MR. SCHULTZE: Thank you, Mr. Chairman, members of the Commission. In five minutes, no jokes. I would like to concentrate on one point. In the long run, a nation's trade balance is principally determined not by its trade policies or those of other countries, but by the relationship between what the country saves and the amount it wants to invest here at home. Trade policies are neither responsible for nor can they cure our current deficit.

My point is illustrated by the diagram which I passed out. I hope you have a copy of it. It's kind of a simple-minded diagram. Start with the lefthand panel of two bars. A country's total output is exactly equal to its total income. National saving is simply that part of a nation's output and income that it doesn't consume, either publicly or privately.

As the second bar shows, the fraction of our national income and output we do not spend on consumption can be devoted to two purposes. First, it can be spent for domestic investment in the form of new housing, new plant and equipment, public infrastructure. If a country spends on domestic investment goods exactly what it saves, then the sum of its spending on consumption and domestic investment will exactly equal its output.

End of story.

But now turn to the right panel on the diagram. Suppose as has been true of the U.S. for many years, that a country invests at home more of its output in income than it is willing to save. In the 1980s, the Federal Government ran a big budget deficit and drove down national saving. Lately, as the budget deficit has shrunk, private saving has dramatically fallen. With investment exceeding total saving, the people in business firms of the U.S. have been spending more on public and private investment and consumption than the country produces.

The only way we can do this is to import the difference. Imports exceed exports, the country necessarily runs a trade deficit. In the process, it finances the deficit by borrowing from abroad. America's large deficit in its current international accounts is a mirror image of the fact that our country's national saving is so low compared to what we want to invest at home.

Japan has for years been in exactly the same situation. It saves more than it can profitably invest at home and runs an export surplus, and in effect, exports the excess.

I do not want to suggest that policies and economic developments that affect our exports or imports cannot alter the trade balance. Of course they can. But they can do so only to the extent that they also alter a nation's aggregate saving or investment. In the long run, apart from short-run fluctuations, the volume of a nation's investment in saving are set by powerful forces that are unlikely to be influenced in a major way by changes in trade policies.

There exists a powerful set of mechanisms which operate to enforce the proposition I just outlined. Let's look at an example. Imagine that domestic or foreign political pressures were successful enough to alter the web of practices that tend to discourage imports of goods into Japan. But also assume there's no change in the persistent excess of Japanese national saving relative to its domestic investment opportunities.

With import liberalization, imports would initially tend to expand and the Japan export surplus would shrink. After an increase in their exports to Japan, foreigners would need to borrow fewer Japanese yen to finance their shrinking trade deficit with Japan. There would be fewer dollars and euros looking for Japanese yen.

But Japanese banks and other financial institutions with the same old excess saving in-flow would still be trying to find foreign loans and bonds in which to invest. The demand by the Japanese for dollars, euros, and other currencies, would quickly begin to exceed the supply of those currencies seeking to be exchanged into yen. The price of those currencies would be bid up in terms of yen. The yen would fall in value.

Spurred by the lower value of the yen, imports into Japan would become more expensive. The cost of Japanese exports to other countries would drop. The initial rise in imports into Japan would be attenuated, but not reversed. Japanese exports would rise.

The end result of this process would be a lower value for the Japanese yen, higher Japanese exports, higher Japanese imports, and an unchanged overall Japanese trade surplus, even though some rearrangement in bilateral surpluses with different trading partners might emerge.

The reform of Japanese trade practices would not have altered the overall Japanese trade balance in any major way. But Japan would have more of both exports and imports. Trade liberalization would have made both Japan and its trading partners better off.

Tongue in cheek, but nevertheless accurately, one can say the problem with the Japanese economy is that it doesn't export enough, despite a long history of policies and attitudes that tended to concentrate effort and resources into favorite export industries. Indeed, the U.S. exports a larger fraction of its GDP than does Japan. If Japan reformed its practices and policies, but still tended to press imports, it would end up increasing its exports as well as its imports. Consumers in Japan and elsewhere around the world would be the gainer.

Should we worry about the size of the current deficit? Partly yes, and partly no. On the one hand, the trade deficit is a symptom that the United States doesn't itself save anywhere near enough to finance the amount that can profitably be invested in productive assets here at home. So we have to make up the shortfall by running trade deficits and borrowing from abroad.

The high level of domestic investment boosts productivity in the growth of U.S. income, but some of that extra income we don't get to keep because it has to be paid abroad to service the foreign borrowing. Future generations would be better off if we saved more and financed our investment directly.

On the other hand, given the unfortunate fact that we do not save very much, then the trade deficit and the associated in-flow of foreign capital is a blessing. The gain in future national income from domestic investment is higher than the interest rates we pay on the money we borrow from abroad. Without the trade deficit and the foreign capital inflow, we would have to raise interest rates and cut back domestic investment sharply. We would have lost more by way of slower income growth than we would have saved by the reduced cost of debt service.

Whether the trade deficit is bad is actually not the right question. What we need to ask is whether or not we like the changes in domestic saving and investment which created the trade deficit. Thank you, Mr. Chairman.

CHAIRMAN WEIDENBAUM: Thank you, Dr. Schultze. You have also established the precedent of staying under the time limit.

MR. SCHULTZE: Only by leaving out priceless words of wisdom.

CHAIRMAN WEIDENBAUM: Which we'll incorporate in the record, as we say in this town.

Our second briefer is Professor Jan Kregel, of the Levy Institute at Bard College, and Adjunct Professor of International Economics at Johns Hopkins. Professor Kregel.