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Testimony by

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I am pleased to appear before this committee to discuss U.S. international competitiveness. This topic has received much attention over the past two decades as the U.S. economy has become increasingly more open.

The concept of competitiveness can mean different things to different people, depending on their particular perspective, so let me begin by defining terms. At the level of the individual firm, competitiveness is, of course, gauged by bottom-line performance in the market. Competitive firms are those whose costs of production lie sufficiently below the market price of the output they sell that they earn a rate of return on equity at or above the market cost of capital. Competitive firms survive, increase their market share, and prosper; uncompetitive firms do not. A similar concept of competitiveness is often applied at the national level as well. The country's international performance is frequently monitored by such measures as the shares of its exports in world markets, movements in its trade balance, and movements in its aggregate price level and production costs relative to those of other countries.

At the national level, however, such conventional measures of competitiveness lose much of their meaning, or at best, are difficult to interpret. In today's open world trading system, exchange rates tend to adjust over time to ensure that the country's international accounts return to balance. For example, if overall production costs rose in the United States, everything else equal, the dollar would depreciate against other currencies, restoring the price and profit competitiveness of

U.S. firms, thereby enabling them to maintain their sales abroad.

However, a gain in price competitiveness associated with a depreciation of the dollar, while good for U.S. firms that compete internationally, could actually worsen overall economic well-being in the United States. A lower dollar means that we must sell more of our output to buy a given amount of foreign-produced goods and services.

Our competitiveness as a nation, therefore, goes beyond movements in the shares of our exports in world markets and the international price competitiveness of our firms and industries. The ultimate test of the country's competitiveness is what is happening to the standard of living of our citizens over time.

Over the past four decades, U.S. real--or inflation adjusted--per capita national income has more than doubled. The United States continues to enjoy the highest standard of living among major industrial countries. In 1990, U.S. real per capita income was on the order of 30 percent above that in both Japan and Germany, our major competitors among industrial countries. We enjoy a similar advantage in total manufacturing productivity.

It is also clear, however, that the gap between the United States and other major industrial countries has narrowed substantially over the post-war period, as per capita income and productivity have grown substantially faster abroad. In some areas, individual firms and even entire industries in other countries may well have caught up to and passed their U.S. counterparts. Does this narrowing of the productivity gap mean we are a nation in decline? Not in and of itself.

To a considerable extent, the narrowing of the gap has been inevitable, reflecting economic forces that are shrinking the globe, providing a strong stimulus to international trade, and making countries better informed about each others' products and production techniques. It is clearly easier to grow fast by catching up, using techniques and processes that have already been developed, than by breaking new ground through technological innovation.

One important factor that has contributed to this process of economic convergence, as well as to the rapid expansion of world trade in the post-World War II period is what I have broadly referred to elsewhere as the "downsizing of economic output." Goods now derive a smaller proportion of their value from the volume of physical matter embodied in them. Advances in design and engineering, the use of lighter but stronger materials, and the availability of smaller but more reliable electronic components all have contributed to the downsizing of output. The increasing importance of conceptual content in output reflects in part the explosive growth of information gathering and processing, which has greatly extended our analytical capabilities of substituting ideas for physical volume.

The downsizing of output, combined with significant advances in intercontinental transportation and communication, has facilitated the rapid growth in international trade we have seen in recent decades. Moreover, information about new products and new technologies spreads further and much more rapidly today

than it did just a few years ago. As information processing capabilities increase in all countries, technological and productivity gaps likely will continue to narrow further.

While other countries have benefitted greatly from technology that has been developed first in the United States, U.S. residents, too, have benefitted significantly from the rapid growth of productivity abroad. As goods and services produced abroad improve in quality and/or decline in price, opportunities for international trade are enhanced, and U.S. consumers who import foreign goods and services benefit directly.

The rapid growth of international trade over the past four decades has enhanced our standard of living more generally, in several respects. One is the well known gains from specialization and exchange, commonly referred to as the law of comparative advantage. Just as individuals within a country gain by devoting their energies to what they do relatively well and exchanging their output for the output of others, so do entire countries gain through specialization and exchange. By specializing in industries where they are relatively efficient producers, and trading for products in which they are relatively inefficient, the citizens of all countries increase the total amount of goods and services available for their own consumption.

Another source of gains from trade is the stimulus to the efficiency of domestic production that is provided by international competition. For example, increases in the quality of U.S. automotive products since the early 1970s were stimulated in part by the competition of Japanese and European automakers.

Although the implications for workers in the domestic automobile industry were not always positive, those for consumers and their standard of living were definitely so. In addition, the rapid expansion of U.S. exports over the past several years owes much to a period of capacity enhancements and productivity improvements by U.S. manufacturing firms earlier in the 1980s when the dollar was strong and foreign competition was intense.

In a dynamic competitive world economy, with new products, technologies, and production processes continually coming on stream, some firms and industries will always be on the decline as others are on the rise. Protectionist pressures often arise when foreign competition intensifies for a domestic industry that is in decline. The ailing industry has a strong incentive to seek protection from foreign competition; the losses of those put out of business and out of jobs are real. However, the appropriate policy response to an industry that is losing ground to foreign competition is not to erect barriers to imports, but rather to facilitate the redirection of workers who do lose their jobs to more productive employment opportunities elsewhere. If the protectionist route is followed, newer, more efficient industries will have less scope to expand, and overall output and economic welfare will suffer.

It is noteworthy that despite the alleged weakening of our international competitive position during the 1980s, it can scarcely be argued that jobs have been lost, on balance. In fact, the unemployment rate by the latter part of the 1980s, at below 5-1/2 percent, was the lowest level since the early 1970s.

Moreover, the view that employment growth has been concentrated in less productive areas more recently is not supported by the data. Indeed, real wages and salaries per worker grew almost as fast during the 1980s as they did during the 1970s.

It is, of course, prudent to be vigilant against unfair trade practices or excessive concentration of market power on the part of foreign firms. Nevertheless, the current level of protection in the United States seems well in excess of the response that would be warranted by the actual existence of unfair trade practices abroad. By some plausible estimates, the unilateral removal of quantitative restrictions now placed on U.S. imports of textiles, apparel, and various agricultural products would result in net gains to U.S. consumers amounting in the tens of billions of dollars. Moreover, the complete removal of existing foreign restrictions on US exports probably would reduce our trade deficit by only modest amounts.

While the traditional impetus for protection has been the loss of domestic market share and jobs to foreign competition, a new school of thought argues that a case can be made for government intervention in the form of promotion of technological change and innovation in particular industries. Certain industries promise the possibility of high profits or above-average wages to employees because of increasing returns to scale in production, spill-over benefits to related industries, and barriers to market entry associated with high initial research and development costs. As the argument goes, other countries are beating us to the punch in such high value-added

areas because their governments have heavily subsidized initial R&D expenditures.

This argument has some appeal, but I would caution against adopting a policy of targeting particular industries for special support from the government, for several reasons. First, if the potential returns to specific industries are really as high as promised, in many cases private investment could be expected to respond. Second, it is not at all clear that the government is in any better position than the private market to identify those particular firms or industries that are most deserving of R&D support. Third, even if the spillovers were significant and obvious enough in a given case to warrant government subsidies, making an exception in one case would risk the spread of government intervention to less clear-cut cases.

I have suggested that the narrowing of the gap between U.S. productivity and that of our major trading partners, to a considerable extent, has been both inevitable and beneficial. Nevertheless, more could be done to promote U.S. productivity growth in the United States.

Some observers have suggested that a case can be made for government support for basic research and development, that is, support not directed at specific products or industries. However, it is important that government involvement in this area be implemented in such a way that it reinforces but does not supplant private market decisions. Much the same could be said for additional government expenditures on education and training.

More could be done to remove outmoded or unnecessary government restrictions on U.S. private industry. In areas where high value added and spillovers are present, the gains in terms of our standard of living could be significant. To take an example, legislation is now pending to put U.S. banks on a more equal footing with foreign banks by allowing them to provide a more complete range of financial services to their customers. In the absence of such banking reform, we could see a decline in the prominence of the United States as an international financial center, and a potential loss of highly skilled jobs in financial services and allied industries.

Because the arguments for free trade are so compelling, one sure way to enhance the prospects for our national standard of living is to continue to work to remove existing barriers to trade globally. Indeed, the primary thrust of U.S. trade policy has been and must continue to be to strive for multilateral reduction of trade restrictions under the auspices of the GATT. I attach great importance to bringing the current Uruguay round negotiations to a successful conclusion. Much progress already has been made in the talks, and prospects may have improved for ironing out remaining nettlesome areas, particularly in agriculture. Any significant step that could be taken toward tearing down the extremely inefficient and costly worldwide system of government subsidies to agriculture would be a breakthrough that would have many benefits.

The recent extension of the fast-track authority was an important step both for the GATT talks, and for the establishment

of a North American Free Trade Agreement. With respect to our impending negotiations with Mexico, predictably, some U.S. industries may be hurt by increased competition from that country. But all of the comprehensive studies that I have seen on the subject indicate that the increase in trade with Mexico that will follow a removal of existing trade barriers, on the whole, will result in a net gain in both jobs and incomes for U.S. residents, as well as for the residents of Mexico.

Perhaps the most important means at the government's disposal to improve U.S. international competitiveness and our standard of living in the long run is to pursue sound macroeconomic policies. It goes without saying that a stable financial system and steady progress toward price stability will tend to minimize risk and enhance the attractiveness of investing in the United States -- both by U.S. investors and by those from abroad. Policies that contribute to low inflation among our major trading partners at the same time will lead to more stable exchange rates and contribute to further sustained growth of international trade and, accordingly, domestic real incomes.

On the fiscal side, the connection between movements in our budget deficits and our external performance, within the equation between national saving and investment, was confirmed by events during the 1980s. The widening of the federal budget deficit, along with a downtrend in the U.S. private saving rate, contributed to an increase in both real interest rates and the dollar's exchange rate during the first half of the 1980s. The stronger dollar and associated decline in the price

competitiveness of U.S. firms, in turn, contributed to a sharp widening of the trade deficit and declines in the world market shares of U.S. exports. In the second half of the 1980s, the budget deficit turned around, interest rates and the dollar fell, the U.S. trade deficit began to narrow, and the world market shares of U.S. exports recovered strongly.

Despite the swing in the U.S. external position during the 1980s, U.S. investment continued to show reasonably strong growth, and productivity in manufacturing advanced at an above average annual rate of 3-1/2 percent. However, given the low and declining U.S. saving rate, the growth in investment was necessarily at the expense of future consumption by U.S. residents. The shortfall of U.S. domestic saving was made up by a substantial net inflow of capital from abroad. All told, the increase in our net debt to foreigners over the past 10 years amounted to something on the order of \$750 billion. Servicing that increased net debt over the years ahead will mean that the rate of consumption in the United States relative to our output will be lower than it would otherwise have been.

There is no question that the decline in the U.S. national saving rate has been costly, and that the recovery of that saving rate should be a national priority. At a minimum, we should ensure that progress toward eliminating the federal budget deficit over the next five years, as envisioned in last year's budget agreement, is achieved.