This seems to be the year for anyone who spent any time inside the Reagan White House to reveal his experiences to the public. Bill Niskanen's book is a model of objective reporting and analysis -- in contrast to the sometimes self-serving (if revealing) "kiss-and-tell" remembrances of some others. My own position at the Council of Economic Advisers was a much less lofty one, but I will begin my remarks with a story from this period. It regards the trade deficit, which I take to be a central theme of this session.

The month is January 1984. The United States in 1983 has just racked up a trade deficit of $67 billion -- double the level of 1977-78, which had itself been a record at that time. In the draft of the international chapter of the Economic Report of the President [or, more precisely, the report of the Council of
Economic Advisers], I make a forecast that the trade deficit would reach about $110 billion in 1984, and would continue to deteriorate thereafter. The Treasury says that the discussion of the trade deficit is too pessimistic; then-Secretary Don Regan tells CEA Chairman Martin Feldstein that if the chapter is not rewritten in a more optimistic way, he will tell the President not to sign the report. We make some minor concessions in language, but keep the basic analysis and predictions. The Report goes to Congress. Secretary Regan, in testimony before a Senate Committee, is asked to reconcile the CEA's pessimistic outlook with his own view that things couldn't be better, and in a widely-quoted answer, says that as far as he is concerned the Senators can take the Report and throw it in the wastebasket.

Perhaps it is unseemly of me to be proud of that episode. But I am; and a major reason is that the trade deficit did indeed exceed $110 billion that year [$113 billion], and did indeed continue to deteriorate thereafter. In 1987 the deficit reached $160 billion, equal to 3 1/2 per cent of GNP. That episode four years ago probably made me more confident than I should have been of the possibility of forecasting the trade balance with standard macroeconomic equations. But I am going to talk some about the recent history and current outlook for the U.S. trade deficit; then I will address the debate over American "competitiveness," and possible remedies.

Our forecast in January 1984 that the trade balance would
continue to deteriorate was largely based on the tremendous real appreciation of the dollar during the years 1981-1984, making U.S. exports more expensive on world markets, and making imports cheaper for American consumers. There were, to be sure, other factors, such as the loss of $20 billion of net exports to Latin America after the debt crisis hit in 1982, and the fact that U.S. income growth was more rapid in 1983-84 than growth among other industrialized countries, so that our imports from them grew faster than their imports from us. But the standard trade equations say that the dollar explains the majority of the 1980-84 deterioration in the trade balance, and that it explains virtually all of the continued deterioration in 1985.

There is a popular alternative view, to the effect that the trade deficit is explained by barriers to our products that Japan and other countries have put in place, that the United States is the only "open market," and that we are patsies by continuing to play by the rules of free trade while no one else does so. Every aspect of this view is wrong. The point that economists like to make is that, even if other countries are "cheating" on the rules of free trade, the we are in theory better off if we resist the urge to put up barriers of our own; for example, if they are subsidizing exports, we should just sit back and happily consume the cheap imports. But in the current context, more appealing arguments can be made.

The fact is, other countries' trade policies do not explain
the U.S. trade deficit, because the $130 billion deterioration in
the trade balance has come entirely since 1980.\footnote{1} During that
period, government trade barriers in Japan and some other major
trading partners have been lowered rather than raised. I will go
so far as to make the unheard-of statement that Japanese policies
are among the least protectionist in the world.

There are exceptions of course. Rice is probably the most
glaring example. But then most industrialized countries are very
protectionist when it comes to agriculture, and it was originally
the United States who decided that agriculture should be exempted
from free trade under the General Agreement on Tariffs and Trade
(GATT: the place where the rules of free trade were written down
after World War II). [No doubt there are other exceptions as
well.]

Some studies of Japanese trade find that Japan imports a
"normal" share of manufactured goods.\footnote{2} Others, such as a recent
one by Bob Lawrence, find that Japan imports less than a "normal"
share of manufactured goods. But (to my knowledge), no studies
find that Japan imports less than a normal share \textit{because of
protectionist policies on the part of the Japanese government.}
The usual claim is, rather, that Japanese consumers, retailers,
and corporate purchasing agents discriminate against foreign
products for engrained cultural reasons.

\footnote{1} Furthermore, the deterioration in the trade deficit has
been spread fairly uniformly across trading partners.

\footnote{2} Given its need to import agricultural and mineral
products, and its remote geographical location.
Obviously, the Japanese are very fussy when it comes to quality, and -- when other things are equal -- they often prefer their own products for this reason (which is the same reason that American consumers often prefer Japanese products). Beyond the quality issue, I am not sure whether Japanese discriminate against our products or not. I know from my visits there that American culture and brand-names are extremely popular in Japan. But let us say that Japanese citizens do have an innate predisposition against foreign goods. There is nothing in such a predisposition that would violate any agreed-upon rules of international trade. Only if the Japanese government were explicitly or implicitly encouraging such discrimination would it conceivably violate any rules. The Japanese government, to the contrary, has run public relations campaigns to try to persuade their people to buy more imports. Such campaigns generally have no more effect than Bob Hope "Buy American" campaigns do in the United States: people usually buy what they want to buy. But the point is that the Japanese government is not currently violating the rules of free trade on any substantial scale, or so it seems to me.³

Instead, it is the U.S. government that has in the 1980s moved substantially in the direction away from free trade, in

³ To make an analogy, in some Moslem countries there is a cultural bias against Western materialism. If consumers in such countries choose not to buy American designer jeans (with no prompting from their government, let us say), we may deplore this bias, but we would not label it protectionism or a departure from the internationally agreed-upon rules of free trade.
such areas as autos, steel and semi-conductors. Let us spend a moment on semi-conductors, because it is an important industry for this region, as it is for my own native California. In 1986 the Administration succumbed to the semi-conductor industry's charge that Japanese chip-producers were not playing on "a level playing field." How do we tell that they are not playing on a level playing field? The same way we always do: if they are doing better than we are, then the playing field must not be level. (Of course this is the way we tell if one team is cheating in a football game: if they are winning, then they must be cheating!)

The Commerce Department negotiated an agreement whereby the Japanese agreed not to dump chips in the U.S. market. "Dumping" was originally defined in the GATT as selling your product in the foreign market for a lower price than in the home market. But in the 1970s we unilaterally changed the definition of dumping, so now it is selling in the U.S. market at a price lower than a mysterious formula that the Commerce Department computes. [The formula is supposed to represent foreign "cost," but it sometimes looks more like the price at which American manufacturers would prefer to compete.]

In any case, the Japanese signed the agreement. My impression is that it has worked to the detriment of the American

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4 Under the GATT, only if there is no home market are prices in third markets, or costs, supposed to be used.

5 The formula uses full cost rather than marginal cost, and adds on an 8 per cent profit margin.
electronics industry, rather than the benefit. But an aspect that intrigues me is the public reporting on Japanese compliance. In 1987, the United States accused the Japanese of not fully living up to the 1986 agreement. We acknowledged that they were now charging a sufficiently high price in the U.S. market, but we accused them of selling at a lower price in Asian markets. In effect, we accused them of precisely the opposite of dumping under the original GATT definition, which would be selling at a lower price in the U.S. and a higher price in Japan. The American media duly reported the news that Japan had been caught "violating the rules."

Then, last March, a GATT panel ruled that the Japanese were in violation of the GATT, because they were carrying out the 1986 agreement with the United States, which establishes a de facto U.S.-Japan cartel and which does violate the rules of free trade. Incredibly, American newspapers reported that Japan had been caught once again violating the rules, in the same terms that they had earlier reported that Japan had violated the semiconductor agreement. In other words, the first stories alleged that they were "violating the rules" because they were not abiding by the 1986 agreement, and the second set of stories alleged that they were "violating the rules" because they were abiding by the agreement! [I say "alleged;" but the media usually states the U.S. side of these controversies as fact, and

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6 Much like the international cartel between Japanese and American auto manufacturers that our trade negotiators set up in the early 1980s.
presents the other side somewhat less assiduously than it presents, for example, the Iranian side of a dispute over terrorism.) Having said all this, I have to admit that much of the fault for the failure to present the other side of the story lies with the Japanese themselves: when faced with outraged Americans, the Japanese generally do not try to point out the logical and statistical flaws in the U.S. argument, but instead bow and say "we will try to do better in the future." 7

Ultimately the trade deficit shouldn't be the object of our concern anyway, except to the extent that it reflects flagging growth in per capita productivity and real income. And there is serious reason to be concerned about trends in this area.

By measures such as the GNP growth rate, the rate of growth of output per worker, and the level of real family income, U.S. economic performance over the last 15 years has fallen substantially short of performance up to 1973. 8 Of course the 1970s oil shocks slowed down most industrial countries. But U.S.

7 But beware! This past pattern is changing, as the Japanese grow more assertive in their new role as our creditor.

performance in many respects looks worse if we compare it to performance among major trading partners, not better. Official measures of productivity in the manufacturing sector show a slower growth rate in the United States since 1970 than in Japan, France, Great Britain or Germany. It is surely the case that U.S. performance would look still worse if a productivity measure were available that accounted for quality changes and for the fact that we have lost our post-war monopoly on the ability to innovate. This explains why U.S. wages have had to rise more slowly than wages among many of our trading partners, just to "stay even." In 1970 American wages were 4 1/2 times as high as Japanese wages. We could afford this difference due to higher productivity and better ability to innovate. But having lost those advantages, we have found it necessary to hold down our rate of wage growth. By now, Japanese workers have almost caught up with American workers.9

The major candidate to explain the U.S. productivity slowdown appears to be the slowdown in the rate of capital formation, particularly when "capital" is defined broadly enough to include human capital and the stock of technological know-how. 

9 Some might consider it a bit sophomoric to measure one's performance only relative to competitors, as if the economic growth standings were an Olympics or a weekly "Top Ten" radio survey. Technically, it has no adverse effect on our economic welfare if another country grows faster. But such international comparisons are one way of controlling for oil shocks and other factors in the global economic environment. [It should be noted that much of the increase in Japanese wages relative to American wages is the real appreciation of the yen against the dollar.]
I was never sure how to judge the claims of some, like Feldstein, that the net national rates of saving and investment in the 1970s, each at about 7 per cent of GNP, were far below the optimum. But in the 1980s we have seen an unprecedented decline in the rate of national saving, relative even to the level of the 1970s, so that there can no longer be any doubt.

National saving has a public component and a private component. After 1980 there was a large decrease in the amount of public saving, because there was large increase in the federal budget deficit. According to some theories, such an increase in the budget deficit should be offset automatically by an increase in private saving. But this has not happened. In fact the private saving rate has fallen rather than risen. Total national saving, the amount of private saving that is left over after financing the budget deficit, has fallen from 7 per cent of GNP in the 1970s to less than 2 per cent last year.

Despite the fall in national saving, investment as a share of GNP has not fallen dramatically. [It did fall in the early 1980s, but by now has approximately reattained the rate of the 1970s.10] The explanation, as must necessarily be the case by the laws of arithmetic, is that foreign saving has made up the

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10 Net private domestic investment in 1987 was 5.4% of GNP, as compared to 6.2% in the 1970s and 7.0% in the 1960s. Gross private investment in 1987 was 15.7% of GNP, as compared to 16.5% in the 1970s.
difference: we have been borrowing from abroad on a scale\textsuperscript{11} large enough to finance two-thirds of our additions to plant and equipment.

The capital inflow is the same thing as the international payments deficit [on current account], viewed from its more flattering profile. It is not clear whether it is better to have investment bear the burden of the low national saving rate, or to have the international trade sector bear the burden. It is a bad situation either way. My own view is that in the early part of the decade, the capital inflow was probably overall a good thing. It is, after all, better to have machines working away on American soil, even if they are owned by foreigners, than not to have them at all. But by 1985 the capital inflow had probably gone too far. Among other problems [such as dollar-satiation on the part of private foreign investors, and the danger of financial instability], the large trade deficit was beginning to generate irresistible protectionist pressures. So I think that it is probably good that the dollar came down from 1985 to 1987 and that the trade deficit is now improving. But unless something is done about the low level of private saving, the improvement in the trade balance will simply translate into a crowding-out of investment, probably via a higher level of

\textsuperscript{11} Net borrowing from abroad [equal to the current account deficit] was 3.4% of GNP in 1987, as compared to an average of zero in the 1970s. I elaborate on the nature and causes of the inflow of funds in "International Capital Flows and Domestic Economic Policies," in M. Feldstein, ed., The United States in the World Economy, (University of Chicago Press), 1988.
interest rates. For this reason, further large real depreciation of the dollar is not in itself the answer to our problems.

Rather, we must raise the rate of national saving. Given that private saving behavior is not easily amenable to influence by government policy, this means a more serious effort to cut the federal budget deficit. Where to cut? I can think of a number of expenditures that need to be cut. But there are others that it seems to me need to be increased, such as research and education, which are inputs into the stock of human capital and thus are key to getting our productivity back up. Everyone has his own priorities, but I haven't heard anyone explain how to balance the budget by cutting spending. [I'm not counting politicians, who think that uttering the words "cut spending" is enough, and that it is not necessary to identify where they want to cut -- either before or after they are elected.] Thus it seems to me that any solution is going to have as an important element an increase in taxes, as politically unpopular as that may be.

[This does not necessarily mean an increase in income taxes. One of several alternatives would be a tax on energy. It seems to me that the major reason why we haven't put a large federal tax on gasoline is that it would hurt Texas too much, especially now when the local economy is already weak. On the other hand, it seems to me that the major reason [politically] why we haven't put a large tariff on imported oil is that it

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12 Of the sort existing in Japan and Europe.
would help the oil companies too much, at the expense of the Northeast. Either kind of tax in isolation would be very difficult to enact on political grounds, and undesirable on grounds of geographical distribution. But what about an oil import fee together with a tax on gasoline and other products, calculated in such a way so that on net it would avoid hurting this region? A few years ago there were proposals for reform that would be revenue-neutral with respect to taxes; this is a proposal that would be neutral with respect to Texas.

I realize that making the proposal "Texas-neutral" just means spreading the political unpopularity uniformly around the country rather than concentrating it here. But an argument for a substantial energy tax, aside from the fact that it would raise a large amount of revenue, can be made on microeconomic and social grounds as well. The country has been losing billions of dollars' worth of time and expense to traffic congestion, accidents, and pollution; and now we have the greenhouse effect and the endangered ozone layer, which are serious matters for concern. A national energy tax could thus be sold as a sort of "user tax," to discourage over-use of the highways, the hospitals, and the atmosphere. One could also make the "national security" argument in favor of conserving oil reserves so as to avoid becoming again vulnerable to future OPECs.]