

Other government policies are going to affect the size of the trade deficit -- their own taxing and spending policies. If foreign countries were to wake up one morning and decide to have large budget surpluses, that would affect their overall savings rate. Anything they could do to affect savings rates in their countries would have an effect.

COMMISSIONER LEWIS: I appreciate your response very much because earlier people have presented to us saying that government policies can't affect trade balances, so I really appreciate your presentation.

PROFESSOR MORICI: Thank you.

VICE CHAIRMAN PAPADIMITRIOU: I, too, want to follow up on this, and, if I may ask Professor Shaikh, you have ended your testimony by saying that a trade balance can be achieved through promotion of economic growth and I wonder whether you have any particular ideas about how the U.S. could engender that kind of growth?

PROFESSOR SHAIKH: As I said, let me qualify my previous remarks a little bit. I put a lot of emphasis on costs and one tends to do that when you have five minutes and want to get a main point across. But it's obvious that while costs are a major factor, they cannot explain everything. I mean we could take two countries with relatively similar costs and we could look at the policies of the government. We could look at entrepreneurship. We could look at historical factors.

And we might see that one country does better in the world market than the other because it has better products or innovates more rapidly, or so on. So these

institutional, cultural and policy influences are very important to deal with at a concrete level very crucial.

It's nonetheless true that costs play a central role because it's easier to succeed in the world market if your costs are lower. It's much harder to do it if your costs are higher, so it's important to look at competitive position in a world market and in that sense I have been dissatisfied with a lot of the discussions which focus on how growth merely worsens the trade deficit. This is only true in the immediate sense, obviously, because other things being equal, people will buy more goods and, therefore, more imports if the country grows faster, and this will worsen the trade deficit. However, if we look at growth from the point of view of business, growth involves expansion of capacity. That involves introduction of new methods, which involves rising productivity, which involves lowering costs and hence stimulating exports. And so it's not correct, I think, to see growth as a one-sided

negative when it comes to trade. It is, in fact, a question of the short run effect versus a longer run effect. It's perfectly possible but growth initially worsens the trade deficit, but a spurt of growth which initially worsens the trade deficit can actually set the stage for an improvement in the trade deficit by lowering relative costs.

Now in my data on the real unit labor costs of the U.S. versus its trading partners (Figure 5) of my written statement, you will notice that the fall in relative costs leveled off in the last two decades. This is quite striking, because during this interval the U.S. has been growing relatively rapidly and yet there hasn't been any further decline in relative real unit labor costs. If that could be changed and the U.S. real unit labor costs could be brought down, then I think the longer term benefits would begin to kick in, and that would have a positive impact on the trade deficit. This

has a direct bearing on many of the discussions before this Commission about whether we're facing a crisis.

For instance, Wynne Godley argued in the morning sessions that there was a potential for a trade crisis because a persistent trade deficit can make the currency of a country more fragile, more likely to undergo a sharp change and that is something to be concerned about. If, however, growth can also set into place the possibility of reducing the deficit and bringing it back within a sustainable range, then at the same time you reduce the fragility and the risk of a sharp currency fall I think that's an important thing to keep in mind.

VICE CHAIRMAN PAPADIMITRIOU: Thank you.

Commissioner D'Amato?

COMMISSIONER D'AMATO: Thank you, Mr. Chairman. I have a question for Mr. Mulloy. I've been waiting for years to ask Mr. Mulloy a question and I can't avoid this opportunity.

(Laughter.)

And I've read your testimony on export barriers in Asia, that's what I wanted to focus on. I know you've been asked about an assessment which we've asked a number of witnesses to try and give us, an assessment as to what part of the very large deficits we have with China, particularly, but the other Asian countries, too, can be attributable to non-tariff barriers. I know that's not completely measurable, but let me ask you a little bit about that. First of all, would you say that it's settled policy on the part of the Asian governments, Chinese government, Japanese government, Korean government to reduce or eliminate non-tariff barriers in any scheduled way, at the particular time? Do we see evidence that they have a policy to remove these non-tariff barriers in an aggressive way in any kind of a time frame?

SECRETARY MULLOY: Let's look at -- Japan,
I don't see --

COMMISSIONER D'AMATO: Don't see that in the case of Japan?

SECRETARY MULLOY: With regard to China, if you look at the market opening agreements and the WTO trade agreement that we have negotiated with them and now they have to go through a process of negotiating a separate agreement with the Europeans, from which we would benefit because all these are being done on an MFN basis. If those type of agreements were put in place and then they were seriously monitored and enforced -- and there was an excellent article in the Financial Times yesterday that even if China wanted to fully enforce those, they need to build some institutions in China in order to be able to do that -- but that if we could, and if they lived up to those and if the WTO and we and other countries were after it on a regular basis, I think that could make some impact there in getting rid of these non-tariff trade barriers.

See what happened, I think, in Asia was Japan was the model. They all looked at what Japan did and how that led to their -- and it was an export- led growth strategy and these other countries modeled themselves on that and have done -- they did well for a while until they fell off into that financial crisis, but they still maybe would have done better if they hadn't adopted such a strategy.

COMMISSIONER D'AMATO: So there are a lot of ifs in the question of China, if they've put the institutions in place, if there was a will and if there was a history of actually attempting to enforce, even if they had the ability to enforce the agreements that they signed with us.

SECRETARY MULLOY: Yes, I think this Administration will make a major effort to be all over that agreement. But let me just follow up on one question and I know you're also looking at organization of the government and other things. Just my own unit --

let me just quickly tell this. We have about a \$19 million budget for our 150 people which are monitoring and enforcing trade agreements. And doing a heck of a lot of other things. Over the last four years, the President has asked \$16 million in total more for that unit and we haven't gotten it.

COMMISSIONER D'AMATO: From the Congress.

SECRETARY MULLOY: From the Congress. This year for the first time in I guess about 8 or 9 years our budget got an increase. We got a couple million and some of that I think was attributable to the fact that the Finance Committee wrote to our appropriators and said you really to need to get this unit built up.

COMMISSIONER D'AMATO: They wrote the appropriators a letter?

SECRETARY MULLOY: Yes, they did and so did the Banking Committee, also wrote to the appropriators.

So my view is this is something maybe you'd want to pay

a little attention to in your report, because it's very important that we be all over these agreements.

COMMISSIONER D'AMATO: Thank you for that.

Let me follow up just a little bit here and I wanted to ask Mr. Galbraith to follow up on that too, but you cite \$112 billion macro trade deficit with the Asian economies, but it is true, is it not, that a very substantial portion of that can be attributed, even though we might not be able to measure it, to non-tariff barriers?

SECRETARY MULLOY: I would bet on it. I believe that, yes.

COMMISSIONER D'AMATO: If you were to add the services that we'd like to get into Asia, entertainment, telecommunications, financial and so on, do you see any evidence that the Chinese and the Japanese are prepared to really open their market to these services at this particular point in time?

SECRETARY MULLOY: In the agreement that's been negotiated, it does cover financial services and I think some other services, engineering and other things, so I think if we, again, can get them to live up to what they've agreed to, it will have some real benefit on that area.

Commissioner D'Amato, just let me make one more point. In my testimony, I noted that many of these Asian countries have not only non-tariff barriers, but through the years as Chairman Eckes pointed out to you their tariff barriers have not been negotiated down in a manner that there would be some equity here. They have so-called bound rates which are what we agreed to in the WTO and then you have applied rates. The applied rates are lower than their bound rates, but they're always free to take those applied rates back up if they run into a problem of some sort and that's why in this new WTO round we were pursuing to go after some of those tariff barriers in these Asian countries.

COMMISSIONER D'AMATO: So then the last question on this I'd like to ask you is there any evidence that it is easier to exercise leverage on the Chinese and Japanese through multilateral organizations than there is evidence that we are able to exercise some progress, get some progress through sustained bilateral leverage? Is it easier to open these markets? Is there historical evidence that an organization like a WTO is going to be more effective than using American bilateral leverage because I think that there is a tradeoff? We're giving up bilateral leverage if we join the WTO. And we're going to be, I guess, relying on the consensus of the community to try and exercise that leverage. What I want to know is what is your sense of the history, and the ability of the community at large, through its institutions to exercise this leverage, versus our own bilateral ability to exercise leverage?

Easy question.

SECRETARY MULLOY: Since 1979 we've had this MFN arrangement with China. We could always use it, like we used 301 on Japan. Now that we have the WTO, it's much more difficult to use 301 because first you have to go to the WTO and get the WTO to say that what you're after is really a barrier and it is a problem and it violates the WTO and at that point you can put sanctions on. So it makes the process much longer than it used to be in terms of how we would behave unilaterally. But I think with regard to China, since we, for the most part, for a lot of reasons did not want to use 301 in a major way, I think we did on some of those IPR problems we were threatening. For the most part we did not want to, but I think the hope is the WTO is the better way to go if we and the international community will be on top of the monitoring and enforcement.

COMMISSIONER D'AMATO: Mr. Galbraith, first, and then --

PROFESSOR GALBRAITH: I am open to being corrected by Mr. Mulloy on this, but I have a little bit of experience with the development of modernization policies in China. And my sense is that there's a risk of being misleading if one conflates China and Japan, that over the course of the past 20 years there's probably no country in the world which has opened more already than China has. It was completely closed in 1979. Parts of the country which are entirely devoted to international trade now were completely undeveloped or were frontier regions that were deliberately undeveloped because of the risk of war with Taiwan 20 years ago.

If you fly around China today you don't see many Tupolevs any more. They're all flying in Boeing and McDonnell Douglas aircraft. In the case, one specific case of the WTO agreement, the Chinese agreed to reduce their tariff on automobiles from 100 to 25 percent.

SECRETARY MULLOY: Yes.

PROFESSOR GALBRAITH: Now this is a country where -- it may be surprising, given that it's a communist country, theoretically -- but it's a country where the number of automobile producers exceeds presently, at least the last time I looked, over 100.

There are many very small shops producing cars behind very high trade barriers and it seems to me very likely that the decision to agree to reduce those tariffs was a decision, quite consciously, to rationalize the automobile industry and it would seem reasonable to expect that that would be carried through and the result would be a more open market for automobiles in China.

I don't know if your view is consonant with that, but I'd be interested. That would be mine.

PROFESSOR MORICI: I want to come back to your question about the WTO versus Section 301.

COMMISSIONER D'AMATO: And Super 301.

PROFESSOR MORICI: All those things, all the weapons, all the weapons. The China Trade Agreement, or

the agreement to admit China into the WTO really mandates fundamental, systemic change which goes even beyond the agreement itself because it really presupposes certain legal structures and certain changes in the role, for example, the communist party because of their unusual role in state-owned enterprises which was not present in the Soviet Union.

In the end, that liberalization will only take place if China chooses to do it. The WTO dispute settlement mechanism, because it is a mechanism designed to arbitrate differences between sovereign governments, was not intended nor is it capable of forcing fundamental systemic change or forcing the Chinese to live up in the full spirit of that agreement. They must choose to do it themselves. But I have to point out to you the only case on record that I know of in the modern times where fundamental systemic change was imposed by one country using leverages on another was essentially after World War II when we took over the Japanese economy and as

frightful as their protectionism is today, we imposed major, major change on the Japanese economy but short of battleships, there's nothing the United States can do unilaterally to force the Chinese to change. Section 301 is not Mr. MacArthur on the deck of an aircraft carrier.

COMMISSIONER D'AMATO: But we could use, what is it, Section 12 of the WTO agreement, can't we, for selected restrictions on the Chinese imports as a lever?

PROFESSOR MORICI: I'm saying the application of sanctions will not cause the kind of change that that agreement presupposes.

In the end, countries only liberalize because they choose to.

COMMISSIONER D'AMATO: Multilateral or bilateral?

PROFESSOR MORICI: The question really comes down to whether the Chinese have now determined in their own minds that these kinds of structural reforms are

necessary to take the next step forward, to move to the next level.

If we don't believe they believe that, then we shouldn't be doing this. Many people do believe the Chinese have come to this conclusion. I would point out to you that China holds prospects that other Asian countries do not. For example, did you know that Japan has the Napoleonic Code and basically it has the European Civil Code adopted around 1870? Well, the Chinese did the same around 1910. If the Chinese revert to the legal system they had before the Revolution, they will be reverting to a European legal system. That is extraordinarily helpful in implementing the kinds of changes that are necessary. You don't have that kind of situation in some other places in Asia.

If China chooses to change, they can change much in the way that Poland changed, as opposed to the way some other places in Eastern Europe changed. The pieces are there for a thriving market-consistent economy

-- I don't want to say market economy, but market-consistent economy. The question is whether they choose to do it.

PROFESSOR GALBRAITH: The other point I'd just add and underline what Mr. Morici just said, this also has to do with the changing character of the leadership in China. We have seen a change in the personnel that does reflect the change in the institutional base of that personnel toward a more open and modernizing group and I think it's clearly a real phenomenon. There is a hidden hand of old-style planners pulling strings behind this group.

COMMISSIONER D'AMATO: Just one last comment. There was a comment this morning that the Chinese decision to join WTO was essentially a geopolitical strategic decision and not an economic decision. Would you agree with that to join, to become -- by the Chinese?

PROFESSOR GALBRAITH: That's hard for me to say anything definitive about. It does seem to me that from the Chinese standpoint, getting away from this annual haggle over the MFN is useful because they don't know the future evolution of American politics and things could turn badly for them.

Secondly, it does seem to me if it's -- I wouldn't necessarily geostrategic. My thought is that it's substantially internal-political, that is to say it is a set of policies consistent with the goals of a modernizing faction which is now ascendant, and indeed, dominant and against the goals of the protectionist faction. There were terrific internal battles in China in May when the deal was originally rejected and people who were in protected industries realized how much was being proposed to be given away and that, I think, is the internal political divide that's important in Chinese politics.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Wessel?

COMMISSIONER WESSEL: Continuing on this line of questioning, I think there's some real concern about the WTO approach in terms of the history we've had in enforcing agreements. We have two outstanding cases, as I recall, bananas and beef hormone where we are several years in the process of seeking to have a decision by the WTO implemented, enforced, so that the loss of Section 301 through the cross-filing with the WTO raises a lot of questions because the WTO process does not appear to be working for our interests. We also have, of course, the extensive politics that's injected now as China becomes a member of the WTO that I fear that our Administration will not want to highlight noncompliance issues in the aftermath of an agreement, saying that maybe it wasn't the right thing to do as well as other countries at the WTO may be reluctant to support any cases, filings or in fact file them on their own for

fear of what kind of retribution there will be by China during the transition period where they have a phenomenal amount of flexibility.

So there are some who believe that -- I being one of them -- that we have the ability in some areas to use reciprocity where, for example, in the Fuji Kodak case there were no rules governing anti-competitive practices that we should be seeking our Administration to be much more flexible in the use of our laws to enforce market access, to respond to the practices. And I'd like your views on that as well as the view that you have of whether the WTO is, in fact, working for us at this point.

Two big questions.

SECRETARY MULLOY: First, let me go into the anti-competitive practices in Japan. I went over and met with Joel Klein at the Antitrust Division and talked about how -- whether there's any way in a couple of particular instances, flat glass and other things, how

we could use those. I think the judgment of the Antitrust Division was to try and get this comity agreement with the JFTC which they eventually did negotiate and it's in place. So, under that, the American industry that feels it's being harmed by these, gathers the evidence, takes it to the Antitrust Division.

The antitrust division evaluates it and, if it agrees, makes a referral to the JFTC and then they try and enforce. We aren't going to apply our antitrust laws to Japan.

COMMISSIONER WESSEL: But in the case of, for example, flat glass which you've raised, we've had very limited success in terms of the Japanese market.

SECRETARY MULLOY: Absolutely true and that agreement, by the way, is expiring at the end of this month and so we're pursuing exactly how to go about that with the Japanese. Do we renew it? Do we go after a new agreement or do we take some other approach? Those are issues that people are wrestling with.

Now to go back to the two cases. We have won a lot of cases in the WTO. I don't have the exact number before me, but the ones that you mentioned, bananas and beef hormones. On beef hormones, we won it. We got an award from the WTO and we are actually putting sanctions now on European exports to our country. Roquefort cheese, for example, you might have heard about, so that's one of the things we're doing. It doesn't seem to -- I think the Europeans at this point seem to be saying well that's a cost we'll bear because our political climate is not one that we want to take hormone beef and we said well, you can just label it, let's label it U.S. beef and let the consumers make the choice, but they have not wanted to accept that deal so there's where we are with that one.

On bananas, again, I think we have a final judgment, but how we implement that one? That's another thing we wanted to try and get in this new WTO round which didn't take -- we didn't kick off, was to improve

and make more transparent the whole dispute settlement system within the WTO, so people can watch it and see it and file amicus briefs and be on top of the situation just like we have people understanding what's going on in the American courts, what precedents are being set and how they're being done. So I think we really have to go out and improve that dispute settlement system within the WTO.

COMMISSIONER D'AMATO: But in areas not covered by WTO rules and I am an advocate of the WTO and multilateralizing the rules, for example, the Fuji Kodak case where the anticompetitive practices have not been negotiated.

SECRETARY MULLOY: Right.

COMMISSIONER D'AMATO: Is our Administration willing to use 301 to try and go after those kinds of problems in the future? Or has 301 essentially been neutered by the WTO?

SECRETARY MULLOY: I would have to get a legal opinion, but my political understanding of what is working now is that we don't use 301 without first getting a WTO ruling that then permits -- and 301 is then the implementing tool if the other country doesn't comply, to put the sanctions on.

COMMISSIONER D'AMATO: Mr. Morici has a response.

PROFESSOR MORICI: It's important to recognize that a nonviolation complaint in the WTO, which the Kodak case was, imposes a much higher standard of proof. That is the real problem with the absence of 301 or our ability to use it when --

COMMISSIONER WESSEL: Because of nullification and impairment?

PROFESSOR MORICI: All GATT, all WTO complaints are nullification and impairment complaints.

There are violation complaints, nonviolation complaints and then a third, vague category that still requires

complete consensus. Nonviolation complaints have a much higher standard of proof and, in point of practice, have only been successful, for example, when a country replaces a tariff with a subsidy and where it is transparent.

What that tells us is that we need to get into the WTO restrictive practices that aren't covered, so they become violation complaints. The European proposal would transform vertical restraints in Japan from nonviolation complaints to violation complaints, making it easier to win.

The problem with the comity agreement is that, unlike a WTO agreement, we would have to take our complaint to the JFTC. If they pursued it and it ended up in the Japanese courts, the Japanese courts have demonstrated time and again they are disinclined to embarrass their government. I can show you some cases where the logic is beyond anything you and I can comprehend. If we had a WTO agreement on antitrust, we

would still use comity. We would first go to court, but then, if the High Court of Tokyo gave us a ridiculous ruling, we could take it to WTO dispute settlement and remand the decision much as, say, our countervailing duty decision can be remanded by a disputes settlement panel inside NAFTA. Now that wouldn't make them change it, but it would apply much greater pressure, and that's all the WTO can do is apply pressure and embarrassment, because the withholding of comparable benefits is not a sufficient sanction in most cases.

In flat glass, it might be because we can keep out their flat glass or something like that, but most of the time it doesn't really require that level of sanction. What's more, it only deals with the specific product in question. It doesn't deal with the systemic issue. You'd have to take the Japanese to court every day across 100 industries to get real change in the vertical restraint problems there and the cartel problems there. And flat glass is a cartel problem.

COMMISSIONER WESSEL: I understand your point on competition policy. I think, however, the Administration was right to oppose European Union efforts to bring their concept of competition policy into full negotiations at this point.

PROFESSOR MORICI: Correct. The European concept of competition policy is much more regulatory than ours and it's laced with the notion of industrial policy.

Unfortunately, most of the scholarly writing that has been done has a European bent. For example, consider the proposed code of the Munich Group. By the Americans not engaging in the discussion, we Americans are not proposing a more open approach to competition policy to put on the table. They are setting the terms of the debate and that poses a real risk because the European view of competition policy is spreading around the world. For example, the Mexicans have just signed a free-trade agreement with the European Union and it

includes competition policy. I haven't seen the details but that frightens me a little bit because, as you recall, the Mexicans didn't have a real antitrust law before NAFTA and they still really don't now. It's not a developed body of law. And so that is problematic.

Our inability to engage them in discussion or our reluctance to engage them in discussion leaves the field to them, and that's dangerous.

COMMISSIONER WESSEL: One very quick, I'm sorry, final question.

Mr. Mulloy, is your division charged with doing the WTO evaluation that will be coming out in March which could trigger a WTO withdrawal resolution in Congress?

SECRETARY MULLOY: In my unit we have an office of what we call Office of Multilateral Affairs.

It's six people that work on the WTO. Again, we're trying to get more resources for that unit.

But the USTR, I think, was given the principal responsibility for putting together that report. The other thing you should know, Commissioner Wessel, is that on any 301 decision, whether to use it or not to use it, those decisions are made in USTR. The statute gives them that authority, not the Commerce Department. But we are -- see USTR is a very small -- it only has 170 people and it's within the Executive Office of the President, so they can't grow too big, so they really have to work very closely with our part of the Commerce Department, the International Trade Administration.

Thank you.

VICE CHAIRMAN PAPADIMITRIOU: You have been all very helpful and very patient with some of us, with our insistence on some of our questions and we do appreciate it very much, and we thank you very much.

SECRETARY MULLOY: In my opening statement I said how important your work is and I really mean it.