THE U.S. TRADE DEFICIT: ARE WE TRADING AWAY OUR FUTURE?

HEARING

BEFORE THE

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THE U.S. TRADE DEFICIT: ARE WE TRADING AWAY OUR FUTURE?

Thursday, July 22, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY AND TRADE,
Committee on International Relations,
WASHINGTON, D.C.

The Subcommittee met, pursuant to notice, at 2:55 p.m., in room 2200 Rayburn House Office Building, Hon. Ileana Ros-Lehtinen [chairwoman of the Subcommittee] Presiding.

Ms. ROS-LEHTINEN. Thank you. The Subcommittee will come to order. Thank you so much for being here this afternoon.

The U.S. trade deficit has been the object of considerable concern and controversy among experts, both advocates of free trade as well as so-called protectionists.

Some contend that the trade deficit is, as one headline read, "bleeding the U.S. economy," draining our domestic markets of potential profits and American workers of jobs. Yet others claim that the growing deficit is a sign of a robust economy, that it indicates the strong role being played by America in providing markets for other countries struggling to recuperate from economic crisis.

Trade has always played a critical role in the development of America's economy. It has helped to enrich our country's market size, productivity and competitiveness, while providing a vehicle for American ingenuity. However, with the economic prosperity which trade can bring comes the challenge of striking the delicate balance between trade that is free, yet fair.

According to experts, America runs trade deficits because for almost 2 decades, foreign investment in the United States has exceeded American investment abroad. The deficit is made up of the difference between domestic savings and investment and because America invests more than it saves, it is forced to increase borrowing to pay for the rising tide of foreign goods and services.

The trade deficit is also tied to the economic success or failure of our global trading partners, and can be tremendously influenced by economic crisis abroad, as recently illustrated by the Asian financial crisis.

Should the growing deficit be a cause for alarm for us in America? The trade deficit, which according to a recently released government report hit an all time high in the first 3 months of this year, reaching over $68 billion, has driven even those who most support trade liberalization to question how much longer the U.S. economy can continue to sustain such losses.

Former Treasury officials have said that the ballooning trade deficit is the single biggest threat to our economy, that it could lead to a plunge in the dollar's value and to a tremendous sell off in stocks and bonds, spurring the U.S. into a recession.

Some experts will point to the increasing trade deficit as a sign of America's purchasing power and of international confidence in the U.S. economy. They maintain that when trade deficits rise, unemployment drops, industrial production surges, and American corporations sell more goods and services than any other country in the world.

By contrast, others argue that trade deficits, meaning declining real wages, increased American job insecurity, and constitute an erosion of America's industrial base, citing recent statistics from the U.S. Department of Labor that over 200,000 workers have lost their jobs because of either shifts in production to Mexico or Canada or because of increased imports from those countries.

Some claim that trade deficits have no relationship with the level of employment in manufacturing and, in fact, claim that cheap imports have helped keep inflation low in the United States during a period of unusually high employment and heavy American spending.

Those who argue that trade deficits do not have a detrimental effect state that years in which the U.S. has run trade deficits have also been years of increasing income for the average American.

Yet, in either case, there exists concern across the board that America is becoming a market of last resort for our foreign trading partners and that the increasing excess with which we import over what we export is putting over $20 billion more into foreign hands each month. Regardless of what we individually believe to be the causes of our increasing trade deficit, our challenge in Congress will be to develop policies which will create balanced trade relationships with our global partners and which seek to restore the balance of trade.

I look forward to the testimony of today's witnesses and to their recommendation as to how we can manage the trade deficit while maintaining freer and more open trade markets. I would like to recognize our Ranking Member, Congressman Bob Menendez of New Jersey.

[The prepared statement of Ms. Ros-Lehtinen appears in the appendix.]

Mr. MENENDEZ. Thank you. Let me give thanks to our witnesses. I just ask unanimous consent to have my full statement entered into the record and paraphrase it.

Ms. ROS-LEHTINEN. Without objection.

Mr. MENENDEZ. I appreciate all of them coming here today. I specifically appreciate Dr. Simon Evenett, an associate professor at Rutgers University, the State University of New Jersey, coming at our invitation. We have all seen the latest headlines this week highlights a new trade deficit record of $21.3 billion. Certainly it is a timely indicator for its need for the Congress to look at some of the causes of the trade deficit and what we can do to boost U.S. exports abroad.

There is a concern that I have, it is in part the statement that Alan Greenspan made as the Chairman of the Federal Reserve

Board at the 35th Conference on Bank Structure and Competition when he said, “There is a limit to how long and how far deficits can be sustained, since the current account deficits add to the net foreign claims on the United States.” .

In essence, I guess what he was saying is the current account deficit puts the economic fortunes of the United States in the hands of foreign investors.

I know that some of these issues are very difficult and there are no single solutions, but think the one thing we can definitely do that we began to do through the Committee is a question of seeking to open markets and to further promote the opportunities for American businesses and manufacturers and the providers of services to seek those markets abroad and to promote, and that is why I am such a strong supporter of the Export Enhancement Act, which finds ways to increase American exports and gain market access for American companies and products.

It certainly is a good start, but it is minor when you think about our competitors like the European Union. We just had some of the new members of the European Union’s leadership here in a meeting with its full committee the other day. Of all of the things that they could talk about, the one thing they clearly focused on was the trade issues, for which they have a surplus with us, a growing surplus, and they have made export promotion, contract securement and market access priority issues at the highest levels of their governments. We need, I believe, to be doing the same.

With that, Madam Chairlady, I look forward to the witnesses and what their testimony can do to enlighten us on some of these issues.

Ms. ROS-LEHTINEN. Thank you so much, Mr. Menendez. I am pleased to recognize Mr. Sherman of California.

Mr. SHERMAN. Thank you. We all know how important this trade deficit is. I would like to respond to the frequent statements of those who are apologists for the present do-nothing policy.

First, we are told that this trade deficit is the sign of a robust economy. That is like an obese person saying it is a sign of health that they are getting enough food. But also keep in mind, 5 years ago, 10 years ago, when our economy was in giant trouble and the Japanese economy was doing very well, we had a trade deficit, and we were told at that time we dare not do anything about it because we need their help, because they are so robust in helping our economy, which at the time was in dire straits.

So when the Japanese economy does well and the American economy does poorly, we are told do nothing, allow lopsided trade. Now when the situation is reversed, we are told for the same reason, to allow the same imbalance.

We used to be told that it was our fault, because it was the Federal budget deficit that caused the trade imbalance. I know some of the real young people here will not remember that. But for how many years were we told it isn’t the protectionism of the trading partners, it is the moral fault of a Congress that keeps spending more than it takes in? Now the United States has a surplus and all these other countries have deficits, and for some reason, all the do-nothing supporters of one-way free trade have forgotten how to pronounce the arguments that they made 10 years ago, those arguments that said that a country that runs a budget deficit will inevitably run a trade deficit.

It only works as an apology for a do-nothing policy for the United States.

We are told that there is nothing we can do, which really means there is nothing we can do without upsetting some foreign governments and upsetting some powerful interests in the United States.

We are told that those of us who want, if necessary, to threaten a reduced access to the U.S. market are protectionists, even if our purpose is to simply use that as a threat in order to break down the walls that other countries have put around themselves to prevent American exports.

We are told somehow that it is a free trading system, we are just losing. But I come from a tourist city, Los Angeles. I don't know if you see the same thing in southern Florida. But people come to the United States, and they don't want to see Olvera Street, they are not so sure they want to see Disneyland, they want to go to the discount stores and buy goods produced all over the world, because they are sold more cheaply in the United States, at retail, than you can get them wholesale back in their own countries. But this is a trading system and we are just losing.

Finally, I would point out as to China, which is the most lopsided, not the largest trade deficit, but the most lopsided trading relationship in the history of millennium life, we keep pretending that society lives by the rule of law, so if we can just get them to change their laws, we accomplished something. But what happens? We change our laws and we tend to, every economic enterprise in the United States, say they have MFN, you can bring in their goods and make a big profit, and don't you want to do that? Of course, business people do. But if you are a business person in China, I don't care whether the tariff is 20 percent—I do care—whether it is 20 percent or 0 percent. But even if the tariff were 0, you can get a call from a party cadre, saying do you really want to buy $1 million or $100 million worth of United States goods or a telephone system or whatever? Because if you do, well, the party might frown on that. You might need to be sent out for reeducation if you do that. It doesn't take very much to get a careful or smart Chinese businessman to say no to American goods. It only takes a phone call, and you can't take a phone call to WTO court.

I thank you for the time.

Ms. ROS-LEHTINEN. Thank you.

[The information referred to appears in the appendix.]

Mr. MENENDEZ. If I just may, I just want to tell my dear colleague, who I always find incredibly interesting in terms of the way he presents his view, and often on point, that there are some of us that are robust and feel robust in the process.

Mr. SHERMAN. Robust and——

Mr. MENENDEZ. You are saying something about overweight.

Ms. ROS-LEHTINEN. That is the old Mr. Menendez.

Thank you so much for those enlightening comments. I thought only ladies talked about weight.

I am pleased to introduce our first panelist, Mr. Patrick Mulloy, Assistant Secretary of Commerce for Market Access and Compliance, the U.S. Department of Commerce's international trade administration. In this capacity, Mr. Mulloy directs an extensive staff of international trade specialists to improve market access for U.S. companies to international markets by removing foreign barriers to U.S. exports, and ensuring the compliance of foreign countries to trade agreements with the United States. Prior to his position at the Department of Commerce, Secretary Mulloy served in various senior positions with the staff of the U.S. Senate Banking Committee, where he helped formulate such important international trade and finance legislation as the Export Enhancement Act of 1992 and the Omnibus Trade and Competitive Act of 1988.

We welcome Secretary Mulloy with us this afternoon. Your statement will be entered in full in the record, and feel free to summarize your statement.

STATEMENT OF PAT MULLOY, ASSISTANT SECRETARY FOR MARKET ACCESS AND COMPLIANCE, U.S. DEPARTMENT OF COMMERCE

Mr. MULLOY. Thank you, Madam Chairperson.

As you mentioned, as someone who worked for 15 years on the staff of the Senate Banking Committee, it gives me great pleasure to appear before this Subcommittee to talk about the large and growing U.S. trade deficit.

As you noted, I have a prepared statement which I will have for the record and I will just make some remarks here to try to give you an outline of what I think is happening.

Let me begin, Madam Chairman, by saluting you and this Subcommittee's efforts to draw attention to this important matter. You had a similar hearing last July; and last October the Congress, recognizing the key importance of this issue, established the Trade Deficit Review Commission, where you had 12 people, 3 appointed by Mr. Hastert, 3 appointed by Mr. Gephardt, 3 appointed by Senator Lott, and 3 appointed by Senator Daschle, and they are getting down to work now. In fact, they are going to begin their first public work on August 19th.

This week, my Department released data showing that for the first 5 months of this year, the deficit in goods and services is running at an annual rate of $225 billion, up 50 percent over the first 5 months of last year. The merchandise deficit so far this year is at an annual rate of $307 billion.

In understanding these huge figures, the most important point to keep in mind is that the recent growth in the deficit stems in part from the fact that the U.S. economy is growing rapidly and others aren't.

The second important point to note is that the recent deficit increase stems principally from the export side. Overall imports so far this year are only up 6 percent, a very modest rate. However, import penetration, imports as a percentage of our total GDP, have not increased since 1997.

This is not to say there have not been significant increases in individual sectors, such as steel, where the administration has acted to halt the flood of imports but, overall, imports have not risen that rapidly.

The real difficulty is in our exports. Typically our exports have been growing about 7 percent a year, but they fell 1 percent last year and so far this year have fallen another 2.4 percent. This decline is serious. It is affecting jobs in America's farms and factories.

The export decline does not reflect a drop in U.S. competitiveness. In fact, the U.S. share of exports to foreign markets last year was 15.2 percent, up significantly from the 14 percent average in recent years.

What it reflects is how slow foreign markets are growing, not just in Asia, but in Europe. Domestic growth is sluggish in these countries, and demand for imports, including from the United States, is stagnating.

The most dramatic drop in exports took place in Asia, where in 1998 exports fell by 15 percent and so far in 1999 they have fallen a further 2 percent.

On a bilateral basis, our largest deficit is with Japan, where over the last 12 months it has reached $66 billion.

Our second largest bilateral deficit, $57 billion last year, is with China. We import 5 times from China what we export to China, meaning that just to keep the deficit from growing any more, our export growth rate has to be 5 times as large as our import growth rate with that country. In the last 3 years, however, the import growth rate has been about 16 percent a year, while our export growth rate has been about 7 percent, and so far this year our exports to China are actually down 5 percent.

As I noted, China runs a $57 billion trade surplus with the United States but, overall, China only has a global trade surplus of $44 billion, so their trade with us is where they are accruing their foreign exchange earnings.

With the focus on Asia, it is frequently not realized how much our trade position has deteriorated with Europe. In 1991, the United States had a surplus of $19 billion with Europe; in 1998, our deficit had reached $32 billion, a negative swing of $51 billion with Europe in 7 years.

With respect to our NAFTA partners, the story of strong U.S. domestic growth pulling in imports also applies. So far in 1999, the trade deficit with Mexico is $24 billion at an annual rate, compared with $14 billion last year, and the deficit with Canada is going to be running at a $27 billion annual rate compared with $13 billion last year. The decline of the Canadian dollar and Mexican peso against the U.S. dollar over the last 3 years also plays a role in creating these deficits with our NAFTA partners.

Overall, there is nothing on the immediate horizon to suggest changes in our recent trade trends. U.S. economic growth, even though expected to slow in 1999 from 1998, should still be relatively strong compared to most of our major trading partners. In Europe and Japan, expectations are for slow growth to continue.

We cannot, however, blame all of our deficit on the Asian financial crisis and on the recent difference between U.S. and foreign economic growth. Longer-term forces are also at work, including the continued existence of trade barriers that have held back U.S. export opportunities. Amazing though it may now seem, from 1894 to 1970, the United States during that 76-year period had an unbroken string of trade surpluses. But since 1970, we have had virtually an unbroken string of merchandise trade deficits that have accumulated to over $2 trillion.

Most of our deficit occurred in the last 15 years. Nearly 80 percent of the deficit is with Asia and fully 40 percent of the total was with one country, Japan.

The recent rise in the trade deficit reflects, in part, the health of the U.S. economy. Our unemployment rate is extremely low by historic standards. Inflation is low, economic growth continues above its long-term trend, and real incomes are rising. In addition, the rise in the stock market has encouraged consumer spending. The biggest negative probably is our personal savings rate, which is close to zero.

While current economic conditions, at least for the United States, are excellent, we can't help but be concerned with running extremely high current account deficits long into the future. To finance these deficits, we must borrow from abroad. Thus, we become ever more dependent upon receiving and retaining foreign capital. The net debtor position of the United States, in fact, stood at $1.2 trillion in 1998. You have to remember just maybe 10 years ago, we were the largest creditor Nation in the world. We are the largest debtor Nation in the world, and that is increasing rapidly.

If current trends continue, our total foreign debt will be close to $1.5 trillion at the end of 1999.

Another factor that must be considered is the impact of trade deficits on the composition of our employment. The drop in our exports has had a serious effect on manufacturing employment in the United States. While overall employment in our country is at record levels and, in fact, has grown by 2 million jobs in the last year, there are 422,000 fewer manufacturing jobs than a year ago. Many of these losses are directly attributable to the decline in U.S. exports globally, especially to Asia.

Few actions we can take domestically would have as great an impact on our trade deficit position as restoration of growth in our major export markets. The key here is in economic policies in Europe and Japan that would promote domestic-led growth rather than export-led growth in those countries.

Former Secretary Rubin, when he was still Secretary of the Treasury on June 10, said this: "It is critically important that Europe and Japan do their part, because the international system cannot sustain indefinitely the large imbalances created by the disparities in growth and openness between the U.S. and its major trading partners.".

On July 13, Secretary of the Treasury Summers said: "We continue to watch the Japanese economy carefully and to believe that what is most important for Japan is the restoration of domestic demand-led growth." .

The need for these other countries to grow is clear as our current account deficit position is unsustainable in the long run. Chairman of the Federal Reserve Board Alan Greenspan, in something that Mr. Menendez referred to earlier, said on May 6th, "There is a limit to how long and how far deficits can be sustained, since current account deficits add to net foreign claims on the United States. Unless reversed, our growing international imbalances are apt to create significant problems for our economy." .

In his testimony today before the House Banking Committee, which I was able to get ahold of, Mr. Greenspan said this: "As our international indebtedness mounts, however, and foreign economies revive, capital inflows from abroad that enable domestic investment to exceed domestic saving may be difficult to sustain. Any resulting decline in demand for dollar assets could well be associated with higher market interest rates, unless domestic savings rebounds." .

Chairman Greenspan went on today to reinforce what Secretary Rubin said about the need for Japan and Europe to grow faster. He said, "Working to offset somewhat this anticipated slowing of the growth of domestic demand, our export markets can be expected to be more buoyant because of the revival in growth in many of our important trading partners." .

Now, that depends on whether they actually get going on whether they are going to be able to turn around this situation.

We need to be working to bring the deficit down over the long-term. We must continue to urge our partners to initiate domestic growth strategies and we must also foster conditions for a restoration of our trade position when foreign markets recover, by assuring that foreign markets remain open by enforcing our trade laws and promoting exports.

While I do not believe that noncompliance by our trading partners with trade agreements is the major factor in the growth of our trade deficit, we must be sure that countries are keeping markets open and complying with the trade agreements they sign with us. We need to assure Americans that the agreements we negotiate are honored and that American firms and workers obtain the benefits and opportunities we have bargained for.

The Commerce Department, as never before, is increasing its monitoring of our trade agreements. When we find indications of violations, we are being very aggressive in taking up these matters bilaterally or working with USTR to have them referred to the appropriate dispute settlement forum, whether in the WTO, NAFTA or elsewhere.

The Commerce Department is also committed to swift enforcement of the fair trade laws. These are the ones we put up to stop surges of foreign imports like we have had in steel over the last year. During this first 6 months of this year alone, we have either completed or are in the process of conducting more than 65 anti-dumping or countervailing duty investigations.

But beyond compliance and enforcement, we must be prepared to take advantage of export opportunities as foreign growth returns. U.S. firms need to take more advantage of overseas markets.

Therefore, we are working with the Interagency Trade Coordinating Committee set up by the Congress and chaired by the Commerce Department, and we continue to develop new strategies and approaches to assisting U.S. firms and workers with trade promotion. ITA's units, including the Foreign Commercial Service, the Trade Development unit, and my own market access and compliance unit, are working together to help small and medium-size firms take advantage of export opportunities.

Before closing, I want to thank you, Madam Chairman, and the other Members of the Subcommittee, for your assistance during the International Relations Committee's reauthorization of our budget. I particularly want to thank you for drawing attention to the critical work done by the Market Access and Compliance Unit which I head.

I am pleased that you and your colleagues appreciate our efforts to access foreign markets for American firms and workers and to get our trading partners to comply with our trade agreements. If we can obtain the funding requested in the President's 2000 budget, we will be able to reach out and help small firms, particularly the small- and medium-size firms that are the engines of growth in our economy.

As I noted to you during my last appearance here, the number of people that we have to maintain and enforce trade agreements has actually been in decline over the last several years because we have not been funded at the levels requested by the President. I will give you an example. We used to have 10 people working on China. We now have 4 or 5. That is just an intolerable situation.

Finally, I want to thank you, Madam Chairman, again, and your Subcommittee, for the work on the trade deficit issue. You have kept after this issue. It is a very important one. You might want to have your staff pass on the records of your hearings to the congressionally created Trade Deficit Review Commission that I mentioned earlier in my testimony. I think that commission would find the work you have done very beneficial.

I thank you again. I will be pleased to try to answer any of your questions.

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

Ms. ROS-LEHTINEN. Thank you so much, Secretary Mulloy. The U.S., as you pointed out, has one of the strongest and most vibrant economies in the world, while at the same time maintaining its highest trade deficit in history. Japan, on the other hand, in spite of the financial difficulties, is still running a surplus. Could you please elaborate on these two seemingly incongruous outcomes? What are the variables that play in these two situations and what lessons can be learned for improving our trade balance?

Mr. MULLOY. It is true, as Congressman Sherman referred to before, even when Japan was growing more rapidly, we had trade deficits with Japan. They did begin to come down from the 1987 period down to about the 1993–1994 period. Then when they went into this economic recession because they weren't growing and couldn't take—are not taking American imports, our exports declined and the trade deficit began to increase with Japan again.

That is why the administration is leaning so hard on Japan to go to export—not export-led growth. In other words, what they tend to do when they get into a recession, instead of trying to increase domestic-led growth, they rely on export-led growth to get themselves out of their recession, meaning they want to increase their trade surplus with the world. They are running a worldwide surplus of well over $100 billion.

Second, Japan, every country in the world, is frustrated by the fact that they do run a pretty closed market over there. It is very difficult, even if it is not the government itself, you have the companies acting in collusion to restrict access to that market. We go into it time after time. My Under Secretary is going over there to take up the construction issue next week. We have 0.02 percent of their construction market. If we could just get 1 percent of that market, instead of selling $50 million, we would have $2.5 billion of construction to that market. So that is a tremendous problem, and it is industry after industry that you find this problem with the Japanese.

Ms. ROS-LEHTINEN. Another question, Secretary Mulloy. What is your view on the proposal espoused by many, including one of the panelists coming up after you, that the U.S. should gradually devalue the dollar as a way of improving the trade balance? What short-term and long-term effects do you think this would have on American competitiveness or on the global market?

Mr. MULLOY. Madam Chairman, as you know, even the President doesn't talk about the value of the dollar. They pretty much restrict the Treasury Department to talking about the value of the dollar. But if you look at—I was reading an article in the Wall Street Journal the other day about the growing deficits with Canada and Mexico, and the Wall Street Journal article referred to the fact that the dollar has increased in value dramatically versus the peso and the Canadian dollar, and that does contribute to the trade deficit.

The problem is when we need to attract foreign capital, if the dollar declines in value it makes it harder to attract the foreign capital you need to finance your borrowing, plus you are borrowing to finance your trade deficits. If your currency is decreasing in value, in order to get those borrowings, you have to raise your interest rates. So it is kind of a difficult situation. But I am not going to comment on the value.

Ms. ROS-LEHTINEN. OK. One last question from you. You contend the best solution to alleviate the trade deficit is the economic recovery of our trading partners. We understand, obviously if their relative economic position were to improve, the belief is they would be more readily able to purchase U.S. goods and services. What policy recommendations would you make to assist in the economic recovery of those countries if that were to be the one thing that would help us?

Mr. MULLOY. I think there was a big debate in the Congress last year about the whole IMF Program and the Congress decided that it was in our national interest to provide that money to the IMF to help restart the economic growth in these Asian economies which fell off so dramatically over the last 2 years. So I think that will be of assistance to us.

The other thing is, as Secretary Summers and others have talked about, Europe. They have not been growing like people had hoped they would be growing. The other thing about Europe is, when they moved to the Euro, people thought it would actually strengthen in value against the dollar, but in fact it has declined by about—I guess it was 14 percent. I think there has been some recent strengthening of the Euro. Both of those result in our trade deficit problem with Europe becoming worse.

So we have really got to get Europe to strengthen domestic demand, have Japan strengthen domestic demand. If that happens, many of the smaller economies that count on those markets to grow will also grow, which should help us then begin to change some of these trends that we are on in terms of being what many people think we are, the consumer of last resort in the world market.

Ms. ROS-LEHTINEN. Thank you, Mr. Secretary. Mr. Sherman.

Mr. SHERMAN. Thank you, Madam Chairman. Just a brief factual question, I don't know if you or your staff have the answer. What were our exports to China last year?

Mr. MULLOY. Do we have that? Let me just—our total deficit was about $57 billion. We exported about $14 billion to China last year.

Mr. SHERMAN. That is goods and services?

Mr. MULLOY. Yes, that is correct.

Mr. SHERMAN. There is an advertisement in a leading publication that claims that we exported $18 billion of goods and services to China last year.

Mr. MULLOY. Congressman, let me have that figure checked. I remember I used to say that last year—that in 1997 our exports to Europe grew in 1 year by more than our total of our exports to China that same year. That year I think we were using about a $13 billion figure. It might have gone up.

Mr. SHERMAN. If you can get back to me, hopefully even today just on what that number is, perhaps we can find out what the Business Coalition for U.S.-China Trade is doing with the $18 billion figure.

Mr. SHERMAN. It has been said that we need to maintain a high dollar, which then leads to trade deficits, in order to attract foreign capital. I would simply comment that if the rest of the world would buy our goods, that would bring billions of dollars into the United States, which we could then invest. Likewise, if we were to be able to reduce imports, that leaves us with billions of dollars more available for us to invest.

So I don't think that you need a trade deficit in order to provide adequate funds for the United States. In fact, a trade deficit is the export of money and the importation of goods. So I was surprised that on several occasions, Japan, which is already running this unbalanced trade relationship with us for decades, was able to go into the currency markets and deliberately manipulate a lower yen and a higher dollar without any protest from the United States.

I would just like to know whether we think it is just fine for countries that are already having unbalanced malignant trade relations with us, to manipulate the currencies so as to increase their trade surpluses with us.

Mr. MULLOY. Congressman, I should note that when I was on the staff of the Senate Banking Committee, Members were very concerned about this type of thing where countries manipulate their currencies to gain a competitive trade advantage. In fact, they put a provision in the 1988 trade bill that the Treasury has to do a report once a year and update it annually, identifying countries that are manipulating their currencies to gain trade advantage. In the early years, they did identify Korea and Taiwan.

Now, coming back to Japan, I did note that there was an article in the Washington Post a little while ago that when the Japanese did that, Secretary Summers did complain publicly that that was inappropriate, and then they quoted Fred——

Mr. SHERMAN. Mr. Secretary, with all due respect of statements of inappropriateness, the correct response is to enter the markets immediately on the other side at double the level and to force the yen much higher than it would have been if Japan—the idea, somebody shoots at you, and the response is to send their mother a note. No wonder we are losing.

I might add, our whole approach, say, on construction in Japan is to use regular mechanisms to try to go from .2 percent of the market to .3 percent of the market, and then come back and say the regular mechanisms are working.

Again, one of the defenses of our present approach is that occasionally we do get a crumb, but as I understand it, it is our policy never to do anything more than send a note when other countries enter currency markets and that we have never entered currency markets for the purpose of increasing our trade position. When I say never, I mean never in recent history. Is that correct, or perhaps you don't know?

Mr. MULLOY. I honestly don't know. The intervention in the markets dealing—they use what they call the Exchange Stabilization Fund over at the Treasury Department, which was set up by Congress, I think in 1935. But that is all a Treasury function. It is not an interagency decision, so I can't really comment when they are doing it.

Mr. SHERMAN. Finally, in your comment you talked about the low U.S. savings rate. I would like to point out that I think we may have a very high savings rate, disguised by our accounting system. An economist would tell you that income is not only realized income, but unrealized income. So let me give you a typical circumstance.

A family might make $5,000 in a month, net, take home, and at the same time, they look at their Dreyfus statement and the value of their assets, money available in their hands right now, has also gone up $5,000. A true economic view of that family is that they are now $10,000 richer before they sit down to pay their bills.

So they sit down and pay their bills, they spend $5,000. Our accounting system, then, because it ignores unrealized income, says, your net wages were $5,000, you spent $5,000, your savings was zero. But really looking at the entire situation, no, they made $5,000 by working, they made $5,000 profit by having their money in the stock market. The family made $10,000, they spent $5,000 on expenses, and they let the other $5,000 remain in the market, just as if they had liquidated Dreyfus and put all the money in T. Rowe Price, they now have, whether you churn the money or leave it in—leaving your profits on the table is investing those profits.

So I don't know whether it is your Department that calculates the savings rate, but do you know of any analysis of the U.S. savings rates that takes into account the huge leave-it-in-the-market savings? I think that American families have reaped hundreds of billions of dollars. "Reaped" may be the wrong word-have accrued, have obtained, have available to them-hundreds of billions of dollars of profits in the stock market, and they have in effect reinvested those by keeping that money in the market. I think if we look at it that way, we may have a very high savings rate. But that won't keep those who want to apologize for our present do-nothing trade system from saying oh, no, it is not the other countries' fault, it is the low savings rate in the United States. That is why we have a trade deficit.

Now, to give you a moment to comment.

Mr. MULLOY. Congressman, let me come back to you now. This only covers goods? I am sorry, what I have got now from the Department, U.S. exports to China in 1998, but it is only goods. It is $14.3 billion. I will try and find out what the services portion is, and I will get back to you, Congressman.

Mr. SHERMAN. Although if anything, you tend to support this add that I questioned. If it is $14.3 in goods, I am sure it is probably another 3.5 or 3.7 in services. Thank you.

Mr. MULLOY. We will check that and get back to you.

Congressman, on the other, I am not an expert in terms of the savings rate. I have read the articles in the press that make the argument that you have put forth here. I just am not an expert in how savings rates are calculated. The Treasury Department, again, is the place that both on exchange rate policy and on the savings rate, you would probably want to hear from them.

Mr. SHERMAN. I hate to think that only your Department would be allowed to have this much fun. I am sure that at some future time we will spread it around the administration.

Mr. MULLOY. But I think that report I referred to, where they give it to the Congress once a year and then update it every 6 months, is very important. That looks at the international economic position of the United States and looks at these kinds of issues that you are very interested in, the currency manipulation and that sort of thing.

I know the last time I testified before the Senate Banking Committee, Mr. Guitner from the Treasury was with me and the Committee Members asked him to make sure that that report was submitted on a timely fashion because they are very interested in it over there.

Ms. ROS-LEHTINEN. Thank you. Mr. Delahunt.

Mr. DELAHUNT. Yes. I really want to applaud the Chair for calling this. I think this is really a very important opportunity for Members to educate themselves. I would encourage the Chair to on a regular interval have these kind of hearings, because I think this really gets to the crux of what we are about as a Subcommittee and obviously is a critical issue given the amounts of these deficits.

Let me just pick up and make some observations upon what the comments by my scholarly colleague from California were in terms of these particular issues, because, it is often stated on the floor of the House by Members from both sides of the aisle, this grave concern about the personal savings rate of Americans.

It is used often in our debate and our discourse. We have got to be really clear about our definitions here. Because it is an accepted fact that Americans do not save. I was going to ask the question out of ignorance, but I think I have been educated by my, like I say, my colleague from California out of his background and experience. That is why it is so much fun to serve with Mr. Sherman.

But the reality is, you are here, Mr. Secretary, you make a statement that you express some concern about our deficit because of the investment by foreigners in our economy as being a source of a dynamic influence in terms of our own growth. But if he is right, and I think he is right, and I think upon—and I would like to have a followup from members of your staff, and there were some other folks back there shaking their head in the affirmative—if he is right, I would like to have it confirmed; because when we talk about the personal savings of Americans, most of us are into 401(ks). Does that include that particular savings rate? The growth of our pension plans that are invested in equities, in the markets, is this part of that definition? We have really got to be clear about it. I think it is important that you, the 435 of us that serve begin to understand that.

Again, I was unaware and I was going to ask that question, like I say. But my sense is many foreigners invest in the United States because of our political stability. That is why we are the beneficiaries of foreign investment, because if you are in South America or Asia or in Third World countries, the lack of political stability is sufficient in and of itself for foreign capital to come to these shores.

I don't know if that is going to change anytime soon, because I continue to see political instability all over the globe. Feel free to interrupt me.

Mr. MOLLOHAN. Mr. Congressman, I agree with you that part of the ability of the United States to attract these savings is because we are kind of an isle of tranquility, politically and other ways, and even economically, particularly with the collapse of these Asian markets, for capital. But it is important to realize that in the old days, people used to think trade flows would determine currency values. What is going on is that the capital flows have a big impact on the currency values. So while we are attracting that flow, it does have an impact on——

Mr. DELAHUNT. The strength or weakness of the dollar.

Mr. MULLOY. Exactly.

Mr. DELAHUNT. I will tell you what I have a problem with. I share Mr. Sherman's frustration in terms of our bilateral relationships with countries that either through tariffs or just administrative impediments restrict access to our markets. We are going to be debating—is it next week—the MFN issue on China.

I mean, put aside some very valid concerns about human rights abuses, about an array of other issues, to just simply restrict it to the trade issues, we have an imbalance of $57 billion. I want to open up trade. I am a fair-trader. But I don't see—all I keep hearing from New England corporations that do business in China is, we want you to support MFN because the potential is there. We have had potential there for a long time. I am getting very tired of potential. It is like that minor league ball player that just, he would come and go back again from the majors, and it would happen. Potential. Meanwhile, we are running a $57 billion trade deficit.

My proposition in the past to MFN has been predicated on the fact of, hey, until you open up, until you remove impediments, whether they are administrative in nature or delays that occur, this is part of a bilateral negotiation, including ascension to WTO. Start playing it straight with us. There is no reason to have this kind of a deficit.

Brad's observation about sending the note home from the teacher, I would suggest we just have to get a little tougher, because my understanding is that in terms of their export market, we are the ultimate, we are the last—what your term was, the consumer of last resort. We represent 35 percent of their export market and they are 2 percent of ours?

We have leverage that I suggest that we are not utilizing now to say, come on, if you want to engage in an honest and fair, free, bilateral trade relationship, that is fine. But we are running out of patience.

Mr. MULLOY. Yes, sir.

Mr. DELAHUNT. If I may indulge the Chair for just another minute, your argument, which is a good argument in terms of how we should encourage these nations with whom we have a trade deficit, encourage them to grow their economies domestically, gee, that is a hell of a trick. It really isn't easy. I mean, we don't have a vote, in the Japanese Parliament, and I don't know of anybody in this Committee that is a member of the Politburo in China. We might do lots of things, but to influence their economic policy to focus on their domestic markets, I mean, I don't know whether that is realistic or not.

Mr. MULLOY. On the point about China, according to if we believe their figures, it is not the differences in growth rates that have been the problem in China. They have been growing actually, if you look at their figures, faster than the United States. With China it has clearly been that we have many multi-tiered trade barrier problems in China.

One of the efforts was in these WTO negotiations to get at those and try and take care of those in this WTO package. The Congress will be the ultimate decider of whether the package, if we get it, is good, because you have to change the law to give China permanent MFN if you want to do the WTO deal. So I would again urge you, when you get that package, to probably do some hearings to really get a good evaluation of it, because that is a very good point that you made, Congressman.

Finally, I want to thank this Committee again. As I pointed out, we are the one group in the U.S. Government, we are charged with monitoring and enforcing trade agreements. We have 149 people. We have 28 other people in my unit, paid for by AID. We have 149 people, and this is global. I mean, we honestly can't do the job with those kinds of resources.

Mr. DELAHUNT. If I could interrupt for one moment, I agree with you there. I think with this Committee and the leadership of the Chair and the Ranking Member and the entire International Relations Committee, they have been extremely supportive of supporting the exportation of American goods and services and opening up other markets. I agree, I think that you are underfunded. I don't think you have the resources that are necessary to really address the issue, and I would hope at some point in time that we could advocate on behalf of those agencies that do, in terms of securing appropriate funding so that they can accomplish their mission.

We all—I don't want to export jobs, I want to export American goods and services. So that is what I really want to do. That is bipartisan in nature. We can have disagreements as to NAFTA, but I think you have unanimous support as far as the ability for us to penetrate markets.

Ms. ROS-LEHTINEN. Absolutely. Well said. If you would like to make some wrap-up statements?

Mr. MULLOY. I want to thank you and this Committee again. You have been very, very supportive to our unit and ITA in general. I hope that you will maybe followup with the appropriate appropriations.

Ms. ROS-LEHTINEN. Your chunk of that agency, Market Access and Compliance, that division is very important in making sure that our trading partners comply with our laws and making sure that they come forth with the promises they have made when they enter into these trade agreements.

Mr. MULLOY. We are only 8 percent of the total ITA budget.

Ms. ROS-LEHTINEN. It is the important chunk. Thank you so much for being here. We look forward to you getting back to Congressman Sherman and the rest of our Subcommittee Members about those numbers.

Mr. MULLOY. I will.

Ms. ROS-LEHTINEN. I would like to introduce the second set of panelists. Robert Scott is an international economist with the Economic Policy Institute here in Washington where he has studied the effects of trade and protection on the U.S. textile, apparel, and steel industries. He is the author of various publications and studies measuring the employment impacts of trade agreements. Mr. Scott has represented U.S. industries as an expert witness on the economic effects of imports in several cases before the U.S. international Trade Commission concerning unfair trade complaints. Prior to joining EPI, Dr. Scott was an assistant professor with the College of Business and Management of the University of Maryland in College Park, and we welcome Dr. Scott with us this afternoon.

Mr. Robert Blecker is Professor of Economics at American University and a Visiting Fellow at the Economic Policy Institute. He is the author of various books covering the issues of international trade and finance. His academic articles have been published in a variety of scholarly journals and edited books. His research focuses on international capital mobility, U.S.-Latin America economic integration, the U.S. trade deficit and our U.S. trade policy. Dr. Blecker has served on the Economic Strategy Institute Advisory Panel on the Future of U.S. trade Policy and on the Council of Foreign Relations Working Group on Development, Trade and International Finance, and we welcome Dr. Blecker here with us today.

He will be followed by Mr. Simon Evenett who is currently the member of the court team drafting the World Development Report and the principal author of the chapters concerning the world trading system and global financial matters. Dr. Evenett is currently on leave from the Department of Economics at Rutgers University in New Jersey, after serving in an appointed position at the World Bank and as a Fellow at the Brookings Institute. He also serves as a research affiliate of the Center for Economic Policy Research in London, as a member of the Trustee 21 Initiative organized by the World Economic Forum. Previously he has served as a Research Fellow and Visiting Fellow at Brookings and has taught in a visiting capacity at the University of Michigan business school. We welcome you as well, Dr. Evenett.

Ms. ROS-LEHTINEN. We will begin with Dr. Scott. Please feel free to summarize your remarks and your entire statement will be entered in full in the record.

STATEMENT OF ROBERT E. SCOTT, ECONOMIST, ECONOMIC POLICY INSTITUTE

Mr. SCOTT. Thank you, Madam Chairman and Members of the Committee. Thanks for inviting me to testify here today on the impact of these large and chronic trade deficits on the American economy. I will this afternoon discuss these causes and consequences of the growth in our trade deficit and suggest policies that could improve the U.S. trade position.

I begin by talking about how trade has affected American workers. I have a few slides. We begin with the first. These are just a few of the slides in my testimony. In the 1950's and 1960's, the U.S. was the world's leading export power house. The Marshall Plan in particular helped provide the capital needed to rebuild Europe and Japan and fueled a tremendous boom in U.S. exports. As we see on the red line in this diagram, we had a large trade surplus in that period. It was about 4 percent of the GDP in the early 1950's.

Since the 1970's, we have moved from a surplus to a deficit as Europe and Japan began first to compete effectively with the U.S. in a range of industries. Later, we had a tremendous growth in imports from developing countries as well, which we will see in a few moments.

Now, this growth in deficits has had a tremendous negative effect on U.S. workers in many ways. The trade surplus of the sixties was transformed in this deficit and this deficit will grow rapidly in the future as a result of the growing financial crisis. One impact on workers is that it has destroyed millions of jobs in the U.S., most of them in high-wage and high-skilled portions of the manufacturing sector. It has pushed workers into other sectors where wages are lower, such as restaurants and health services. When I appeared before this Committee last spring, I summarized an EPI forecast that the Asia crisis would eliminate about 1 million jobs in the U.S., with most of those losses concentrated in manufacturing.

Those losses have begun to materialize, despite the growth in the rest of the economy. We have lost almost 500,000 jobs since March 1998, and most of this has been due to the rising trade deficit.

Based on the recent IMF forecasts that the U.S. current account deficit could reach nearly $300 billion this year, the U.S. can expect to lose another 400,000 to 500,000 manufacturing jobs in 1999.

Now, trade deficits also have a direct impact on wages, especially for noncollege educated workers, those who make up about three-quarters of the labor force. In figure 1, the wage line in yellow shows that real wages for U.S. production workers peaked in 1978 and declined more or less steadily through 1996. What is responsible for this decline? Trade is certainly one of the most important causes, because it hurts workers' wages in several ways. First, it eliminates high-wage manufacturing jobs, as I already mentioned. Second, it depresses wages through competition with imports, particularly from low-wage countries. If the prices of these products fall, this puts downward pressure on prices that firms receive and forces them to cut wages or otherwise cut costs.

Third, globalization also depresses wages through foreign direct investment. When U.S. firms threaten to move a plant to Mexico, it can force workers in those plants to take wage concessions rather than lose their jobs. We have seen that happen increasingly in the 1990's.

Why are these trade deficits growing? There are many reasons that I go over in the statement. I will summarize a few key facts from my exhibits that emphasize particularly the unbalanced trade that exists with a few countries and in a few industries.

If we move to my figure 2, we see that the U.S. trade imbalances are concentrated in a few regions of the world. Mr. Mulloy mentioned Asia, and we have a huge trade deficit with Asia, we see, that approaches $175 billion in 1998. We also had a fairly large deficit of about $25 to $30 billion each with NAFTA and Europe in 1998. We also see that the deficits with all 3 regions are increasing steadily throughout this period.

Now, the causes of these deficits, particularly with Asia, are discussed in depth in my statement. There are many important differences in the economic structure and strategy of each country in this region. However, each follows a general pattern established by Japan in the fifties and sixties that is a pattern which is based on export-led growth. Exports are increased through state promotion and control of targeted critical industries and, as we have heard, exchange rates are systematically undervalued as part of this strategy.

Now, in addition to these countries—I am sorry, the reasons: There are only a few countries responsible for the majority of the deficit as we see in my figure 4.

In fact, only 10 countries are responsible for the entire trade deficit in goods. These 10 are listed in figure 4. As you see here, the deficit in 1998 in those countries total $229 billion. Japan, China, and Germany alone had a deficit of about $144 billion in 1998, or about two-thirds of this amount.

Now, as I mentioned, the Japanese deficit does reflect numerous public and private barriers to imports in this policy of export-led growth, discussed a moment ago. China, as we have heard earlier, also has a heavy government role which dramatically restricts imports into that economy, and, as mentioned earlier, we have a very unbalanced trading relationship with China, the most unbalanced in the world.

If we turn to the table next, table 1 from the figure, we see that the trade deficit is growing rapidly this year. These are the trade deficits, by country, through May of this year. These are data released on Tuesday. If we look at the trade deficits, the first column is year-to-date through May 9; second, year-to-date through May 1998. We see the trade deficit overall in goods has increased by slightly more than a third, but the deficit with the NAFTA countries has nearly doubled, increased by 93.5 percent; and the deficit with western Europe is up by 75 percent this year.

In addition to the currency factors mentioned earlier, we also have seen a tremendous surge in foreign direct investment into Mexico in the last 2 years that stimulated this deficit.

Just quickly, I will mention that in figure 6 we see the deficit is concentrated in a few key industries. I go into this in some depth in the testimony, but what is surprising is that motor vehicles and parts make up such a large part of our deficit. You would think that most economists would suggest that we would import lots of low-tech goods, like apparel and shoes, and we do in fact import those and basic commodities like petroleum, but we import huge amounts of motor vehicles and parts. In fact, it makes up half of our deficit with Japan, two-thirds of our deficit with Canada, and essentially the entire bilateral trade deficit last year with Mexico.

We also have big deficits in other high-tech products such as computers, steel, and blast furnace products, TV's, radios; and in fact only 3 of the top 8 trade deficit products are what we traditionally think of as low-tech: apparel, leather, and toys.

Let me summarize, then, my policy recommendations, what I think we can do about this, in order to save time. I mentioned four specific points in my testimony that I think are critical to the development of an environment that is going to generate what I think is the bottom line, a high and rising standard level of living for all Americans, and a competitive domestic manufacturing base is key to achieving this.

First, we should enter into no new trade agreements, including China's proposed entry into WTO, unless and until those agreements agree to raise the bar, to include labor and environmental standards so we don't engage in a raise to the bottom in those areas.

Second, I think we have to take measures to address these chronic trade deficits with countries like China and Japan in a few key industries like motor vehicles and commercial aircraft as well, where China is exploiting our technology.

Third, I do think we should steadily reduce the value of the dollar. I am not in the government, so I can say that. I think we need to do that, and we can talk about that more if you have time in the Q and A.

Finally, I think we have to develop new incentives to interest developing countries to change the way in which the trade negotiating game is played. In the past we have traded off access to our markets in exchange for protection for our investors. I think in the future we have to offer them some kind of new incentives; for example, debt relief and development aid, in exchange for raising the bar in the way that I think we need to do it.

I think these goals are achievable. I look forward to our discussion of these topics.

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

Ms. ROS-LEHTINEN. Thank you. Dr. Blecker.

STATEMENT OF ROBERT A. BLECKER, PROFESSOR OF ECONOMY, AMERICAN UNIVERSITY

Mr. BLECKER. Madam Chairman and Members of the Subcommittee, thank you very much for the opportunity to testify here today on this important topic. I would like to begin by directly addressing the question posed in the title of today's hearing, which I think was an excellent title, and saying that yes, we are trading away our Nation's economic future with our massive trade deficits today.

We are trading away our future in two important respects. First, the damage to our workers and industries, which Dr. Scott has just discussed; and, second, the damage to our Nation's financial position, which Mr. Mulloy referred to earlier and on which I will focus in my remarks.

The trade deficits of the past 15 years, as Mr. Mulloy also said, have already transformed our country from the world's largest creditor into the world's largest debtor. Today, as a result of our record trade deficits, the Nation's net international debt is rising faster than ever. The Commerce Department reported last month that the net international debt had reached $1.2 trillion at the end of 1998, and my projections, shown in this figure which is also in my written statement, show that this debt, that is the green line there, will reach $3.8 trillion by 2005 if present trends continue.

Furthermore, I calculate what I call the net financial debt, excluding certain assets that are not liquid, and that red line there, pardon the analogy to the local Metro system, the red line excludes certain illiquid assets, and that was already a net debt of $1.6 trillion last year, and I forecast it to reach $4.1 trillion by 2005, which would then be 35 percent of the gross domestic product.

In the next slide, I also project the net outflow of interest and dividend payments—this is what we have to pay out to foreigners for our borrowing from them—will grow from 66 billion, the red line here. There was a $66 billion deficit on net income and dividend payments last year. I project that will grow to $166 billion in 2005, which would be equivalent to last year's trade deficit in goods and services.

Now, as a result of this growing indebtedness and interest outflow, our Goldilocks economy could come grinding to a halt sometime in the early 21st Century. This negative financial position makes us extremely vulnerable to any loss in confidence in U.S. asset markets, such as the stock market, or in the U.S. dollar. As figure 6 shows, foreign investors now hold over $5 trillion of financial assets in the United States. Most of those assets, as you can see, the vast majority, have been acquired in just the last 4 or 5 years.

It would not take a very large sell off of these assets to precipitate a dollar crisis. In fact, if foreigners sold off only 5.75 percent of that $5.2 trillion that you see on the right, this would be about $300 billion, or just about the projected level of the current account deficit for this year.

Such a sell off could cause a collapse of the U.S. dollar and a hard landing for the American economy unless steps are taken to put our Nation on a more sustainable growth trajectory, with smaller trade deficits and less international borrowing.

In my written statement and also in an attachment I gave the Committee with a recent report I did for the Economic Policy Institute on the international debt situation of the United States, I go into some more detail on these possible hard-landing scenarios and how we might avoid them or what could be the triggers for a financial crisis. I would be happy to discuss that more in response to questions.

But now let me try to move to the policy conclusions. I think we need to work on two fronts, and that is to reverse both the short-term and the long-term consequences of our high trade deficit and our growing international debt.

Now, the two main short-term causes of the high trade deficit are the rise in the value of the dollar since 1995, which you can see in figure 1 coming up here, the order of the figures is different for the presentation than it was in the paper. The green there is the greenback, the dollar. As you can see, it started rising in mid-1995. Most of that increase came with the industrial country major currencies. Then it shot up even faster in 1997 during the Asian financial crisis. While it has leveled off, it has stayed at an uncompetitive level ever since.

Now, no matter how efficient American producers are, no matter how hard the workers work, no matter how much new technology they invest in, they cannot compete in global markets at a dollar that is now 20 percent higher than it was a few years ago. Therefore, I believe that there cannot be any solution to the trade deficit problem that does not begin with and include as an important component a significant effort to bring down the value of the dollar to a more competitive level.

Now, how we do that will have to vary between the different kind of trading partners, those that manipulate their currencies and those with floating rates. We can discuss that more in the question period.

Second, I do agree with Mr. Mulloy and the administration statements that he quoted, that we must encourage our trading partners to stimulate their domestic economies and to open their markets more to imports of American goods and services. I think it is time for Europe to abandon some of the self-imposed restrictions which have already backfired. They were supposed to make the Euro strong, and instead they made it weak. It is time for Japan to pull itself out of its slump. Both regions need a significant fiscal stimulus along with continued monetary ease, and I think we also need to work on our administration to pressure the IMF to let up on the crisis countries. We have imposed on them austerity conditions as part of IMF causality—I am sorry, IMF conditionality, which have led directly to this drop-off in our exports to those regions, to Latin American and Asia, which are such vital export markets for us, a lot of this is self inflicted damage from our treasury department telling the IMF to tell those countries they had to raise their interest rates and slash their budget deficits and put their economies into depressions. When they go into depressions, the first thing they do is stop buying imports from us, not to mention their currencies fell so they couldn't afford them anyway. We need to start thinking about the repercussions of some of these things we tell other countries to do.

Finally, for the longer term, I largely agree with what Dr. Scott said, but let me put it in my own words. I think we need to modify the way we approach trade negotiating to better promote the interests of American-based producers, to look at things from the perspective of industries and farmers producing products in the United States, rather than just our companies selling things abroad.

It is all very well and good to sell bananas in Europe, but we don't grow bananas here, and we need to think about what we do produce here. I think we also need to put social concerns such as human rights, labor standards, and environmental protection on an equal footing with intellectual property rights and other types of investor rights in our approach to trade negotiations. I think this can help to create a more level playing field with other countries in which a more balanced trading relationship can emerge.

We also need to remember that competitiveness starts at home. We should not short-change domestic research and development, education, public infrastructure, the things that make our economy productive, because those are the things in the long term that help our private sector to be more competitive.

With a more secure economic base at home and more balanced commercial relations with our trading partners, we should be able to balance our trade without undue sacrifices of domestic jobs and living standards in the future.

Thank you.

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

Ms. ROS-LEHTINEN. Thank you so much. Dr. Evenett.

STATEMENT OF SIMON EVENETT, ASSOCIATE PROFESSOR, RUTGERS UNIVERSITY

Mr. EVENETT. Thank you for the invitation to present some testimony before this Subcommittee, Madam Chairperson. I also would like to thank Mr. Menendez and his staff for getting in contact with me with respect to this testimony. I should add that Rutgers University has always appreciated its close links with Mr. Menendez.

Ms. ROS-LEHTINEN. We will let him know you said so.

Mr. EVENETT. Thank you very much. I should add that I am speaking very much in my capacities as a Rutgers University professor and a fellow at Brookings, and not in my World Bank capacity. The articles of the World Bank are extremely clear about the involvement of World Bank officials in member countries' politics, so please see me with a Rutgers and a Brookings hat on. Maybe two hats is too much, but not three. Thank you.

Let me turn to the substance of my presentation. I have put together some testimony. I am one of these simple guys who likes to make three or four points with graphs. I am a professionally trained economist. I can do it with mathematically complicated, incomprehensible nonsense.

Mr. DELAHUNT. We would not understand it.

Mr. EVENETT. Most of the time I don't understand it either. But I leave that for the privacy of my own home. For the rest of you, I would like to share the following graphs and make four points. They somewhat go against the grain of what you have heard up until now, which is first, I don't think the trade deficits reflect economic malaise.

The second point is that I don't think the U.S. trade deficit is caused by closed foreign markets.

The third point is in the current U.S. boom, it seems its trade deficit growth and job creation have gone hand in hand. There is no big surprise. They are caused by exactly the same factors. We will talk about that.

Finally, I think the plummeting U.S. savings rate is the real policy headache, and for more important reasons than its effect on the trade deficit, as we enter an era where more and more Americans are approaching their retirement. So let me take you through those four points.

The first point, and I summarized this, as I said, in four graphs. The first is that I don't think trade deficits imply economic malaise. It is actually very interesting that the United States since 1990 has had the highest growth rate in the G–7 economies and also had the largest trade deficits all the way through. In fact, if you were to plot a graph of growth in the G–7 against their trade deficits, you would find the countries that have the higher trade deficits were the ones that were growing.

So I would urge you to ask what you really care about, a growing economy which, as we will see, produces a lot of jobs, or are we going to worry about one specific narrow economic indicator? I think you get more miles or bang for the buck out of economic growth than you do about worrying about trade deficits.

The second point I would like to make is I don't think the U.S. trade deficit is caused by closed foreign markets. In fact, on my second graph here, it is interesting that if it is the case that the current U.S. trade deficit was caused by closed foreign markets, and we have had three rounds of multilateral trade negotiations, lowering tariffs, lowering nontariff barriers, then presumably back in the sixties we would have had even more closed foreign markets, but back then we had a trade surplus. So something is driving the U.S. trade deficit, and it is not closed foreign markets, and that is something I will come to in a minute, and it has to do with domestic macroeconomic factors.

Really a historical perspective, not history—going back to 1960 is not history for most of us—but going back to 1960, you can see the U.S. trade deficit has varied for a large number of reasons, and it doesn't have much to do with closed foreign markets.

When we looked more recently as to what happened since 1990, we found that employment, nonfarm employment in the United States, has surged, and so has the current account deficit. The real explanation there is entirely demand-led, especially in the last few years.

On my final graph, I think I get to the heart of this, but looking at what we have had is both an investment boom, a very healthy investment boom which is bringing new production techniques, managerial techniques and skills for U.S. workers, helping to raise their wages and offset some of the growing inequality we have seen since the seventies.

We have had a healthy investment boom, and we have had a somewhat more dubious consumption boom. Yes, we have all had a big party here. One thing is definitely clear: If you don't like the savings numbers, look at the consumption numbers. The consumption numbers have absolutely gone through the roof, I think really for two reasons.

First, as we have said, people are starting to spend down some of their stock market gains; and, second, people have refinanced on their houses, too. As interest rates have come down, they have refinanced at lower interest rates, releasing some income to be spent on goods and services.

So what that means is when the traditional measure of the savings rate—which of course is nothing more than the difference between what America consumes and what it earns—but that has been shrinking, mainly because consumption has been surging. Now, that comes out as a plummeting savings gap.

Now, some questions have been raised earlier about how to measure savings. Some of the more rigorous and sophisticated ways of trying to measure savings, getting at precisely the issues raised earlier, still point to a fall in the U.S. savings rate over the last few years. So this savings rate has fallen, even when you take account of the factors which were quite correctly raised earlier.

The second thing is even if you don't think savings have fallen in the U.S., investments certainly have. All that matters, all that you need to get a trade deficit is for the difference between investment and savings to rise. All you are really saying is the demand in the U.S. economy is rising faster than its capacity to supply it, so you have to buy goods from abroad. We have seen a huge surge in investment in the U.S., primarily in information technology and other areas. But that is the real reason why we have a trade deficit and a current account deficit at the minute.

I guess to sum up, I don't want to come off and say—I don't want to appear to say don't worry about the trade deficit; because if you think that the savings and investment imbalance is very precarious, in other words, if you think people are over consuming, spending far too much money, spending down stock market gains which could disappear tomorrow—after all, the Dow fell 200 points very recently, right?—if you think that is a very precarious way to organize household consumption decisions, I would agree with you and turn around and say these numbers could reverse very, very quickly. That would lead to a quite serious adjustment problem.

What I don't think I agree with is that somehow we have these foreign markets which are systematically closed to U.S. goods. I think that where there are problems, countries have legitimately taken complaints to the WTO, and the U.S. is the biggest complainant of the WTO, it takes the most cases, and also answers the most cases, by the way. This country is not innocent on that score. It has been found guilty in some cases, too. So the fact is the WTO is the right forum for dealing with trade complaints.

The second thing is if you think there are existing barriers that still need to be negotiated down, that is what I would urge you to do, is endorse a new round of trade negotiations which could be launched in Seattle and help craft and shape that agenda. In that agenda I would not put labor and environmental standards. I can tell you that if those decisions to negotiate on those issues goes to Seattle, you will get large numbers of developing countries, countries whose economies are not growing very fast, potential exports for the United States, they are not interested and they will walk out.

So my sense is we have to find—we are going to need some innovative thinking on trade policy that is going to require an honest discussion about what the remaining trade impediments are and bringing up labor and environmental standards is merely going to antagonize our trading partners, who otherwise I think are quite interested in reducing their trade barriers even further.

Thank you Madam Chairman.

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

Ms. ROS-LEHTINEN. Thank you so much for your testimony.

I have one question for each of you. I would like for you to elaborate on the factors that you believe cause the deficits that we have: the merchandise trade deficit, the manufacturing trade deficit, the deficit in goods and services. What are the factors you think contribute to their causes, and the varying impact that these would have on the U.S. economy? Also related to that, if you think that the trade deficit in this one sector is preferable to the deficit in another sector. Dr. Blecker.

Mr. BLECKER. That is a big area to talk about, but let me just say a few points. I think what has happened in the last few years—and by the way, one area I think I agree with Dr. Evenett is on the saving rate. I think a major change in recent years is that what has been happening on the balance of payments has been driven largely by what is going on in the capital account rather than the current account. These two things have to balance each other out, because it is an accounting statement. But we have seen large inflows of funds. These in turn pushed up the value of the dollar. They have financed the shortfall of savings, allowed the consumer boom to continue, prevented investment from falling, in spite of the low savings rate.

I disagree somewhat about investment being high. That depends on how you measure it—in constant dollars or current dollars—and I prefer a current dollar measure.

But this in turn has basically forced us, then, to run a current account deficit which is the other side of the coin of the capital account surplus. That, then, reverberates on to all of the other balances that are subcomponents of the current account. Especially it reverberates on to goods and merchandise because the high dollar and then boom in our economy compared to sluggish conditions abroad, where I also agree—which is in fact in my testimony as well—that forces a merchandise deficit which is very large, but which then has the consequences that Dr. Scott was discussing.

Even services—we have seen a lot of arguments in recent years, don't worry about the merchandise deficit, because we have a services surplus. The services surplus has shrunk, too, and it is not growing as was expected, because when the rest of the world is depressed and the dollar is too high, it is not surprising they don't want to buy so many of our services.

Then there a new part of the overall current account deficit that is getting worse, which I flagged in my figure, I think number 2, in my written statement, and that is the deficit on investment income.

In the past when we were the world's largest creditor, we had a large net inflow of investment income, mostly from our multinational corporations abroad. But that is now being overwhelmed by the net outflow of interest payments and dividend payments on our financial obligations, and it is a long story why it has taken a while to turn negative; but it has now, and if present trends continue, it will become a major negative factor in the current account and balance of payments in the next several years. That is going to make it necessary for us to run even harder just to stay in place as far as preventing rising current account deficits.

So essentially my causal story would start with the capital inflows through the dollar and go on through the rest of it.

Ms. ROS-LEHTINEN. Thank you. Mr. Scott?

Mr. SCOTT. Sure. I would say that there are two causes, generally speaking. They are both short-return financial sector causes and I think there are long-run structural causes to the trade deficit.

On the short-run side, as Dr. Blecker describes, I would like to describe it as a boomerang economy. The rest of the world collapsed, they sent their capital here, and that stimulated a boom in the stock market which led to a consumption boom, and that generated also a short-term increase in the trade deficit. I think there is no question about that.

On the other hand, as we all know, boomerangs are dangerous to play with. If that capital decides to depart and it causes a crash in the stock market, it could certainly destabilize the economy. So we are playing with a very dangerous situation here, I think, given the state of the world economy.

So that on the structural side, I very much appreciate Dr. Evenett's first figure on the structural trade, which to my view illustrates the pattern of the structural trade deficit. Obviously I think the data is correct. We all get the data from the same sources. I think the title is a little bit wrong. It is very interesting.

He paints this picture of the three long-term rounds of trade negotiations, the Canada, Tokyo and Uruguay Rounds of negotiations, and they are clearly linked in some way to an increase in the U.S. trade deficit. It says on the title of that, the deficit has grown as foreigners lowered their trade deficits, not the other way around.

But, in fact, I would argue just the opposite. Our deficit has grown because we have lowered our trade barriers in total more than foreigners have. During each round we have reduced our tariffs to the present day to just about as close to zero as they can get. Other countries have not reduced their tariffs as rapidly as we have, first.

Second, more importantly, they have maintained and enhanced a set of nontariff barriers to trade that both promoted their exports to the U.S. and acted in new and in creative ways to restrict U.S. exports to their markets. I think that is the long-term nature of our trade problem. That is why this trade deficit goes up as it follows a steady increasing trend, as you see. That a not a macro short-term problem, that is a long-term problem and dates from the 1950's and 1960's, I would argue.

Ms. ROS-LEHTINEN. Thank you. Dr. Evenett?

Mr. EVENETT. Up until the last minute, I was about to say you were going to witness something rare, which is three economists agreeing on something. But let me say on the short-term questions, I think we are all quite agreed. We have had this surge of investment in the U.S. which has needed to be funded somehow. The U.S. consumers are not providing it, nor is the corporate sector, so the money has come from abroad. That is fine. Everybody understands that, and I think we understand. Let's talk about the stuff I am less sure I agree with my colleagues on.

Thinking in terms of breaking it out between manufacturing and services, I would argue that the downturn—the slowing growth in service exports is primarily due to these lower incomes and recessions abroad. In fact, I would point to the recent forecasts of Professor Alan Dierdorf at the University of Michigan, one of our most respected trade economists in the services area and on trade in general, and he has been examining how the U.S. trade patterns in services will vary over the next 2 or 3 years. As east Asia and Latin America bounce back—we are already seeing evidence of that—then service exports to those areas, an area where is U.S. has strong comparative advantage, are expected to bounce back. I think that will provide some good news in terms of the trade deficit and the current account.

The second thing in terms of the interpretation of this trade liberalization over the last 30 years, I would argue that in fact certainly in the Uruguay Round, the U.S. made out like bandits, quite frankly. You got reduced in your tariffs, but not by that much. A lot of developing countries for the first time came onboard and seriously negotiated substantial reductions in their trade barriers, and not just in the areas where the U.S. cares about—manufacturing, some in services and a fair amount in agriculture—although there is a lot more work that needs to be done in agriculture.

So I would argue that the U.S. did very well out of the Uruguay Round, and I think the numbers on the gains to the U.S. which have come out of the economic studies bear that out.

The second thing is in terms of an enhanced nontariff barrier. For the U.S. ever to lecture the rest of the world on this is the pot calling the kettle black. The spread of antidumping laws which was founded on K Street and spread around with the help of others, has now reached the point that 29 countries are using these laws. Guess who is the No. 1 target? This country. It is this country's exports. So we are seeing the spread of—if there is a spread of nontariff barriers, we started it in large part. That is one of the things, I think antidumping should be on the Seattle negotiating list. You can bet your life that USTR will want it to be there, and I can tell you people on K Street don't want it to be there, but it will be raised by Australia, the European Union and many other countries, and I do think we need to nip these nontariff barriers in the bud, and let's start with antidumping.

Ms. ROS-LEHTINEN. Thank you. Mr. Delahunt.

Mr. DELAHUNT. So you think it is time to get out of the stock market?

Mr. BLECKER. We don't give advice on that.

Mr. DELAHUNT. That is the measurement we will measure you by.

A little bit of a primer here, if you will. You all referred to the $1.2 trillion debt. Please explain that. Is that debt held by individual Americans, by mutual funds, by government agencies? Please, just a real kind of concise, very simple explanation. Anybody.

Mr. BLECKER. I will tackle that, since I just wrote a report on that and just read the latest Commerce Department release. Basically, this is debt held by foreigners that is their ownership of American assets in excess of what we own abroad. So essentially we are saying the foreigners own more bonds, stocks, Treasury securities, et cetera, et cetera, in the United States, compared with what we own abroad.

Mr. DELAHUNT. It is a mix, in other words. It can be equities, U.S. obligations, it can be private corporate instruments.

Mr. BLECKER. Right. But what has changed most dramatically in the last 10 or more years that has caused the big swing are the more liquid financial assets, especially Treasury securities. We now have, I think, about $1.3 trillion worth of U.S. treasury securities owned abroad. About half of that is owned by foreign central banks and the other half is owned by private investors. That is somewhere around 35 percent or maybe almost 40 percent, somewhere in that range, of all outstanding Treasury securities.

Mr. DELAHUNT. We have been debating the last several days regarding reducing American debt.

Mr. BLECKER. The government debt. You all have been talking about government debt.

Mr. DELAHUNT. I understand that. My point is that is a component of the debt we are talking about.

Mr. BLECKER. Right.

Mr. DELAHUNT. What are the consequences? Clearly it is my sense, no matter whether what occurs, that there will be debt reduction, which I presume would mean there would be a demand, because it is such an attractive, secure investment in an unstable world. What are the consequences for action that the United States is now taking in terms of reducing public debt held by foreigners?

Mr. EVENETT. I think the first consequence is that obviously the return, the interest the U.S. has to pay on existing long-term debt, that rate of interest will start falling. The liquidity or the ability to sell those debt instruments very easily will begin to be reduced because there won't be such a huge market for it.

I think what will happen, what this will do is, I mean, as these long-term Treasury instruments get scarcer and scarcer, then you will find that again the U.S. taxpayer will win out and that hopefully they will have to pay less and less interest on the remaining Treasury bills which get issued.

Mr. DELAHUNT. I understand that. But my point is, what does it do in terms of multilateral commercial relations, if anything?

Mr. EVENETT. I am not sure—the second point I was going to make is that I remember 10 years ago a certain British Prime Minister announcing that the U.S.—the U.K. public debt was going to be paid down in 15 years because of a huge budget surplus which emerged at the end of the eighties. Within 3 years——

Mr. DELAHUNT. Who is that.

Mr. EVENETT. Within 3 years, Britain had, I think, a 5 percent budget deficit, the currency had gone through the floor, and that Prime Minister was out tending roses in her garden and no longer——

Mr. DELAHUNT. "her" garden?

Mr. EVENETT. Her garden, yes. So my sense is that come the next recession, this budget surplus will evaporate and we have a short-term gain here. The issue is short-term windfall; the issue is what to do with it.

Mr. DELAHUNT. Let me just followup in a question, because I think you both, Dr. Blecker and Dr. Scott, talked about the devaluation, if you will, of the American dollar. I hear what you are saying, but I will tell you what causes me concern, and I don't know if I have any basis to be concerned. But if we do devalue, and I don't know how you go about doing that—you were talking about bilateral devaluation, and, again, I am not conversant certainly with the world money markets—but if that were done in any abrupt fashion, I mean, the impact in terms of the world financial markets, including our own stock market and bond markets. One thing I continue to hear is that the financial markets do not like uncertainty and instability. It would cause me some concern.

Dr. Scott?

Mr. SCOTT. Yes——

Mr. DELAHUNT. I understand how it would create more fairness. But, hell, I mean, we could end up shooting ourselves while we are trying to solve a problem.

Mr. SCOTT. I think we don't have to look very far back into our own history, and remember back to the mid-1980's, the last time we had a trade deficit that reached 3 percent of GDP. At that point the dollar was about 50 percent higher than it is today, perhaps, maybe 40 or 50 percent higher, and we had an agreement that was reached in the Plaza as I recall, although I am not a finance person, the Plaza in New York, as I recall, in roughly 1985, and it was amongst the finance secretaries of the G–7 countries, and they agreed to gradually reduce the value of the dollar.

So in my testimony I called for a gradual reduction of the dollar. We have done it before, we can do it again. Though financial markets don't like uncertainty, they like even less to lose. If they have to bet against all of the major central banks of the G–7 countries, they are going to lose. So if the finance ministers announce they are going to reduce the value of the dollar, I think they can successfully do that, as they did in 1985 through 1987, when they reduced the dollar by about 50 percent.

Mr. DELAHUNT. Do you agree with that, Dr. Blecker?

Mr. BLECKER. Let me amend that very slightly. Actually the dollar fell quite precipitously between 1985 and 1987. It fell more rapidly in those years than it rose between 1980 and 1985. But it did not cause a financial catastrophe, and I think the reason is what Dr. Scott put his finger on, that this was seen as an agreed-upon managed depreciation that the major countries were prepared to stand behind. There were tacit target zones. That wasn't quite announced, but it was understood the dollar would stay within certain limits.

I think if we take that approach, again, because I agree absolutely with the concern you raised, and that is my whole concern, if we let the debt get out of hand, we will see that true hard landing for the dollar in the economy further down the road. The way to get there is not by letting the dollar stay too low, but by easing it down gradually. This is going to require cooperation with the other countries.

Mr. DELAHUNT. Would that be the invisible hand of the marketplace? It will require active——

Mr. BLECKER. Active intervention and cooperation with our trading partners. What is it our trading partners want out of all of these negotiations? Access to our markets. We need to insist on reasonable equilibrium exchange rates as one of the things that we look for in a normal trading relationship, whether it be with China, Japan, Europe or anybody else.

Mr. EVENETT. I must say the postscript of this story is they had to get together in 1988 and decide the dollar had fallen off too much.

Mr. DELAHUNT. This is all above my pay grade.

Mr. EVENETT. So the fact is, the end of this story is it wasn't quite the smooth managed transition that perhaps has been suggested. I think you are absolutely right, sir, to suggest that this is a very dangerous game to go down. To get people—trying to devalue the U.S. dollar means in effect scaring foreign investors. That is what you have to do.

Mr. DELAHUNT. That creates that flight from our capital markets which creates an impact which would slow down our economy, which returns us to the issues that we talked about before in terms of that surplus that I have very little confidence in, by the way.

I happened to vote not only against the Republican plan, but the Democratic plan, because when I arrived here 2 years ago we had a deficit. These estimates, these CBO estimates, they were telling me we were going to have a $200 billion deficit; 2 months later, 170; 2 months later, 120; 4 months later, it broke 100; 3 months later, hell, we can't forecast 2 months ahead, let alone a decade ahead. That is what really makes me nervous.

Mr. SCOTT. You notice none of us want to tell you what to do with your investment funds.

Ms. ROS-LEHTINEN. Thank you so much, Mr. Delahunt. I want to thank the witnesses for your excellent testimony. As you know, on a bipartisan level, this trade deficit growing out of control is of increasing concern to us, even if we disagree on how best to handle it. We look forward to continuing our conversations with you. Thank you so much.

The Subcommittee is now adjourned.

[Whereupon, at 4:45 p.m., the Subcommittee was adjourned.]

APPENDIX

July 22, 1999

COMMITTEES:

INTERNATIONAL RELATIONS
GOVERNMENT REFORM

CHAIR:
SUBCOMMITTEE ON
INTERNATIONAL ECONOMIC
POLICY AND TRADE

VICE CHAIR:
SUBCOMMITTEE ON
WESTERN HEMISPHERE

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The Honorable Ileana Ros-Lehtinen, Chair
Subcommittee on International Economic Policy and Trade
"The U.S. Trade Deficit: Are We Trading Away Our Future?"
Thursday, July 22nd, 1999

The U.S. trade deficit has been the object of considerable concern and controversy among experts–both advocates of free trade as well as protectionists.

Some contend that the trade deficit is, as one headline read, "Bleeding the U.S. Economy"-- draining our domestic markets of potential profits and American workers of jobs. Others yet, claim that the growing deficit is a sign of a robust economy--that it indicates the strong role being played by America in providing markets for other countries struggling to recuperate from economic crises'.

Trade has always played a critical role in the development of America's economy. It has helped to enrich our country's market size, productivity, and competitiveness while providing a vehicle for American ingenuity. However, with the economic prosperity which trade can bring comes the challenge of striking the delicate balance between trade that is free, yet fair.

According to experts, America runs trade deficits because for almost two decades, foreign investment in the United States has exceeded American investment abroad. The deficit is made up of the difference between domestic savings and investment, and because America invests more than it saves, it is forced to increase borrowing to pay for the rising tide of foreign goods and services.

The trade deficit is also inextricably tied to the economic success--or failure-- of our global trading partners and can be tremendously influenced by economic crises abroad—as recently illustrated by the Asian financial crisis.

Should the growing deficit be a cause for alarm for America?

The trade deficit, which according to a recently released government report, hit an all-time high in the first three months of this year reaching over $68 billion, has driven even those who most support trade liberalization to question how much
longer can the U.S. economy continue to sustain such losses.

Former Treasury officials have said that the ballooning trade deficit is the single biggest threat to our economy-- that it could lead to a plunge in the dollar's value and to a tremendous sell-off in stocks and bonds spurring the U.S. into recession.

Some experts will point to the increasing trade deficit as a sign of America's purchasing power and of international confidence in the U.S. economy. They maintain that, when trade deficits rise, unemployment drops, industrial production surges, and American corporations sell more goods and services than any other country in the world.

By contrast, others argue that trade deficits mean declining real wages, increased American job insecurity and constitute an erosion of America's industrial base citing recent statistics from the U.S. Department of Labor that over 200,000 workers have lost their jobs because of either shifts in production to Mexico or Canada or because of increased imports from those countries.

Some claim that trade deficits have no relationship with the level of employment in manufacturing and, in fact, claim that cheap imports have helped keep inflation low in the United States during a period of unusually high employment and heavy American spending.

Those who argue that the trade deficit does not have a detrimental effect state that, years in which the U.S. has run trade deficits, have also been years of increasing income for the average American.

Yet, in either case, there exists concern across the board that America is becoming a "market of last resort" for our foreign trading partners and that the increasing excess with which we import over what we export are putting over $20 billion more into foreign hands each month.

Regardless of what we individually believe to be the causes of our increasing trade deficit our challenge in Congress will be to develop policies which will create balanced trade relationships with our global partners and which seek to restore the balance of trade.

I look forward to the testimonies of today's witnesses and to their recommendations as to how we can manage the trade deficit, while maintaining freer and more open trade markets.

Prepared Statement of
The Honorable Patrick A. Mulloy
Assistant Secretary of Commerce for Market Access and Compliance

before the
Subcommittee on International Economic Policy and Trade
of the House Committee on International Relations

July 22, 1999

Madam Chair, I am pleased to appear before this Subcommittee today to discuss the large and growing U.S. trade deficit. The very rapid increases in the trade deficit starting in 1998 are not something that can be ignored, but it is also important that the significance and causes of the deficit not be misunderstood. My objectives today are threefold. First, I would lay out what I see as the elements of the deficit in terms of its geographic and industrial composition. Second, I would like to review the key factors that have brought us to this point. And third, I would like to offer some thoughts on what this means for our economy and where we go from here. I would like to add that we look forward to working with the Congressionally-mandated Trade Deficit Review Commission which is charged with addressing, among other things, the extent to which we have fair market access in countries with which we have persistent and substantial bilateral trade deficits.

Earlier this week, the Commerce Department released the trade data for May 1999. These data show that for the first five months of this year the deficit in goods and services is running at an annual rate of $225 billion -- up 50 percent over the first five months of last year. The merchandise deficit so far this year is running at an annual rate of $307 billion. Imports were up 6 percent over the comparable period of 1998 -- not an unusual rate of growth. The real difficulty is that exports did not grow well. In fact, they didn't grow at all -- they fell 2.4 percent from the same period a year ago. Even worse, the data show American exports are no higher than they were two years ago. This stagnation is a serious matter. It is affective jobs in America's farms and factories.

The Growth in the Trade Deficit

Before discussing the causes and effects of our deficit, I would like to begin by reviewing the course and composition of our deficit over the last few years.

The U.S. trade deficit in goods and services grew in the mid-1980's, reaching a peak of $153 billion in 1987 before beginning to decline. It reached a low of $31 billion in 1991 as the economy bottomed out. As the economy strengthened in the 1990s, and I might add that the economies of our trading partners languished, the deficit grew once more. By 1994 it had reached $100 billion and remained at about that level for the next three years. Both exports and imports grew strongly over this period, averaging around 10 percent for exports and 9 percent for imports.

But in 1998, the trade balance started to deteriorate sharply. During the first six months of 1998, the deficit ran at an annual rate of $150 billion, while in the second six months it ran at an annual rate of almost $180 billion. The Asian financial crisis hit hard. Our exports to the most affected Asian countries -- Indonesia, South Korea, Malaysia, the Philippines and Thailand -- dropped sharply in the June to December period of 1998 compared with the same period in 1997.

Despite the fact that the trade deficit has reached record levels, as a share of the country's GDP, the trade deficit in the first quarter of 1999 was equal to 2.2 percent of GDP -- up significantly from the 1.5 percent of GDP it registered in the first quarter of 1998, but significantly less than the record of 3.1 percent of GDP that was reached in the third quarter of 1987.

Geographic Composition

Where did these deficits originate? As I already noted, the Asian crisis was important. Our merchandise trade deficit with the so-called "Asian five" (the five countries named above) went from $18 billion in 1997 to $38 billion in 1998, an increase of $20 billion. That change was equivalent to 41 percent of the total increase in the deficit. Another important source of the deficit growth was Europe. Our bilateral deficit with Europe grew by almost $15 billion, equal to about 30 percent of the deficit. Additionally, our bilateral deficit with China, already large, grew another $7 billion -- reaching $57 billion, and our also already-large deficit with Japan increased about $8 billion -- reaching $64 billion in 1998. For the Western Hemisphere as a whole there was a small improvement of about $3 billion, due mainly to lower oil prices (primarily imports from Mexico and Venezuela).

Overall, we can see two distinct trends at work. The Europeans experienced a significant gain in exports to the United States, which seems to reflect increased competitiveness on their part which allowed them to gain market share, but also increased U.S. economic growth. For most of Asia, however, the picture was of a dramatic drop in their purchases of U.S. goods. The financial crisis in several of these countries resulted in severe economic contractions that precipitated large import declines.

Asia -- The most dramatic drop in exports took place in Asia where 1998 exports fell by 15.1 percent compared to 1997. During the preceding three years exports to Asia had grown at an average annual rate of 9.9 percent. In 1998 U.S. import growth from Asia fell to 3.6 percent from 6.8 percent in 1997.

The fall-off in U.S. exports to Asia was concentrated mostly in the Asian Five where they dropped by 28 percent. Imports from these five countries, on the other hand, did not surge; import growth dropped from 9.3 percent in 1994-97 to 5.8 percent in 1998. U.S. trade with

Japan exhibited some of the most unusual behavior. U.S. exports to Japan dropped by almost 12 percent while, U.S. imports from Japan grew by only 0.1 percent. Thus, virtually the entire Asian deficit increase was the result of falling exports.

On a bilateral basis, the largest deficit is with Japan. Since 1985, the U.S. bilateral deficit with Japan has fluctuated between a low of $41 billion in 1990 and a high of $66 billion in 1994. Over the last 12 months it has again reached $66 billion. The largest component of the deficit is motor vehicles and parts, currently more than $34 billion. In 1998, however, the increase was due entirely to lower U.S. exports to Japan; imports from Japan remained flat.

Our second largest bilateral deficit is with China. The key reasons for the continuing increase in that deficit increase are first that our exports to China are not keeping pace with our imports, and second that we import five times from China what we export to China -- meaning that just to keep the deficit with China from growing any more, our export growth rate has to be five times as large as the import growth rate. In the last three years, however, the import growth rate has been 16 percent a year while our export growth rate has been 6.6 percent. While there is no reason for bilateral trade to be in balance with each individual country, in the case of China the divergence between import and export growth far exceeds what should normally be expected. Last year the United States ran a $57 billion trade deficit with China while China maintained a global trade surplus of $44 billion.

Europe -- With all the talk of Asia and the trade deficit, it is frequently not realized how much our trade position deterioration since 1991 has been with Europe. In 1991, the United States had a surplus of $19 billion with Europe; in 1998, our deficit had reached $32 billion -- a negative swing of $51 billion. Unlike other parts of the world, especially Asia, these swings in the trade balance with Europe are not uncommon. From 1986 to 1991, the United States went from a $28 billion deficit to a $19 billion surplus. These wide fluctuations illustrate that economic forces are allowed virtually a free rein in determining U.S.-European trade. The trade position oscillates dramatically with changes in economic growth rates and exchange rates. Thus, if the

EU ever begins to resume strong economic growth and the EURO shows some strengthening, that deficit could turn around.

With respect to our NAFTA partners, the story of strong domestic U.S. growth pulling in imports also applies. Given increasing economic integration among firms on both sides of the border, this is not surprising. For the year to date, the trade deficit with Mexico was $24 billion (annual rate) compared with $14 billion a year ago, with U.S. exports down 1 percent and imports up 11 percent. The deficit with Canada was $27 billion compared with $13 billion a year ago, with exports up 2 percent and imports up 10 percent. Particularly significant factors include rising oil prices and a strong U.S. dollar in relationship to the Canadian dollar. In addition, while Canada and Mexico have been growing well, the pace of growth lags that in the United States and as a result our trade deficit with those countries continues to widen.

Sectoral Composition

From a commodity standpoint, the deficit derives from three main areas -- imports of fuels, consumer goods, and motor vehicles. In 1998, the U.S. deficit in consumer goods was $136 billion, for motor vehicles the deficit was $ 78 billion and for mineral fuels $48 billion. On the positive side the United States has consistently run a surplus in capital goods ($29 billion in 1998). In 1998, the growth in the deficit was exacerbated by a decline in the trade surplus for services. For the first time since 1985, the surplus declined. Instead of the positive gains, we experienced a $9 billion deterioration.

In terms of broad commodity groups, consumer goods had the largest deficit increase in 1998, increasing by $21 billion to a total of $136 billion. The U.S. surplus in capital goods decreased by $11 billion to a $29 billion surplus; computers and parts and microprocessors are included in this group. Foods, feeds and beverages saw an historically small surplus of $11.8 billion in 1997 whittled further to $5 billion. Sharp decreases in farm prices are a major factor behind the decline in the trade surplus in this category of goods. The deficit in autos was up by $11 billion to $78 billion, the second largest category. Industrial materials actually showed a small improvement with the deficit declining $3 billion to $52 billion, reflecting lower oil prices.

Overall, there is nothing on the immediate horizon to suggest changes in our recent trade trends. U.S. economic growth, even though expected to slow in 1999 from 1998, will still be relatively strong compared to most of our major trading partners. In Europe, expectations continue to be for growth of less than 2.5 percent. In Japan, a strong recovery still seems a long way off. There are some positive signs, however. The Asian financial crisis has bottomed out. Our exports to Korea are growing again. In the first five months of 1999 our deficit with Korea fell to $5.9 billion from $7.7 billion in the same period last year. But there is still a long way to go to get back to the surplus we had with Korea prior to 1998.

What Does This Mean for the U.S. Economy?

We cannot blame our deficit all on the recent economic crisis in Asia. Longer term forces are also at work -- including the continued existence of trade barriers that have held back U.S. export opportunities. Amazing though it may now seem, from 1894 to 1970 the United States had an unbroken string of trade surpluses, but since 1970 we have had virtually an unbroken string of merchandise trade deficits that have cumulated to over $2 trillion. Most of our trade growth, and most of our deficit occurred in the last ten years. Nearly 80 percent of the deficit is with Asia -- and fully 40 percent of the total was with one country, Japan.

The short term rise in the trade deficit reflects the health of the U.S. economy and does not under present circumstances present a serious problem. Our unemployment rate is extremely low by historic standards, inflation is low, economic growth continues above its long term trend, and real incomes are rising strongly. The biggest negative is probably our personal savings rate which is close to zero. Thus despite the Federal surplus and state and local government surpluses, overall investment in the United States continues to outstrip savings. Our trade deficit has permitted us to continue a high level of investment while sustaining strong consumption expenditures -- but at the expense of incurring considerable debt. The net debtor position of the United States, in fact, stood at -$1.24 trillion in 1998 -- more than doubling in two years.

Currently, the factors that led to the recent growth in our deficit are largely macro economic: strong domestic growth, lower import prices -- largely the result of declining value of foreign currencies -- and economic developments abroad. Trade has helped the U.S. economy to continue to grow with low unemployment and low inflation. The trade deficit, and the foreign investment that must accompany it, allows us to consume and invest at a higher rate than we otherwise could. We are at virtually full employment and our overall economic performance is one of the best in the industrial world. Our economy has many competitive strengths, especially its flexibility and ability to adopt new technologies. These qualities are much admired by our industrial trading partners.

While current economic conditions, at least for the United States are excellent, we can't help but be concerned with running extremely high deficits long into the future. To finance these deficits we must borrow from abroad. Thus, we become ever more dependent upon receiving and retaining foreign capital.

Another serious problem is in employment. The drop off in our exports has had a serious effect on manufacturing employment in the United States. While overall employment in the United States is at record levels and has grown by 2 million jobs in the last year, there are 422,000 fewer manufacturing jobs than a year ago. Many of these losses are directly attributable to the decline in U.S. exports globally -- and especially to Asia.

The fact that our exports have dropped so significantly points out a significant factor in reversing the deficit. Few actions we can take domestically would have as great an impact as restoration of growth in our major export markets. We must increase the rate of growth of exports. The key here is in economic policies in Europe and Japan that would promote domestic-led growth. As an examination of the industrial production data in Exhibit 1 attached to my statement makes plain, economic growth in these economies is inadequate. In fact, Japanese industrial production is now less than it was ten years ago!

Former Secretary Rubin, speaking recently of the need for strong economic growth abroad, said, "It is also critically important that Europe and Japan do their part because the international system cannot sustain indefinitely the large imbalances created by the disparities in growth and openness between the U.S. and its major trading partners." More recently, Secretary Summers said, "We continue to watch the Japanese economy carefully and to believe that what's most important for Japan is the restoration of domestic demand-led growth and it is important that the basis for growth be firmly established. I may leave it at that..."

Along these same lines, Chairman of the Federal Reserve Board Alan Greenspan recently said, "There is a limit to how long and how far deficits can be sustained since current account deficits add to net foreign claims on the United States."

He went on to say, "It is very difficult to judge at what point debt service costs become unduly burdensome and can no longer be sustained. There is no evidence at this point that markets are disinclined to readily finance our foreign net imbalance. But the arithmetic of foreign debt accumulation and compounding interests costs does indicate somewhere in the future that, unless reversed, our growing international imbalances are apt to create significant problems for our economy."

We need to be working to bring the deficit down over the long term. As I have noted above, it is not rapid import growth that is the problem. Imports as a percent of GDP in fact, have not grown since the third quarter of 1997, and have remained at or below 13.2 percent. The problem has been in our stagnating exports. When growth prospects in our major markets improve, they will attract more imports, and our exports will grow. It is slow markets that are our problem -- not a drop in U.S. competitiveness. The U.S. share of world markets is strong, and our share of major country markets shows no deterioration. The U.S. share of foreign country imports last year, in fact, was 15.2 percent -- significantly above our average 14.1 percent share for this decade, and up from 1997's strong 14.8 percent share of foreign markets.

What is weak is foreign demand, and it is unrealistic to believe our exports will grow significantly until economic policies in our major markets begin to restore prospects for their economic growth. We must continue to urge such policies, and we must also foster conditions for a restoration of our trade position when foreign markets recover by assuring that foreign markets remain open, enforcing our trade laws and promoting exports.

While I do not believe that non-compliance is a major factor in the growth of the deficit, we must be sure that countries are keeping markets open and complying with the trade agreements they sign. We need to assure Americans that the agreements we negotiate are honored and that American firms and workers obtain the benefits and opportunities intended. Hence, compliance and enforcing our trade laws are a priority throughout the International Trade Administration. The Trade Compliance Center coordinates our compliance activities but all our country market access officers, our industry experts, as well as our Commercial Service officers overseas, are involved.

Our increased monitoring tells us that most countries are attempting to live up to their trade agreements, but we have seen some actions inconsistent with obligations. We have been trying to get Korea to live up to its obligation to allow American companies to compete fairly on contracts for its new $6 billion airport. Despite months of effort, we have had to turn to the dispute settlement process through USTR and a WTO panel has been formed to hear our complaint and we expect to prevail.

But we have successes too. We have been successful in getting Korea to reinterpret its standards so as to allow the sale in Korea of high efficiency washing machines that use a step-down transformer. Our team of MAC and TD as well as our US&FCS officers at the Embassy cleared the way for the U.S. company to begin exporting by successfully marshaling U.S. government technical and standards experts and working with the Koreans to resolve the issue without appealing to the WTO. Congressional interest in this issue also helped convince the Koreans to resolve it.

We helped a small company in Auburn, Indiana, making specialized bulk packaging products for the chemical industry, which was being shut out of the European market by a European competitor who got product standards changed to exclude its product design. We got European governments to remove the discrimination, and saved over 300 Indiana jobs.

The significance of compliance advocacy lies in attempting to resolve problems rapidly without the necessity of the United States having to enforce its rights through formal dispute settlement mechanisms. It also creates confidence that the United States is actively monitoring and ensuring that our exporters receive their rights under our trade agreements.

The Commerce Department is also committed to swift enforcement of the fair trade laws which ensure that U.S. industries and American workers are not injured by imports of unfairly priced or subsidized goods. Commerce vigorously enforces the fair trade laws – during the first six months of this year alone, we have either completed or are in the process of conducting more than 65 antidumping or countervailing duty investigations.

As you are aware, steel imports surged dramatically in 1998, up 33 percent over 1997, resulting in the loss of 11,000 jobs. In response, the Administration has pursued a two-prong strategy combining swift and vigorous enforcement of our trade laws with bilateral pressure on our trading partners to reduce steel exports. Commerce's strong and swift enforcement of the unfair trade laws is an integral part of the Administration's action plan on steel.

Commerce currently enforces more than 100 antidumping and countervailing duty orders on steel products from a number of countries, and since January 1999 is conducting or has completed 64 new steel investigations.

Commerce has taken a number of steps over the past year to enhance trade law enforcement. In the recent investigations of hot-rolled steel and of carbon steel plate we announced the preliminary determinations early, providing more immediate relief to the industry and its workers. We have also applied our new policy on critical circumstances, putting importers on notice soon after the investigation has begun that they could be liable for dumping duties retroactively. Prior to this change in policy, critical circumstances decisions were always made at the time of the preliminary determination.

Commerce continues to administer its enhanced early warning system to monitor imports of steel and other import-sensitive products. Such monitoring is designed to provide the Administration with an early warning on import trends for import-sensitive products, and to develop the information needed to help ensure that our trading partners bear their fair share of the burden of the global crisis.

Commerce's enforcement of the unfair trade laws has been a key factor in the decline of steel imports since November. In addition, strong bilateral pressure has been exerted on our trading partners to reduce their steel exports to the United States.

Beyond compliance and enforcement, we must be prepared to take advantage of export opportunities as foreign growth returns. U.S. firms need to take more advantage of overseas markets. Between 1992 and 1997, the number of exporters almost doubled from 113,000 to 209,000. Most of the exporters (just under 97 percent) are small- and medium-sized firms. While this has been a dramatic improvement, we know much more is possible. For example, half our small and medium sized exporters export to only one market.

The Commerce Department and its International Trade Administration, working with the Trade Promotion Coordination Committee, continue to press ahead with new strategies and approaches to assisting U.S. firms and workers. Our export promotion services are reaching out to an ever-wider universe of potential exporters to help them bring the benefits of exports to their communities.

Commerce is undertaking a number of new and innovative efforts to reach out to small and medium-sized enterprises. This year, our Advocacy Center is implementing an initiative to expand U.S. Government advocacy outreach to more small, medium and minority-owned businesses throughout the country. And we opened the U.S. Trade Center at the Ronald Reagan International Trade Center Building this year to make it easier than ever for a company to take the first step toward global export counseling and assistance from the Commerce Department and the other federal agencies providing export services and financing (1-800-USA-TRADE).

Commerce is also working hard to respond to the rapidly changing needs of the exporting community. Through our *Innovation 2003* Initiative, we have begun shifting our product focus from a standard, off-the-shelf approach toward full customization based on the needs of clients.

We are engaging an array of new E-commerce products that will reduce market entry costs and open up a world of business opportunities. Virtual trade shows showcase U.S. products and services in distant markets at a fraction of the cost of on-site participation. Video conferencing puts American companies in front of prospective foreign business partners without costs of travel. And electronically delivered market research, trade leads, and business contacts will enable clients to receive information updates instantaneously.

We are also putting our global network of trade professionals in over 100 U.S. cities and more than 80 countries into the hands of traditionally under served or disadvantaged communities. The total number of businesses owned by minorities increased 60 percent, from 1.3 million to 2.2 million over five years. To better serve this growing business segment, through our *Global Diversity and Urban Export Initiative* we are working with national and local organizations, conducting outreach activities, and integrating minority-owned firms into our programs. This Initiative seeks not only to boost exports, but to enhance the economic development of minority communities through trade.

Our *Rural Export Initiative* is helping companies located in rural areas to enter into export markets via the Internet, satellite communications, and other state-of-the-art technologies. Our domestic network provides these companies with access to export assistance, global market research, and international trade services such as freight forwarding and banking otherwise unavailable to them.

Over the past year, Commerce sponsored a series of 12 conferences about the Euro and EMU preparedness. These conferences brought together leaders in business, education and government to discuss the euro and its implications for U.S. businesses in the future. There were also more than two dozen other Euro-related events initiated by U.S. export assistance centers across the country.

Conclusion

Before I close, I want to again thank the Chair and other members of the Subcommittee for your assistance, during the International Relations Committee's reauthorization of the Commerce Department's International Trade Administration, in drawing attention to the critical work done by the Market Access and Compliance (MAC) unit which I head. I am pleased that you and your colleagues appreciate our efforts to access foreign markets for American firms and workers and to achieve full compliance by our trading partners with the trade agreements they sign with our country. If we can obtain the increase in funding requested for us in the President's FY 2000 budget, we will be able to strengthen our efforts to help U.S. firms, particularly the small- and medium-sized firms that are the engines of growth in our economy.

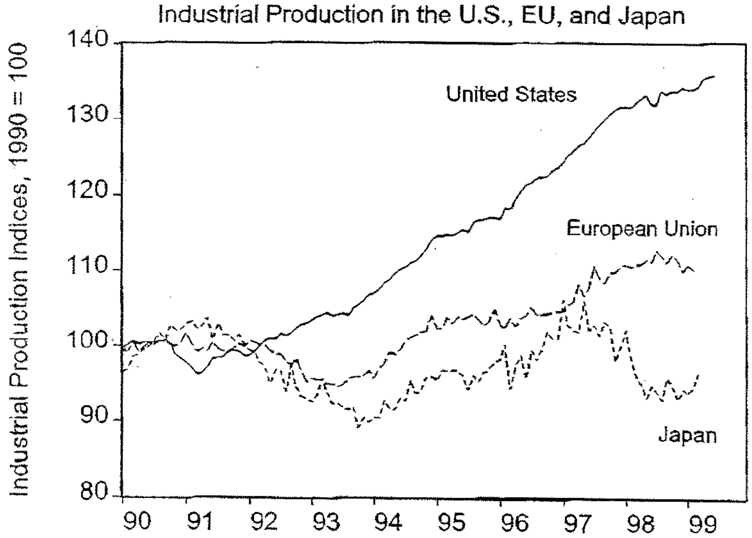
Madam Chair, I want to emphasize the central element of my testimony today: Nothing will do as much to restore our export growth and reduce the deficit as an economic recovery abroad, especially in Asia. Meanwhile, we are committed at Commerce to doing everything thing we can from compliance to enforcement to trade promotion to helping address the deficit and put U.S. exports back on the growth path.

Thank you and I will be pleased to answer your questions.

Exhibit 1

U.S. ECONOMY SOARS ABOVE OTHERS IN 1990's

Industrial Production in the U.S., EU, and Japan



Note that Japan's Industrial Production is less than it was a decade ago!

Exhibit 2

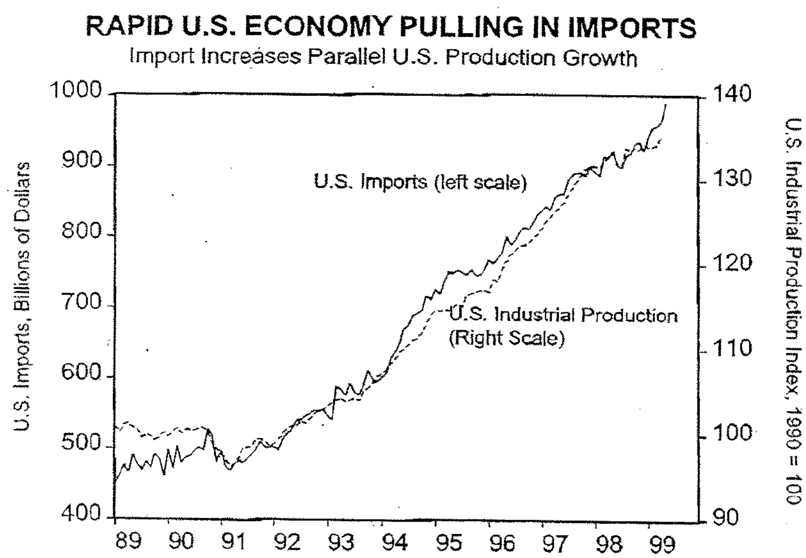
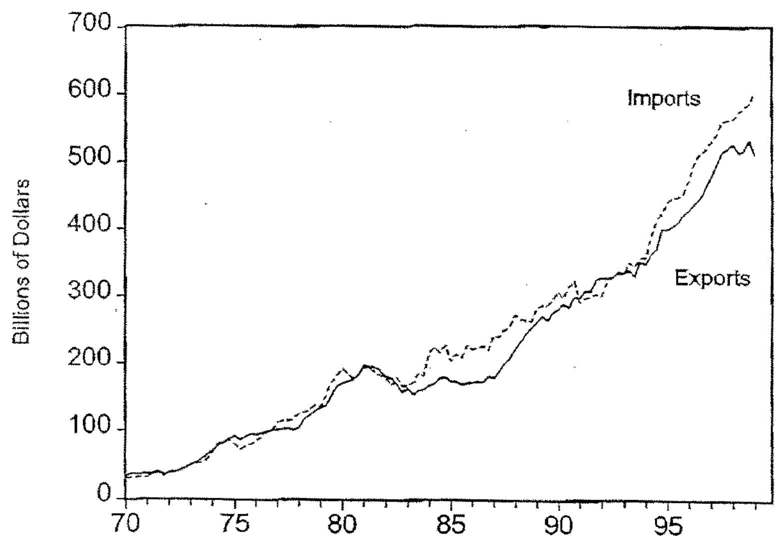

RAPID U.S. ECONOMY PULLING IN IMPORTS
Import Increases Parallel U.S. Production Growth
U.S. Imports (left scale)
U.S. Industrial Production
(Right Scale)
U.S. Imports, Billions of Dollars
U.S. Industrial Production Index, 1990 = 100
1000
900
800
700
600
500
400
140
130
120
110
100
90
89
90
91
92
93
94
95
96
97
98
99

Exhibit 3

U.S. NON - ASIAN TRADE

U.S. Trade with the World Except Asia has Generally Been in Rough Balance Except in mid-80's When Dollar was Very Strong . . .



... and Since 1992, when the U.S. Economy Began to Outpace Others Dramatically. Note especially the Recent Flattening of U.S. Exports

Exhibit 4

U.S. TRADE BALANCE WITH NON-ASIA

The Rapid U.S. Economic Expansion and Slow Growth in Our Major Trading Partners Has taken Non-Asian Trade from a Substantial Surplus in Early 1992 . . . .

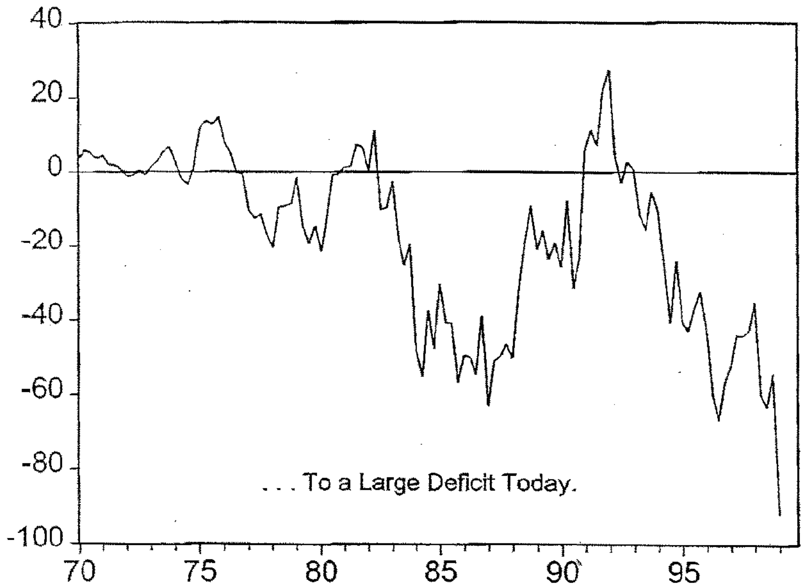
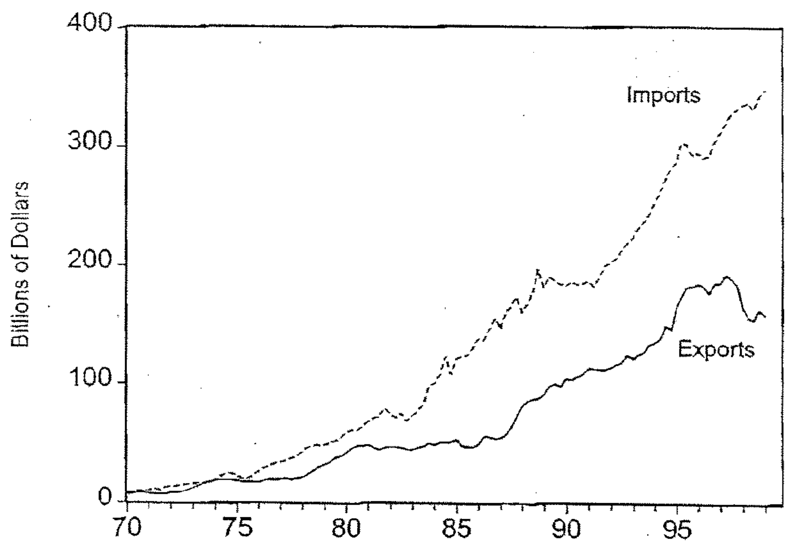


Exhibit 5

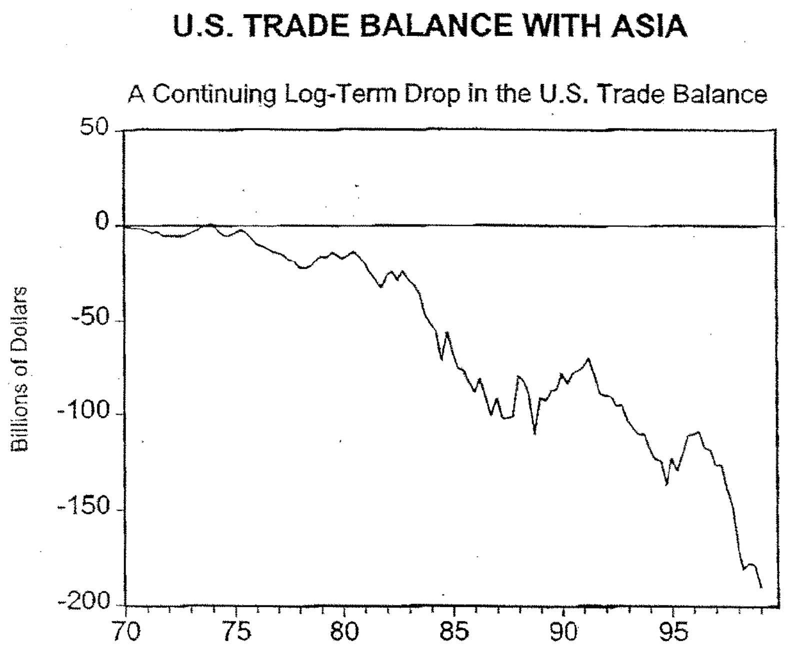
U.S.TRADE WITH ASIA

U.S. Trade With Asia, Though, has Shown a Continuing and Growing Gap Between Exports and Imports



Note the huge drop in U.S. exports to Asia since 1997 due to the Asian financial crisis.

Exhibit 6


U.S. TRADE BALANCE WITH ASIA
A Continuing Log-Term Drop in the U.S. Trade Balance
Billions of Dollars
50
0
-50
-100
-150
-200
70
75
80
85
90
95

ORAL REMARKS OF
THE HONORABLE PATRICK A. MULLOY
ASSISTANT SECRETARY OF COMMERCE FOR MARKET ACCESS AND COMPLIANCE

BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY AND TRADE
OF THE HOUSE COMMITTEE ON INTERNATIONAL RELATIONS

JULY 22, 1999

MADAM CHAIR, I AM PLEASED TO APPEAR BEFORE THIS SUBCOMMITTEE TODAY TO DISCUSS THE LARGE AND GROWING U.S. TRADE DEFICIT. I HAVE A PREPARED STATEMENT FOR THE RECORD AND SOME INTRODUCTORY REMARKS I WOULD LIKE TO MAKE AT THIS TIME.

LET ME BEGIN MY REMARKS BY SALUTING YOU FOR YOUR EFFORTS TO DRAW ATTENTION TO THIS IMPORTANT MATTER. YOU HAD A SIMILAR HEARING LAST JULY AND IN OCTOBER THE CONGRESS, RECOGNIZING THE KEY IMPORTANCE OF THIS ISSUE, ESTABLISHED THE TRADE DEFICIT REVIEW COMMISSION. THAT COMMISSION, COMPRISED OF SOME OF THE BEST TRADE AND ECONOMIC EXPERTS IN THE COUNTRY, WILL BEGIN ITS PUBLIC WORK ON AUGUST 19.

THIS WEEK, THE COMMERCE DEPARTMENT RELEASED DATA SHOWING THAT FOR THE FIRST FIVE MONTHS OF THIS YEAR THE DEFICIT IN GOODS AND SERVICES IS RUNNING AT AN ANNUAL RATE OF $225 BILLION -- UP 50 PERCENT OVER THE FIRST FIVE MONTHS OF LAST YEAR. THE MERCHANDISE DEFICIT SO FAR THIS YEAR IS AN ANNUAL RATE OF $307 BILLION.

IN UNDERSTANDING THESE HUGE FIGURES, THE MOST IMPORTANT POINT IS THAT THE RECENT GROWTH IN THE DEFICIT STEMS IN PART FROM THE FACT THE U.S. ECONOMY IS GROWING RAPIDLY -- AND OTHERS AREN'T.

THE SECOND IMPORTANT POINT TO NOTE IS THAT THE RECENT DEFICIT INCREASE STEMS PRINCIPALLY FROM THE EXPORT SIDE.

OVERALL IMPORTS SO FAR THIS YEAR ARE UP ONLY 6 PERCENT -- A VERY MODEST RATE. MOREOVER, IMPORT PENETRATION -- IMPORTS AS A PERCENT OF GDP -- HAVE NOT INCREASED SINCE 1997.

THIS IS NOT TO SAY THAT THERE HAVE NOT BEEN SOME SIGNIFICANT INCREASES IN INDIVIDUAL SECTORS -- SUCH AS STEEL, WHERE THE ADMINISTRATION HAS ACTED TO HALT THE FLOOD OF IMPORTS. BUT OVERALL, IMPORTS HAVE NOT RISEN RAPIDLY.

THE REAL DIFFICULTY IS IN EXPORTS. TYPICALLY OUR EXPORTS GROW ABOUT SEVEN PERCENT A YEAR. BUT THEY FELL 1 PERCENT LAST YEAR AND SO FAR THIS YEAR HAVE FALLEN A FURTHER 2.4 PERCENT. THIS DECLINE IS SERIOUS. IT IS AFFECTING JOBS IN AMERICA'S FARMS AND FACTORIES.

THE EXPORT DECLINE DOES NOT REFLECT A DROP IN U.S. COMPETITIVENESS. IN FACT, THE U.S. SHARE OF EXPORTS TO FOREIGN MARKETS LAST YEAR WAS 15.2 PERCENT -- UP SIGNIFICANTLY FROM THE 14 PERCENT AVERAGE IN RECENT YEARS.

WHAT IT REFLECTS IS HOW SLOW FOREIGN MARKETS ARE GROWING. NOT JUST IN ASIA, BUT IN EUROPE AS WELL, DOMESTIC GROWTH IS SLUGGISH, AND DEMAND FOR IMPORTS, INCLUDING FROM THE UNITED STATES, IS STAGNATING.

THE MOST DRAMATIC DROP IN EXPORTS TOOK PLACE IN ASIA WHERE 1998 EXPORTS FELL BY 15 PERCENT AND SO FAR IN 1999 THEY HAVE FALLEN A FURTHER 2 PERCENT.

ON A BILATERAL BASIS, THE LARGEST DEFICIT IS WITH JAPAN, WHERE OVER THE LAST 12 MONTHS IT HAS REACHED $66 BILLION.

OUR SECOND LARGEST BILATERAL DEFICIT -- $57 BILLION LAST YEAR -- IS WITH CHINA. WE IMPORT FIVE TIMES FROM CHINA WHAT WE EXPORT TO CHINA -- MEANING THAT JUST TO KEEP THE DEFICIT FROM GROWING ANY MORE, OUR EXPORT GROWTH RATE HAS TO BE FIVE TIMES AS LARGE AS THE IMPORT GROWTH RATE. IN THE LAST THREE YEARS, HOWEVER, THE IMPORT GROWTH RATE HAS BEEN 16 PERCENT A YEAR WHILE OUR EXPORT GROWTH RATE HAS BEEN 7 PERCENT -- AND SO FAR THIS YEAR OUR EXPORTS TO CHINA ARE DOWN 5 PERCENT.

AS I NOTED CHINA RUNS A $57 BILLION TRADE SURPLUS WITH THE UNITED STATES, BUT OVERALL HAS A GLOBAL TRADE SURPLUS OF $44 BILLION -- SO THEIR TRADE WITH US IS WHERE THEY ARE ACCRUING THEIR FOREIGN EXCHANGE EARNINGS.

WITH THE FOCUS ON ASIA, IT IS FREQUENTLY NOT REALIZED HOW MUCH OUR TRADE POSITION HAS DETERIORATED WITH EUROPE. IN 1991, THE UNITED STATES HAD A SURPLUS OF $19 BILLION WITH EUROPE; IN 1998, OUR DEFICIT HAD REACHED $32 BILLION – A NEGATIVE SWING OF $51 BILLION.

WITH RESPECT TO OUR NAFTA PARTNERS, THE STORY OF STRONG DOMESTIC U.S. GROWTH PULLING IN IMPORTS ALSO APPLIES. SO FAR IN 1999 THE TRADE DEFICIT WITH MEXICO IS $24 BILLION AT AN ANNUAL RATE COMPARED WITH $14 BILLION THIS TIME LAST YEAR, AND THE DEFICIT WITH CANADA IS $27 BILLION COMPARED WITH $13 BILLION A YEAR AGO. THE DECLINE OF THE CANADIAN DOLLAR AND MEXICAN PESO AGAINST THE U.S. DOLLAR OVER THE LAST THREE YEARS ALSO PLAYS A ROLE IN CREATING THESE

DEFICITS WITH OUR NAFTA PARTNERS.

OVERALL, THERE IS NOTHING ON THE IMMEDIATE HORIZON TO SUGGEST CHANGES IN OUR RECENT TRADE TRENDS. U.S. ECONOMIC GROWTH, EVEN THOUGH EXPECTED TO SLOW IN 1999 FROM 1998, SHOULD STILL BE RELATIVELY STRONG COMPARED TO MOST OF OUR MAJOR TRADING PARTNERS. IN EUROPE AND JAPAN EXPECTATIONS ARE FOR SLOW GROWTH.

WE CANNOT, HOWEVER, BLAME ALL OUR DEFICIT ON THE ASIAN FINANCIAL CRISIS AND ON THE RECENT DIFFERENCE BETWEEN U.S. AND FOREIGN ECONOMIC GROWTH.

LONGER TERM FORCES ARE ALSO AT WORK -- INCLUDING THE CONTINUED EXISTENCE OF TRADE BARRIERS THAT HAVE HELD BACK U.S. EXPORT OPPORTUNITIES. AMAZING THOUGH IT MAY NOW SEEM, FROM 1894 TO 1970 THE UNITED STATES HAD AN UNBROKEN STRING OF TRADE SURPLUSES, BUT SINCE 1970 WE HAVE HAD VIRTUALLY AN UNBROKEN STRING OF MERCHANDISE TRADE DEFICITS THAT HAVE CUMULATED TO OVER $2 TRILLION DOLLARS.

MOST OF OUR DEFICIT OCCURRED IN THE LAST FIFTEEN YEARS. NEARLY 80 PERCENT OF THE DEFICIT IS WITH ASIA – AND FULLY 40 PERCENT OF THE TOTAL WAS WITH ONE COUNTRY, JAPAN.

THE RECENT RISE IN THE TRADE DEFICIT REFLECTS, IN PART, THE HEALTH OF THE U.S. ECONOMY. OUR UNEMPLOYMENT RATE IS EXTREMELY LOW BY HISTORIC STANDARDS, INFLATION IS LOW, ECONOMIC GROWTH CONTINUES ABOVE ITS LONG TERM TREND, AND REAL INCOMES ARE RISING STRONGLY. IN ADDITION, THE RISE IN THE STOCK MARKET HAS ENCOURAGED CONSUMER SPENDING. THE BIGGEST NEGATIVE IS PROBABLY OUR PERSONAL SAVINGS

RATE WHICH IS CLOSE TO ZERO.

WHILE CURRENT ECONOMIC CONDITIONS, AT LEAST FOR THE UNITED STATES ARE EXCELLENT, WE CAN'T HELP BUT BE CONCERNED WITH RUNNING EXTREMELY HIGH CURRENT ACCOUNT DEFICITS LONG INTO THE FUTURE. TO FINANCE THESE DEFICITS WE MUST BORROW FROM ABROAD.

THUS, WE BECOME EVER MORE DEPENDENT UPON RECEIVING AND RETAINING FOREIGN CAPITAL. THE NET DEBTOR POSITION OF THE UNITED STATES, IN FACT, STOOD AT $1.2 TRILLION DOLLARS IN 1998 -- MORE THAN DOUBLING IN TWO YEARS. IF CURRENT TRENDS CONTINUE, OUR TOTAL FOREIGN DEBT WILL BE CLOSE TO ONE-AND-HALF TRILLION DOLLARS AT THE END OF 1999.

ANOTHER FACTOR THAT MUST BE CONSIDERED IS THE IMPACT OF TRADE DEFICITS ON THE COMPOSITION OF OUR EMPLOYMENT. THE DROP IN OUR EXPORTS HAS HAD A SERIOUS EFFECT ON MANUFACTURING EMPLOYMENT IN THE UNITED STATES. WHILE OVERALL EMPLOYMENT IN OUR COUNTRY IS AT RECORD LEVELS AND, IN FACT, HAS GROWN BY 2 MILLION JOBS IN THE LAST YEAR, THERE ARE 422,000 FEWER MANUFACTURING JOBS THAN A YEAR AGO. MANY OF THESE LOSSES ARE DIRECTLY ATTRIBUTABLE TO THE DECLINE IN U.S. EXPORTS GLOBALLY -- AND ESPECIALLY TO ASIA.

FEW ACTIONS WE CAN TAKE DOMESTICALLY WOULD HAVE AS GREAT AN IMPACT ON OUR TRADE DEFICIT POSITION AS RESTORATION OF GROWTH IN OUR MAJOR EXPORT MARKETS. THE KEY HERE IS IN ECONOMIC POLICIES IN EUROPE AND JAPAN THAT WOULD PROMOTE DOMESTIC-LED GROWTH IN THOSE COUNTRIES.

WHEN FORMER SECRETARY RUBIN SPOKE ON THIS ISSUE ON JUNE 10, HE SAID,

> "IT IS ALSO CRITICALLY IMPORTANT THAT EUROPE AND JAPAN DO THEIR PART BECAUSE THE INTERNATIONAL SYSTEM CANNOT SUSTAIN INDEFINITELY THE LARGE IMBALANCES CREATED BY THE DISPARITIES IN GROWTH AND OPENNESS BETWEEN THE U.S. AND ITS MAJOR TRADING PARTNERS."

ON JULY 13, SECRETARY SUMMERS SAID,

> "WE CONTINUE TO WATCH THE JAPANESE ECONOMY CAREFULLY AND TO BELIEVE THAT WHAT'S MOST IMPORTANT FOR JAPAN IS THE RESTORATION OF DOMESTIC DEMAND-LED GROWTH AND IT IS IMPORTANT THAT THE BASIS FOR GROWTH BE FIRMLY ESTABLISHED."

THE NEED FOR THESE OTHER LEADING ECONOMIES TO GROW IS CLEAR AS OUR CURRENT ACCOUNT DEFICIT POSITION IS UNSUSTAINABLE IN THE LONG RUN. CHAIRMAN OF THE FEDERAL RESERVE BOARD ALAN GREENSPAN SAID ON MAY 6,

> "THERE IS A LIMIT TO HOW LONG AND HOW FAR DEFICITS CAN BE SUSTAINED SINCE CURRENT ACCOUNT DEFICITS ADD TO NET FOREIGN CLAIMS ON THE UNITED STATES .... UNLESS REVERSED, OUR GROWING INTERNATIONAL IMBALANCES ARE APT TO CREATE SIGNIFICANT PROBLEMS FOR OUR ECONOMY."

IN HIS TESTIMONY TODAY BEFORE THE HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE, HE NOTED:

> "AS U.S. INTERNATIONAL INDEBTEDNESS MOUNTS, HOWEVER, AND FOREIGN ECONOMIES REVIVE, CAPITAL INFLOWS FROM ABROAD THAT ENABLE DOMESTIC INVESTMENT TO EXCEED DOMESTIC SAVING MAY BE DIFFICULT TO SUSTAIN. ANY RESULTING DECLINE IN DEMAND FOR DOLLAR ASSETS COULD WELL BE ASSOCIATED WITH HIGHER MARKET INTEREST RATES, UNLESS DOMESTIC SAVING REBOUNDS."

CHAIRMAN GREENSPAN WENT ON TO REINFORCE FORMER SECRETARY RUBIN'S REMARKS THAT I CITED EARLIER IN MY TESTIMONY THAT:

> "WORKING TO OFFSET SOMEWHAT THIS ANTICIPATED SLOWING OF THE GROWTH OF DOMESTIC DEMAND, OUR EXPORT MARKETS CAN BE EXPECTED TO BE MORE BUOYANT BECAUSE OF THE REVIVAL IN GROWTH IN MANY OF OUR IMPORTANT TRADING PARTNERS."

WE NEED TO BE WORKING TO BRING THE DEFICIT DOWN OVER THE LONG TERM. WE MUST CONTINUE TO URGE OUR PARTNERS TO INITIATE DOMESTIC GROWTH POLICIES, AND WE MUST ALSO FOSTER CONDITIONS FOR A RESTORATION OF OUR TRADE POSITION WHEN FOREIGN MARKETS RECOVER BY ASSURING THAT FOREIGN MARKETS REMAIN OPEN BY ENFORCING OUR TRADE LAWS AND PROMOTING EXPORTS.

WHILE I DO NOT BELIEVE THAT NON-COMPLIANCE BY OUR TRADING PARTNERS WITH TRADE AGREEMENTS IS THE MAJOR FACTOR IN THE GROWTH OF OUR DEFICIT, WE MUST BE SURE THAT COUNTRIES ARE KEEPING MARKETS OPEN AND COMPLYING WITH THE TRADE AGREEMENTS THEY SIGN WITH US. WE NEED TO ASSURE AMERICANS THAT THE AGREEMENTS WE NEGOTIATE ARE HONORED AND THAT AMERICAN FIRMS AND WORKERS OBTAIN THE BENEFITS AND OPPORTUNITIES WE HAVE BARGAINED FOR.

THE COMMERCE DEPARTMENT, AS NEVER BEFORE, IS INCREASING ITS MONITORING OF OUR TRADE AGREEMENTS. WHEN WE FIND INDICATIONS OF VIOLATIONS, WE ARE BEING VERY AGGRESSIVE IN TAKING UP THESE MATTERS BILATERALLY OR WORKING WITH USTR TO HAVE THEM REFERRED TO APPROPRIATE DISPUTE SETTLEMENT FORA WHETHER IN THE WTO, NAFTA OR ELSEWHERE.

THE COMMERCE DEPARTMENT IS ALSO COMMITTED TO SWIFT ENFORCEMENT OF THE FAIR TRADE LAWS WHICH ENSURE THAT U.S. INDUSTRIES AND AMERICAN WORKERS ARE NOT INJURED BY IMPORTS OF UNFAIRLY PRICED OR SUBSIDIZED GOODS. DURING THE FIRST SIX MONTHS OF THIS YEAR ALONE, WE HAVE EITHER COMPLETED OR ARE IN THE PROCESS OF CONDUCTING MORE THAN 65 ANTIDUMPING OR COUNTERVAILING DUTY INVESTIGATIONS.

AS YOU ARE AWARE, STEEL IMPORTS SURGED DRAMATICALLY IN 1998, UP 33 PERCENT OVER 1997, RESULTING IN THE LOSS OF 11,000 JOBS. IN RESPONSE, THE ADMINISTRATION HAS PURSUED A TWO-PRONG STRATEGY COMBINING SWIFT AND VIGOROUS ENFORCEMENT OF OUR TRADE LAWS WITH BILATERAL PRESSURE ON OUR TRADING PARTNERS TO REDUCE SURGES OF STEEL EXPORTS. COMMERCE'S STRONG AND SWIFT ENFORCEMENT OF THE UNFAIR TRADE LAWS IS AN INTEGRAL PART OF THE ADMINISTRATION'S ACTION PLAN ON STEEL.

PRELIMINARY FIGURES FOR THE MONTH OF JUNE SHOW THAT STEEL IMPORTS DECREASED BY 13 PERCENT FROM MAY'S LEVEL, AND REMAIN WELL BELOW LAST YEAR'S SURGE LEVELS. OVERALL STEEL IMPORTS IN JUNE 1999 WERE 20 PERCENT BELOW JUNE 1998 LEVELS. IN THE FIRST SIX MONTHS OF THIS YEAR, STEEL IMPORTS ARE DOWN APPROXIMATELY 9 PERCENT COMPARED TO 1998 AND ARE LESS THAN 3 PERCENT ABOVE 1997'S PRE-CRISIS LEVELS.

COMMERCE CONTINUES TO ADMINISTER ITS ENHANCED EARLY WARNING SYSTEM TO MONITOR IMPORTS OF STEEL AND OTHER IMPORT-SENSITIVE PRODUCTS.

BEYOND COMPLIANCE AND ENFORCEMENT, WE MUST BE PREPARED TO TAKE ADVANTAGE OF EXPORT OPPORTUNITIES AS FOREIGN GROWTH RETURNS. U.S. FIRMS NEED TO TAKE MORE ADVANTAGE OF OVERSEAS MARKETS.

THE COMMERCE DEPARTMENT, WORKING WITH THE INTER-AGENCY TRADE PROMOTION COORDINATION COMMITTEE (TPCC), CONTINUES TO PRESS AHEAD WITH NEW STRATEGIES AND APPROACHES TO ASSISTING U.S. FIRMS AND WORKERS WITH TRADE PROMOTION. ITA'S UNITS, INCLUDING THE FOREIGN COMMERCIAL SERVICE, THE TRADE DEVELOPMENT UNIT AND MY MARKET ACCESS AND COMPLIANCE UNIT, ARE WORKING TOGETHER TO HELP SMALL AND MEDIUM SIZED FIRMS TAKE ADVANTAGE OF EXPORT OPPORTUNITIES.

BEFORE CLOSING, I WANT TO AGAIN THANK THE CHAIR AND OTHER MEMBERS OF THE SUBCOMMITTEE FOR YOUR ASSISTANCE, DURING THE INTERNATIONAL RELATIONS COMMITTEE'S REAUTHORIZATION OF THE COMMERCE DEPARTMENT'S INTERNATIONAL TRADE ADMINISTRATION. IN ADDITION, I THANK YOU FOR DRAWING ATTENTION TO THE CRITICAL WORK DONE BY THE MARKET ACCESS AND COMPLIANCE (MAC) UNIT WHICH I HEAD.

I AM PLEASED THAT YOU AND YOUR COLLEAGUES APPRECIATE OUR EFFORTS TO ACCESS FOREIGN MARKETS FOR AMERICAN FIRMS AND WORKERS AND TO ACHIEVE FULL COMPLIANCE BY OUR TRADING PARTNERS WITH THE TRADE AGREEMENTS THEY SIGN WITH OUR COUNTRY. IF WE CAN OBTAIN THE INCREASE IN FUNDING REQUESTED FOR US IN THE PRESIDENT'S FY 2000 BUDGET, WE WILL BE ABLE TO STRENGTHEN OUR EFFORTS TO HELP U.S. FIRMS, PARTICULARLY THE SMALL- AND MEDIUM-SIZED FIRMS THAT ARE THE ENGINES OF GROWTH IN OUR ECONOMY.

FINALLY, I AGAIN WANT TO SALUTE YOU, MADAM CHAIR, FOR YOUR WORK ON THE TRADE DEFICIT ISSUE. YOU MIGHT WANT TO HAVE YOUR STAFF PASS ON THE RECORDS OF YOUR HEARINGS TO THE CONGRESSIONALLY-CREATED TRADE DEFICIT REVIEW COMMISSION THAT I MENTIONED EARLIER IN MY TESTIMONY.

THANK YOU AND I WILL BE PLEASED TO ANSWER YOUR QUESTIONS.

The U.S. Trade Deficit:
Are We Trading Away Our Future?

Testimony given before the
Subcommittee on International Economic Policy and Trade
of the House Committee on International Relations

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Madam Chair and members of the Committee, thank you for inviting me to testify on the impacts of large and chronic trade deficits on the American economy. This afternoon I will discuss the causes and consequences of the steady growth in the U.S. trade deficit, and then suggest policies that could improve U.S. trade deficits.

The Changing Effects of Trade on American Workers[1]

In the 1950s and 1960s, the U.S. was the world's leading export powerhouse. The Marshall plan helped provided the capital needed to rebuild Europe and Japan, and fueled a tremendous demand for U.S. exports.

During this period, the U.S. ran a substantial trade surplus, of about one percent of Gross Domestic Product, as shown in **Figure 1**. The U.S. also benefited initially from strong export demand in a wide range of industries, from low-tech textiles and apparel to sophisticated aircraft and machine tools.

Since the 1970s the U.S. moved from a trade surplus to a deficit position, as Europe and Japan began to compete effectively with the U.S. in a range of industries. There are many ways in which trade has injured U.S. workers since then. First, deterioration in the trade balance (the difference between exports, which create jobs, and imports, which eliminate domestic employment) has reduced employment, especially in manufacturing and other industries producing traded goods

The trade surplus of the 1960s was transformed into a deficit that reached 2.9% of GDP in 1998, as shown in Figure 1. This deficit will grow rapidly in the future as a result of the continuing global financial crisis. Although financial markets are beginning to recover throughout the world, the real economies of many developing countries and Japan remain mired in recessions. For example, reliable private sector reports show that unemployment in Sao Paulo, Brazil currently exceeds 20%.

The growth in the trade deficit over the past two decades has destroyed millions of high-wage, high skilled manufacturing jobs in the U.S., and pushed workers into other sectors where wages are lower, such as restaurants and health service industries. When I appeared before this committee last spring, I summarized EPI forecasts that the Asia Crisis would lead to the elimination of one million jobs in the U.S., with most of the losses concentrated in the manufacturing sectors of the economy (Scott and Rothstein 1998). These job losses have occurred, as expected. The U.S. has lost nearly 500,000 manufacturing jobs since March of 1998, due to the impact of the rising trade deficit.[2]

[1] This statement is based, in part, on an article by the author that will appear in a forthcoming issue of *Business Network* magazine, the official journal of the British-American Chamber of Commerce.

[2] For changes in manufacturing employment, see the U.S. Bureau of Labor Statistics homepage: http://stats.bls.gov/.

The IMF recently forecast that the U.S. current account deficit (the broadest measure of the trade balance) would reach nearly $300 billion in 1999, exceeding 3.5 percent of GDP for the first time in the post-war era (IMF 1999). The U.S. can expect to lose another 400,000 to 500,000 manufacturing jobs as a result, even if the economy continues to expand at its current pace in 1999.

Trade deficits also have a direct impact on wages, especially for non-college educated workers, who make up three-quarters of the U.S. labor force. The other line in Figure 1 shows that the average real wage for U.S. production workers peaked in 1978, declining more or less steadily through 1996. Real wages have begun to increase in the past 3 years. However, the small upturn increased real wages by only 4.5%, not nearly enough to offset a decline of more than 11% since the 1978, nor to return workers to the path of steadily rising wages they experienced from 1950 through 1973.

What is responsible for the decline in U.S. wages? Trade is certainly one of the most significant causes, because it hurts workers in several ways. First, the steady growth in our trade deficits over the past two decades has eliminated millions of U.S. manufacturing jobs. As we showed in another recent EPI report, trade eliminated 2.4 million jobs in the U.S between 1979 and 1994 (Scott, Lee and Schmitt 1997). Growing trade deficits eliminate good jobs and reduce average wages in the economy. Since then, many more jobs have been lost to NAFTA and other sources of our trade problems, including China, and recently, Europe.

The second way in which trade depresses wages is through the growth in imports from low wage countries. If the prices of these products fall, it puts downward pressure on prices in the U.S. Domestic firms are forced to cut wages or otherwise reduce their own labor costs in response. A third way in which globalization depresses wages is through foreign direct investment. When U.S. firms move plants to low wage countries, as they have done at an increasing rate in recent years, it has a chilling affect on the labor market. The mere threat of plant closure is often sufficient to extract wage cuts from workers. This tactic has also been used with increasing frequency in the 1990s and is effective even when plants don't move.

Most economists now acknowledge that trade is responsible for 20 to 25 percent of the increase in income inequality which has occurred in the U.S. over the past two decades. However, existing research can only explain about half of the change in income inequality. Therefore, trade is responsible for about 40% of the *explainable* share of increased income inequality. The rest is due to forces such as declining unionization, and inflation-induced erosion in the value of the minimum wage.

Causes of Growing U.S. Trade Deficits

There are many causes of the steady growth in U.S. trade deficits. These include non-tariff barriers to U.S. exports in a number of key foreign markets, and export-led growth strategies in many countries that target American markets because they are the largest and are more open than many others. Macroeconomic factors such as the overvaluation of the U.S. dollar and slow growth abroad have also played important roles in the 1990s, and especially in the past few years. Perhaps most important is a pattern of neglect of the American industrial structure by the federal government.

Important insights into the roles played by each of these factors can be gained by recognizing that the vast majority of the U.S. trade deficit is explained by extremely unbalanced trading relationships that exist with a few key countries, and in a limited number of critical industries. I will examine the pattern of U.S. trade deficits by county, and then by industry in the remainder of this section. Policy issues are addressed in the concluding section.

The Geography of US Trade Flows

U.S. trade imbalances are concentrated in a few regions of the world, as shown in **Figure 2.**[3] Trade flows at the country level are discussed below. Trade flows are shown for 1991, 1993 and the most recent period available (1997 or 1998) in each of the figures discussed here.

The vast majority (about three fourths) of our trade deficit in manufactured goods is caused by imbalanced trade flows with Asia, as shown in Figure 2. The deficits with Asia are large and rapidly growing, despite very high rates of growth in the region until 1997. Europe and NAFTA were each responsible for about 13% of the deficit in 1998. The U.S. ran a small surplus with the other countries in the Western Hemisphere, and with the rest of the world, in this period.

The causes of American trade deficits with Asian countries are discussed below. There are many important differences in the economic structure and strategy of each country in the region. However, each follows a general pattern established by Japan in the 1950s and 1960s. The Japanese strategy revolved around export-led growth. Exports were increased through state promotion and control of targeted critical industries. Exchange rates were systematically undervalued to enhance the competitiveness of domestic industries, and to discourage imports. Imports were also restricted through a combination of tariff and non-tariff barriers to imports and through private associations that acted to restrain trade and provide a protected home market for domestic producers.

U.S. trade with Europe moved from a substantial surplus in 1991 to a large and rapidly growing deficit in 1998.[4] This deficit reflects at least two trends. First, growth in Europe has slowed while the U.S. economy has recovered. The difference in growth rates has increased sharply in the past two to three years. Higher growth in the U.S. pulls in imports from Europe, while the slowdown on the continent has reduced the demand for U.S. exports.

[3] All information used in Figures 2 through 7 was obtained from the U.S. Department of Commerce, *Foreign Trade Highlights*, web page: http://www.ita.doc.gov/cgi-bin/otea_ctr?task=otea.

[4] See Table 1, below, for current growth rates in key U.S. regional and bilateral trade deficits.

Second, the European trade deficit was also increased by E.U. industrial and agricultural policies. European subsidies to Airbus have dramatically increased E.U. aircraft exports and reduced U.S. exports to the continent (Barber and Scott 1995). European subsidies to agriculture have also increased substantially since the WTO agreements, which were designed, in part, to reduce such payments, went into effect in 1995 (Scott 1999b). In addition, E.U. firms have illegally dumped steel and other products in the U.S., injuring U.S. workers and industries.

In addition to eliminating hundreds of thousands of U.S. jobs (Scott and Rothstein 1997), NAFTA has also initiated tremendous structural changes in all three member countries (EPI *et al* 1997). For example, the U.S. trade surplus in agricultural products has declined sharply with Mexico, and has turned into a deficit with Canada. However, changes in the trade balance mask even larger changes in the structure of agriculture. Some U.S. producers of corn and cattle have profited, as have all the major grain trading companies, while Canadian Dairy farms, US farmers growing wheat, barley, fruits and vegetables, and Mexican corn producers have all suffered catastrophic losses (Scott 1999b).

Other groupings of countries are shown in the remaining bars of Figure 3 (there is overlap in the countries included in these groups). The U.S. has accumulated sustained, structural trade deficits with both rich and poor nations, as shown in **Figure 3**. The majority (55 percent) of the U.S. trade deficit is with developing countries. Developed countries are responsible for the remainder (45%). Both groups have grown rapidly since 1991 (in excess of 225%).

The U.S. has a small but rapidly growing trade deficit with ASEAN, the Association of Southeast Asian Nations. The broader APEC group, which includes Japan, Canada, Mexico and 17 other countries along the Pacific Rim, was responsible for 87% of the overall U.S. deficit in manufactured goods in 1997.

The ten Big Emerging Markets (BEMs), made famous by former Commerce Undersecretary Jeffrey Garten, had some of the most rapidly growing trade deficits in Figure 3 (21.9 percent per year), second only to ASEAN (22.5 percent).[5] The ten BEM countries were responsible for about half of the U.S. trade deficit in 1998.

Trade Deficits are Concentrated with a Few Countries

Only ten countries were responsible for the entire U.S. trade deficit in 1998, as shown in **Figure 4**.[6] Japan, China and Germany had a combined deficit of $144 billion with the U.S. in 1998, nearly two-thirds of the total deficit in goods trade of $229 billion.

[5] There are several countries, such as Indonesia, which are members ASEAN, APEC and the BEMs.

[6] Smaller deficits with a number of other countries were offset by the total of all U.S. bilateral trade surpluses, discussed below.

U.S. trade deficits with Japan are the result of numerous public and private barriers to imports, and a policy of export led growth that has been maintained by a Japanese Ministry of Finance policy of consistently undervaluing the yen. While many official, government policies that restrained trade have been reformulated or phased out in recent years, private institutions that act to bar imports, such the extensive networks of Kieretsu relationships, have assumed a more important role in sustaining the trade deficit.

China's trade policies are modeled on Japan's, in many ways. Government ownership and control of the majority of economic resources, and an extensive network of government controls over banking, economic activity, trade and foreign exchange flows have combined to create the U.S.' most unbalanced bi-lateral trading relationship. U.S. imports from China are five times as large as exports to that that country. Even at its most extreme, the U.S.—Japan trade imbalance never exceeded a three-to-one ratio.

China's trade policies reflect an aggressive, state-led modernization effort that uses the pull of China's massive low-wage labor market to lure foreign direct investment from multinationals, while extracting the maximum amount of technology, jobs and exports from those relationships. China is rapidly moving up-stream from low-tech products such as shoes and apparel into higher-technology products such as aircraft and parts, computers, motor vehicles and telecommunications equipment (Scott 1999a).

China and Germany also stand out among the top ten deficit countries for having the most rapidly growing deficits (24 percent and 25 percent per year, respectively) as shown in Figure 3.[7] The German deficit reflects the combination of macroeconomic, industrial and agricultural policies discussed above. The U.S. deficit with Mexico also grew very rapidly in this period, especially after the 1994 Peso crisis (Blecker 1997).[8] The U.S. deficit with Mexico was caused by the resulting devaluation, plus a combination of low-wages, proximity to the U.S. market, preferential tariffs, and a package of investor protections and intellectual property guarantees that was codified in the NAFTA (EPI *et al* 1997).

The U.S. trade deficit through May1999 has increased by more than one-third, over the same period last year, as shown in **Table 1**. The deficit with the NAFTA countries has more than doubled over 1998 (Table 1), reflecting the impacts of the decline in the value of the Canadian dollar and the peso last year and the rapid growth of foreign investment in Maquiladora production facilities in Mexico. The U.S. deficit with Western Europe is also on pace to increase by nearly two-thirds in 1999 (Table 1), reflecting the continuing slowdown in that region, combined with EU trade barriers discussed above. Trade deficits have also increased with many countries in Asia, though not as rapidly as with NAFTA and Europe.

[7] To some extent, these growth rates reflect relatively low levels of the bilateral deficit in 1991. Both the level and the growth rate of bilateral deficits have import impacts on the U.S. economy.

[8] It is meaningless to report growth rates for the Mexican deficit, because the bilateral trade balance was positive in 1991.

Trade Surpluses are Rare

The U.S. does have trade surpluses with a few countries, as shown in **Figure 5.** This figure is drawn on the same scale as Figure 4 (trade deficits). Thus the size of the deficit or surplus (as measured by the height of the bars) is directly comparable in the two figures. A number of important issues are illustrated by comparing figures 4 and 5.

First, the U.S. total trade surplus with the top 10 surplus countries was only $47 billion (Figure 5), less than one quarter of the total deficit incurred with the top ten deficit countries of $229 billion (Figure 4). Second, the countries that the U.S. has surpluses with are smaller and more diverse than the deficit countries. The surplus countries include several major oil producers, two countries in Latin America where the surplus is probably unsustainable, and Egypt, which is a top recipient of U.S. military assistance. The deficit countries are all larger, and most have followed export-led growth paths for at least the past decade.

Finally, the surplus countries do not exhibit any consistent pattern of sustained surplus growth. Three of the top 10 surplus countries in 1998 had deficits with the U.S. in 1991 (Brazil, Saudi Arabia and Hong Kong, as shown in figure 5). Only one of the top 10 deficit countries had a surplus in this period (Mexico, Pre-NAFTA), and the U.S. experienced a growing deficit each country in Figure 4 between 1991 and 1998.

These data do not reflect any evidence of resurgent U.S. competitiveness. The rise in U.S. exports in the 1990s has not measurably affected the size or distribution of the U.S. trade deficit in any systematic manner. Trade deficits have grown steadily throughout this period with America's most important trading partners.

The Industrial Structure of U.S. Trade Deficits

Even if the U.S. does have large trade deficits with some countries, some economists would argue that these simply reflect macroeconomic problems in the U.S. (a shortage of domestic savings, relative to investment). Furthermore, some claim that the U.S. benefits from exporting "high-value added goods such as aircraft and computers (Lardy 1999, 3-4)" while importing low-tech goods such as apparel, footwear and toys.

The truth about U.S. trade patterns is more complicated, as shown in **Figures 6 and 7**. The industry with the largest U.S. trade deficit is crude oil and natural gas (SIC 13), which is not surprising since the U.S. now imports about half of its petroleum.[9] However, the next largest deficit is in motor vehicles and parts, which are not low-technology industries by most measures. Motor vehicle trade is also responsible for more

[9] Figures 6 and 7 contain information for a mixture of two and three-digit industries, based on their Standard Industrial Classification, or SIC code. Disaggregated (3 digit) industries were selected for presentation over the two-digit aggregates in cases where there were significant differences in trade patterns within two-digit industries. For example, the U.S. had a significant trade deficit in motor vehicles and parts (SIC 371) and a large surplus in aircraft and parts (SIC 372). These trade flows would be obscured if only total trade for transportation equipment (SIC 37) were reported.

than half of the U.S. trade deficit with Japan, two-thirds of the deficit with Canada and essentially the entire bilateral deficit with Mexico.

Other high-technology and/or high-wage industries that also generated top trade deficits included Computers and office machines and parts (SIC 357), Steel and other blast furnace products (SIC 331) and TVs, radios and other electronic equipment (SIC 365). Only three of the top eight trade deficit sectors are what economists traditionally consider to be low-technology products (Apparel—SIC 23, Leather products—SIC 31 and Toys and sporting gods—SIC 331).

The overall trade deficit with these eight industries was $230 billion in 1997, which exceeds the total U.S. deficit in manufactured goods in that year by a substantial amount. If the deficit in those eight industries could be eliminated, then the trade deficit could be converted into a surplus.

The top 8 trade surplus industries are shown in Figure 7. This figure is drawn on the same scale as Figure 6 (industrial trade deficits). Thus the size of the deficit or surplus (as measured by the height of the bars) is directly comparable in the two figures, as it was in Figures 4 and 5. Comparison of Figures 6 and 7 also yields important insights into the causes of the U.S. trade deficit.

The total surplus of the top 8 surplus industries was $101 billion in 1997 (Figure 7), less than half of the deficit in the top 8 deficit industries (Figure 6). In addition, while most of the surplus industries do involve high-technology and high-wage production (Aircraft—SIC 372, Chemicals—SIC 28, Construction machinery—SIC353, Scientific instruments—SIC 38 and Engines and turbines—SIC 351)), the U.S. is also a net exporter of three major commodity products—Cash grains (SIC 011), Meat packing products (SIC 201) and Cigarettes (SIC 211), as shown in Figure 7. Competition in commodity markets is price based and generates few high-wage jobs.

Finally, the surplus industries do not demonstrate any pattern of sustained growth. Surpluses grew steadily between 1991 and 1997 in only three of the top 8 industries (Figure 7). However, U.S. trade deficits increased (or surpluses disappeared) in each of the top 8 deficit industries in this period (Figure 6).

The dependence of the U.S. on commodity exports and the steady erosion of output and employment in high-wage, high technologies industries are stark indicators of the failure of U.S. trade and industrial policies to nurture and sustain U.S. international competitiveness. Other countries have prospered at the expense of the U.S. Can these problems be reversed?

Policy Recommendations

The development of new approaches to U.S. trade problems must be based on an analysis of how and why the current trade policy process has failed. This analysis must begin with an examination of business influence in the policy-making process.

The Corporate Role in Globalization

While U.S. workers have been hurt by globalization, U.S. multinational businesses have prospered. The soaring prices of U.S. stocks reflect the renewed worldwide dominance of U.S. companies. Concerns about the declining influence of U.S. firms that were widespread a decade ago have disappeared.

The competing interests of U.S. business and workers are reflected in trade statistics. The U.S. has suffered a declining share of world production and trade over the past four decades. In 1970, the U.S. produced 18% of world exports, but by 1998 the use share had declined to less than 14%.

U.S. corporations have continued to play a dominant role in world production and trade by aggressively investing and moving production abroad. Multinationals use plants in other countries to serve foreign markets and, increasingly, to service the U.S. market as well. For example, Mexico now exports more cars to the U.S. than the U.S. exports to the rest of the world. And Mexico's largest exporter is Daimler-Chrysler.

Trade policy has provided a significant stimulus to such corporate outsourcing, especially in the 1990s. The Uruguay Round, which created the World Trade Organization, and the NAFTA trade agreement, greatly advanced the interests of multinational business. These agreements protected investors through limits on trade related investment measures, intellectual property rights enforcement and by bringing services trade into the WTO.

New, binding, dispute settlement mechanisms were also created to enforce international property rights. These new measures have unleashed a torrent of foreign investment that has accelerated the impact of trade on workers throughout the developed and developing worlds.

Investor rights have been given top priority in bilateral and multilateral trade negotiations. Workers, consumers and environmentalists have been left out. These groups have formed an informal coalition with conservatives in many regions that has successfully blocked fast track, the MAI and several other important trade initiatives in the past several years.

New Approaches

The current global financial crisis suggests that globalization has allowed business to escape the bounds of regulatory systems that were established after the 1930s, which brought stability and broadly shared growth and prosperity to the world for decades. The trading system has become unbalanced, and exhibits a bias in favor of investor rights while remaining silent on labor, human rights and the environment. Is there a way out of this situation?

In an important address to the Council on Foreign Relations last year, President Clinton acknowledged that we must "modify the financial and trading institutions of the world to match the realities of the new economy." He said that "we must do more to ensure that spirited economic competition among nations never becomes a race to the bottom -- in environmental protection, consumer protection, or labor standards."

The key to achieving these goals is to build a new coalition in support of international integration. For the past 40 years, a bi-partisan, center-right coalition, has supported U.S. trade negotiations. This group was based in the Republican Party, but also included a large number of democrats sympathetic to the needs of U.S. business.

Now many members of Congress of both parties have deserted this coalition. 71 Republicans and 151 Democrats opposed a bill last year to extend that President's fast-track trade negotiating authority. Breaking this bottleneck will require rebuilding the pro-trade coalition from the left to the center. The President's remarks in New York reflect this new political reality.

The construction of a new trade coalition will depend on four essential ingredients. Start from the basic principle that the top priority for U.S. international policies is the development of an environment that is conducive to a high and rising standard of living for all Americans, and for working people around the world. A strong, competitive *domestic* manufacturing base is a necessary ingredient of any strategy designed to achieve a high and rising standard of living in all countries, but especially here in the U.S.

First, the U.S. should enter into no new trade agreements, including China's proposed entry into the WTO, unless and until those agreements are revised to include enforceable labor rights and environmental standards as core elements. This will require, at a minimum, agreements to achieve internationally agreed upon standards, international performance reviews, and enforcement of these standards through trade sanctions.

Second, measures must be taken to reduce chronic U.S. trade deficits with certain key countries, and in a few critical industries such as motor vehicles and commercial aircraft. These include China, Japan, the NAFTA countries, and Europe. The reasons for these deficits differ in each case. Part of Europe's problem is simply slow growth. The Chinese situation is more complex, involving exchange rate manipulation and systematic discrimination against U.S. imports, as well as advanced industrial policies that pilfer critical jobs and technologies from U.S. firms doing business there.

Third, the U.S. must reduce steadily reduce the value of the U.S. dollar, in coordination with other major advanced industrial nations. Similar steps were taken between 1985 and 1987 period, the last major period of dollar-overvaluation and exploding trade deficits. The over-valued dollar is having a particularly damaging impact on U.S. agriculture (Scott 1999b).

Finally, we must develop new incentives to interest developing countries in joining the developed world in raising labor and environmental standards. Developing countries also need an alternative to the model of export-led growth that has become the core of the commonly accepted Washington consensus growth package. That model has become exhausted because too many countries are competing for access to the only open market in the world, and the U.S. can no longer afford to be the market of last resort.

How can we solve the twin problems of resistance to labor standards and dependence on U.S. markets in developing countries? What is needed is a series of regional Marshall plans. The U.S., for example, should offer a greatly expanded program of debt relief and development aid to the countries in Latin America, in exchange for the upgrading of social standards throughout the hemisphere. Japan could take the lead elsewhere in Asia, and so on. This type of development-oriented model can provide the basis for a new type of regional integration that can build demand for high-wage, high-skilled exports of capital goods from North America, which can be used to help the rest of the hemisphere and the world grow more rapidly.

These are the building blocks of a new architecture for the global economy, a new deal for the 21st century. The regulatory state that evolved from the progressive era and the great depression was a natural response to the excesses of capitalism, as expressed on a national scale. The Asian financial crisis has convincingly demonstrated that the market has outgrown the bounds of the domestic regulatory state in many important ways. These problems cannot be solved on the cheap, or by avoiding the big picture.

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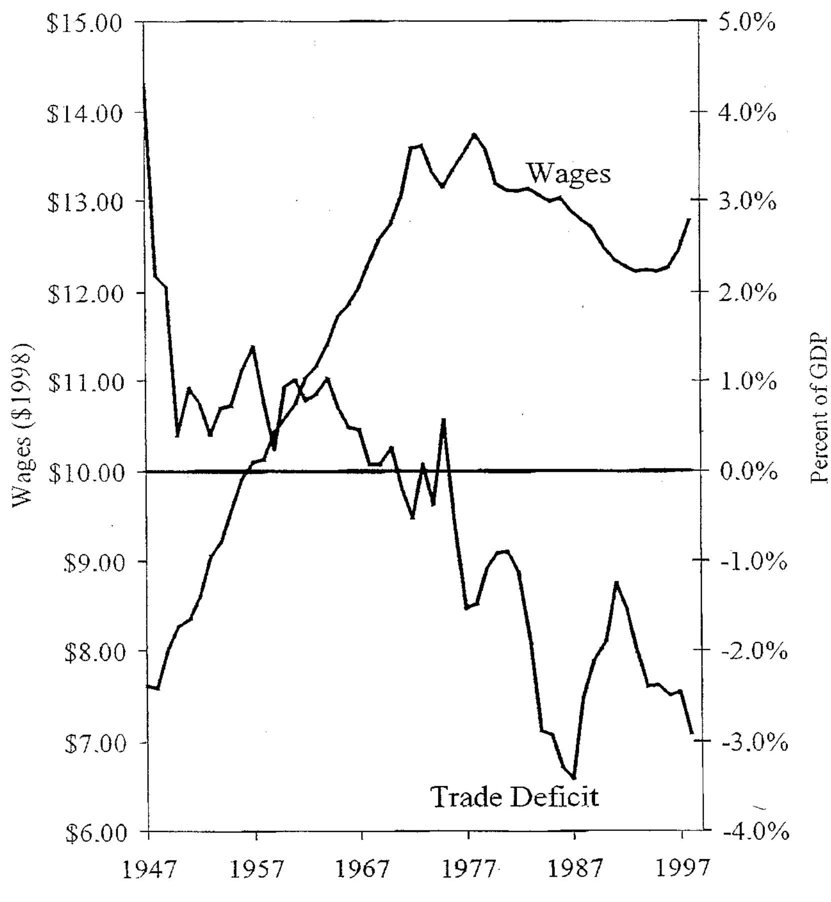
[10] Most EPI papers can be obtained from the EPI homepage: epinet.org, or by calling the number listed on the cover of this statement (a duplication fee is charged for printed copies of reports).

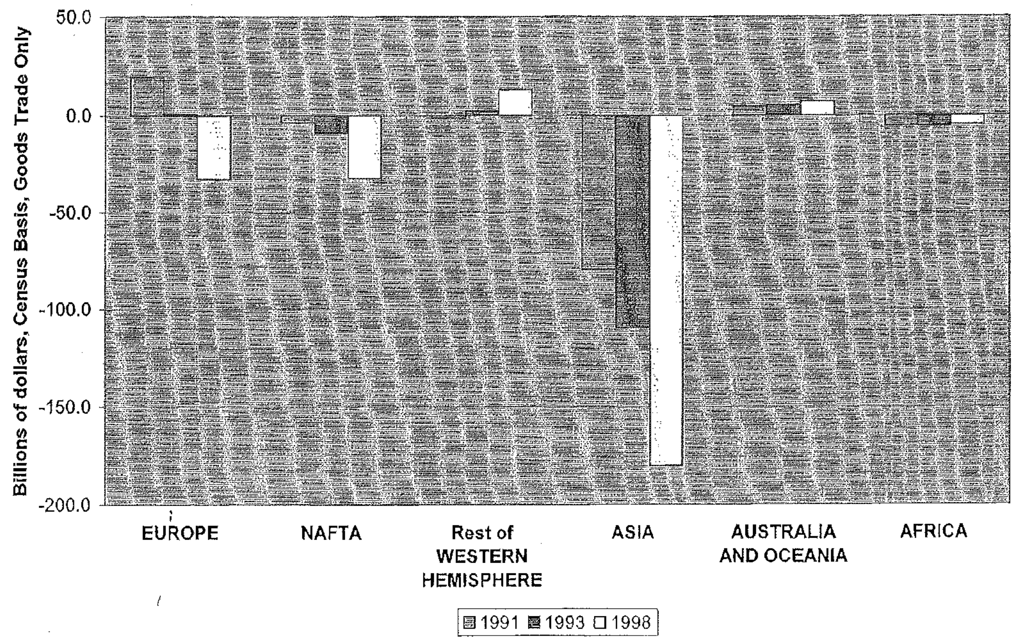
Figure 1
Real Wages & Trade Deficit, U.S., 1947-98



Source: Economic Policy Institute

Figure 2

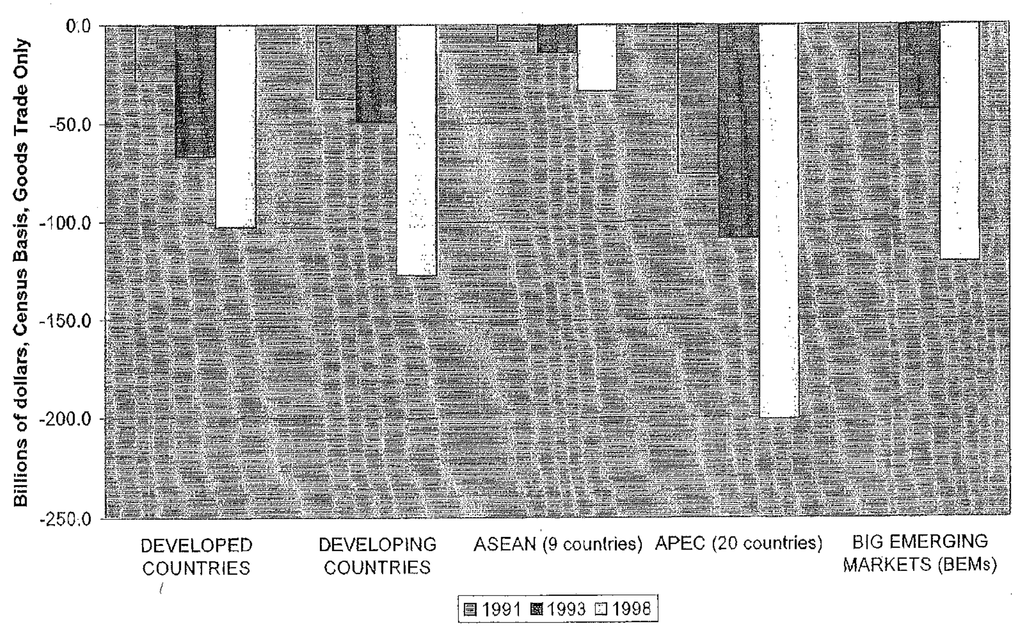
US Trade Balances by Region, 1991 to 1998



Source: Economic Policy Institute and U.S. Department of Commerce, *Foreign Trade Highlights*

Figure 3

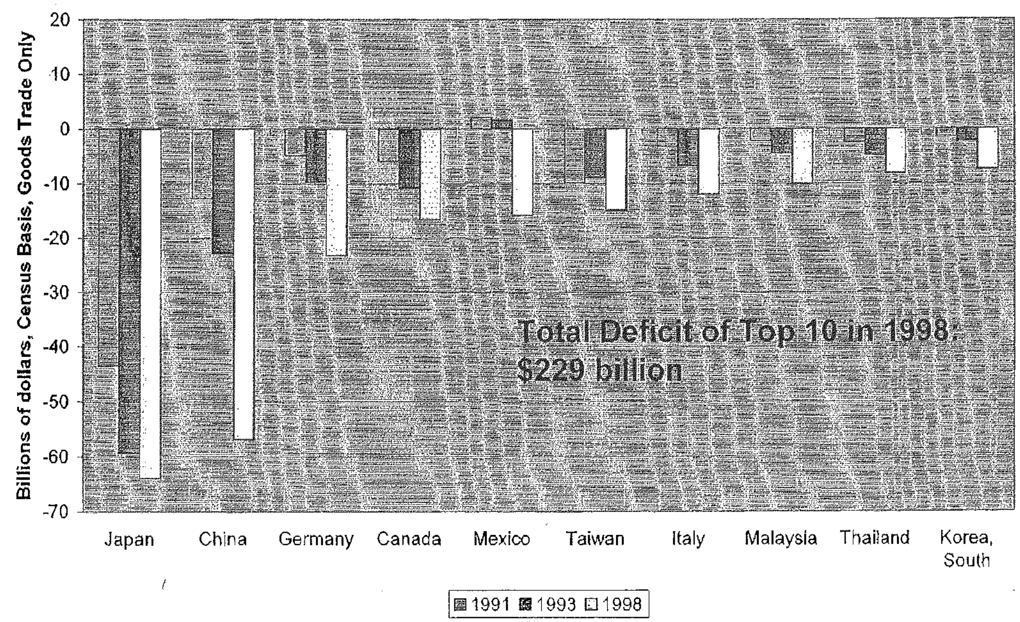
US Trade Balances by Category, 1991 to 1998



Source: Economic Policy Institute and U.S. Department of Commerce, *Foreign Trade Highlights*

Figure 4

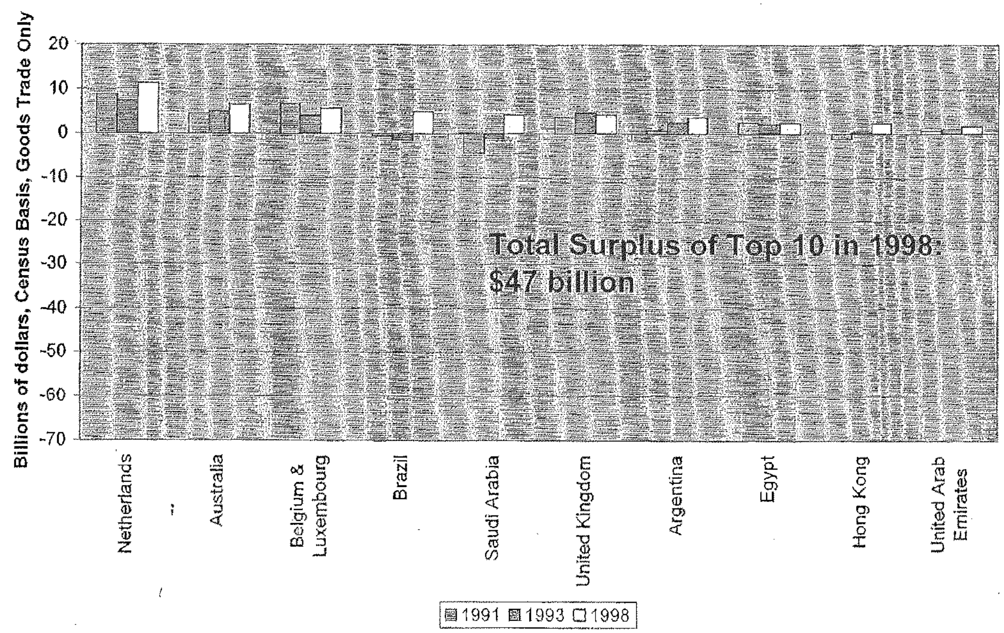
Top 10 Deficit Countries, 1991 to 1998



Source: Economic Policy Institute and U.S. Department of Commerce, *Foreign Trade Highlights*

Figure 5

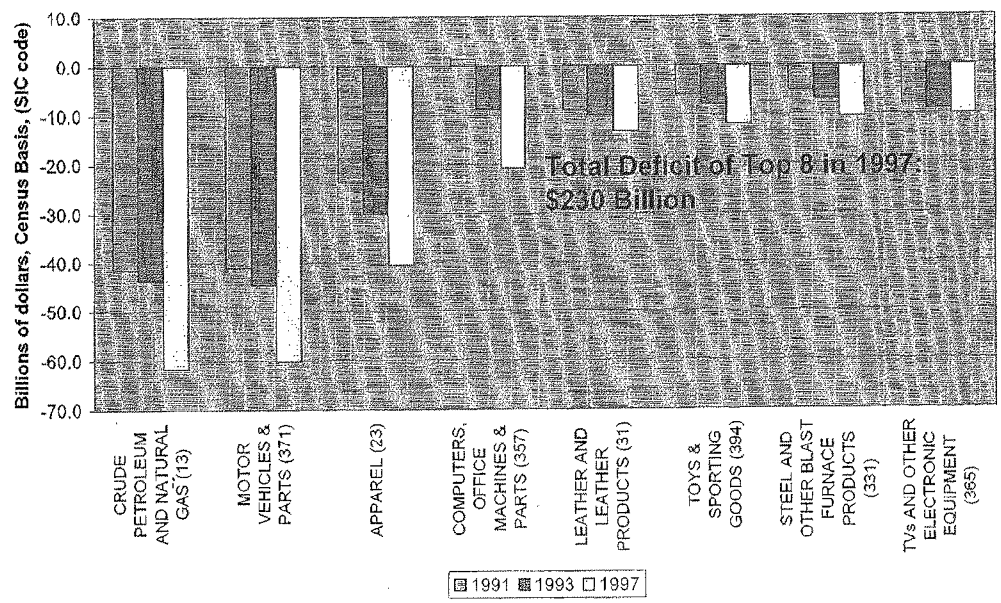
Top 10 Surplus Countries, 1991 to 1998



Source: Economic Policy Institute and U.S. Department of Commerce, *Foreign Trade Highlights*

Figure 6

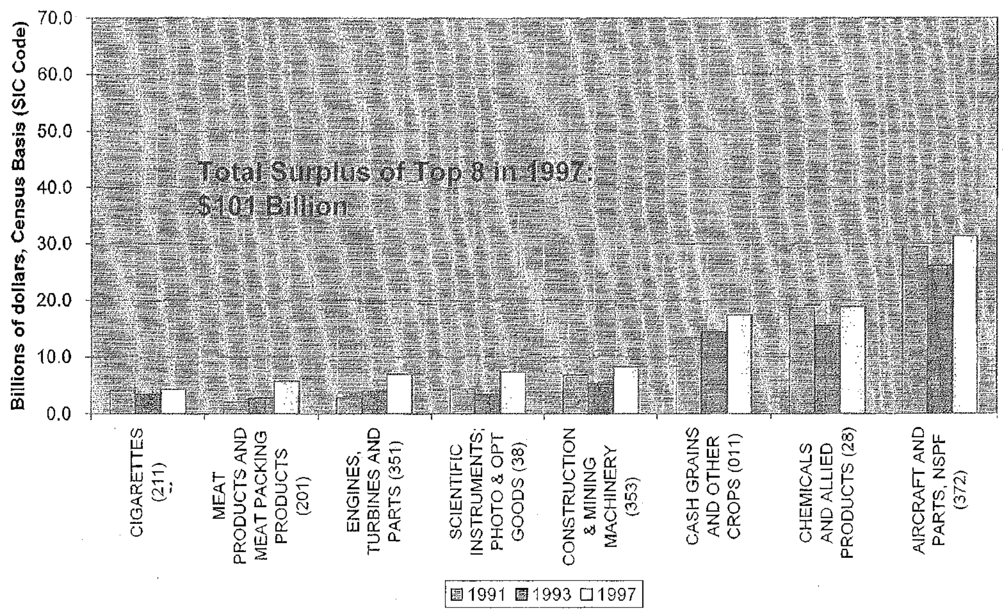
Top 8 Trade Deficit Industries, 1991-1997



Source: Economic Policy Institute and U.S. Department of Commerce, *Foreign Trade Highlights*

Figure 7

Top 8 Trade Surplus Industries, 1991-1997



Source: Economic Policy Institute and U.S. Department of Commerce, *Foreign Trade Highlights*

Table 1
US Balance of Goods Trade by Selected Areas and Countries, 1998 and 1999, year-to-date

(millions of dollars)

	Cumulative year to date through: May-99	May-98	Percent change
Total Balance of Payments Basis	-117,477	-86,087	36.5%
Net Adjustments	-6,294	-5,681	10.8%
Total Census Basis	-111,183	-80,406	38.3%
NAFTA	-21,156	-10,934	**93.5%**
Canada	-11,235	-5,259	113.6%
Mexico	-9,921	-5,675	74.8%
Western Europe	-13,231	-7,565	**74.9%**
Euro Area (2)	-66,536	-58,957	12.9%
Pacific Rim Countries	-23,675	-20,392	**16.1%**
China	-27,317	-25,657	6.5%
Japan	-22,056	-20,755	6.3%
Newly Industralized Countries(NICS)	-6,335	-6,447	-1.7%
Hong Kong	1,064	1,212	-12.2%
Korea	-1,825	-2,654	-31.2%
Singapore	-449	-968	-53.6%
Taiwan	-5,125	-4,036	27.0%
Other Pacific Rim	-7,526	-6,101	23.4%

Source: Economic Policy Institute and The U.S. Census Bureau, FT900 -- U.S. International Trade in Goods and Services, May 1999: http://www.census.gov/foreign-trade/www/press.html.

Statement of

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Before the

United States Congress
House of Representatives
Committee on International Relations
Subcommittee on International Economic Policy and Trade

Hearing on

The U.S. Trade Deficit:
Are We Trading Away Our Future?

July 22, 1999

Yes, the massive U.S. trade deficit is a clear sign that we are trading away our future with our massive trade deficits today. Basic economics teaches that a country pays for its trade deficit by borrowing against future consumption, and that is exactly what we are doing today. At present, our international borrowing is enabling us to continue a consumption-led economic expansion. Undoubtedly, the current trade deficit brings us some short-term gains, especially the flood of cheap imports which has helped to hold down inflation to an almost negligible rate. But any household could give an impressive showing of consumer spending providing that it could borrow without limit. No household can borrow without limit, however, and neither can the United States. The continuous and growing trade deficits of the last few years are contributing to a rising mountain of foreign debt that, sooner or later, is bound to force significant and possibly painful adjustments on the U.S. domestic economy. We are not Mexico or Thailand, but their currency collapses in 1994 and 1997 (respectively) forcefully demonstrate the risks of running excessively large trade deficits financed by international borrowing. Unless we want to risk a future financial crisis that could truly engulf the entire global economy, we need to take strong measures now to curb our trade deficit and restore more balance to our international finances.

Of course, the trade deficit is already having a serious impact on trade-oriented sectors and regions of the U.S. economy. Both import-competing sectors such as steel and machine tools and export sectors such as aerospace and agriculture have been devastated in the past few years. The country's poor trade performance is the main reason why good-paying manufacturing jobs are being lost in spite of the steady growth of the domestic economy. Moreover, this industrial damage has long-term consequences as well, as it will undermine the nation's competitive advances of the early 1990s and provide a weaker foundation for global competition in the future. But other speakers at this hearing will focus more on the industrial and employment effects of the trade deficit, and I would like to focus my testimony today on the macroeconomic causes and financial consequences.

In analyzing the causes of the rising U.S. trade deficit, we have to distinguish long-term and short-term factors. The United States has had a rising long-term trend in its trade deficit since the 1960s, due to the fact that, as our economy grows, we tend to increase our purchases of imports much faster than other countries increase their purchases of our exports when their economies grow. In technical terms, we say that the "income elasticity of U.S. import demand" is significantly higher than the "income elasticity of U.S. export demand," which has been demonstrated in numerous studies over the years.[1] This in turn implies that, in order to keep our trade balanced, we would have to do one or the other of the following two things: (1) continuously depreciate the dollar in real (inflation-adjusted) terms; or (2) grow more slowly than our trading partners.[2] In years when these adjustments have occurred—such as the late 1980s for (1) and the early 1990s for (2)—the trade deficit has indeed fallen. But in the last few years, neither has occurred—the dollar has rather appreciated in value, and the U.S. economy has grown faster than most of our trading partners, resulting in a return to the long-term trend of rising trade deficits.

Of course, in the long term it is not desirable to have to have either a falling currency or relatively slow growth. Therefore, in order to escape this dilemma, it is vital to make long-term structural reforms, such as opening up foreign markets more to U.S. exports and insisting on improved labor standards and environmental regulations as conditions of access to the U.S.

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[1] See Robert A. Blecker, *Beyond the Twin Deficits: A Trade Strategy for the 1990s* (Armonk, NY: M.E. Sharpe, Inc., Economic Policy Institute Series, 1992), and "The Trade Deficit and U.S. Competitiveness," in *U.S. Trade Policy and Global Growth: New Directions in the International Economy*, ed. Robert A. Blecker (Armonk, NY: M.E. Sharpe, Inc., Economic Policy Institute Series, 1996, pp. 179-214), for evidence and further citations.

[2] See Robert A. Blecker, "International Competitiveness, Relative Wages, and the Balance-of-Payments Constraint," *Journal of Post Keynesian Economics*, vol. 20, no. 4 (Summer 1998), pp. 495-526.

market. Overall, a trade policy that would place more emphasis on the interests of U.S.-based producers (both firms and workers) rather than the interests of U.S.-owned companies operating abroad would do much to help address the long-term imbalances in U.S. trading relationships. More investment in civilian R&D, better education, and improved domestic infrastructure are also essential ingredients in a long-term competitive strategy that could reverse our unfavorable "income elasticities" and solve the long-term trade deficit dilemma. The neglect of our long-term trade problems has allowed the trade deficit to reemerge and to reach record heights.

But the massive increases in the U.S. trade deficit over the past few years are not just the result of these long-term, structural trade problems; they are also the consequences of very specific events and policies that have made our trade deficit much worse than it had to be. Simply put, the surge in the trade deficit has resulted from two causes: the rising value of the dollar and slow growth in most of our major trading partners. Both of these causes were exacerbated by, but did not originate with, the Asian financial crisis of 1997-98. And both of these causes are the products of deliberate policy decisions that have been made here in the United States, in our major trading partners, and at international institutions such as the International Monetary Fund (IMF). To paraphrase the cartoon character Pogo, "we have found the culprit, and it is our own policies—and those of our trading partners."

The Federal Reserve Board's new indexes of the real (inflation-adjusted) value of the dollar tell the story of why U.S. products have suddenly become so uncompetitive both at home and abroad. The new broad dollar index (**Figure 1**) shows that, after trending downward from 1990 to mid-1995, the dollar began to rise in value between mid-1995 and mid-1997 and then accelerated its ascent following the Asian crisis in mid-1997. Although the dollar has since stabilized, it has not fallen back to the levels of the early 1990s at which U.S.-produced goods and services would be more competitive.

More detailed indexes for two separate groups of countries (**Figure 2**) show that the timing of this dollar appreciation has varied between our major industrialized country trading partners and our other important trading partners. The dollar began to rise against the major industrialized countries' currencies (mainly the Canadian dollar, Japanese yen, and European currencies) back in mid-1995 and rose steadily and sharply against them through early 1998. Since that time, the dollar's value against the major currencies has fluctuated but has remained at a high, uncompetitive level (especially since the fall in the euro so far this year). With regard to our other trading partners (especially the developing countries and newly industrializing countries [NICs]), the dollar was falling gradually through mid-1997 (except for an upward blip in early 1995 following the Mexican devaluation), but then shot upward sharply in the second half of 1997 following the Thai baht crisis and the subsequent collapses of other currencies throughout Asia and other developing regions. The dollar has also stabilized against these currencies since early 1998, but still remains significantly above its pre-crisis level as of mid-1999.

The upshot of all this is that U.S. producers of tradable goods find it very hard to compete, no matter how advanced their technology or how productive their labor, when the dollar's rise has made their products about 20% more expensive relative to other countries' products over the past four years. Therefore, *there cannot be any solution to the trade deficit that does not begin with a significant effort to bring down the value of the dollar to a more competitive level.*

The second factor in causing the recent rise in the U.S. trade deficit is the slowdown in other countries' growth rates combined with continued robust expansion in the United States. **Figure 3** shows that the U.S. grew faster than *almost all* of its major trading partners, especially those that constitute major markets for U.S. exports.[3] The forecasts for 1999 from the same source (the IMF's *World Economic Outlook*, April 1999) show some variation, especially insofar as the Asian NICs are projected to recover somewhat while Latin America is projected to have a recession. Overall, the situation remains that most major U.S. export markets are growing sluggishly at best or else are in actual recessions (i.e., with falling output), both among the developing nations and the industrialized countries.

Of course, this slow foreign growth is also related to the rise in the value of the dollar, since investors have fled depressed areas of the world economy and have bought assets in the United States—thus pushing up the value of the dollar. Indeed, one of the distinguishing things about the recent rise in the trade deficit is how much it has been driven by huge inflows of funds in the capital account of the balance of payments, which require an offsetting deficit on the current account (most of which is the deficit on goods and services plus net investment income). And we need to recognize that our own policies as well as those of our trading partners and the international institutions we support, such as the IMF, have contributed to this situation. By keeping interest rates higher here than in other industrialized countries, the Fed has encouraged financial capital to invest here, thus keeping the dollar high. By pushing austerity policies on developing countries that had currency crises (such as Korea and Brazil), the U.S. Treasury and the IMF have contributed to the shrinkage of our export markets. And by sacrificing their domestic growth on the alter of fiscal rectitude, both the Europeans and the Japanese have failed to stimulate their own economies and thus have contributed to the massive imbalances in global trade (as well as to the depressed conditions in Latin America, Asia, and other developing regions). Finally, slow

[3] China is an exception, which grew at a 7.8% annual rate in 1998 (not shown). But contrary to the mythology of its "vast export market," China hardly buys any U.S. exports—a mere $14 billion of U.S. exports in 1998, compared with $71 billion of U.S. imports from China.

growth in most of the world (except the United States) has led to depressed prices for primary commodities, which benefit U.S. consumers today but are hurting our own farmers and miners as well as agricultural and mineral producers around the world—including crisis countries like Brazil and Russia, as well as numerous poor countries in regions such as Central America and sub-Saharan Africa.

Turning to the future, and leaving aside the industrial damage that will be covered in more depth by other witnesses, I want to focus the rest of my testimony on the rising trend in the U.S. international debt position that results from the borrowing required to cover the trade deficit.[4] The U.S. net international debt reached a record $1.2 trillion at the end of 1998. According to my projections, if the U.S. continues to run trade deficits at the present rate, this net international debt will reach about $3.8 trillion by 2005 (see **Figure 4**). Moreover, if we exclude certain items that should not be counted in calculating the U.S. net external *financial* debt, namely direct foreign investment and gold reserves, we find that the U.S. net *financial* debt was already $1.6 trillion at the end of last year and is projected to hit $4.1 trillion by 2005—which will be about 35% of GDP at that time (up from 18% in 1998). Furthermore, the growing external financial debt of the United States has a negative "feedback effect" on the current account of the balance of payments via increased net outflows of interest and dividend payments to foreigners (**Figure 5**). The net outflow of financial investment income (interest and dividends, but referred to simply as "interest" in Figure 5 for brevity) was already $66 billion in 1998 and is projected to reach $166

[4] The following discussion draws upon my recent EPI Briefing Paper, "The Ticking Debt Bomb: Why the U.S. International Financial Position is Not Sustainable" (Washington, DC: Economic Policy Institute, June 1999), which will be submitted as an attachment to this testimony, but uses recently released revised data from the Department of Commerce, as reported in Russell B. Scholl, "The International Investment Position of the United States at Yearend 1998," *Survey of Current Business* (July 1999, pp. 36-47). See my Briefing Paper for the methodology used in making the forecasts for 1999-2005 (the projections made in that paper for 1998 have been replaced with the actual data just released by the Commerce Department, and all the data series were revised using the new data).

billion by 2005, if present trends continue (and assuming no change in interest rates)—an amount that would exceed the 1998 trade deficit in goods and services (which was $164 billion).

This kind of debt accumulation and interest outflow is sustainable only as long as international investors are willing to continue lending us the funds required to finance our current account deficit, which is projected to reach a record $300 billion this year, and are also willing to continue to hold onto or roll over their existing portfolios of U.S. assets (stocks, Treasury securities, other bonds, bank deposits, etc.). While there is no cause for immediate alarm—confidence in the U.S. economy remains strong, especially relative to the weakness of most foreign economies—the longer-term outlook is not necessarily so bright.

If we keep accumulating foreign debts at this rapid pace, it is inconceivable that foreigners will continue to want to pour hundreds of billions of dollars a year into U.S. assets and to hold ever-larger portfolios of U.S. assets indefinitely, without at some point beginning to entertain fears about the value of those assets declining—either because the assets themselves become perceived as overvalued (e.g., the stock market bubble), or because there is a fear of an inevitable dollar depreciation to reduce the trade deficit as indicated earlier. At whatever point in the future such fears develop, recent history teaches us that confidence can decline rapidly and unexpectedly, causing the fears of asset price declines or dollar depreciation to become self-fulfilling prophecies as speculators sell off their positions in a panic and precipitate the very outcome that they fear.

When this happens—as I think it inevitably must, if we don't get our trade deficit under control sooner—it will put U.S. policy makers in a difficult bind. They will either have to jack up interest rates to try to restore investor confidence and rescue the dollar, thus precipitating a severe recession, or else abandon the high dollar strategy and let the exchange rate depreciate. Either way, the dollar and the U.S. economy could have a "hard landing," although I would argue (based on the preceding analysis of the causes of the trade deficit) that it would be better to let the dollar fall than to try to rescue it with high interest rates.

It must be emphasized that it would not take a very large initial shift in investors' behavior to force painful adjustments on the U.S. economy in order to balance our trade. Consider that, by the end of 1998, the total stock of foreign financial assets in the U.S. (gross U.S. liquid liabilities) had reached $5.2 trillion (see **Figure 6**). If foreign investors decided to sell off only about 5¾% of their portfolios of U.S. assets, this would amount to a net capital outflow on the order of about $300 billion, or just about what the U.S. current account deficit is projected to be this year (1999). If we can no longer borrow this amount from abroad, we would be forced to balance our trade overnight through very painful adjustments at home—some combination of a steep dollar decline and a sharp fall in national income (i.e., a recession). Some simple calculations reveal that the fall in GDP required to eliminate even half of a $300 billion trade deficit via income adjustment (assuming the other half was eliminated by dollar depreciation) would easily exceed 5%—and a 5% fall in GDP would be the worst recession in modern U.S. history (but not unlike what countries like Mexico, Thailand, and Korea have experienced in recent years).

Such a "hard landing" scenario does not have to come to pass, of course, but if we want to reduce the risk of such a crisis occurring there are steps that we need to take *now* in order to bring down the trade deficit and stem the growth of the U.S. foreign debt. There are four major parts of a policy package for reversing the rise in the trade deficit and reducing the burden of the international debt:

1. First and foremost, we need to engineer a gradual but significant reduction in the value of the dollar. This will require us to reduce interest rates, in order to make U.S. financial assets less attractive to foreigners—not to raise interest rates further, as the Fed is

currently contemplating. In order to keep the dollar decline orderly and prevent a panic, clear targets should be announced in advance, consistent policies (i.e., interest rate reductions) should be implemented, and massive intervention should be promised to defend the target ranges. For the longer term, we should support rather than resist European initiatives for "target zones" or "crawling bands" for managing exchange rates among the major currencies (dollar, euro, yen, and sterling).[5] And we need to recognize that this in turn will require coordination of our macroeconomic policies with those of other major countries, especially those of Europe and Japan, in order to stabilize currency values and promote more balanced growth (and more balanced trade).

2. Secondly, and equally importantly, we need to encourage a reorientation of macroeconomic policies in our major trading partners to stimulate more domestic growth, along with structural reforms to make some of their markets more open to imports of U.S. manufactures and agricultural products. It is time for Europe to abandon the straightjacket of Maastricht policies, which have already backfired in failing to make the euro a strong currency, and for Japan to pull itself out of its prolonged slump and to open its market to manufactured imports. Moreover, it is time to reverse the austerity policies that have been adopted in most of the developing countries that underwent financial crises in the past five years, under the tutelage of the U.S. Treasury and the IMF, so that these economies can once again grow and provide for the needs of their own citizens as well as provide more prosperous markets for U.S. exports. It is also high time to stop encouraging so many developing countries to all try to revive their economies with export-led

[5] See Robert A. Blecker, *Taming Global Finance: A Better Architecture for Growth and Equity* (Washington, DC: Economic Policy Institute, 1999), for further discussion of exchange rate management and macro policy coordination among the industrialized countries.

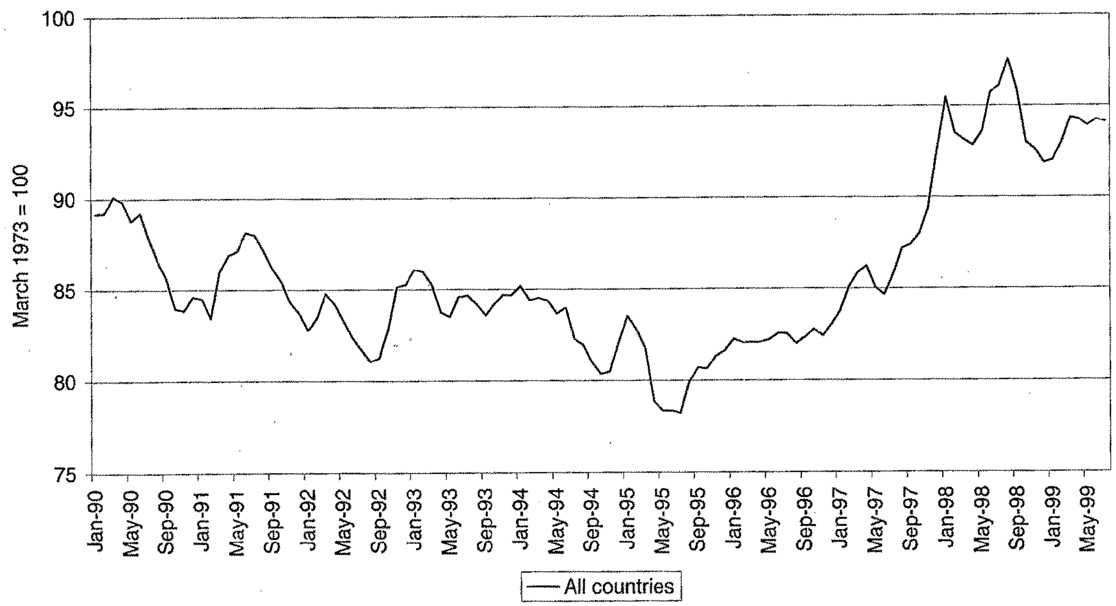
growth focused on the U.S. consumer market, a strategy that is bound to fail when too many try it at the same time, and which has led to dramatic surges of underpriced imports in many U.S. industries such as steel. And finally, it is time to reverse the premature drive to liberalize capital flows that has proved so disastrous in so many developing countries whose "emerging" financial markets were unprepared for the resulting inflows of volatile "hot money," and to recognize and accept the need for developing countries to use reasonable capital controls to stabilize their economies (as many countries, including Chile, India, and Malaysia, have done).

3. Third, we need to stop relying on Federal Reserve interest rate policy as our sole policy lever for every conceivable economic objective, from inflation control to full employment to solving financial crises to keeping the dollar at a competitive level. There is no way that we can find one interest rate policy that will satisfy all of these objectives at once, and at present the result has been that our policy has been very successful at some objectives (e.g., full employment with low inflation) but at the expense of sacrificing others (e.g., the trade deficit and the growing international debt). Without going into the details here, suffice it to say that we need to revive other instruments of macroeconomic and financial policy, such as fiscal policy, incomes policies, and credit regulations, in order to achieve a more balanced and sustainable economic growth trajectory.

4. Finally, as mentioned earlier, we need to modify the objectives of our trade negotiating strategy in order to better promote the interests of U.S.-based producers, rather than to sacrifice them to ideological free-trade purity or to the interests of multinational corporations and banks that want free rein to move capital and jobs around the world with impunity. For example, our trade representatives should be prioritizing the needs of

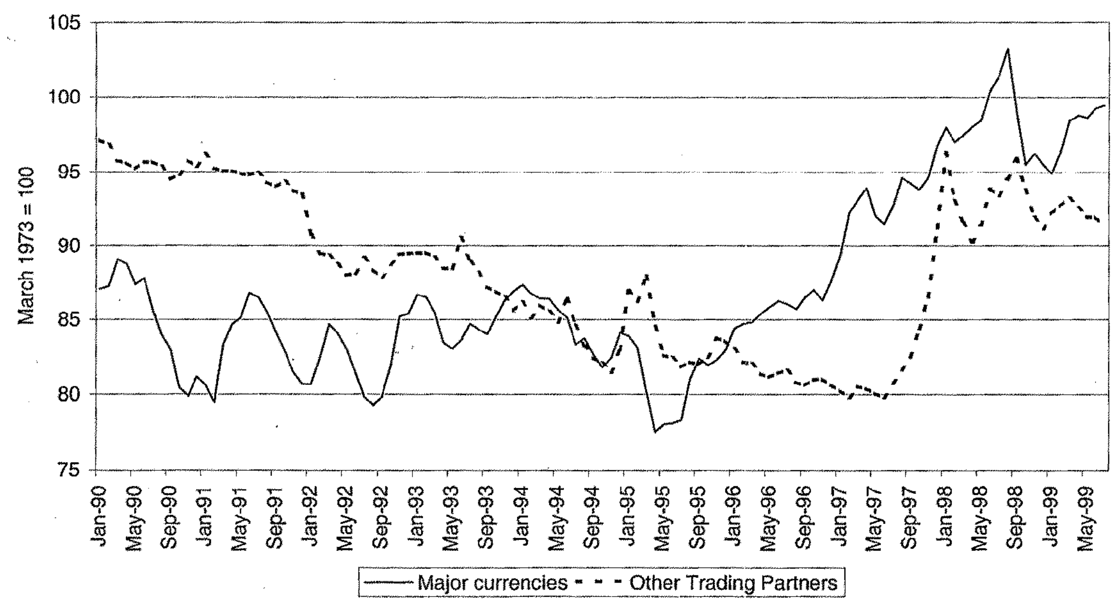
domestic industries like steel, rather than of companies selling foreign produce like bananas in third markets. Also, we should be pursuing the upgrading of global standards in areas such as human rights, labor standards, and environmental protection, just as much as we do for intellectual property rights or rights of foreign investors. Market access should be reciprocal and enforced, and granted on the basis of continuing efforts to create a true "level playing field" in terms of social standards as well as property rights. Such a new approach to trade policy could help to relieve the long-term structural decline in the U.S. trade position, which perennially forces us to choose between the two evils of depreciating the dollar and slowing our growth if we want to balance our trade. With a more balanced set of trading relations with our trading partners, we should be able to balance our trade without making these types of sacrifices in the future.

Figure 1
Broad Real Dollar Index (Inflation Adjusted Value of the Dollar)
January 1990 - July 1999



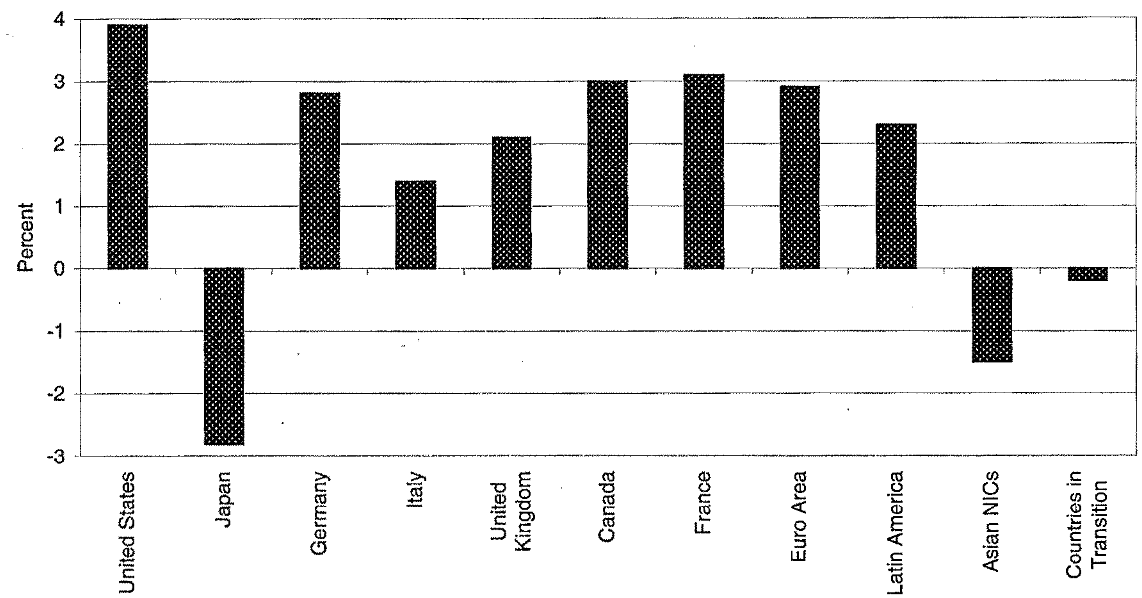
Source: Economic Policy Institute and Board of Governors of the Federal Reserve System.

Figure 2
Real Dollar Indexes (Inflation Adjusted Value of the Dollar)
January 1990 - July 1999



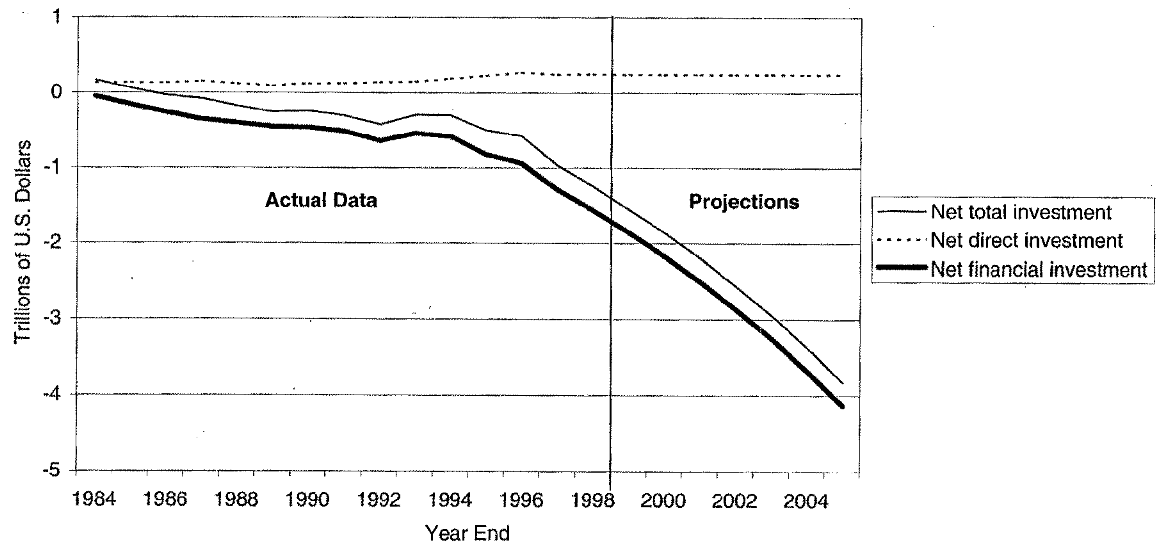
Source: Economic Policy Institute and Board of Governors of the Federal Reserve System.

Figure 3
Growth Rates of Real GDP in the United States and Trading Partner Economies, 1998



Source: Economic Policy Institute and International Monetary Fund, *World Economic Outlook*, April 1999.

Figure 4
U.S. Net International Investment Position, Actual Data for 1984-1998 and Forecasts for 1999-2005



Sou[illegible] Economic Policy Institute and U.S. Department of Commerce, B[illegible]au of Economic Analysis.

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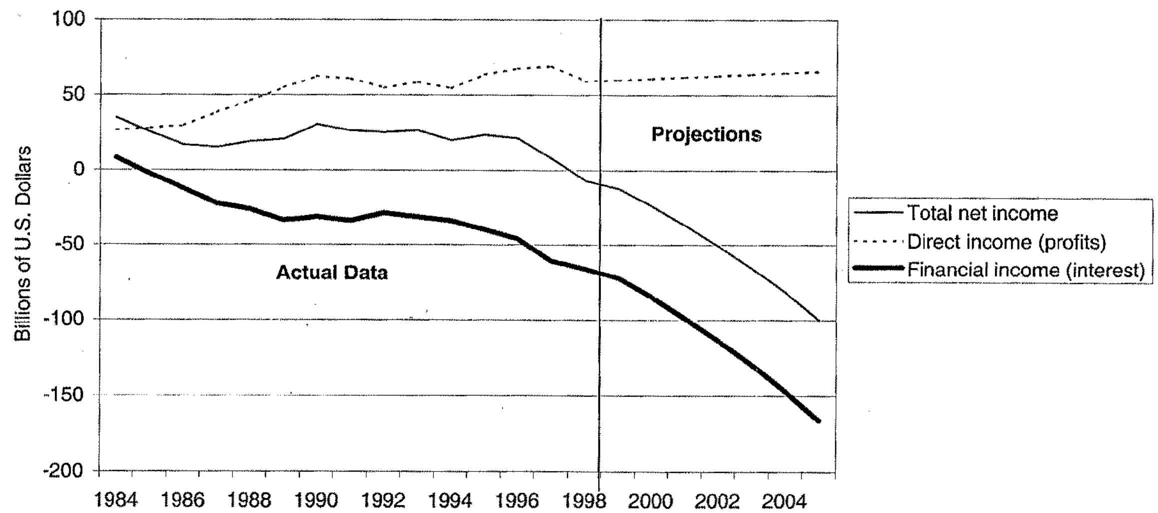
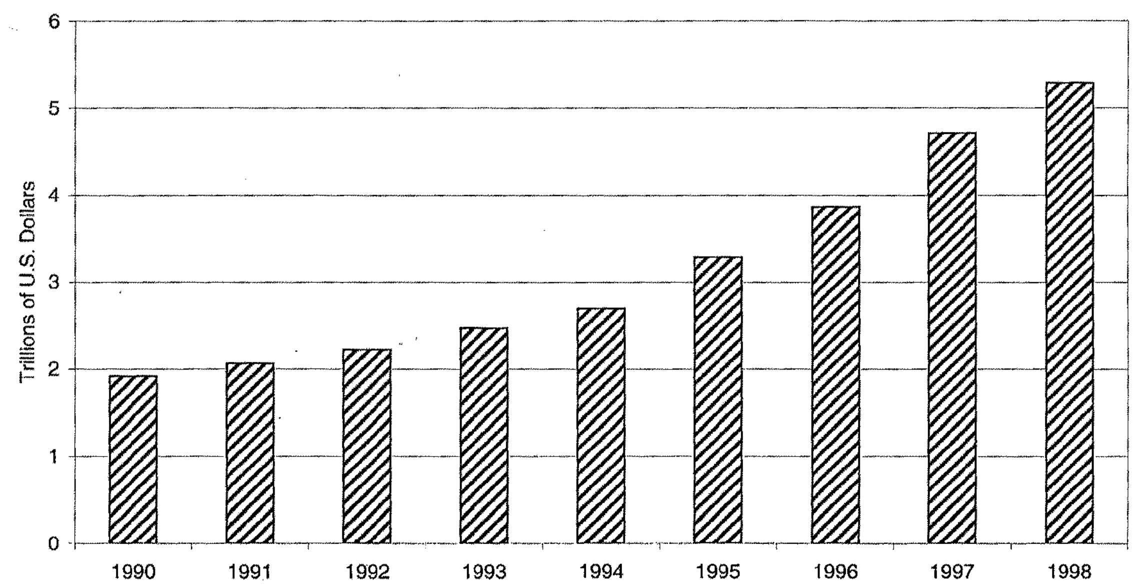


Source: Economic Policy Institute and U.S. Department of Commerce, Bureau of Economic Analysis.

Figure 6
Foreign Financial Assets in the United States (Gross U.S. Liquid Liabilities), 1990-1998



Source: Economic Policy Institute and U.S. Department of Commerce, Bureau of Economic Analysis.

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THE TICKING DEBT BOMB

Why the U.S. International Financial Position Is Not Sustainable

by Robert A. Blecker

For the last few years, most of the economic news in the United States has been glowing. The U.S. economy has grown at a healthy 4% average rate since 1997, with virtually full employment and almost negligible inflation, thus returning to macroeconomic conditions not experienced since the early 1960s. Two-and-a-half years after Federal Reserve Board Chairman Alan Greenspan warned of "irrational exuberance" on Wall Street, the New York stock market continues to climb to unparalleled heights. Meanwhile, more and more observers claim that we are now in a "new economy" that is immune to the forces that caused inflation and recessions in the past.

Yet in the midst of this celebratory environment, certain indicators regularly cast a pall over these otherwise sunny times. Month after month, year after year, the U.S. trade deficit sets new records. And as the United States borrows to cover the excess of its imports over its exports, the U.S. position as the world's largest debtor grows by leaps and bounds. Closely related to both of these trends is the drop in the U.S. private saving rate, which forces the country to continue borrowing from abroad in spite of the shift from a deficit to a surplus in the federal budget balance.

In fact, the U.S. economy's current prosperity rests on the fragile foundations of a consumer spending boom based on a domestic stock market bubble, combined with foreign bankrolling of the U.S. trade deficit. If present trends continue, the growth in U.S. international debt will not be sustainable in the long run. No country can continue to borrow so much from abroad without eventually triggering a depreciation of its currency and a contraction of its economy. The rising trade deficit and mushrooming foreign debt are thus warning signals of underlying problems that—if not corrected—could bring the U.S. economic boom crashing to a halt in the not-too-distant future.

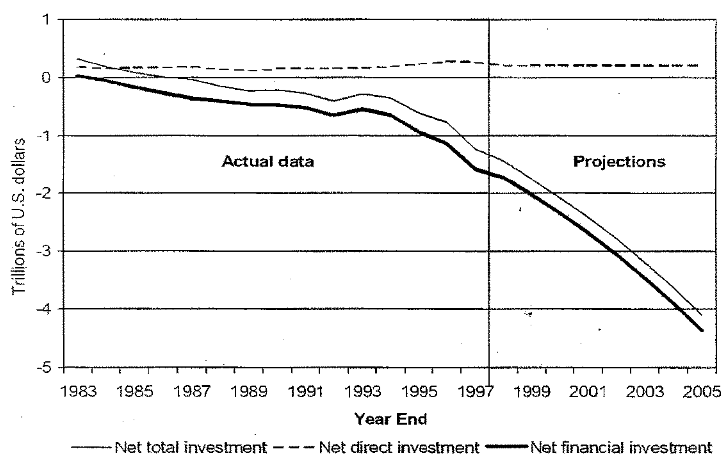
Addressing the U.S. international debt situation will require action on two fronts: reducing the trade deficit and keeping interest rates low in order to reduce the burden of servicing the debt. Four specific policies that could help to avert a serious crisis over the next few years include: (1) promoting stimulus policies among U.S. trading partners with depressed economies in order to promote growth and to enable them to reduce their trade surpluses with the U.S.; (2) engineering a gradual depreciation of the dollar; (3) using a fiscal stimulus to keep the economy growing when the current consumption boom slows down; and (4) restructuring U.S. trade policy to promote more reciprocal market access and to stress the interests of U.S.-based producers exporting abroad.

The dimensions of the problem: trends and forecasts

Figure 1 shows the actual trends in the U.S. net international debt for 1983-97 along with baseline projections for 1998-2005, which are explained in more detail in the Appendix.[1] The United States was a

FIGURE 1

U.S. net international investment position, actual data for 1983-1997 and baseline forecasts for 1998-2005



Sources: Scholl (1998), U.S. Bureau of Economic Analysis (1999b), and author's calculations as explained in the Appendix.
Note: Net total investment includes U.S. official gold reserves, which are not shown separately.

net creditor country as recently as 1987 for total international investment, as it was for financial investment until 1983. But the borrowing required to cover chronic current account deficits since the 1980s has long since turned the United States from the world's largest creditor into the world's largest debtor (see Blecker 1991, 1998).[2]

As of the end of 1997, the total U.S. net international debt stood at $1.22 trillion.[3] Excluding official gold reserves held by the Treasury Department and direct foreign investment by multinational corporations, both of which are not liquid assets,[4] the net *financial* debt of the United States was $1.57 trillion at year-end 1997. This net financial debt represents the difference between the value of U.S. liquid financial assets (such as corporate stock, bank deposits, government securities, and other bonds) owned by foreigners and the value of similar foreign assets owned by Americans.

The U.S. still has a net positive (creditor) position in *direct* investment, since U.S. multinational corporations own more assets abroad than foreign multinationals own in the United States. However, this position has been relatively small and stable, and it is likely to stabilize at $200 billion starting in 1999. In contrast, the net *financial* investment position is negative (i.e., foreigners own more liquid financial assets in the U.S. than Americans own abroad), and this net financial debt is much larger and increasing rapidly.

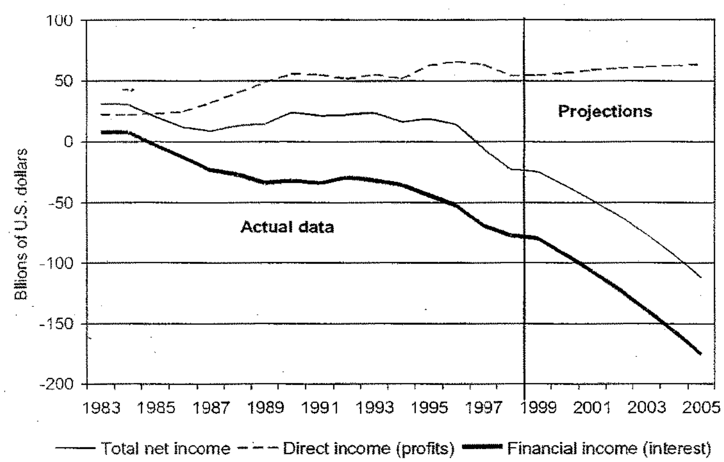
According to the baseline forecast, the U.S. net financial debt increased to $1.72 trillion in 1998, and it will rise further to $2.02 trillion during 1999, $2.34 trillion in 2000, and a mammoth $4.36 trillion by 2005 (or an estimated 36.4% of gross domestic product at that time).[5] Adding back the positive net position in direct investment and the value of U.S. gold reserves, the total net debt is also projected to grow rapidly: from $1.22 trillion in 1997 to $1.43 trillion in 1998, $1.75 trillion in 1999, $2.07 trillion in 2000, and $4.09 trillion by 2005 (or an estimated 34.2% of GDP in that year).

The corresponding projections for U.S. net investment *income* balance—the difference between the inflows of profits, dividends, and interest received from U.S. investments abroad and the outflows of profits, dividends, and interest paid out on foreign investments in the U.S.—are shown in **Figure 2**. In spite of the U.S. turn to an overall net debtor position in the mid-1980s, total net investment income remained positive in the early 1990s because the rate of return on direct investment (in which the U.S. has a net creditor position) exceeded the rate of return on financial investments (in which the U.S. is a net debtor).[6] However, in the last few years the sheer volume of the net financial debt has begun to overwhelm the difference in rates of return, and the net investment income balance has been negative since 1997.[7]

In the baseline forecast, the net outflow of financial income (interest and dividends) jumps from an actual $77.1 billion in 1998 to an estimated $175.3 billion in 2005—a net outflow greater than the U.S. goods and services trade deficit in 1998. Including net direct investment income, which is assumed to remain positive (see Appendix for details), total net investment income jumps from an actual deficit of $22.5 billion in 1998 to a projected deficit of $111.3 billion by 2005. These deficits in investment income in turn worsen the overall current account balance, on top of the underlying deficit for trade in goods and services and net transfers[8] (which is assumed to be 3.0% of GDP in the baseline scenario). Thus, by 2005, the total current account deficit is projected to be 3.9% of GDP.

FIGURE 2

U.S. net international investment income, actual data for 1983-98 and baseline forecasts for 1999-2005



Sources: DiLullo (1998), U.S. Bureau of Economic Analysis (1999a, 1999b), and author's calculations as explained in the Appendix.

Like all economic forecasts, this baseline projection is conditioned on the assumptions that drive the analysis, in this case, the persistence of an underlying trade deficit of 3% of GDP and the continuation of moderate interest rates (averaging 4.25%)[9] through 2005. These are actually very conservative assumptions given that the Federal Reserve is now (as of June 1999) leaning toward raising interest rates and many analysts fear larger trade deficits in the next few years. Yet even these conservative assumptions show the net financial debt rising to $4.36 trillion (or 36.4% of GDP) and the current account deficit reaching $470.6 billion (or 3.9% of GDP) by 2005.

By altering these assumptions, we can make a series of alternative forecasts that illustrate a range of possible outcomes for the U.S. net foreign debt and net interest burden. **Table 1** summarizes the results of several alternative forecasts for 2005, the final year of the projections (the baseline scenario shown in this table corresponds to the forecasts depicted in Figures 1 and 2). Using these alternative forecasts, we can better assess the prospects for a hard or soft landing for the U.S. dollar and the U.S. economy.

The *improving trade balance* scenario assumes that the underlying trade deficit drops to 2.0% of GDP in 2000 and then falls gradually to 1.0% in 2005, perhaps because foreign economies recover from their current doldrums (and thus buy more U.S. exports) or because the dollar depreciates (i.e.,

TABLE 1
Alternative forecasts of U.S. net interest outflow, current account deficit, and net international financial debt for 2005

Scenario	Net financial income (interest) inflow (+) or outflow (-)	Current account surplus (+) or deficit (-)	Net financial credit (+) or debt (-) position
		In billions of dollars	
Baseline (moderate trade deficit, 4.25% interest rate)*	-175.3	-470.6	-4,360.3
Improving trade balance**	-135.1	-190.8	-3,273.5
Worsening trade deficit***	-215.6	-750.3	-5,447.1
2% interest rate	-74.7	-370.0	-3,918.7
7% interest rate	-326.8	-622.1	-4,980.3
10% interest rate	-535.9	-831.2	-5,774.7
		In percent of GDP	
Baseline (moderate trade deficit, 4.25% interest rate)*	-1.5	-3.9	-36.4
Improving trade balance**	-1.1	-1.6	-27.3
Worsening trade deficit***	-1.8	-6.3	-45.5
2% interest rate	-0.6	-3.1	-32.7
7% interest rate	-2.7	-5.2	-41.6
10% interest rate	-4.5	-6.9	-48.2

* The baseline assumes that the underlying trade deficit for goods and services plus net transfers remains at 3% of GDP from 2000 to 2005.
** The improving trade balance scenario assumes that the underlying trade deficit falls to 2% of GDP in 2000 and then gradually declines to 1% of GDP in 2005.
*** The worsening trade deficit scenario assumes that the underlying trade deficit rises to 4% of GDP in 2000 and then gradually rises to 5% of GDP in 2005.

Note: Both alternative trade balance scenarios assume a 4.25% interest rate. All alternative interest rate scenarios assume the baseline underlying trade deficit of 3% of GDP.

See Appendix for more details.

foreign currencies recover, and U.S. products become more price competitive). In this optimistic scenario, the net financial debt grows more slowly to $3.27 trillion, or 27.3% of GDP, in 2005. The total current account deficit is also more moderate in this scenario, rising only to $190.8 billion in dollar terms, and falling to 1.6% of GDP in percentage terms. If this happens, the U.S. external debt and deficits would become sustainable and a soft landing for the economy would be assured.

In contrast, the *worsening trade deficit* scenario assumes that the underlying trade deficit jumps to 4.0% of GDP in 2000 and then rises gradually to 5.0% in 2005, perhaps because foreign economies (especially in Asia, Europe, and Latin America) become more depressed or because the dollar appreciates further (i.e., foreign currencies sink even more than they have in recent years, and U.S. products become even less price competitive than they are at present exchange rates). In this pessimistic scenario, the net financial debt explodes to $5.45 trillion or 45.5% of GDP by 2005, while the current account deficit hits $750.3 billion or 6.3% of GDP—levels that would almost guarantee the outbreak of a financial panic. These simulations reveal how strongly the U.S. external financial position depends on what happens to the underlying trade balance.

Table 1 also shows the results of varying the assumptions about interest rates.[10] If interest rates fall to an average of 2.00% from 2000 to 2005 (perhaps because of central bank efforts to prevent a global depression or deflation), the growth in the U.S. net financial debt is somewhat attenuated, but this debt still rises to $3.92 trillion or 32.7% of GDP by 2005. If interest rates are increased, however (perhaps because of renewed fears of inflation or efforts to prevent currency collapses), the U.S. net financial debt rises more sharply, to $4.98 trillion (41.6% of GDP) with a 7% interest rate and $5.77 trillion (48.2% of GDP) with a 10% rate.

The impact of alternative interest rates on U.S. international debt service payments is even more striking. At the low 2% interest rate, net financial income (interest) outflows fall to $74.7 billion in 2005, slightly lower than the actual level in 1998 ($77.1 billion), even though the foreign debt continues to rise in this scenario. On the other hand, higher interest rates generate alarming increases in net interest payments, reaching $326.8 billion in 2005 at a 7% interest rate and $535.9 billion with a 10% rate (accounting for 2.7% and 4.5% of GDP, respectively).[11] Financing such large net interest outflows would put a serious squeeze on U.S. income, as it has in debtor nations in the developing world.

Thus, these alternative forecasts forcefully demonstrate the importance of reducing the U.S. trade deficit and keeping interest rates down in order to prevent explosive growth of the nation's international debt position and debt service burden, and thereby lessen the risk of a hard landing. With a reduced trade deficit and/or a lower interest rate, the U.S. foreign debt could stabilize in relation to GDP and become sustainable with moderate continued borrowing. But with increased trade deficits and/or higher interest rates, the external debt could quickly reach a level that would be likely to spark a negative reaction from international investors, and hence be unsustainable.

How investors may react

The question of the sustainability of the U.S. international debt revolves around two closely related issues. First, will confidence in the U.S. economy remain strong enough for foreigners to continue to desire to invest hundreds of billions of dollars a year in U.S. financial assets, in order to cover our annual current account deficits? And second, will foreign creditors continue to be willing to hold the large portfolios of liquid U.S. financial assets that they have already accumulated? Note that these issues mainly concern the state of investors' psychology rather than economic models of whether a given debt trajectory is theoretically stable.[12]

If foreign investors cease to extend new loans to the United States, or if they sell off their existing portfolios of U.S. liquid assets, the debt growth projected in the baseline forecast (and in the more pessimistic alternative forecasts) could not occur. By refusing to extend new credits or selling off existing assets, foreign investors could force painful adjustments on the U.S. financial sector and the domestic real economy. Moreover, it is not only the reaction of foreign investors that matters. U.S. investors could also help to precipitate a financial crisis if they decided to move more of their assets offshore (what in developing countries is known as "capital flight").[13] Of course, a flight from U.S. assets requires other attractive locations to which investors could flee. While this may seem unlikely at present, an economic turnaround in Europe, Japan, or the emerging market nations over the next few years could create one or more alternative poles of attraction for international money managers.

The notion of an eventual U.S. financial crisis may seem far-fetched at a time when the U.S. economy is the envy of most of the world. Yet recent economic history is full of episodes in which confidence in a particular economy has changed dramatically and quickly—witness the 1994-95 crash in Mexico, which followed the pre-NAFTA euphoria about the booming Mexican economy, or the rash of crises in East and Southeast Asia in 1997-98, which followed many years of touting Asia's "miracle" economies and emerging financial markets. These experiences show that spending booms fueled by overly optimistic expectations can lead to the creation of unsustainable financial positions, including speculative bubbles in asset markets and real overvaluation of exchange rates, eventually leading to a revision of expectations and an inevitable crash (see Blecker 1998, 1999).

The United States has not been immune to losses of international confidence in the past. In 1978-79, confidence in the United States plummeted, forcing the dollar to depreciate and inducing the Fed to launch an infamous experiment with high interest rates to squelch inflation at the cost of high unemployment. (These high interest rates also led to an eventual dollar overvaluation in the early 1980s, which in turn contributed to the rise in the U.S. trade deficit and the shift to net debtor status later in that decade.) Earlier, the post-World War II Bretton Woods monetary system was brought down in large measure by fears of a "dollar overhang" in Europe, which led European governments to try to convert their dollar holdings to gold in the late 1960s. This in turn helped motivate the Nixon Administration to end the convertibility of dollars into gold, abandon pegged exchange rates, and let the dollar depreciate in the early 1970s.[14]

The problem in the late 1960s was an accumulation of large amounts of U.S. dollar reserves by foreign central banks, which engendered a fear of dollar depreciation that eventually became a self-fulfilling prophecy.[15] The problem in the late 1990s is an accumulation of large amounts of U.S. financial assets of all kinds—including private holdings of stocks and bonds as well as official central bank reserves (which are largely held in the form of U.S. Treasury securities). This situation runs the risk of creating a fear of dollar depreciation that could again become a self-fulfilling prophecy, only this time not so much through the actions of foreign central banks but through those of private international investors and banks (both domestic and foreign).

Possible triggers for a crisis

Although we can clearly see the risks of such a crisis of confidence developing in the future, there remains the question of what could be the "trigger" that would set it off. One possibility is that either the current account deficit or the net international debt will become so large as to create self-fulfilling expectations of an inevitable depreciation of the U.S. dollar. In recent crises (Mexico in 1994, Thailand in 1997), current account deficits that surpassed about 5% of GDP became seen as signals of a necessary currency devaluation. The U.S. current account deficit could easily become this large, as shown in some of the more pessimistic scenarios considered above (i.e., with a larger underlying trade deficit or a higher interest rate, compared with the baseline forecast). Alternatively, a growing net financial debt—reaching over 35% of GDP by 2005 in the baseline forecast, and between 40% and 50% of GDP in some of the more pessimistic forecasts—could ring alarm bells for international investors.

What matters for foreign investors is not just the *net* U.S. financial debt but also the *gross* amount of U.S. assets that they hold in their portfolios. **Figure 3** shows the dramatic surge in

FIGURE 3

Foreign holdings of U.S. securities, 1990-98

Sources: Scholl (1998), U.S. Board of Governors of the Federal Reserve System (1999), and author's calculations.

Note: Other U.S. securities for 1998 were estimated by the author, based on the net increase in foreign-owned securities other than U.S. Treasury securities (as reported in U.S. Bureau of Economic Analysis 1999b, Table 1) and the Standard & Poor's composite stock price index (as reported in U.S. Council of Economic Advisers 1999, Table B-95, 436). The December 1997-December 1998 percentage change in the S&P index was used to estimate the increase in the value of foreign stock holdings in the United States during 1998.

foreign ownership of U.S. securities since 1995. The series for U.S. Treasury securities includes both official holdings by foreign central banks and private holdings by other foreign investors, in roughly equal proportions. The series for other U.S. securities includes corporate and other bonds as well as corporate stocks, valued at current market prices. This surge in foreign security holdings has been driven in part by the speculative expectation that these assets will rise in price (especially the stock market boom), and in part by foreign investors searching for safe havens for their wealth while their own countries are in turmoil (especially U.S. Treasury securities). The foreign holdings of nearly $1.3 trillion of U.S. Treasury securities in 1998 account for fully 35% of all Treasury obligations outstanding at that time (about double the percentage in the early 1990s).[16]

Once foreigners own such large amounts of U.S. financial assets, they need to be concerned about their value—not only in dollar terms, but also in terms of foreign currencies. If investors begin to perceive that the assets themselves are overvalued and fear a collapse of U.S. stock or bond prices (e.g., due to a decline in the New York Stock Exchange), then they will move to sell off their U.S. stocks or bonds, which will push those markets down further and depreciate the dollar in the process. If investors perceive that the dollar is overvalued, they will fear a depreciation, with the same result.

There are no hard-and-fast rules for how big a current account deficit, net debtor position, or gross foreign asset ownership has to be in order to generate self-fulfilling expectations of a currency depreciation. But it is simply inconceivable that these variables could continue to increase indefinitely without engendering such an investor reaction at some point.

Indeed, there is one sign that international investors already expect a dollar depreciation sometime in the near future: the fact that money market interest rates are higher in the United States than in most other major industrialized countries. In the first quarter of 1999, U.S. money market interest rates averaged 4.73%, while the corresponding rates in the euro area averaged only 3.09% and in Japan a mere 0.15% (International Monetary Fund 1999a, 47). According to the theory of "uncovered interest arbitrage," when the interest rate on one country's bonds is lower than that on another's, investors will be willing to hold the first country's bonds only if the lower interest rate is compensated by an expected appreciation of that country's currency.[17] Thus, the persistence of lower interest rates in Europe and Japan compared with the United States suggests that international investors expect the European currencies and the Japanese yen eventually to appreciate relative to the U.S. dollar. This is not surprising, since both Europe and (to a much larger extent) Japan have trade surpluses with the U.S.

The trigger for a U.S. external financial crisis does not have to come from its international trade deficit or rising foreign debt, however. Any problems in domestic financial markets—such as a collapse of the New York stock market or a banking crisis resulting from overlending to consumers in an economic downturn—could precipitate a loss of confidence and drive international investors overseas. But even if the external debt is not the trigger, it makes the U.S. economy more vulnerable to a loss of confidence. If confidence is lost for any reason, foreign investors will react by selling off their portfolios of U.S. assets, which will exacerbate the decline in U.S. asset markets and put downward pressure on the value of the dollar. Moreover, if foreign investors refuse to lend more, they will force the U.S. to reduce its trade deficit, either through a massive depreciation of the dollar, a painful contraction of the domestic economy, or some combination of both.

How hard a landing—and what kind?

If there is a loss of confidence in the dollar in the near or medium term, there is still a question of whether the dollar will have a "hard landing" or a "soft landing." One factor that mitigates against a hard landing is that, unlike in Mexico in 1994 and various Asian economies (plus Russia and Brazil) in 1997-99, the U.S. dollar has a floating exchange rate. In contrast, the countries that underwent currency crises over the past several years all had some kind of pegged or fixed exchange rate, which their governments vainly tried to defend when investors lost confidence and began to pull their assets out. Especially in the original crisis countries (Mexico and Thailand), the governments spent billions of dollars of hard currency reserves in failed efforts to defend their pegs, and then eventually had to devalue anyway once they were virtually out of reserves.

Since the dollar has no official target value that the U.S. monetary authorities (the Treasury Department and the Federal Reserve) are obligated to uphold, it is possible that the dollar could decline gradually, essentially reversing its ascent since 1995 in a relatively smooth fashion. In an optimistic scenario, this could engender a soft landing for the real economy as well, by restoring the competitiveness of U.S. traded goods. This increased competitiveness would help lower the trade deficit and reduce the rate of increase in the net foreign debt (as in the optimistic scenario for an improving trade balance, discussed above). An improvement in the trade balance could then help the current economic expansion to continue, if the current sources of domestic stimulus (which are mainly related to consumer spending) begin to weaken, as most analysts expect. Something analogous occurred in the 1985-89 period, when a falling dollar helped the U.S. economy keep growing after the stimulus from the increased budget deficits of the early Reagan years had worn off.

But it is important not to be lulled into thinking that such a soft landing is assured. As we move into a situation where the country that issues the world's main reserve currency has such large foreign debts, we are moving into uncharted waters. The possibility of a dramatic reversal in confidence in the U.S. economy cannot be ruled out, especially in the case of a rupture in the stock market bubble. Moreover, floating exchange rates do not always depreciate gradually, but can collapse abruptly—as the dollar did in 1985-87 and numerous other currencies have since. If self-fulfilling expectations of a dollar depreciation do break out, investors could panic and try to sell off massive amounts of U.S. assets in a hurry, thus precipitating a sharp decline in the dollar's value.

Another factor often cited as precluding an Asian or Latin American-style crisis for the United States is the fact that this country can borrow in its own currency, while other countries generally have to borrow in foreign currencies such as Japanese yen or U.S. dollars. Thus, the U.S. does not have to worry about having adequate international currency reserves or export earnings to service its debts—and in a pinch, the Fed can always print more dollars to ensure adequate liquidity for debt service. Furthermore, the fact that the United States can service its debt in dollars means that a dollar depreciation would not force the U.S. to devote an increased proportion of its national income toward servicing its existing international debts, as other countries have to do when their currencies depreciate (essentially because it takes more of their own currency to meet debt service obligations that are fixed in foreign currency terms).

While there is some truth to this argument, the ability to borrow in its own currency does not completely insulate the U.S. economy from a possible currency collapse or other adverse consequences of a loss of confidence, especially in the long run. The world's willingness to lend to the U.S. in dollars is predicated on the expectation that the dollar will maintain its value (or, as noted above, that the U.S. will offer an interest rate high enough to compensate for any expected depreciation of the dollar). If there is a loss of confidence in either the U.S. as an investment location or the dollar's ability to hold its value, foreigners may become unwilling to continue lending to the U.S. in dollars—at least, not without a major hike in interest rates or some kind of indexing of debt service to the value of the dollar. In the extreme, the U.S. could someday be forced to borrow in euros or some other foreign currency.

Moreover, the Fed would be very reluctant to print dollars to satisfy external obligations. Increasing the dollar money supply in order to facilitate external debt service would be viewed as inflationary and would therefore be likely to engender precisely the kind of loss of confidence in the dollar that the Fed would be trying to avoid. Inflating away external debts, while always a possible strategy, would be the surest way to ensure that the dollar would lose its preeminent role in the international monetary system. Thus, if the U.S. ever tries to take undue advantage of its ability to service debts in dollars, it would undermine its power to do so in the future.

The current willingness of foreigners to lend to the U.S. in its own currency thus does not avoid, and in a sense only tightens, the constraints placed upon domestic monetary policy in order to maintain "confidence" in the dollar. While other countries are more free to let their currencies depreciate in order to improve their external competitiveness and solve their payments deficits, the United States cannot allow the dollar to depreciate too much if it wants to preserve the role of the dollar as the world's pre-dominant international reserve currency and the primary vehicle for international lending activity. As a result, current international monetary arrangements can force the United States to keep the dollar at an exchange rate that is overvalued from the standpoint of balancing U.S. trade, and which therefore results in chronic large trade deficits and persistent foreign debt accumulation.

Even if the United States succeeds in avoiding a hard landing for the dollar, it may not be able to avoid one for the real economy. In fact, efforts to rescue the dollar could well backfire and make matters worse for domestic workers and firms. If the dollar starts to fall and the government wants to prevent a rapid collapse in the dollar's value, the most likely reaction would be an increase in interest rates by the Fed in order to reassure wary investors (just as the U.S. advised Mexico, Korea, Brazil, and other countries to raise their interest rates in the aftermath of their financial crises). High interest rates would be likely to slow the economy, especially by raising the costs of consumer and business borrowing and thus stemming the current rapid growth of consumption and investment spending.

If interest rates are increased, however, the existence of large debt burdens, both domestic and foreign, creates vulnerabilities that are generally ignored in standard economic models. With consumer debts rising to record levels in relation to household income,[18] a rise in interest rates would increase household debt service burdens[19] and could push financially strapped families over the edge into bankruptcy (especially if unemployment begins to rise as a result of higher interest rates). The same is true for corporations that have become highly leveraged—regardless of whether they borrowed for productive investments or for mergers, acquisitions, and buyouts. If interest rates spike upward while sales growth slackens and cash flow shrinks, highly indebted firms could become illiquid and the risk of corporate bankruptcy would increase. And if personal and business bankruptcies rise, banks that have lent heavily to consumers and corporations could be in serious trouble—as they were in the Asian crisis countries. Furthermore, the existence of complex derivative contracts and unregulated hedge funds has allowed investors to create highly leveraged financial positions that could be difficult to unwind without significant losses in the event of a general financial panic in the U.S.

Moreover, as shown earlier, higher interest rates would imply greatly increased net outflows of interest payments to foreign creditors, which would worsen the current account deficit and depress U.S. national income. Thus, the large domestic and foreign debts of the United States could potentially turn a soft landing into a hard one. This could happen if bankruptcies rise, banks fail, and domestic incomes have to be squeezed to permit greater outflows of net interest payments. Even the International Monetary Fund, while projecting a gradual slowdown of U.S. growth in its baseline forecast, and normally relatively optimistic in its outlook, warns ominously of the possibility of a hard landing for the U.S. economy:

> The willingness of foreign investors to continue financing the rapidly growing external deficit of the United States at current interest rates may not continue, in which case downward pressure on the dollar might be another cause of higher interest rates. All these factors could give rise to larger and more abrupt adjustments in private sector behavior, and a more abrupt economic slowdown, than envisaged in the baseline. (IMF 1999b, 26)

How big a "hit" could the U.S. economy take in the event of such a crisis? Some simple calculations reveal that a serious economic depression could easily result. Suppose that the U.S. was forced by a withdrawal of net foreign lending to balance its current account. Conservatively, this would require shrinking the current account deficit by 3% of GDP, or about $270 billion at current prices (given a GDP of approximately $9 trillion in 1999). Suppose further that the dollar falls only by enough to eliminate half of this gap. It can easily be estimated[20] that to close the rest of the gap (i.e., to reduce the trade deficit by $135 billion) via income adjustment, national income would have to fall by about 6% in real terms.[21] This would be an adjustment on the order of magnitude of what has been felt in crisis countries such as Brazil, Mexico, Korea, and Thailand in recent years, and much larger than the drop in output in any recent U.S. recession. That a depression of this magnitude would be needed to eliminate even half of the U.S. current account deficit via income reductions is a result of the U.S. economy's extreme openness to imports, which requires a major income squeeze to achieve a significant reduction in the volume of imports.

Is the U.S. borrowing to finance investment?

Some commentators have claimed that the growth in the U.S. foreign debt position is benign, because the United States has been borrowing to finance increased investment rather than to pay for a government budget deficit or a consumer spending boom.[22] But such a claim is mistaken on several counts. Of course, by definition U.S. international borrowing constitutes "net foreign investment" in the United States, but much of this "investment" is simply in paper assets such as stocks and bonds and does not necessarily translate into increases in productive investments in plant and equipment.

It is true that the government deficit has turned into a surplus in recent years, so that it can no longer be labeled a "twin" of the trade deficit (as it was rather misleadingly called in the 1980s—see Blecker 1992 and Morici 1997). Investment demand has been strong in the current economic expansion, but is not unusually high for this point in the business cycle. What *is* unusual about the current period is that *consumption* is abnormally high relative to national income (GDP).

As **Table 2** shows, productive investment spending (defined as gross private domestic investment in the national income and product accounts—essentially, business expenditures on plant and equipment plus new residential construction and inventory accumulation) was 16.1% of GDP in 1998, which is slightly higher than the 15.2% level recorded at the peak of the last business cycle (1989), but below the investment rates recorded at the peaks of the 1970s business cycles (17.6% of GDP in 1973 and 18.8% in 1979).[23] Consumption, on the other hand, accounted for 68.2% of GDP in 1998, and has been around 68% of GDP every year since 1993.

This is an unusually high proportion of consumption in GDP, as can be seen from the comparisons with the earlier years shown (and it is also high compared with the non-peak years omitted from the table). As a result, the private saving rate (which includes both personal and corporate saving) plummeted to 12.8% of GDP in 1998, down from 15.0% in 1989 and 17.5% in both 1979 and 1973. Indeed, as Godley (1999) notes, it is mainly the boom in consumer spending that has kept the U.S. economy growing so rapidly (and hence supported the increased demand for imports that has driven the increases in the trade deficit). At the same time, other traditional sources of economic stimulus, especially government spending and net exports, have been depressed.

As can be seen in Table 2, government expenditures on goods and services accounted for only 17.5% of GDP in 1998, the lowest level in many decades (and certainly in the 25 years covered by this table). The government budget surplus, by either of the definitions shown in Table 2, was a higher (positive) percentage of GDP in 1998 than at any time in the last 25 years.[24] Yet net exports (the trade balance in goods and services) remained in a deficit of -1.8% of GDP in 1998, while net foreign investment (the equivalent of the current account balance in the national income accounts) was -2.5% of GDP (a negative number indicating net U.S. borrowing from abroad).[25]

These data suggest the need for a serious rethinking of the conventional wisdom on the so-called "twin deficits." Back in the 1980s, it was argued that the government's increased fiscal deficit caused "crowding out" to some extent of both domestic investment and net exports (see, e.g., Branson 1985 or Dornbusch 1985). According to some proponents of the twin deficit hypothesis, mostly net exports were crowded out in the short run—due to the rise in the dollar (hence the run-

TABLE 2
Consumption, investment, government spending, the budget balance, the trade balance, and saving rates as percentages of GDP, in business cycle peak years since 1973 compared with 1998

	1973	1979	1981	1989	1998
Expenditures on:					
Personal consumption	61.6	62.3	62.3	66.1	**68.2**
Private domestic investment[a]	17.6	18.8	17.9	15.2	**16.1**
Government consumption and investment[b]	20.8	19.8	20.3	20.1	**17.5**
Government budget balance[b] as measured by:					
Surplus or deficit on current expenditures[c]	1.6	1.3	-0.1	-0.3	**2.6**
Government net lending or borrowing[d]	0.5	0.2	-1.1	-1.7	**1.7**
Trade balance as measured by:					
Net exports of goods and services	0.0	-0.9	-0.5	-1.5	**-1.8**
Net foreign investment in the U.S.	0.6	0.1	0.2	-1.7	**-2.5**
Saving rates:					
Private saving[a]	17.5	17.5	18.7	15.0	**12.8**
National saving[e]	17.9	17.8	17.6	13.3	**14.5**
Memorandum:					
Public investment[b]	3.5	3.3	3.3	3.4	**2.8**

Source: Author's calculations based on data from the U.S. Department of Commerce, Bureau of Economic Analysis, as published in U.S. Council of Economic Advisors (1999), and updated from the *Survey of Current Business*, various issues.

Notes: All variables are measured on a national income and product account basis in current dollars and expressed as percentages of gross domestic product (GDP).

[a]Investment and saving are measured on a gross basis, i.e., including depreciation ("consumption of fixed capital"). Private investment includes business fixed investment, residential investment, and inventory accumulation. Private saving includes personal saving of households plus gross corporate saving.
[b]Includes federal, state, and local governments.
[c]Current government revenues minus government consumption expenditures.
[d]Includes the surplus or deficit on current expenditures plus government depreciation ("consumption of fixed capital") minus government investment.
[e]Equals the sum of private saving and the government budget surplus (net lending).

up in the trade deficit up to 1987)—while investment was crowded out in the long run (late 1980s and early 1990s; see Feldstein 1992). The implication was that, if the federal government balanced its budget, the trade deficit would disappear and private investment would boom. The data in Table 2 show that after the emergence of government budget surpluses in the late 1990s, the promised "crowding in" of domestic investment and net exports did not occur. The investment rate was slightly higher in 1998 compared with 1989, but the trade deficit was also larger, and the most notable change between these two years is the boom in consumption spending.

Of course, U.S. borrowing from abroad does allow us to *maintain* current levels of investment spending in spite of the decline in the private sector saving rate. However, these data show that U.S.

international borrowing has *not* financed a significant increase in the investment rate, but rather has permitted a striking increase in the *consumption* rate, contrary to what is claimed by those who view the U.S. trade deficit as benign.

However, even if the United States were borrowing more for investment and less for consumption, this would not necessarily preclude a future financial crisis. An investment boom that rested on excessive accumulation of foreign debt could still be unsustainable in the long run. Borrowing for investment purposes is no guarantee of future stability, as the Asian crisis amply demonstrated. Thus, the consumption-led boom is not a problem simply because it is consumption led, but rather because it rests on the fragile foundations of wealth effects (the stock market bubble) and increased borrowing (rising consumer debt at home and rising international debt to make up for the domestic saving shortfall), neither of which can persist indefinitely.

Policy implications

The rising trade deficit and international debt of the United States are sustainable only as long as foreign investors are willing to continue lending this country the hundreds of billions of dollars annually required to cover the underlying trade deficit and service the increasing foreign debt. This dependency on international borrowing makes U.S. policy making vulnerable to the decisions of both domestic and foreign investors about whether they want to keep their funds pouring into U.S. financial markets or prefer to send those funds elsewhere. Moreover, the projections in this paper show that in just a few years, under a range of plausible assumptions, the U.S. external debt burden could rise to a level that would be likely to alarm financial investors and cause a sudden withdrawal of funds from U.S. financial markets and dollars. In that event, confidence in the U.S. dollar would plummet, and the United States would be forced to accept a major dollar depreciation or to raise interest rates sharply to prevent one. Either way, the U.S. economy could be put through a painful economic contraction.

The issue, then, is not whether the U.S. can sustain large increases in its foreign debt position, but rather when and how the country will make the adjustments needed to correct the underlying problems. The worst-case, hard-landing scenarios do not have to happen if policy measures are taken soon to prevent them. Just as the Federal Reserve's interest rate cuts in the fall of 1998 helped to stabilize global financial markets and to prevent a U.S. recession, additional policy interventions both in the U.S. and abroad could help to slow down the growth of the U.S. foreign debt and prevent a future financial meltdown. But time is growing short, and—as recent experiences in Asia and elsewhere show—the longer action is delayed, the more difficult it can be to prevent a major economic downturn once a financial crisis erupts.

As the simulations in this paper reveal, alleviating the U.S. international debt burden requires action on two fronts: reducing the trade deficit in order to lessen the need for future borrowing, and keeping interest rates low in order to reduce the burden of servicing the debt. While there is no magic cure for U.S. indebtedness, there are several measures along these lines that could help to ensure a "soft landing" and avert a serious crisis over the next few years:

- First, the U.S. cannot act alone, and it cannot continue to serve as the world's "consumer of last resort" indefinitely. Thus, significant domestic stimulus policies are needed in our major trading partners with depressed economies: Europe, Japan, other Asian countries, and Latin America. This is a win-win strategy, which will benefit our trading partners and relieve trade tensions by boosting their growth and reducing their surpluses with the U.S. Without such foreign demand expansion, it will be much harder for the United States to reduce its trade deficit at a socially acceptable cost. The types of stimulus policies that are needed vary from country to country. In Europe and Latin America, standard monetary and fiscal stimuli would probably suffice (although in Latin America, debt relief would also help). In Japan and other Asian countries, structural reforms to increase consumption and liberalize imports are also necessary.

- Second, the dollar needs to come down gradually to a level that is more consistent with balanced trade. Engineering a gradual depreciation rather than a collapse will not be easy, but keeping interest rates low and cutting them further would be useful for this purpose as well as to mitigate the debt service burden. Recovery in Europe, Japan, and other areas would also help by boosting confidence in their economies, thus sparking appreciation of foreign currencies. In the long run, target zones with crawling bands should be used to stabilize the dollar's value at a lower level (Blecker 1999). Capital controls and foreign exchange restrictions (such as a "Tobin tax" on currency transactions) could be used to prevent speculators from pushing the dollar down too far, too fast. However, if there is a loss of confidence and the dollar falls—and especially if international cooperation has been lacking—it would be better to let the dollar drop than to raise interest rates through the roof and sacrifice jobs and incomes to maintain a strong currency. If a hard landing is unavoidable, it is better to have one for the dollar than for the real economy.[26]

- Third, raising the incomes of U.S. workers and reducing economic inequality could help by allowing families to finance their consumption expenditures more out of current income and with less borrowing, leading to a recovery of the personal saving rate. This in turn would require labor market policies such as strengthened minimum wage laws and union organizing rights, as well as a commitment by the Fed not to raise interest rates and slow the economy in response to workers' gains (see Palley 1998). In addition, when the consumption boom slows down, as it inevitably will, the U.S. government needs to be prepared to use a fiscal stimulus (such as an increase in public investment spending); trying to preserve a budget surplus in a slowing economy would be a recipe for turning a mild recession into a severe, 1930s-style depression. Tax cuts are less preferred than government investment spending, since they would probably only boost consumption and contribute to further shrinkage of the public sector in the future.

- Fourth, U.S. trade policies need to be reoriented to promote more reciprocal market access. These policies should stress the interests of U.S.-based producers exporting abroad rather than the rights of U.S. multinational firms investing abroad, especially when the latter are investing in

> export platforms targeting the U.S. import market or in sales of goods produced in third countries. For example, U.S. trade negotiators should be more concerned about steel than bananas, and more concerned about labor rights than intellectual property rights. New and more effective methods of stemming import surges should be instituted, instead of relying on the time-consuming and legalistic anti-dumping laws. And the U.S. needs to stop signing trade agreements that do more to help U.S. businesses operating abroad than to help U.S. workers seeking good-paying jobs at home.

If these kinds of policies are not adopted by the U.S. and its trading partners, the debt bomb will keep ticking, eventually going off with unpredictable consequences both at home and abroad.

June 1999

Appendix

The projections of the U.S. net international investment position and net investment income in this paper are based on a simple dynamic model of the current account balance and net international borrowing or lending. The current account balance for each year t (CAB_t) is determined by

(A1) $CAB_t = TB_t{*}GDP_t + INVINC_t$

where TB_t is the (assumed) ratio of the "underlying" trade balance (for trade in goods and services plus net transfers) to GDP, GDP_t is the (projected) nominal gross domestic product, and $INVINC_t$ is the total net investment income balance of the country, for each year from 2000 through 2005 (the treatment of 1998 and 1999 is discussed separately below). The net financial investment position ($NETFIN_t$) for each year is assumed to change by the amount of the current account balance, i.e., the entire net borrowing required to cover the current account deficit is assumed to be done through the accumulation of financial debt. Thus,

(A2) $NETFIN_t = NETFIN_{t-1} + CAB_t$

Net financial income (interest and dividend) payments ($FININC_t$) are assumed to be paid at a given interest rate each year (INT_t) on the average level of net financial assets or debts for the year, which is simply the mean of the current and one-year lagged net financial position:

(A3) $FININC_t = INT_t{*}0.5{*}(NETFIN_t + NETFIN_{t-1})$

The total net investment position ($NETINV_t$) is determined by the identity:

(A4) $NETINV_t = NETFIN_t + NETDIR_t + GOLD_t$

where $NETDIR_t$ is the net direct investment position and $GOLD_t$ is the value of U.S. gold reserves. Finally, by another identity, total net investment income ($INVINC_t$) equals the sum of the financial net income ($FININC_t$) and direct net income ($DIRINC_t$):

(A5) $INVINC_t = FININC_t + DIRINC_t$

Using exogenously set forecasts for TB_t, GDP_t, INT_t, $NETDIR_t$, $GOLD_t$, and $DIRINC_t$, as well as an initial lagged value of $NETFIN_{t-1}$, these five equations solve for the time paths of the five endogenous variables CAB_t, $NETFIN_t$, $NETINV_t$, $FININC_t$, and $INVINC_t$. Note that since each year's value for $NETFIN_t$ depends on itself (since $NETFIN_t$ depends partly on interest payments that are a function of current $NETFIN_t$), the model has to be solved using an iterative procedure (which was done using the Excel spreadsheet program).

The exogenously forecast variables are specified as follows. We assume that the underlying trade balance is a deficit of 3% of GDP for 2000-05 (i.e., $TB_t = -.03$) in the baseline scenario, and then vary this percentage for the alternative trade balance scenarios as discussed in the text. This baseline assumption is consistent with current predictions about the level of the U.S. trade deficit for the next few years. We assume that nominal GDP grows at a 5% annual rate each year, starting from the actual 1998 level (i.e., $GDP_t = 1.05^* GDP_{t-1}$), since the actual growth rate of nominal GDP has been approximately 5% in the last few years.

The interest rate is set at 4.25% in the baseline scenario ($INT_t = .0425$), which is approximately the mid-range of the implicit "interest rate" on U.S. international financial assets and liabilities over the past few years (actually, this "interest rate" includes both interest on bonds and bank deposits and dividends from corporate stock and other securities). This rate is determined by taking the gross inflows and outflows of financial investment income as proportions of the stocks of international financial assets and liabilities, respectively. This method yields the following implicit interest rates (in percent) for the last four years for which complete data are available:

Implicit interest rate on:	1994	1995	1996	1997
U.S. financial assets abroad	4.16	4.72	4.15	4.22
Foreign financial assets in the U.S. (U.S. liabilities)	4.48	4.70	4.27	4.28

Source: Author's calculations based on data in DiLullo (1998) and Scholl (1998).

A 4.25% interest rate is assumed in all scenarios for 1999; alternative interest rates are assumed for 2000-05 in the other interest rate scenarios as discussed in the text.

Since U.S. gold reserves are essentially constant in real terms at approximately 261.6 million fine troy ounces, their value varies only as a result of fluctuations in gold prices. We used the actual decrease in the market price of gold from \$290.20 at year-end 1997 to \$287.80 at year-end 1998 (International Monetary Fund 1999a, 42), to estimate the value of U.S. gold reserves at \$75.3 billion for 1998. For 1999, based on a report in the *Financial Times* (June 9, 1999, 26), which forecast a price in the range of \$250-\$275 per ounce by the end of 1999, we used the mid-range forecast of \$262.50 to estimate the value of U.S. gold reserves at \$68.7 billion for this year, and then assumed that this value remains constant for 2000-05.

For the net direct investment position ($NETDIR_t$) and net direct investment income ($DIRINC_t$), we make *ad hoc* forecasts based on extrapolation from recent trends (see Figures 1 and 2). For the position, we start with the actual net direct investment position of +\$272.0 billion at year-end 1997 and subtract the actual net direct investment inflow of \$60.5 billion for 1998 (from U.S. Bureau of Economic Analysis 1999b) to get +\$211.5 billion at year-end 1998 (ignoring valuation adjustments, which tend to be minimal for direct investment measured at current cost). Actual net direct investment flows have been quite variable in recent years, with net inflows in some years and net outflows in other years, and are hard to predict *ex ante*. We therefore assume that the net direct investment position levels off at +\$200 billion in 1999 and remains constant at that level through 2005. Direct investment income also fluctuates, depending on levels of economic activity and rates of return at home and abroad and on the exchange rates at which U.S. investment income from abroad is converted into dollars. Actual net direct investment income fell from \$63.7 billion in 1997 to \$54.7 billion in 1998 as a result of the economic slowdown abroad and the fact that most other currencies depreciated against the dollar. We assume that net direct investment income is \$55.0 billion in 1999, increases by \$2 billion each year from 2000 to 2002, and then increases by \$1 billion each year from 2003 to 2005, thus recovering to \$64.0 billion (or approximately its 1997 level) by 2005.

The complete model as specified in equations (A1) to (A5) is used for the years 2000-05. For 1998 and 1999, the model is modified to take account of the additional information that is available for these years. For 1998, the actual level of net investment income (total, direct, and financial) is available from the balance of payments statistics. These actual data are therefore used for $INVINC_{98}$, $DIRINC_{98}$, and $FININC_{98}$, and equation (A3) is not used for 1998 (although it is used for 1999). Also, we do not use equations (A1) and (A2) for 1998 or 1999. For 1998, actual balance-of-payments data can be used to determine how much the net financial investment position increased over the previous year. U.S. net financial inflows for 1998 were $149.3 billion, including both official and other financial assets (but excluding direct investment).[27] Again ignoring valuation adjustments (since fluctuations in stock markets in the U.S. and abroad were highly correlated in 1998, and therefore changes in values of domestic and foreign stocks roughly cancel out, and the dollar did not substantially rise or fall in value between December 1997 and December 1998), we therefore compute the net financial position for year-end 1998 as $NETFIN_{98}$ = $NETFIN_{97}$ - $149.3 billion. For 1999, we assume that net financial inflows are $300 billion, i.e., $NETFIN_{99}$ = $NETFIN_{98}$ - $300 billion.[28]

Endnotes

1. The likely growth in the U.S. net international debt over the next several years is projected using currently available information about the U.S. balance of payments, the value of the dollar, and asset market conditions in 1998-99, as well as by extrapolating from current economic conditions and forecasts. The baseline scenario assumes that the underlying deficit for trade in goods and services plus net transfers equals 3% of the gross domestic product from 2000 through 2005. However, the total current account deficit (and thus the amount of net international borrowing) is larger than this underlying trade deficit because it also includes the net outflow of investment income (interest, dividends, etc.). The assumptions about the trade deficit and international borrowing for 1998 and 1999 are based on currently available data and forecasts and are discussed in detail in the Appendix. The baseline scenario also assumes that GDP grows by 5% per year in nominal terms and that the interest rate on international financial assets and liabilities stays at 4.25% from 1999 through 2005.

2. The U.S. net debt increases by the amount of net borrowing from abroad during each year, which should in principle equal the current account deficit. However, in practice there are always "statistical discrepancies" in the actual balance-of-payments statistics. Also, adjustments are made each year for the effects of changes in asset values (especially stock market share prices) both at home and abroad, as well as for the effects of changes in foreign currency values on the dollar value of U.S. assets abroad.

3. All U.S. international debt data used in this paper are taken from Scholl (1998). The net debt figure cited here includes direct foreign investment (DFI) valued at current cost, i.e., the replacement cost of the investment goods (plant and equipment) owned by U.S. firms abroad and by foreign firms in the United States. The Department of Commerce also reports a series that includes DFI valued at market value, i.e., the stock market value of corporate equity in each country. The latter measure fluctuates much more in the short run, due to the volatility of the stock market indexes used to measure the market value of DFI. Thus, we prefer to use the series with DFI valued at current (replacement) cost, which is more stable over time and better reflects a country's long-term DFI position. All data used in this paper include DFI at current cost where relevant.

4. U.S. gold reserves, although technically included as an international asset for the United States, cannot legally be sold to service other U.S. obligations, and are therefore irrelevant to the ability of the U.S. to service its debts. DFI is usually based on long-term competitive strategies of multinational business firms and—as recent experiences in Latin America and East Asia have demonstrated—is usually not liquidated during a financial panic. Hence, DFI can also be regarded as illiquid and should be excluded in calculating the financial debts of the United States.

5. All debt or credit figures cited are measured at the end of the year. In contrast, the figures for net investment income flows, discussed below, are measured for entire calendar years. These are standard procedures for measuring financial variables—stocks of assets or liabilities are measured at a point in time, while financial flows are measured over periods of time.

6. Some analysts suspect that the magnitude of the net inflow of direct investment receipts may be exaggerated by the fact that foreign multinationals in the United States are more likely to take their profits out in the form of high transfer prices for inputs sourced from their home countries, while U.S. multinationals are more likely to bring their foreign profits home in the form of explicit accounting profits. If this suspicion is true, the upward bias this imparts to the investment income balance is exactly matched by a downward bias to the trade balance, with no net effect on the current account as a whole. See Godley and Milberg (1994).

7. All balance-of-payments data used in this paper are taken from DiLullo (1998) and the Department of Commerce's international transactions statistical release of March 11, 1999 (U.S. Bureau of Economic Analysis 1999a), except as otherwise noted. Major revisions to the U.S. international transactions accounts for 1982-98, released on June 17, 1999 (in U.S. Bureau of Economic Analysis 1999b), were issued too late to be fully incorporated in this paper, but information from the latter release was used in the forecasts as cited in the Appendix.

8. Net transfers are unrequited inflows and outflows of funds, such as foreign aid and private remittances (e.g., funds sent to relatives overseas by immigrants). In 1998, the United States had a net transfers deficit of $41.9 billion, in addition to a goods-and-services deficit of $169.1 billion and a net investment income deficit of $22.5 billion.

9. An interest rate of 4.25% is assumed as the baseline because the implicit interest rates on U.S. international financial assets and liabilities have mostly been in the range of about 4.00% to 4.50% for the last several years (see Appendix), and thus this rate represents a continuation of current interest rate policies at home and abroad.

10. All of the alternative interest rate scenarios assume that the interest rate is 4.25% in 1999; the scenarios differ in what they assume for 2000-05. All of these scenarios also assume the same underlying trade deficit for the United States (3% of GDP) as assumed in the baseline, although the total current account deficits are larger because they include the net outflow of investment income.

11. Note that these forecasts ignore other effects of changes in interest rates (e.g., effects on demand and income) and their repercussions for the trade balance, effects that would have to be incorporated in a more complete model. In particular, high interest rates would probably stifle growth or cause a recession, which in turn would reduce the underlying trade deficit and thus ameliorate the increase in the debt.

12. As discussed in more detail in Blecker (1999), new economic theories recognize that self-fulfilling expectations of investors can cause an economic situation to be unsustainable even if it would be sustainable under a different (i.e., more optimistic) set of expectations. These theories have been confirmed by recent experiences in the Asian financial crisis, in which "contagion effects" caused collapses of some currencies that did not otherwise have to be devalued (or which might have required more modest devaluations without the speculative attacks). Of course, when an economic situation is truly unsustainable, smart speculators will perceive this, often forcing sharp corrections in advance of when they would occur in the absence of the speculation.

13. In recent financial crises, such as those in Mexico in 1994 and Thailand in 1997, it was often domestic investors who led the rush to the exits, since they were the most aware of their countries' problems.

14. Another motive was the rise of U.S. merchandise trade deficits, which prompted a belief that the dollar was overvalued in the Bretton Woods system of adjustable exchange rate pegs.

15. This problem was known as the "Triffin dilemma," after Triffin (1960), which has been described as follows in Caves et al. (1990):

> If the United States was allowed to continue running [overall] balance of payments deficits, eventually there would be a crisis of confidence, as foreigners all tried to cash in their dollars for gold before it was too late, and thereby exhausted the U.S. gold reserves. On the other hand, if steps were taken to end the U.S. deficit, then the rest of the world would be deprived of sufficient liquidity in the form of a steadily growing stock of [dollar] reserves. (480)

16. Calculated by the author using data from U.S. Board of Governors of the Federal Reserve System (1999, Table L.209).

17. Econometric evidence suggests that strict uncovered interest parity (interest rate premiums equal to expected rates of depreciation) does not generally hold (see Blecker 1998 for discussion and citations). However, the measurement of exchange rate expectations is a problem in all such studies, and there is still a presumption that interest rate differentials at least reflect the expected *direction* of exchange rate changes.

18. According to Mishel et al. (1999, Table 5.12, 275), total household debt (both consumer and mortgage debt) as a percentage of personal income climbed from 57.6% in 1973 to 84.8% in preliminary data for 1997. At the same time, the household debt *service* burden rose only from 15.5% of disposable income in 1973 to 17.0% in 1997, due to low interest rates and more generous repayment terms (e.g., longer-term mortgages). See also International Monetary Fund (1999b, Figure 2.18, 103), which gives similar figures.

19. This problem would be mitigated by the existence of long-term consumer debt with fixed interest rates, especially mortgage loans. Only consumers with flexible-rate loans or who take out new loans would be affected by the higher rates. However, if interest rates spike upward, the value of securitized fixed-rate mortgages could plummet, which could wreak havoc in financial markets.

20. This estimate also assumes that foreign income stays constant, so that exports are unchanged, and that the income elasticity of import demand is approximately 2 (i.e., imports rise by 2% for every 1% increase in income). Many studies have found income elasticities of import demand for the U.S. over 2 (see Blecker 1996). However, most of these studies include only merchandise imports or some subset thereof (often, non-petroleum imports, and sometimes non-computer, non-petroleum imports). With imports of all goods and services included, the income elasticity is likely to be somewhat lower, and we use 2 as a ballpark figure.

21. Using the advance gross domestic product estimates for the first quarter of 1999, the chain-type price index for imports of goods and services is 89.1 (=100 x (1,154.0/1,295.0), where nominal imports are $1,154.0 billion and "real" (1992 dollar) imports are $1,295.0 billion). Dividing $135 billion by 0.891 yields $151.5 billion in 1992 dollars, which is 11.7% of $1,295.0 billion. With an income elasticity of 2 (see previous note), real income needs to fall by ½ of 11.7%, or 5.9%, in order to reduce real imports by $151.2 billion. Data are from *Survey of Current Business* (May 1999, Tables 1.1-1.2, D-2).

22. See, for example, the statements of Gary Hufbauer, Richard N. Cooper, Claude Barfield, Isaiah Frank, and Daniel T. Griswold in the *International Economy* (1999), who state slightly different versions of this proposition. However, other individuals in that symposium express views closer to those argued here (especially Martin Feldstein, Clyde Prestowitz, Ulrich Ramm, and Charles P. Kindleberger).

23. Those who claim that investment has been unusually high in recent years generally cite data on "real" investment at chained 1992 prices, rather than the current price data used here (see, e.g., U.S. Council of Economic Advisers 1999, 69-73). The "real" data do show higher investment rates: in real terms, the share of gross private domestic investment in GDP rose to 17.6% in 1998, up from 14.2% in 1989 and 15.2% in 1973. But this appearance of an increased "real" investment rate is due entirely to the fact that prices of investment goods have been rising more slowly than prices of consumer goods (and some investment goods—especially computers and other electronic products—have fallen in price). While this increase shows that business firms spending on productive investment are getting relatively more bang for their bucks, compared with consumers, it does not gainsay the fact that such investment spending has not increased as a share of total domestic expenditures when measured at current prices.

24. Note that this increase in public sector saving has not been matched by an increase in public investment; on the contrary, at only 2.8% of GDP in 1998 (see Table 2), public investment has shrunk to its lowest level in more than a generation. This dramatic contraction of the public sector's role in the economy is a direct result of the obsession with balancing the federal budget and shrinking the size of government, and is leading to emerging shortfalls of public investment in many areas (see Palley 1998).

25. These were not the largest trade deficits in the period covered by Table 2; both peaked in 1987, when net exports were -3.0% of GDP and net foreign investment was -3.3% (not shown in the table, since 1987 was not a business cycle peak year).

26. This is analogous to Jeffrey Sachs' argument (e.g., in Sachs 1999) that Russia, Brazil, and the East Asian countries should not have used high interest rates in efforts to keep their currencies from depreciating.

27. In the newly revised balance-of-payments data in U.S. Bureau of Economic Analysis (1999b), what is now called the total "financial account" balance for 1998 was +$209.8 billion; subtracting net direct investment inflows of $60.5 billion yields net financial inflows (as defined in this paper, i.e., for liquid assets) of $149.3 billion.

28. The total projected net capital inflow for 1999 is slightly larger due to the assumed net direct investment inflow of $11.5 billion, implying a total current account deficit of $311.5 billion or about 3.5% of GDP (which we project to be $8,936.6 billion). This is consistent with current projections that the U.S. current account deficit will be 3.5% of GDP in 1999 (IMF 1999b, Table 2.6, 67).

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TESTIMONY

By

Dr. Simon J. Evenett
Rutgers University and The Brookings Institution

before

United States House of Representatives

Committee on International Relations
Subcommittee on International Economic Policy and Trade

On

July 22nd, 1999

The U.S. Trade Deficit: Are we Trading Away our Future?

Simon J. Evenett[1]
Rutgers University and Brookings Institution

Summary

Misconceptions abound about the U.S. trade deficit. They lead to policy recommendations which would not only hurt the U.S. economy, but also undermine America's standing in the world. Falling private U.S. savings rates have fueled the current consumption boom—and the surge in imports—and is the real cause of the current U.S. trade deficit. Encouraging private savings, especially as so many Americans are nearing retirement, is good public policy and will—as a byproduct—reduce the trade deficit too.

To sort out the debate over the U.S. trade deficit, this testimony uses several graphs to make four points:

- Trade deficits don't mean economic malaise.
- The U.S. trade deficit is not caused by closed foreign markets.
- In the current U.S. boom the trade deficit and job creation go hand in hand—the same factors cause both.
- Plummeting U.S. private savings is the real policy headache—for reasons more important than its effect on the U.S. trade deficit.

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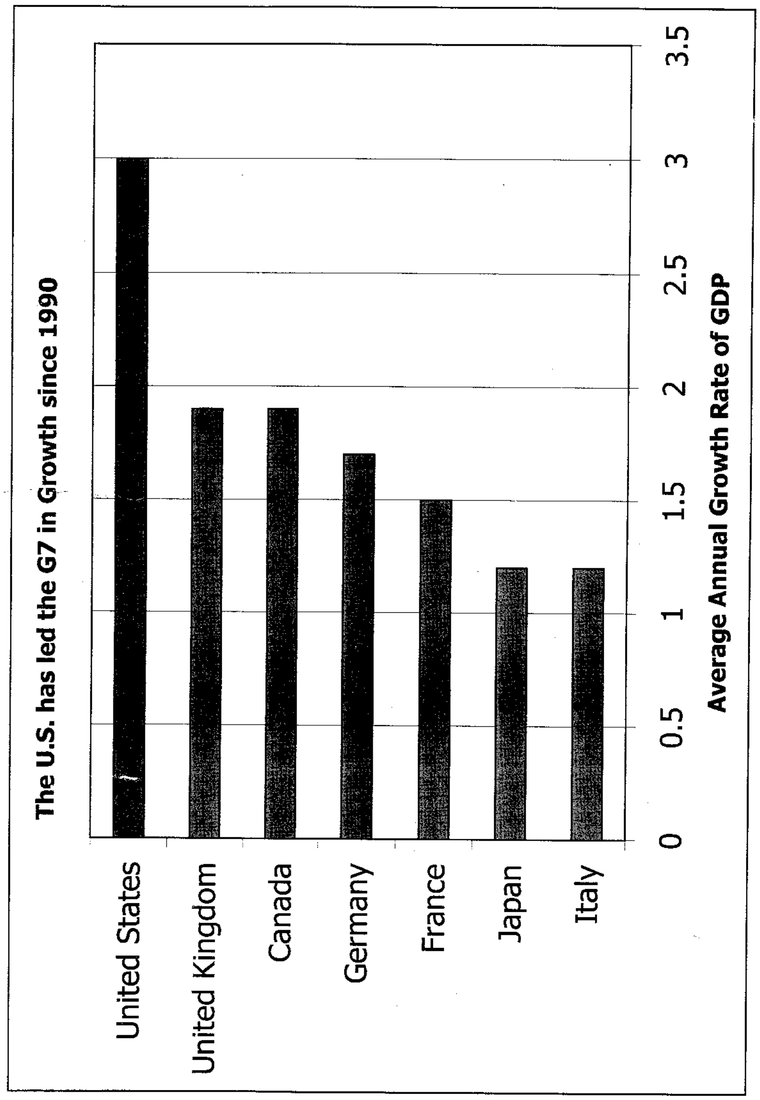
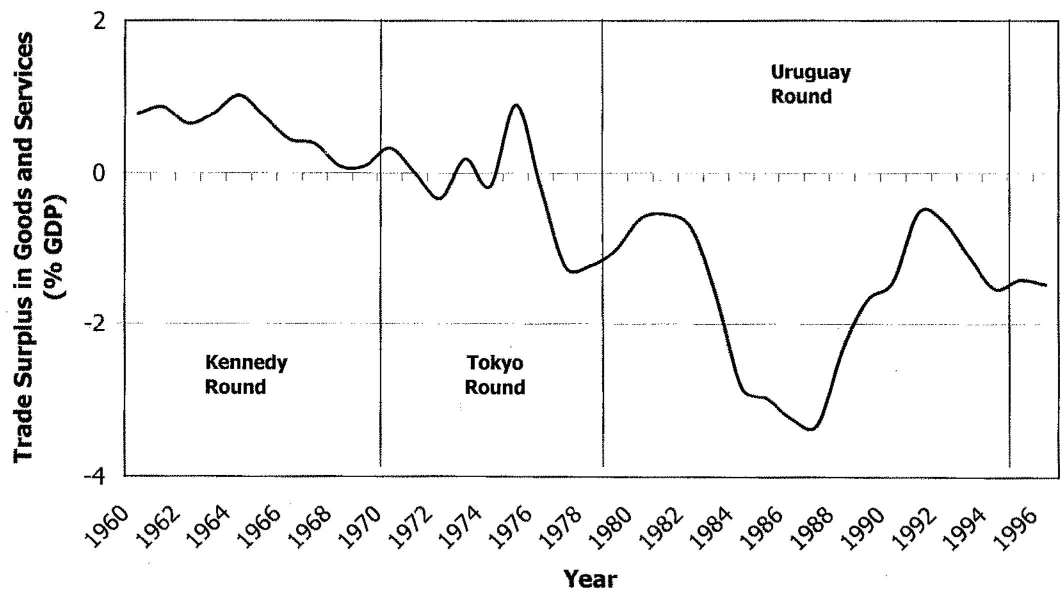
First Point: Trade Deficits don't mean economic malaise.

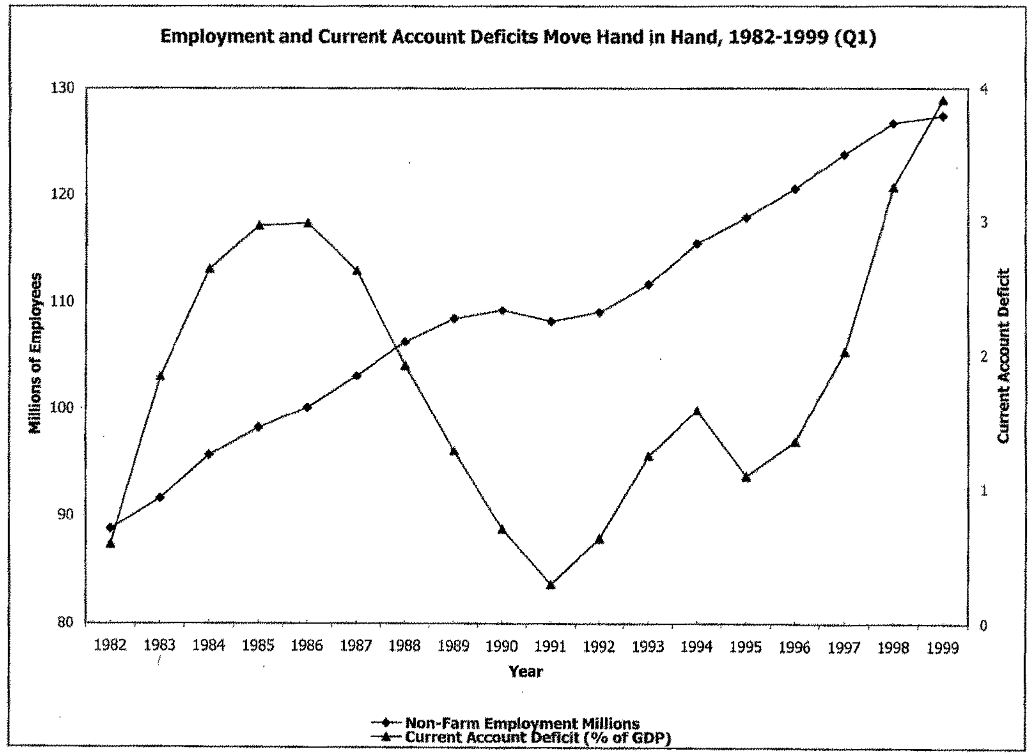


Second Point: The U.S. Trade Deficit is not caused by closed foreign markets.

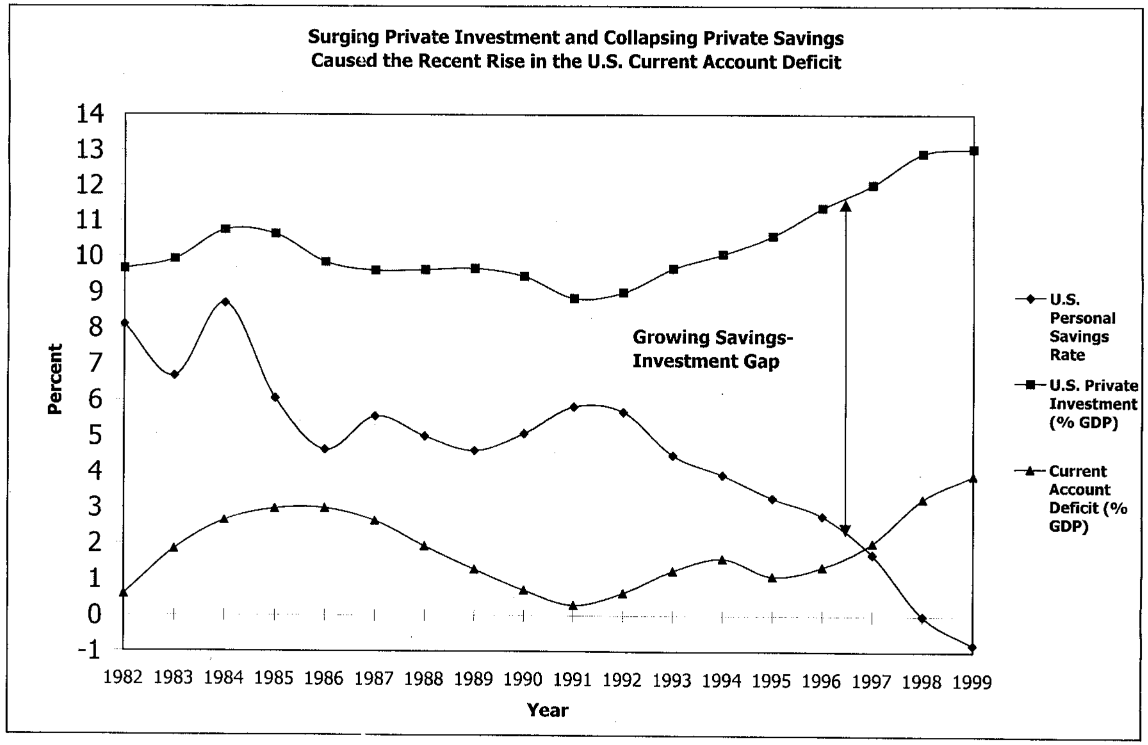
Rewriting History:
The U.S. Trade Deficit has Grown as Foreigners have Lowered their Trade Barriers, Not the Other Way Around



Third Point: In the current U.S. boom the trade deficit and job creation go hand in hand—the same factors cause both.



Fourth point: Plummeting U.S. private savings is the real policy headache--for reasons more important than its effect on the U.S. trade deficit.



Data on non-residential private investment is the measure of U.S. private investment reported here.

Simon J. Evenett

Simon J. Evenett is currently a member of the core team drafting the World Development Report 1999/2000, *Entering the 21st Century: The Changing Development Landscape.* He is the principal author of the chapters on the world trading system and global financial matters, reflecting his long standing interests in international economic policymaking. He holds a Ph.D in economics from Yale University and a B.A. (Hons) from the University of Cambridge.

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Dr. Evenett's current research is into the U.S.-E.U. cooperation into competition policy, the economic effects of government procurement policies, antidumping policies as well as the rigorous evaluations of theories of international trade. At the moment he is preparing two edited volumes for publication, one on development policy in the next century and the other on cooperation in competition policy.