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Testimony by

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I appreciate the opportunity to appear before this Subcommittee to comment on the Treasury Department's report on U.S. international economic and exchange rate policy.

As indicated in the report, there has been considerable change in the U.S. trade and current account balances over the past couple of years. The current account deficit (excluding capital gains or losses reported by direct investors), which peaked at $160 billion in 1987, had declined to $106 billion at a seasonally adjusted annual rate by the first half of this year. As a percentage of GNP the decline has been from 3-1/2 percent to 2.1 percent over this same period.

The decline in our merchandise trade deficit has been of about the same magnitude. The volume of U.S. exports has been increasing at an average annual rate of about 20 percent for nearly three years, while the rate of growth of the volume of our non-oil imports has slowed substantially.

The counterpart to the reduction in U.S. external deficits is the reduction in external surpluses in a number of countries abroad, notably Japan, Taiwan, and Korea; a massive movement into current account deficit in the United Kingdom; and some further increase in deficits of some other European countries. Japan's surplus declined from $87 billion (3.6 percent of GNP) in 1987 to $67 billion (2.3 percent of GNP) at a seasonally adjusted annual rate in the first half of 1989. Taiwan's current account surplus declined from $18 billion in 1987 to a $10 billion rate in the first half of this year. Korea's surplus likewise declined from $14 billion in 1988 to about a $4 billion annual rate this year. And the U.K. current account deficit moved from $ 5 billion in

1987 to a deficit rate of $32 billion (3.8 percent of GNP) in 1989's first half.

On the other hand, there was no reduction in Germany's surplus, which actually rose from $46 billion in 1987 to a $59 billion annual rate (5 percent of GNP) in the first half of this year, accounted for by an increase in Germany's surpluses with its EC partners.

The dramatic change in U.S. external balances in the past two years was the result of the earlier decline in the dollar against major foreign currencies and against the Taiwan dollar and the Korean won, increases in productivity and cost competitiveness by U.S. producers, the slowing of the rate of growth in U.S. domestic demand, and a sharp increase in the rate of growth of domestic demand abroad. While the adjustment process has continued, there are signs suggesting it has begun to slow. This reflects, in part, the necessary actions taken by foreign industrial countries to reduce the growth of domestic demand in order to contain inflationary pressures, and the continued relative attractiveness of assets denominated in U.S. dollars which has bid up dollar exchange rates.

Since our current account deficits are significantly lower than they were in 1985-1987, the sustained financing of such deficits is more likely now than was the case earlier. In thinking about options to improve our external accounts further, it must be remembered that a significant portion of our current account deficit reflects a worldwide saving-investment imbalance. Accordingly, any strategy designed to reduce the trade deficit should focus on policies that address this fundamental structural issue. Removing the many distortions which adversely affect U.S. savings must be high on the policy agenda. Recent suggestions by Treasury Secretary Brady to increase U.S. private savings are constructive. Reducing government deficit spending must also be a high priority in order to free up more overall domestic savings and help lower relative real interest rates.

In present circumstances, with the U.S. economy pressing on capacity constraints and monetary policy focussing on containing inflationary pressures, there is little room for substantial further reduction in U.S. external deficits absent a significant reduction of the saving-investment imbalance. In the meantime our efforts should concentrate on maintaining and improving the environment for the free flow of capital and on resisting protectionist non-solutions.

The recognition that balanced and mutually consistent economic policies among major countries are essential for a healthy and stable world economy underlies the dialogue not just with other G-7 countries but also with the newly industrializing countries. We are pleased to see that considerable progress has been made in Taiwan and Korea over the past year in terms of allowing market forces to be reflected in the operation of their exchange markets.

Having said all this with regard to external adjustment, it is important to emphasize that the G-7 process of international economic policy coordination properly is not concerned primarily with exchange rates or external adjustment per se. Rather, the aim is to achieve and to sustain the maximum long-run growth for the world economy consistent with low inflation. Current account imbalances and exchange rates become matters of policy concern when they threaten to lead to financial market and other disturbances which could thwart the attainment of the fundamental goal of sustainable growth with low inflation.