# U.S. INTERNATIONAL TRADE STRATEGY



## HEARINGS

BEFORE THE

## SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

DECEMBER 5 AND 9, 1980

Printed for the use of the Committee on Finance

**Part 2**

U.S. GOVERNMENT PRINTING OFFICE

70-794 O WASHINGTON : 1981 HG 96-109

## COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, JR., Virginia
GAYLORD NELSON, Wisconsin
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas
SPARK M. MATSUNAGA, Hawaii
DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey

ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, JR., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
JOHN HEINZ, Pennsylvania
MALCOLM WALLOP, Wyoming
DAVID DURENBERGER, Minnesota

MICHAEL STERN, *Staff Director*
ROBERT E. LIGHTHIZER, *Chief Minority Counsel*

---

### SUBCOMMITTEE ON INTERNATIONAL TRADE

ABRAHAM RIBICOFF, Connecticut, *Chairman*

HERMAN E. TALMADGE, Georgia
HARRY F. BYRD, JR., Virginia
MIKE GRAVEL, Alaska
DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
BILL BRADLEY, New Jersey

WILLIAM V. ROTH, JR., Delaware
JOHN C. DANFORTH, Missouri
JOHN HEINZ, Pennsylvania
ROBERT DOLE, Kansas
JOHN H. CHAFEE, Rhode Island

# CONTENTS

## ADMINISTRATION WITNESS



## PUBLIC WITNESSES



## COMMUNICATIONS



## ADDITIONAL INFORMATION

# U.S. INTERNATIONAL TRADE STRATEGY

---

## FRIDAY, DECEMBER 5, 1980

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
COMMITTEE ON FINANCE,
*Washington, D.C.*

The subcommittee met pursuant to notice at 9 a.m., in room 2221, Dirksen Senate Office Building, Hon. Bill Bradley presiding.

Present: Senators Bradley and Danforth.

[The press releases announcing the hearing follows:]

[Press Release]

FINANCE SUBCOMMITTEE ON INTERNATIONAL TRADE ANNOUNCES FOURTH HEARING ON U.S. INTERNATIONAL TRADE STRATEGY

The Honorable Abraham Ribicoff (D., Ct.), Chairman of the Subcommittee on International Trade of the Senate Committee on Finance, announced today that the Honorable Bill Bradley, (D., N.J.), will chair the fourth in a series of hearings on the trade and economic issues confronting the United States and on an international trade strategy for the United States. The series of hearings was described in Finance Committee Press Release No. H-35 of July 3, 1980. The fourth hearing will be held on Friday, December 5, 1980, in Room 2221 of the Dirksen Senate Office Building, beginning at 10:00 a.m.

This hearing will receive testimony on U.S. trading relations with developing countries. Senator Bradley said, "The Subcommittee will hear testimony on the trade and investment policies of Third World countries, particularly those of the newly industrializing countries (the so-called NICs), such as Taiwan and Brazil. It will examine the nature of these policies, their objectives, and key factors shaping them. Special attention will be given to the influence of the debt and energy position of Third World countries on these policies and to alternative options available to these countries for meeting financing requirements in connection with their debt and energy requirements. The Subcommittee seeks to draw the implications of these various factors for Third World trade and financial relations with the United States."

The witnesses who will appear are as follows:

The Honorable Richard Cooper, Under Secretary for Economic Affairs, Department of State;

Mr. Frank Zarb, General Partner, Lazard, Freres and Company; and

Dr. Thomas J. Trebat, Chief Latin American Economist, Bankers Trust Company.

*Written statements.*—Persons who desire to present their views to the Subcommittee are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be submitted to Michael Stern, Staff Director, Committee on Finance, Room 2227 of the Dirksen Senate Office Building, Washington, D.C. 20510, not later than Friday, December 12, 1980.

[Press Release]

FINANCE SUBCOMMITTEE ON INTERNATIONAL TRADE CHANGES TIME FOR DECEMBER 5, 1980, HEARING ON U.S. INTERNATIONAL TRADE STRATEGY

The Honorable Abraham Ribicoff (D., Ct.), Chairman of the Subcommittee on International Trade of the Senate Committee on Finance, announced today that the Subcommittee's fourth hearing in a series of hearings on the trade and economic issues confronting the United States and on an international trade strategy for the

United States, to be chaired by the Honorable Bill Bradley (D., N.J.), originally scheduled to begin at 10:00 a.m. on December 5 (Press Release No. H-62, dated November 26, 1980), will now begin at 9:00 a.m. in Room 2221 of the Dirksen Senate Office Building.

Senator BRADLEY. The subcommittee will come to order.

I have an opening statement I will read, and then we will go right to the testimony.

A commitment to encourage the expansion of U.S. exports runs strong in the Senate and nowhere is that commitment stronger than among members of the Finance Committee. Some two-thirds of the Senate's members participate in the Senate export caucus, and this year the Senate enthusiastically enacted the Export Trading Companies Act to encourage the formation of multifunctional trading companies for the purpose of promoting exports.

Several members of the Finance Committee were active in that effort, and the committee as a whole played a seminal role in developing trade laws implementing the Multilateral Trade Agreements to assure a free and fair trade environment for U.S. business.

The Senate's strong interest in stimulating exports requires that we give close attention to one compelling development in recent years—the emergence of the nations of the Third World as the most dynamic market for U.S. exports. These nations, eager for development and striving for decent living standards, can become the frontier of world economic growth, bettering their own conditions as they stimulate international economic activity. They can be, and are becoming, magnets for American products. Their attractive markets can serve to catalyze vigorous American efforts to improve the productivity and general competitiveness of the U.S. economy.

U.S. exports to developing countries have been growing at a faster rate than U.S. exports to industrialized countries during this decade, reversing a historical pattern in favor of exports to the industrialized world. Consequently, not only have developing countries become this Nation's most rapidly growing market but also just the non-OPEC developing countries purchase more from the United States than does the European Community, the Soviet Union, Eastern Europe and China combined.

Today, 38 percent of U.S. exports flow to the Third World; 26 percent go to the non-OPEC developing countries alone. It is estimated that Third World purchases of U.S. manufactured goods account for over half a billion jobs in the United States.

Finally, leaving aside our well-known problem of high-priced petroleum purchases, predominantly from OPEC, U.S. trade with countries of the Third World has strengthened our balance of payments. The United States enjoys a large surplus in trade of manufactured goods with developing countries, nearly $12 billion in 1979, and an impressive surplus on the service account of over $17 billion in 1979. Indeed, more than two-thirds of the U.S. surplus on the service account in that year was due to transactions with developing countries.

The clear message is that trade with the Third World can be a critical source of stimulation for U.S. domestic economic growth, particularly in those sectors in which the United States enjoys a comparative advantage. U.S. trade with the Third World can offer a striking example of how U.S. domestic economic performance can benefit by the integration of industrial policies with trade policies.

To benefit fully, we must prepare to take advantage of trade opportunities with these nations as well as to minimize the risk that trade with them will cause dislocations to our own economy. This requires greater familiarity with their trade and investment policies, the objectives of these policies and the major factors that shape them. This is the main purpose of our hearing today.

We hope in the hearing to give special attention to the trade deficits, of third World countries, their financing needs, changing trade policies, how this relates to oil import costs. In sum, we hope to address the whole range of issues that affect our trade with the Third World.

Our trade and financial relationships with the countries of the Third World bind us to them in a network of interdependence that is rife with opportunities for mutual benefit, but also is riddled with dangerous mines that can explode into mutual loss.

There are no easy solutions to the problems such as Third World debt and the petrodollar recycling. The hard ones will demand imagination and initiative, compromise and courage. There are promising options but they have to be carefully crafted so as to favorably balance potential gains against losses.

I am very pleased today to have as our first witness in the hearing the Under Secretary of State for Economic Affairs, the Honorable Richard Cooper. He will be followed by Mr. Frank Zarb, and then by Dr. Thomas Trebat, who will all give the committee the benefit of their experience.

I would like to welcome the Under Secretary to the committee. He is, of course, Under Secretary for Economic Affairs because of his expertise in these matters. He has the benefit of several years in the arena trying to implement policies in an increasingly complex world and an increasingly contentious world, and has presided over the United States or part of the U.S. economic policy, precisely at a time when the Bretton Woods system is becoming unraveled and there are serious threats on many fronts.

With that bright introduction, let me welcome the Under Secretary to the committee and ask him to proceed.

[Full text of opening statement of Senator Bradley follows:]

### Opening Statement by Senator Bill Bradley

A commitment to encourage the expansion of U.S. exports runs strong in the Senate, and nowhere is that commitment stronger than among members of the Finance Committee. Some two-thirds of the Senate's members participate in the Senate Export Caucus, and this year the Senate enthusiastically enacted the Export Trading Companies bill to encourage the formation of multi-functional trading companies for the purpose of promoting exports. Several members of the Finance Committee were active in that effort, and the committee as a whole played a seminal role in developing trade laws implementing the Multilateral Trade Agreements to assure a free and fair trade environment for U.S. business.

The Senate's strong interest in stimulating exports requires that we give close attention to one compelling development in recent years: the emergence of the nations of the Third World as the most dynamic market for U.S. exports. These nations, eager for development and striving for decent living standards, can become the "frontier" of world economic growth, bettering their own conditions as they stimulate international economic activity. They can be, and are becoming, magnets for American products. Their attractive markets can serve to catalyze vigorous American efforts to improve the productivity and general competitiveness of the U.S. economy.

U.S. exports to developing countries have been growing at a faster rate than U.S. exports to industrialized countries during this decade, reversing a historical pattern in favor of exports to the industrialized world. Consequently, not only have developing countries become this nation's most rapidly growing market, but just the non-OPEC developing countries purchase more from the United States than does the European Community, the Soviet Union, Eastern Europe and China.

Today, 38 percent of U.S. exports flow to the Third World; 26 percent go to the non-OPEC developing countries alone. It is estimated that Third World purchases of U.S. manufactured goods account for millions of jobs in the United States.

Finally, leaving aside our well-known problem of high-priced petroleum purchases, predominantly from OPEC, U.S. trade with countries of the Third World has strengthened our balance of payments. The United States enjoys a large surplus in trade of manufactured goods with developing countries—nearly $12 billion in 1979—and an impressive surplus on the services account of over $17 billion in 1979. Indeed, more than two-thirds of the U.S. surplus on the services account in that year was due to transactions with developing countries.

The clear message is that trade with the Third World can be a critical source of stimulation for U.S. domestic economic growth, particularly in those sectors in which the United States enjoys a comparative advantage. U.S. trade with the Third World can offer a striking example of how U.S. domestic economic performance can benefit by the integration of industrial policies with trade policies. To benefit fully, we must prepare to take advantage of trade opportunities with these nations, as well as to minimize the risk that trade with them will cause dislocations to our own economy. This requires greater familiarity with their trade and investment policies, the objectives of these policies, and the major factors that shape them. This is the main purpose of our hearing today.

I believe special attention should be given to one factor which could be a source of serious stagnation in the Third World, with adverse consequences for their economic relationships with the industrialized world. That factor is the problem of financing debt and deficits in the Third World, a problem which arises from the soaring oil costs that now compete with urgent development needs. Because of its wide ramifications for the economies of developing and developed countries alike, financing the debt and deficits of Third World countries could prove to be the most explosive economic problem of the 1980s. The core of this problem is managing the recycling of petrodollars from OPEC oil exporters to non-OPEC Third World importers. Because of the imbalance in OPEC's ability to sell oil and buy goods, petrodollar recycling has become a deepening, self-perpetuating process that threatens to push several Third World countries over the brink to insolvency, possibly triggering a crisis of confidence concerning some of the more exposed Western banks. Short of international economic crisis, the swelling deficits and cumulating debts of Third World countries will stifle their development and trade efforts, thereby dimming prospects for lively economic growth in the industrialized countries hoping to sell to them.

Since 1975, oil import costs for non-oil developing nations have climbed from just over $22 billion to nearly $58 billion in 1980—even though their imports by volume grew only a mere .4 barrels a day. Since 1973, their current account deficit in aggregate rose from over $11 billion to $68 billion, and is projected to rise to more than $100 billion by 1990. As a result, their total cumulative external debt has soared from $76 billion in 1973 to nearly $280 billion in 1980—more than three times the 1973 level. Debt service burdens alone will cost them $42 billion in 1980.

Prospects for financing Third World needs until their economies can adjust to the shocks are poor. The level of financing that will be required in the 1980s is much higher than what was required in the 1970s. At the same time, opportunities to expand the financial resources available to Third World countries in deficit are more limited.

The consequences of financing shortfalls in the Third World will be directly felt in the developed world. Stagnation in developing nations will afflict our own economies. Their liquidity demands may feed international inflationary pressures. Episodes of financial crisis in developing countries may put exposed Western banks in jeopardy. And the frustrated development aspirations of their people, exacerbated by economic austerity measures aimed at correcting deficits, may induce political instability that seriously threatens U.S. foreign policy interests.

Our trade and financial relationships with countries of the Third World bind us to them in a network of interdependence that is rife with opportunities for mutual benefit, but also is riddled with dangerous mines that can explode into mutual loss. There are no easy solutions to problems such as Third World debt and the petrodollar recycle. The hard ones will demand initiative, imagination, compromise and courage. There are promising options, but they will have to be crafted carefully so as to be sensitive to the need to favorably balance potential gains against potential losses. First we must draw up a working "map" of our economic and security relationships with the Third World and then seek to chart the safest courses leading to mutual cooperation and prosperity.

I thank the distinguished witnesses who are with us today, and I invite them to help us begin sketching that important map.

## STATEMENT OF HON. RICHARD COOPER, UNDER SECRETARY OF STATE FOR ECONOMIC AFFAIRS, U.S. DEPARTMENT OF STATE

Mr. COOPER. Thank you very much, Mr. Chairman.

I am very pleased to have this opportunity to discuss the range of issues which you have so eloquently laid out at this time. I am really at your disposition. I have a statement which I would like to submit for the record.

Senator BRADLEY. Your statement will be received for the record. If you would like to summarize it instead of reading it, that will be fine.

Mr. COOPER. I can either go through a shortened version of it, or a drastically shortened series of points, if you want to allow time for questions.

Senator BRADLEY. Fine.

Mr. COOPER. If I can then rest on my statement for full exposition, let me here orally make four points:

The first is that despite labels implying homogeneity, like "the Third World" or "developing countries" or "less developed countries" or "G-77", there is, in fact, enormous diversity among these countries in size, in per capita income, in the structure of their economies, in their trade positions, in their external debt position; and even leaving aside the countries that export oil, which obviously are in a special position today, there is a great variety among these countries. It is for conversational purposes and even for some policy purposes useful to group them, but we must always keep their great diversity in mind in framing policy.

My second point is that taking these countries as a group, we have become very dependent upon them, not only for traditional products like coffee and tea and exotic minerals, and now, above all, oil, with nearly half of our oil consumption coming from other countries, countries in the Third World, but also, as you pointed out in your introductory remarks, as dynamic markets spawn exports, both manufactured exports and agricultural products, we reckon that these countries taken together take about 40 percent of our exports of manufactured goods and over 50 percent of the exports of capital goods from this country.

Moreover, not only do they take a substantial fraction of our exports, but also they have been the most rapidly growing markets for our exports. They grew markedly more rapidly in their demands for U.S. products in the last 10 years than was true of our traditional markets in Canada, Europe and Japan taken together, so that we have become, as you pointed out, more intertwined with them, more interdependent with them economically.

Of course, we are also concerned about the political fate of these countries, their alliances with other countries, especially when they are in strategically important locations or when they supply us with strategically important commodities.

My third point is that many of these countries, not all but many of them, are now in serious difficulty, not through domestic mismanagement of economic policy, although at any moment in time there are a number of cases where that has been so, but more through adverse external conditions, above all, the sharp increase in oil prices, first in 1974 and then more recently in 1979–80, plus being aggravated by world economic slowdown and aggravated further by world inflation, all of which are, of course, themselves related.

But these three factors taken together have created an adverse external environment for countries who are still relatively prosperous compared with the traditional industrialized societies, many of whom had been doing very well in the 1960's and early 1970's, and they are finding it more and more difficult to continue to prosper economically under these external circumstances.

Because of our dependence on them—and here I lead to my fourth point—because of our dependence on them and our interest for their welfare, for economic and political reasons we owe to them as well as to ourselves to help them through their difficulty. It is very much in our interest to do so. The question is, How do you do it?

Here I have just a series of points and then I will stop and lead into some discussion of them.

It seems to me the first and most important by far is that we must try to maintain adequate domestic management of our own economy. That means maintaining vigor in our economy and doing what we can to get inflation under control. But the worse impact we could have on the world economy at large is to run the U.S. economy at recession levels for year after year after year.

A second injunction for us is to keep our markets open. I have pointed out that we are highly dependent on these countries; we have become dependent on them for markets for our exports. Of course, they are able to buy our goods only as they are able to earn. The principal source of earnings is sales to other countries. This is not a responsibility alone of the United States but it is also a responsibility of the United States and, as I say, it is in our interest to keep our markets open so that they can sell to us so that they can buy from us.

It has the not incidental advantage of helping to maintain a competitive environment in the United States and helping us in our own struggle against inflation.

We also need to bolster the international financial system. That means doing what we can to keep capital markets functioning. I would register the view that I think capital markets have done remarkably well during extraordinarily difficult circumstances both in the midseventies and more recently; but we should do what we can to keep it that way.

Private markets alone cannot carry the whole responsibility and I think we need to rely on and bolster the International Monetary Fund. It is commonplace these days to pronounce the benediction on the Bretton Woods system, but I think it is worth keeping in mind that the Bretton Woods system involved a number of elements. One of them was institutional—creation of the International Monetary Funds and the World Bank.

The second was introducing rules of behavior of countries as regards their international accounts; and the third was adopting a system of fixed but changeable exchange rates. It is only the third of those elements of the Bretton Woods system that has changed, changed in the early 1970's. The first two are still very much in place; indeed, I would say, stronger than ever.

We need to do what we can to reinforce those elements. In particular, I would urge the Congress to pass before this session ends the increase in IMF quotas for the United States. The United States is the last of major countries to endorse the quota increase. This is a vital element of the ability of the IMF to do its job in today's world.

Along the same lines, we need to encourage and, where appropriate, reinforce, the capacity of the World Bank to deal with these problems. I am sorry—"sorry" is too mild a word—to learn that this week the authorization for IDA Six failed to pass. It seems to me a grievous mistake on the part of the United States not to give support to IDA Six. We have a need internationally to increase the normal capital of the World Bank to enable it to carry out its functions in the world in which we find ourselves, and I would hope very much that in the next session of Congress that Congress will give its support to a substantial increase in the capital of the World Bank.

Finally, there are a number of countries who as a practical matter cannot go to private capital markets; they can and do borrow from the World Bank, but the terms, as you know, are commercial ones and somewhat onerous, and I think, therefore, foreign aid, of which, of course, IDA is one dimension, but only one dimension, plays an important role in keeping these countries afloat, able to function and able to import from the United States.

I am fully aware that foreign aid is not the most popular program in the Government's budget. I should like to make the case, however, that while there are humanitarian concerns underlying it, the rationale for foreign aid does not rest exclusively or even predominantly on humanitarian concerns.

We have major foreign policy interests, strategic interests, in many parts of the world and, in addition, as I have said, we have a growing economic interest in many parts of the world. Foreign aid I see as being an entering wedge and early investment in developing an interest in American products. One can think of it as a precursor to rapidly growing markets for the future.

If one wants a historical example of that, I would cite the case of South Korea, which was on its feet but depended on aid, with close tie-in with American engineering standards and worked well with Americans. It was a marvelous investment which we made in the late 1960's.

I think today that foreign aid, properly applied, has the additional advantage of easing the world imbalance in energy. One of the major components, both of our bilateral aid program and increasingly of the World Bank's program, is to encourage both energy conservation and development of alternative energy sources in developing countries. This seems to me to be vital there, as it is in the United States and Europe and Japan, and we can contribute to a better balance in the world energy situation through the 1980's by making some investments outside the country as well as inside.

Mr. Chairman, I think I should stop there. I will be glad to answer any questions you might have.

Senator BRADLEY. Thank you very much for a summary of your testimony, and your statement in full will be inserted in the record.

[Full text of prepared statement of Mr. Cooper follows:]

Statement by
Richard N. Cooper
Under Secretary of State for Economic Affairs
before the
Senate Finance Committee
December 5, 1980

I am pleased to have the opportunity to discuss with you today the relationship between development strategies in developing countries and resulting economic benefits and responsibilities for developed countries such as the United States. The notion of such interdependence often receives lipservice. But in actual practice it is sometimes difficult for us to look beyond immediate national concerns and recognize that economic actions we take, even when the focus is on domestic problems, can have much wider international ramifications. Similarly, policies pursued in one economic area may have unintended spinoffs in others. This is now true of our increasingly complex relationship with the developing countries. We have become increasingly reliant on Third World nations for raw materials and as a market for our goods, and the resolution of the development and financial problems most of these nations face will have a significant impact on the growth of our own trade and economy.

Many factors are important in determining the success or failure of a country's efforts to develop economically.

Most critical is the creativity of a country's own human resources and its ability to marshall its own domestic capital. But no country has succeeded in developing in an international vacuum. Countries need raw materials, food, and technology from abroad. To get them they need foreign exchange. The most common link between the need for such foreign goods and the ability to acquire them is trade. Thus trade has played a crucial role in the development of all countries, including, of course, the United States during its formative period of economic development.

In the 1960's many developing countries pursued a trade policy centered on the notion of "import substitution." This approach assumed that many goods on which a country expended scarce foreign exchange could be produced at home. If high barriers to imports were established, domestic (or often international) entrepreneurs would gain the confidence needed to invest in domestic industries. As such "infant industries" matured, with more highly trained work forces, movement up the technological learning curve, and domestic market expansion, hopefully the import barriers could be gradually reduced.

The import substitution approach can be successful for a time. Developing countries do face problems at the outset in putting together capital and labor to produce goods efficiently. With an expanded domestic market brought about by greater domestic production, more experienced entrepreneurs and workers, and more extensive infrastructure in such areas as energy production and transportation, countries will grow rapidly for a while and may actually foster some industries which are economically viable under competitive conditions.

But as a policy, import substitution carries several drawbacks. It assumes that governments can be successful in picking industries which can be successful over time, a proposition which is dubious at best. It establishes a series of industries which begin by depending heavily on government protection for their very existence. This often leaves a legacy of "adolescent industries" which are unwilling or unable to accept removal of such protectionism and thus never grow up.

Finally, import substitution essentially stresses the negative aspects of trade -- the costs, rather than the benefits. Trade, after all, provides extensive benefits for any society, industrial or developing. It offers a wide array of the world's best technology. It allows a society to use its resources in a most efficient fashion by purchasing goods at the lowest price -- whether domestically or from abroad. It offers the chance to use domestic factors of production most efficiently by producing for both a domestic and international market. And it provides strong discipline on domestic industries -- forcing them to be innovative and efficient or risk going out of business.

For these reasons U.S. leaders have generally urged developing countries to use great caution in applying import substitution measures, and encouraged those countries to focus more actively on the possibilities which exports offer their economies. And in the seventies, many of the more successful developing countries have been pursuing precisely such a strategy. The economic success stories in the developing world -- such as Brazil, Taiwan, Korea, Mexico, and Singapore -- have all pursued policies which place emphasis on exports as a means of promoting rapid industrialization.

In recent years most of these countries have shifted toward more liberal trade and payment regimens. Mexico is shifting from a licensing system to a more transparent tariff schedule on 38% of its trade. Korea also eased import licensing requirement on a large number of items in

1978 and 1979. The U.S. negotiated 27 bilateral agreements with LDCs in the MTN which resulted in more trade liberalizing activities. For example, Taiwan reduced its overall tariff rates by about 50% on a substantial portion of our exports to them.

It is true that often these moves have not been as rapid or as inclusive as we might want. Many countries still have tough import restrictions to protect certain domestic industries or to limit imports of goods which are considered inessential to development purposes. But overall, particularly in Latin America and East and Southeast Asia, there has been a clear tendency of the more economically progressive and successful countries to move in the direction of liberalizing trade barriers and adopting policies aimed at stimulating exports.

The success of such export oriented strategies for those countries can be seen in their economic performance over the past 10-15 years., In 1965, only three developing countries exported more than $1 billion of manufactured goods. By 1975 this number had risen to eight, with three each exporting more than $7 billion in industrial products. Their growth in exports between 1970 and 1978 was 10.6%, or nearly double the rate of growtn of other developing countries in the same income categories. Their overall annual economic growth rates have also been high, ranging over the same period from 8.2-9.7% per year, as compared to an average for developing countries in comparable income groups of 5.7%.

These nations can only be successful in pursuing export promotion if we, in turn, maintain our own markets open to their exports. Our record is generally a good one. First, we have pursued a global policy of seeking to lower trade barriers, particularly in the various rounds of multilateral tariff negotiations. The Tokyo Round of trade negotiations, completed last year, continued this process. When its reductions are complete, average U.S. MFN tariffs will drop from 10.6% to 6.5%. In addition, the Tokyo Round also increased discipline on nontariff barriers to trade through a series of new codes. We are urging developing countries, particularly those which most actively participate in the world trading system, to join these codes.

The United States, along with all other industrialized nations, has also provided special access to its markets for certain products from developing countries. Members of the Finance Committee are well aware of the U.S. Generalized System of Preferences program, authorized in the Trade Act of 1974. Roughly 2800 eligible items from 140 beneficiary countries now enter the U.S. duty free, subject to cut off criteria designed to remove benefits for specific products from those developing country suppliers which no longer need the special competitive edge provided by GSP. Last year imports under the U.S. program totaled $6.3 billion. By way of perspective, this equaled about 3% of our total imports, or about 7% of our overall imports from developing countries. It provided a helpful but relatively modest margin of preference to developing country suppliers.

Exports from developing countries can occasionally have a disruptive effect on our specific industries and agricultural products, particularly when several countries expand exports dramatically in a narrow range of products over a short period. We can of course take measures to ease the rate at which domestic industry and labor have to adjust to such competition, either by becoming more competitive in the same product line or by shifting to alternative economic activities. We have federally financed assistance programs to aid such adjustment. But we must keep in mind that the same arguments which we make to developing countries on the advantages of competition and open markets apply equally to industrial societies, and in the long run we benefit by keeping such market intervention to a minimum.

Keeping our markets open to exports from the developing countries should not be regarded only as a costly responsibility. We benefit from such trade. Products from LDCs provide us with a greater variety of goods, often at lower costs, which helps restrain inflation. Perhaps more important, the main reason the developing countries export is in order to increase the imports they need for their own consumption and development. Much of those imports come from the United States. During the 1970's the share of U.S. exports that went to LDCs grew from 27% to 35%, increasing in value from $12 billion to $63 billion. While such growth has of course been partly due to increased imports by oil exporting LDCs, other rapidly growing developing countries were also important. In 1979 the U.S. exported over $1 billion to each of 16 developing countries, and had a cumulative $1.5 billion trade surplus with them.

Exports of manufactured goods particularly benefited from LDC buyers. U.S. sales of manufactured goods to the developing countries grew twice as fast in this decade as to the rest of the world. In 1979 nearly 40% of U.S. manufactured exports went to developing countries, for a total of $41.3 billion. Only one-third of that amount went to OPEC countries. Not surprisingly, developing countries are particularly good customers for our capital equipment with almost one-half -- $24.3 billion -- of such exports going to LDCs in 1979. Developing countries are also important purchasers of our agricultural products. They took about one-third -- $9 billion -- of our food and beverage exports last year, nearly two-thirds of U.S. exports of processed agricultural products, and more than one-half of U.S. cotton exports.

The rapidly expanding demand for imports by the developing countries by no means automatically favors the United States. We must compete with other industrial and advanced developing countries. Our goods must be of high quality and meet the specific needs of the developing countries, and must be comparable in price to the competition. Financing can also play an important part in determining a developing country's decision as to supplier. Therefore the role of the ExIm Bank is a vital one. It must be able to compete in volume and terms with similar institutions in other countries.

In sum, the ability of developing countries to shift from import substitution development schemes to export led development plans depends heavily on the willingness of industrial countries to keep their markets open. The amount of foreign exchange earned from such exports is in turn an important determinant of the amount of imports developing countries can purchase -- with a large share of those imports coming from the United States. But there is not an exact one-to-one relationship between LDC exports and imports. With very few exceptions, primarily of the Persian

Gulf OPEC states, most developing countries import more than they export. They must finance the difference through foreign investment, private borrowing, or with concessional assistance.

Historically, a perennial trade deficit was normal for a developing country. When growth prospects are attractive and a government maintains sensible policies, international lendors have been forthcoming for domestic investors, both private and governmental. In addition, foreign investors have made a significant contribution to LDC development. As long as such investment was used in projects with adequate economic rates of return, it made sense for developing countries to encourage such lending and investment, as did the United States in the 19th century. Likewise, for the poorer countries, or countries with particular problems of importance to potential donors, concessional assistance has also played a key role in allowing countries to purchase in excess of current exports.

Occasionally a country found itself in difficult financial circumstances, either resulting from its own economic mismanagement or from a temporary or cyclical problem beyond its immediate control. In such circumstances a country could be assisted on a case by case basis through the International Monetary Fund and cooperation of bilateral creditors. In general, short-term financing was made available to a country on the condition that it pursued "adjustment" policies which brought demand more into line with its economic prospects.

This pattern of deficit financing and the use of corrective measures to deal with individual country problems came under severe strain during the seventies. The leap in oil prices (and food prices) in the mid-seventies, combined with recession in the industrial countries, severely increased the trade deficits of the oil-importing developing countries. The costs of their imports rose, the demand and price for their exports fell. Many of the middle-income countries attempted to maintain economic growth and import levels by greatly stepping up borrowing from international financial markets. The increased liquidity of many international banks, brought about in part by deposits from oil surplus countries, encouraged the banks to increase their general balance of payments lending to the more advanced developing countries. The same process repeated itself in 1979-80.

These countries significantly increased their reliance on the international capital markets during the '70's. The combined annual payments deficits of middle income oil importing developing countries (those with per capita incomes of over $300 a year) was $7.1 billion in 1970, fell to $4.4 billion in 1973, but then jumped to $27.2 billion in 1974 and to over $35 billion in 1979. The 1980 deficit will be higher still. Total debt of these countries amounted to around $240 billion in 1979.

The ready access of many middle-income developing countries to private capital markets, supplemented by loans from the hard-loan windows of the multilateral development banks, generally handled these deficits adequately. In fact, availability of such funding in the mid-seventies often allowed these countries to put off taking the kind of longer term adjustment measures needed to deal with the changing world economic scene. Now the accumulated debt of these countries, greatly exacerbated by the most recent round of oil price rises, is becoming worrisome. Their ability to repay or refinance these debts will be further limited by slower world growth rates in the early 1980's as the industrial countries also have to adjust to higher oil prices and lower rates of productivity increases.

In the past, if any one of these countries had run the kind of deficit which is common now, we would likely have argued that the country had to adjust by cutting back demand to be more in line with its financial capacities. But today we are dealing with a different kind of problem, one which affects almost all countries in the world economic system.

It is true that some middle-income countries have mismanaged their economies and some stiff medicine is needed. But most of these middle income countries which import oil also confront the same kind of long-term adjustment problem faced by the industrial countries. Adjustment for them must be recognized as a broad and prolonged process, incompassing the restructuring of their capital stock and habits of consumption to conserve energy and develop alternative energy sources. Their payments deficits will only shrink over a period of year. For in the short-run they must continue to import fuel and other needed imports which allow some economic growth if they are to meet the basic needs of their people, avoid political instability, and maintain the production levels that will be necessary to transform their economies as necessary.

My comments thus far should have made clear why the United States and other industrial countries should help these countries undergo a sensible adjustment process which takes into account their need to maintain reasonable levels of imports and economic growth. Without needed finances and without the adjustment that permits their economies to sustain such financing, these nations will not be the growing market for our goods upon which we have come to count. As oil in most LDCs is largely used for public transport, industry, and cooking, it is even more difficult for them to reduce oil consumption rapidly than it is for the industrial countries. Thus if they are forced to curtail imports sharply, they are likely to reduce them more from industrial countries than from oil exporting countries. This would mean that the oil deficit would be shifted toward the industrial countries, while simultaneously contributing to reduced economic activity in those countries. An adjustment process which simply shifts oil deficits about while reducing economic growth in all countries is not sensible for any participants in the international system.

We should also bear in mind that we have strategic interests in the welfare of many middle-income countries. Requiring LDCs to adjust too quickly to economic shocks can bring on political instability which may endanger our own security and increase our defense burden. Finally, from a humanitarian point of view, lower economic growth strikes hardest at the poorer segments of society in the LDCs which already often face large unemployment problems and marginal living conditions.

For all these reasons the United States and other governments have joined in promoting new and enlarged roles for the IMF and the World Bank. Recent decisions by the IMF Board to enlarge its resources by 50%, to increase access of members to those resources, and to tailor to a greater extent economic adjustment programs to the needs of the member countries are all designed to achieve more effective adjustment. The United States is now the only industrial country which has not yet voted for the IMF quota increase. We hope the current session of Congress will allow us to formally agree to this change. In addition to the IMF's activities, the World Bank is expanding its program of lending for structural adjustment, which will also help countries obtain resources for adjustment. These innovations will not only facilitate the adjustment process in developing countries, but also encourage them to seek international assistance with such adjustment on a more timely basis, before their economic condition reaches crisis proportions and becomes much more difficult to manage.

While the problems of middle-income countries revolve around their ability to attract private financing for sensible development programs, with some help from the multilateral institutions, the difficulties faced by the lower income developing countries are of a different nature. These countries, which include the majority of all LDCs, must depend primarily on official concessional loans or grants to support development of social infrastructure. There are some projects in many of these countries which can support normal commercial financing and hard-window borrowing from the development banks. But they basically rely on aid from the developed countries and increasingly from the oil producers if they are to invest beyond levels made possible by immediate exports.

The future for these countries is particularly bleak. Their per capita economic growth rates in the seventies averaged only 1.6% per annum, compared to 3.7% for the middle-income countries. With slower world growth rates predicted for the eighties, prices and demand for many of their commodities are likely to be depressed. If foreign assistance continues to stagnate or decline in real terms, many of these countries will be required to cut imports, resulting in growth rates over the next decade which will barely allow them to maintain current low standards of living, and in some cases will mean that living standards will decline.

Most of these countries are admittedly not now quantitatively important in the international trading community. But they represent a large segment of the world's population and land area, and therefore their potential economic and political importance is considerable. Providing concessional assistance not only helps them, but as such aid is largely used to import needed goods, increases demand for our own products as well. And buying patterns established during early phases of development often continue into the future, when demand becomes larger and more commercial.

We also need to recognize that if the development prospects of these countries are stymied, their impoverished populations will continue to despoil the land through overgrazing, destroy forests for fuel and new agricultural land, and wear out the carrying capacity of the land. This will have a lasting impact on the world biosphere in which we all live.

This brings us full circle. It reminds us that we live in a world which is increasingly interdependent economically, politically, and physically. We can pursue policies which are mutually reinforcing or mutually destructive. In the economic arena we can design sensible policies which keep markets open to trade and facilitate the financing of development and adjustment from which we can all benefit. Or we can focus on immediate national problems, trying to shift adjustment onto others by closing markets, limiting capital flows, and restricting aid. The coming decade will challenge us as has no other since the thirties. Hopefully our response will be more intelligent than it was then. Our experience in the post-World War II period provides room for considerable optimism, but an optimism tempered by the realization of the magnitude of the adjustment process ahead.

Senator BRADLEY. I should like to start with a few general questions and then get into specific questions. We will take the bigger questions first.

You said that you felt that the Bretton Woods system was premised on liberal trade, the liberal flow of capital and the dollar as the reserve currency, with fixed exchange rates. You alluded to the fact that you felt only the fixed exchange rate aspect of the system had changed.

I wonder if you feel, therefore, that there is not, as I sense there is, a rising protectionism throughout the world, in this country certainly in major sectors, in Europe certainly in agriculture, and in Japan in computers and other things, and whether or not you don't think that indeed one of the other premises upon which this system is based—the liberal trade—is in real danger as each country tries to improve its own position?

Then, second, I wonder if you do not also think that the absence of complementarity in industrial countries' economies has not fundamentally altered the trading patterns and put too great an emphasis and pressure on trade to developing countries?

So, my question to you is really asking you, if you would, to defend in greater detail your statement that the Bretton Woods system is alive and well against these two specific challenges?

Mr. COOPER. On your first point, I would like to make what I suppose is a historical statement, and then address what I think is the guts of your question.

What I said, or meant to say, about the Bretton Woods system was that it had several aspects, one of which was institutional building; it created some major institutions. Second, it laid down some rules; and, third, it laid down a particular rule, if you would like, concerning exchange rates and the manipulation of exchange rates.

It is only the third rule which has been set to one side in the last decade, the rules that the Bretton Woods system did lay down, which are still intact, concerning the convertibility of currencies—it is not universally practiced today—that currencies are convertible. In fact, many developing countries continue to maintain exchange controls; but the general evolution over the last 30 years has been toward greater and greater convertibility.

The IMF as an institution exerts constant pressure toward unification of exchange rates and currency convertibility, and while it has not fully succeeded it has, I would say, largely succeeded in this respect. I do not see tendencies in today's world toward a reversion to extensive use of exchange controls or other restrictions on payments, largely because I think as the world has become more interdependent and there have been more channels developed for international transactions, it is more and more difficult for countries to do that even if they wanted to.

You raised the question of protectionism, which technically falls into the bailiwick of a different organization, that is, the General Agreement on Tariffs and Trade, rather than the Bretton Woods institution; but I think it would be fair to say, as you did, that the Bretton Woods system is premised on a degree of liberality in trade movement—not in capital movement, I would hasten to add.

There is a contradiction in capital movements and, in my judgment, it would take us too far afield to develop that. One reason we had to abandon fixed exchange rates is that we moved toward liberalization of capital movement. I would not reverse it; I think it is a good thing, but I think there was a contradiction in the Bretton Woods system in that respect.

Senator BRADLEY. Could I interrupt you there and ask you why you felt the system—the GATT, plus the Bretton Woods agreements—did not assume the liberal flow of capital?

Mr. COOPER. If one looks back, as I did on one occasion a number of years ago, at the actual language of the Bretton Woods agreement and of the discussions, the minutes of the meetings, there was enormous ambivalence about capital movements at that time. It was not accepted at the time that there should be relatively free movement of capital. It was not rejected, either.

It is just that there was a lot of ambivalence in contrast to trade where the underlying philosophical assumption was that there should be relatively free movement of trade. That came out of the experience of the 1930's in which capital movements were seen to have been highly disruptive of international transactions.

The British, of course, played a major role at Bretton Woods. The British adopted an extensive system of exchange controls during World War II, and they were not at all sure that as a permanent feature of the system they didn't want to maintain some kind of exchange control.

The whole question of capital movement is treated very ambivalently in Bretton Woods. What happened subsequently is that as private institutions evolved and as trade evolved increasingly toward long-term goods, capital goods, long-term order goods and so forth, we in the system came to realize that it is not that easy to separate capital movement from trade transactions, that, in fact, you cannot make a sharp separation.

The British themselves learned that through the famous leads and lags which they experienced every time they ran into difficulty; and it was in the end, I think, the movement of capital which, in anticipation of exchange rates, changes in exchange rates, put such heavy pressure on the adjustable pegged exchange rate system, that it had to break down. In my own judgment, that is not necessarily a matter for regret, but I am making an analytical statement here.

So, there was that ambivalence in the beginning about capital movement in contrast to trade.

On the question of whether the whole system is in jeopardy due to protectionism, I think there are very substantial risks now. I would like to draw a distinction between protectionist pressures and protectionist actions.

My sense of what has happened in the world economy is that protectionist pressures have mounted and they are stronger today than they were, say, 15 years ago. I have to be careful about the choice of dates, because there have been waves of protectionist pressures.

You may recall we had very heavy protectionist pressures in this country in the 1960's before devaluation of the dollar. Nevertheless, protectionist pressures are high at the present time. I would say, however, that the governments of all the major countries have been very sensitive to the consequences, the undesirable consequences, for the system as a whole, are acceding to those protectionist pressures and on the whole I would report the view that they have resisted the protectionist pressures quite well, and there have been far fewer protectionist actions than one might think on the basis of reading about the protectionist pressures.

I like to think that one reason for this is the OECD, which keeps countries together in conversation and reminding them collectively of their collective interests and, similarly, the seven-nation economic summits which have become an annual event, in which discussion of protectionist pressures has played an important part in the conversation among heads of governments; and all of them appreciate the tremendous disadvantages that would accrue to each country if together, advertently or inadvertently, we were to accede to protectionist pressures.

I think, while the record has not been a perfect one and, of course, there has always been provision in the system for derogations from liberal trade under certain circumstances, and they have been used from time to time—the British, for example, earlier this year found the sale of certain American textile products too competitive in their market, so they acted under the GATT to restrain those imports for a limited period of time—I find a rather juicy irony in the fact that Britain is protecting itself from textile exports from the United States—but provision for that kind of derogation has been made from the beginning. We used to call it the escape clause in this country, and we have taken certain escape-clause actions; other countries have.

On the whole, I think we have succeeded in keeping the protectionist pressures from erupting in major protectionist groups which—and I agree with your statement—would undermine the system we have built up and which, I would say, has served our interests, not only our collective interests but also the interests of the United States, very well.

Senator BRADLEY. Could you address the decline in complementarity of the industrial world economies and whether you think that presents a real problem in the way of competition for Third World markets, in the way of pressure on exports and related monetary measures? Is the Third World stable enough and are the markets sure enough to allow for the partners in the original Bretton Woods/GATT agreements to effectively assure their own growth through the process of developing the Third World?

Mr. COOPER. I think the answer to the question you first posed is "Yes"; we manage our collective affairs well. That is really the thrust of my testimony. I think it is possible and would be desirable for us collectively to take those actions which do, even in difficult circumstances, maintain growth and prosperity in Third World countries; and if we succeed in doing that, I think one after another of them will take off, as the phrase goes, become more self-sustaining in their growth and become really not only rapidly growing—they already are—but also large markets for products not only from the United States but also from Europe and Japan as well.

I do not want to suggest, however, that I consider that prospect a certainty. We could collectively mismanage our affairs; that is possible. One scenario which one could envisage 10 to 20 years out is one of economic stagnation in large parts of the world in which there is a high degree of protectionism, countries have retreated back into themselves, markets are closed and growth is slow.

I would certainly not forecast that, but I would hold that out as a possibility if we do not succeed in managing successfully through the difficult period.

On the question of complementarity, I pause, because I am not sure, and I really mean that I am not sure—not that I think it is wrong—I am not sure that there is less complementarity today than there was, say, 50 years ago or even 100 years ago among these countries.

Senator BRADLEY. The absence of complementarities among the industrial nations?

Mr. COOPER. I understand. That is what I am talking about. The complementarities in international trade have traditionally been between the temperate states and tropical states and not among the industrialized states. It has been true, was true a century ago, that North America exported large amounts of food to Europe and Japan, and Europe and Japan, on their side, were net importers of food. You know, that is still true today. The composition has changed; they produce more grain than they did, let us say, 50 years ago, although less proportionally than they did 150 years ago; but we are still a major exporter of agricultural products both to Europe and to Japan.

So, those complementarities are still there. What is true is that there are a number of products that we make that they make, and we are straight on in competition with them. You know that was true 100 years ago. We are the second country, really, after Britain, to enter the industrial revolution, and we find ourselves early on competing first on some products with Britain and other products with Germany for third markets. Sometimes the third markets were in Europe; but we have had the competition for a long time.

The United States is a big enough country so that we have that kind of competition within the United States and we don't think that there is something especially difficult because firms in Wisconsin are in competition with firms in California for business in Oklahoma. We manage; in fact, we think on balance that is part of the vigor and the dynamism of the U.S. economy, and I think that the same arguments apply to international competition.

We continue to carry the edge in some products. The Europeans carry the edge in other products, and there are some on which there is straight-on competition.

Senator BRADLEY. What I would like to do is to ask you a few more questions, and then have the other witnesses testify, and then have a panel discussion, so that it is not just the witness and me, but so that all of us can kind of participate and disagree on the record, if that is amenable to you, Mr. Cooper.

Mr. COOPER. It depends on the timing. I have another obligation at the White House at 11:30.

Senator BRADLEY. It is your choice.

70-794 O - 81 - 3

Mr. COOPER. I will stay as long as I can.

Senator BRADLEY. Let me go to your point about foreign aid and how important foreign aid is to some of our development objectives in the Third World and economic objectives, and ask you if you think the way we run our aid programs, particularly AID, is the most efficient.

Since becoming a Senator 2 years ago, I have seen a long list of horror stories of bureaucratic mismanagement of certain projects, but that is not the point I would like you to address. I would like you to address this point: should we be more like the French, who when they send their aid make sure they send aid in conjunction with French enterprises, so that specifications developed for an aid recipient are made in terms of French products.

Is there any way that through our aid programs we can be more directly supportive of American exports and investment?

Mr. COOPER. I would prefer not to comment on the quality of the administration of AID. I have my share of horror stories; but I am not sure that they are greater in AID than they are in other agencies or indeed in foreign aid programs which have their own horror stories.

The underlying truth is that it is difficult at best to function in developing countries and it is really impossible to function efficiently by our standards in developing countries. Indeed, that is one reason why they are developing countries rather than developed countries.

Again, I should not comment in detail on the French aid program, because I am not familiar with it in detail, but I will give some general impressions.

One impression is that a much higher proportion of their aid expenditures than is true for us goes into financing French personnel abroad. That is to say, they pay the salaries, of teachers especially, teachers in some African countries, even middle level bureaucrats or, I guess, increasingly technical advisers to the government.

We, for better or worse, have had an inhibition, coming partly from the Congress, coming partly from the White House, on large numbers of American personnel abroad. So this marks an important difference between the French aid program and the U.S. aid program.

When one comes to familiarizing a developing country with the products of one's own country, of course personnel are key. One does not do that just through capital projects. So they operate a different kind of program in that respect. If we were to match them, we would have to overcome some of our inhibitions about maintaining personnel, particularly technical advisers and teachers, abroad.

We do have, as you probably know, what used to be part of AID—it has now been moved this year to have some separate identity—something called the trade development program, which is designed especially to operate in countries which are not the poorest countries, the middle-income but still developing countries, where we have either phased out our aid programs, properly speaking, or we are in the process of phasing out the aid programs; but we do see a need still to finance things like feasibility studies or prefeasibility studies or get in there and give some advice on how they might do it, going to capital markets ultimately to raise the money, but they need some advice ahead of time.

This seems to me to be money very well spent. It serves to establish a line of human communication with the countries in question; it keeps those countries interested in American ways of doing things and American products and American standards, familiarizing themselves with American standards and so forth.

I am sure that in the countries in which we do have aid programs we could do that with somewhat greater consciousness than we now do, and I think it would be desirable to do so. But the trade development program is designed to operate in countries in which we don't have aid programs as such.

Senator BRADLEY. I should like to turn to the problem of Third World debt and the immediate problem you seem to allude to in your statement, that you felt it was a short-term issue, just to get them over the hump in the next couple of years and we will be all right.

I wonder if that is indeed what you think, and regardless of whether it is or isn't, which mechanism do you think is best suited to finance their oil imports and general deficit, to remedy the drag on their economies that oil price increases create, along with the inflationary problems. Do you think this should be handled through existing international monetary facilities such as the IMF? Do you think the private banking sector is loaned up? It can't really sustain another $70 billion in loans? Do you think that there should be greater emphasis on co-financing? Do you think there should be some innovative approach, such as one that was suggested in these hearings a month ago called the "equity kicker," where you provide to investors an equity interest in a pool of public works projects in the Third World along with granting them a rate of return slightly above the London Interbank rate, or should we resort to indexed bonds, or really emphasizing special drawing rights and a substitution accounts as a means for financing deficits in the Third World?

I have given you a whole menu there. What do you think is the most effective way of financing this debt?

Mr. COOPER. This is a very large topic.

Senator BRADLEY. The reason I have chosen that large question instead of 15 smaller ones is because of the time limit.

Mr. COOPER. Let me start with the general situation, and then move to the particular issues that you have raised.

Let me start out by saying that I do think this is a short-term problem. By "short term" I mean really, however, 3 or 4 years; maybe perhaps one should call that a medium-term problem, but I don't see it as a permanent problem or an indefinitely long problem with the international system.

It is true that the external debt of developing countries has grown to what, by the standards of 5 or 10 years ago, would seem to be staggering proportions; I mean, roughly $300 billion, for example, in external debts, not counting the OPEC countries. But I think it is worth keeping in mind that everything has grown since 5 or 10 years ago in nominal terms and that the real burden of this debt——

Senator BRADLEY. Everything looks as if it has grown?

Mr. COOPER. Yes, that is a useful correction. The real burden of this debt is not as great as the nominal figures would suggest. The real burden has gone up, but it has gone up rather modestly. For example, debt/service ratios of developing countries have had this gradual change, sometimes pausing, sometimes rising. They are higher than they were but for the system as a whole I see this as a problem that is limited in time and, I think, manageable, provided—one crucial proviso—that we get the world energy situation into balance. That is a necessary condition for seeing us satisfactorily through the 1980's, in my judgment.

Senator BRADLEY. Assuming the probability of success in that is not 1 in 2 but more like 1 in one 50, what would you then say about the need to find some way to finance this debt on a more permanent basis?

Mr. COOPER. I am not as pessimistic as 1 in 50 would imply.

Senator BRADLEY. Would you care to assess the probability?

Mr. COOPER. Yes. I would give it at least 1 in 2.

Senator BRADLEY. 1 in 2?

Mr. COOPER. Yes, maybe even a little better than that; but I recognize that there is some consequential probability that that will slip away from us and we will have further major increases in price. To the extent that that happens, one would have to revise what I am about to say about the debt problem.

Again speaking in generalities, I want to come back to the point I made at the outset about the enormous diversity in LDC's, because there will be individual countries that will be in acute difficulty and will require emergency action.

Speaking in general terms, I see this as a manageable problem. I see the bulk of it in quantitative terms being handled as it has been since 1974, by the private financial system, by the banking system. I think the banking system is perfectly capable of handling it. The banks, quite understandably, will shy away from the worse credit risks.

As I have just said, there will be a number of countries, perhaps an unusually large number of countries, in 1981 that fall into that category, but still when all of that is said and done, the bulk of the problem, quantitatively, will be handled by the private banks. They cannot handle the whole job, it seems to me, and therefore supplementation by a strengthened International Monetary Fund and strengthened World Bank is an essential element to a solution to this problem.

Senator BRADLEY. How would you specifically strengthen the IMF, and the World Bank?

Mr. COOPER. It has come in several phases. We augmented the resources of the IMF, the supplementary finance facility 2 years ago. At the interim committee in the spring of this year, and then more definitively in the World Bank/IMF meetings in September, the Fund revised its criteria for lending and augmented its willingness to lend to individual countries in the context of a medium-term adjustment program. It seems to me it is desirable, indeed necessary, under the circumstances.

What is important now is that the IMF have enough resources in order to accomplish that, and it is in that connection that the 50 percent quota increase takes on such an essential role.

So, I see a combination of the supplementary financing, the revisions in adjustment and the practices of IMF and the quota increase taken together as enough for the time being—I mean, for the next few years—augmenting, not supplanting but augmenting the role of the private sector.

The World Bank can also play a role in this and in particular in its what is called structural adjustment programs, which is really, I guess, one way of looking at it, a somewhat longer-term IMF.

Senator BRADLEY. Let me interrupt to say that there are some people who would argue that this new authority given the IMF is basically a recipe for disaster because what it does is force unacceptable conditions on countries like Peru and Turkey and other countries when the IMF loans them the money they set conditions that force remedial austerity to such a degree that it produces political shifts, and suddenly what was an economic risk becomes a security risk and requires an expenditure of enormous sums of money as well.

Do you see that as a problem?

Mr. COOPER. I have to say I see that issue in a completely different light.

Senator BRADLEY. Good. That is what these hearings are for.

Mr. COOPER. The IMF is in a position, we should not forget, of lending money. In the absence of it, the country would not be able to get any money at all and it really would have to adopt austerity conditions. So, the IMF is, if you like, an outlet rather than a squeezer of countries; it provides countries a little more running room than they would have if the IMF did not exist.

I would like to get the groundwork clear. I know developing countries see it differently. Some of them want free money. Second, however, the IMF is in the job not of giving income grants to countries—that is not what it was set up to do; that is not what it can do—but is in the job of giving countries some breathing space to make the adjustments that they have to make.

Now, IMF has developed a reputation over the years of imposing austerity programs in countries, and I have to say in many cases those programs were needed from an economic point of view, it is then a question of judgment.

Generally speaking, the government of the country that borrows the money makes the ultimate judgment of what can and what cannot be taken politically in those countries. The changes that were made in the IMF last fall were in the nature of the conditions that the IMF will impose, less emphasis where that is appropriate, less emphasis on the traditional demand restraints, credit restrictions, balance your budget and so forth.

I hasten to add that in many cases that will still be appropriate; but where it is not approprate more emphasis on supply-side conditions, on getting an energy program in place, on raising savings rates and so forth. I think what the IMF has done recently, far from tightening its conditions in a traditional way, has broadened the base for conditions. I won't say loosen the conditions because I hope they won't, but give themselves more room appropriate to circumstances of individual countries.

As you are aware, the IMF also has moved increasingly from 1-year programs, which really are short-term, get-your-house-in-order programs, to 3-year programs, or even 3-year programs, with a somewhat longer horizon, medium term, supply oriented and so forth.

I think all of these are healthy developments and I would hope that we would not fall into the practice of seeing the IMF as the ogre, which if it did not exist, all problems would be fine. Nothing could be further from the truth. IMF is carrying a necessary, if sometimes unpleasant, message to countries, that in order to get out of this over a period of time they have to make certain adjustments.

If the IMF did not play that role, we would have to have somebody else play that role in the system.

It seems to me, on balance, and one can find some individual horror stories, but on balance IMF has played that role well and is showing the flexibility now in new circumstances in 1979 and 1980 to continue to play it.

Senator BRADLEY. So, you would argue that in the absence of IMF intervention and lending, that the security risk would increase dramatically?

Mr. COOPER. Would be very much greater.

Senator BRADLEY. And that, therefore, in the absence of IMF lending, with conditions, the cost to the American taxpayer could conceivably be much higher because of the increased defense expenditures to take account of the increased security risk; is that correct?

Mr. COOPER. That is correct. It is not just the funds that the IMF loans increasingly; the private banks also look to the IMF as a kind of guarantor, not a formal guarantor but a guarantor, that things will come out all right in the end. So, in the absence of its IMF or functional equivalent, I think you are right, countries would have to squeeze down even harder. We would see more political revolt in countries and more political instability.

Senator BRADLEY. I know that Senator Danforth might want to ask a question. Since he is going to be taking over as the chairman of this subcommittee in the next Congress, I want to be sure to be very courteous to him.

Mr. COOPER. In the interest of reciprocity.

Senator BRADLEY. Yes, indeed. I will ask, then, another question while he is waiting:

Let us say that we have a default. Let us say Brazil defaulted on a major loan, what would be the ramifications on the system and what could we do, or should we do, to minimize the consequences?

Mr. COOPER. Just to make clear the groundrules, I don't want anything I say to suggest that Brazil will default.

Senator BRADLEY. This is hypothetical; pick another country. Pick Xanadu.

Mr. COOPER. Xanadu, which is a large debtor; in the first place, if Xanadu is a large debtor, most of the debts are to private institutions and not to public institutions; so that in talking about default one is talking about the response of private institutions and the viability of private institutions.

Let me say several things, but some of your other panelists probably have more wisdom on this subject than I do.

Senator BRADLEY. I wanted the academic view before I got the bankers' view.

Mr. COOPER. I am here to give you the official view.

I think in the first instances, if we can judge from the experiences over the last decades, banks will be very accommodating in order to avoid default. They will try to find ways to refinance.

Senator BRADLEY. At what point does that become self-defeating? I can always increase my assets by refinancing.

Mr. COOPER. That is a judgment which the management of banks and their boards have to make, of course, always with the bank examiners looking over their shoulders. I guess my own guess, from some experience before I came into government in the banking world, is that banks are remarkably flexible in this regard, and it is not until the bankers really begin to question some of their practices that they would cut back. That is stage I.

Suppose it doesn't work? Suppose in the end there is a default?

Senator BRADLEY. I was curious as to who is the examiner for the Dresdner Bank?

Mr. COOPER. The Germans have a system which is roughly similar to ours, bank examining, even to the extent it is done at the state level in Germany, rather than at the federal level.

Senator BRADLEY. You feel confident that the Federal Reserve in New York can actually determine the degree of exposure associated with refinancing by American banks abroad?

Mr. COOPER. Yes. As far as U.S. banks are concerned. Now, there is a problem which I am coming to, in terms of joint-venture banks, but in terms of U.S. banks the bank examiners, Comptroller of the Currency and in particular the State of New York examiners, have wide-ranging powers of gathering information which they can and typically do exercise to assure themselves about the quality of the loans of the banks.

Senator BRADLEY. At a hearing in this series of hearings, a representative of one of that group simply said the powers that they had were to counsel the potentially exposed bank that it was moving toward a very dangerous loan portfolio. It was then up to that bank's managers to decide if that risk was something they were willing to take.

Mr. COOPER. I said powers of gathering information. Perhaps I misunderstood your question. I thought your question was, somehow because American banks operate out of London, it represents a slippage in principle outside of the network of observation. I do not think that is the case.

Again, I am not an expert on bank examining. I think they have wide powers of information and then they, as you say, put down a mark when they think that a bank is overextended, or a loan is bad and so forth. Anyway, Phase I is refinancing in some way. Banks try to work it out.

Suppose for whatever reason the situation gets beyond that and there really is a default or writeoff of a loan as a bad loan, and that can happen, and of course it does happen many times on a small scale. By assumption here we are talking about a large debt. Here one gets to the exposure of the banking system as a whole, and there, I think, those who have looked at it find that while loans to developing countries are substantial and have grown, they still represent only a small fraction of the total assets, the total plus side of the balance sheet of the banking system, and although taken in their totality they exceed the capital of the banking system, we are not talking about the whole rest of the world; we are talking about one, although to be sure a major country, and the banking system as a whole has the capacity to absorb that.

Now, I talked earlier about the diversity of countries. There is also a diversity of banks. There is always the possibility that while the system as a whole could handle this all right, a single bank or several banks would go down. That is to say, they would technically go into insolvency. We have a system to handle that, both before it happens and after it happens.

But as long as it is not systemwide but focused on a few banks—we saw the Franklin National case several years ago; it was not a happy case in many ways, but it did not bring down the system; we managed it.

I once had a conversation with the then Chairman of the Federal Reserve, some years ago, during the early difficult period of the midseventies, and he said he would assure us as far as American banks are concerned that no bank would fail with respect to its depositors, he would discuss with the successors of the current management how to rectify the situation.

Senator BRADLEY. Do you agree with that?

Mr. COOPER. Yes.

Senator BRADLEY. Do you think the Government has any responsibility to the stockholders?

Mr. COOPER. Not to the stockholders, to the depositors.

I am now in phase III. I am hypothesizing a case in which there is not only a default but also a default that leads to a potential bank failure. Then the central bank, in our case the Federal Reserve, in Germany the Bundesbank, can step in to keep that from developing into a runaway situation, and they are prepared to step in to do that. There is an understanding among central banks through the Bank for International Settlements, as I understand it, which allocates responsibility for the so-called international bank. An Italian bank operating in London in dollars potentially poses a problem. There is an understanding. The understanding—again, this is not really my field—but as I understand it, the understanding is not fully comprehensive in scope and there are some cracks in it, or some uncovered points, and in particular joint-venture banks, where you have a bank which has ownership of the banks of several other countries and there the understanding is limited to saying that the responsibility for the joint-venture bank falls on the parent bank.

To try to sum this up, I think that we are not at the point now, nor would I expect us to be at the point within the next few years, when the international financial system is in real jeopardy from default of a major country. I would say that the situation is dicey. I don't want to convey the impression that all is perfectly smooth and no problems will arise.

The message I do want to convey is that while there are problems there, I think we have the mechanisms to deal with them, if they do arise, and that they are manageable. It does not mean that there won't be some scarey headlines from time to time. It does not mean there won't be some difficult problems in the foreign countries or in the form of banks that might arise from time to time.

Senator BRADLEY. I know the danger of drawing scenarios, but let us say that the situation in Poland really does deteriorate, the Soviets move into Poland, the West deliberates what it is going to do in response, and concludes one of the things it is going to do is to try to cut back on trade and credit, and that West Germany particularly has to cut back. As they cut back, having seen the uncertainty and jitters that went through the financial community in West Germany prior to the death of Tito, what if a lot of people decided to get out of marks and into dollars and get out of West Germany into Switzerland or into the United States, does that not generate some pressure on the German banking system, and isn't that similar to generating pressure on our own banking system?

Mr. COOPER. Let me say, first, that the example you now give is quite different in nature, it seems to me, from what we have been talking about up to now, because there are the kinds of political overtones to a Russian move into Poland that don't obtain in the kind of cases we have been talking about up to now, and of such a nature that they arouse anxieties quite different from financial anxieties. So, we are talking about a different class of problem altogether, in my view, in that eventuality, which we trust will not take place.

I would not want to get into speculating in detail about what the Russians might do, or how we might respond to it. But to take your narrow question, suppose there were a run from the mark into dollars; there we have two safety valves, and I would not venture to guess what combination, but I am sure both of them would be used.

One is the exchange rate system itself, the mark depreciates, the dollar would appreciate against the mark. To judge from some of the headlines we saw in 1977 and 1978, one would consider that a great ground for a plus on both sides of the Atlantic. I say that with some irony, I must say. I am sure there wouldn't be, but I think there is a problem in seeing too much in exchange rate movement. So that is one safety valve. No doubt some of that would happen and German goods would become somewhat more competitive relative to American goods, and that itself would have some corrective feature.

On top of that, however, we have established in the last several years really very close working relationships between the central bank, and while there is no disposition to move toward a fixed-rate system again, neither are we committed to freely floating rates. We are committed to a system of managed floating rates.

The Bundesbank and the Federal Reserve bank working together, through swaps essentially, would, I am sure, in some measure, and the question is how much, move to offset the impact on exchange markets or to mitigate the impact on exchange markets of that kind of transaction.

Once again, central bank cooperation has the possibility of eliminating the really runaway movement, if that is what one fears. There would be some movement and some movement should not necessarily be cause for alarm.

Senator BRADLEY. Senator Danforth, do you have any questions?

Senator DANFORTH. Mr. Cooper, you have been here on this job about 4 years?

Mr. COOPER. And ready to leave.

Senator DANFORTH. And where are you going?

Mr. COOPER. I am embarrassed to tell you. I am going to the other place.

I have received an appointment at the Center for International Affairs at Harvard. When I was asked by both the Harvard Crimson and Yale Daily News whether I dropped my allegiance to Yale, I said, "No, not at all. I regard Yale and Harvard as basically part of the same team."

Senator DANFORTH. Let me ask you this: You have been here 4 years. The United States has attempted to use economic sanctions and trade embargoes as a means of accomplishing foreign policy objectives. What is your departing comment on that? Is it effective as a general principle? What are the minuses as well as the pluses of economic sanctions? Should this be a strategy that the United States should follow in the future?

Mr. COOPER. Are you speaking specifically of the sanctions against the Soviet Union?

Senator DANFORTH. Soviet Union, Iran.

Mr. COOPER. Let me say that as an economist—maybe it is built into the professional training—I am sure I am not wildly enthustiastic about the use of economic sanctions to pursue a broad objective, and they generally show slippage over time and therefore I have a general disposition against the use of economic sanctions for the pursuit of other objectives.

I put it that way deliberately. It is a general disposition rather than an absolute principle. I think there are occasions in which sanctions can be effective. One has to asssess what one means by effective.

I also think there are cases where even if sanctions are not effective in terms of some stated objectives, it may be necessary.

Let me elaborate a little bit on what I mean. I guess I can say here what I said to European officials in connection with the Iranian sanctions, for example, last December, when we were negotiating them. I would not give them more than one chance in five of working. By working I mean bringing the Iranian Government around to a state where it would release the hostages in the relatively near future. But one chance in five is a lot higher than the alternative moves that we saw. It was the best of a number of unpalatable alternative courses of action.

The difficulty is that the decisionmaking in Iran was not a rational process. There was nobody to negotiate with; nobody could make a decision; therefore, one was gambling on the fact that an indirect approach would put such pressures on the system as a whole, or nonsystem as a whole, that it would gradually bring some rationality into the decisionmaking process.

That was the idea. I never gave it better than a 50-percent chance of working, but it seemed the best alternative. With that kind of spirit, we negotiated them. Here we are, over a year later, and the hostages are still in Iran. I don't think, in saying that, that the sanctions were necessarily the wrong strategy; it is just one of those things.

Senator DANFORTH. What are the minuses?

Mr. COOPER. What we do know is that the Iranian economy is in bad shape.

Senator DANFORTH. What effect has it had on us?

Mr. COOPER. One has to distinguish, I think, the different kinds of sanctions in that case. Our embargo on Iranian oil was not really seen as a sanction so much as removing that from the bargaining table. We wanted to disabuse the Iranians of any thought that they had an oil leverage on us. Then the sanctions fall into two categories, the financial measures and the trade sanctions.

I fear that there will be some long-term consequences from the financial sanctions, that there will be an element of doubt, perhaps not more than that, but nonetheless there will be an element of doubt that was not there before, in the minds of asset holders around the world about the security of their dollar assets. I think that is something we have to accept as a consequence of that action.

We recognized it at the time. We were dealing with a threat and action begun to execute the threat of massive withdrawal of dollars. We thought for a variety of reasons that we would run the risks, that there were risks and particularly long-term risks in terms of willingness of other countries to hold dollars for those short-term gains.

As far as the trade sanctions are concerned, I think the main complication is some loss of business. We did in this case, by and large, with some loopholes, engage the cooperation of all the other major industrial countries. So, there is a general array of trade sanctions, food and medicines excepted, against Iran, so that the loss of business is less than it would have been if the United States had acted alone.

The case of the Soviet Union is, I think, quite a different one. There the Soviet Union engaged in a dramatic globally unacceptable action and the question is, how are we perceived to be, and to a major extent accepted the role of the leader of the non-Soviet part of the world, how are we going to respond to that? What can we do?

When you look at the array of things that we had available to us for action, they were quite limited. We picked and chose from that list. We did the Olympics; we have done all kinds of diplomatic things and so forth; but among the things on that list is economic sanction. As you know, we took a number of forceful but limited economic actions against the Soviet Union. It was designed to make a political point, to hurt the Soviet Union, which it has done, without question; but I don't think we had any expectation that these kinds of actions would literally turn the Soviet Union around on the issue at hand. That was not part of the initial expectation.

A punitive action, although the Europeans don't like that word, a punitive action in a situation that called for punitive action, some kind of forceful, vigorous response that was perceived to be vigorous not only by the Soviet Union but also, I would say, at least as much, perhaps even more, by other countries around the world who would have been shattered and would have revised their views of the United States completely if we had sat by and done nothing under those circumstances.

Senator DANFORTH. What is the range of additional sanctions that would be possible against the Soviet Union should they attempt to invade Poland?

Mr. COOPER. If you stay away from the military area, which is not my——

Senator DANFORTH. That is right.

Mr. COOPER [continuing]. Which is not my department, we have all the things that we didn't do then, up to a total embargo on trade. There are many things that are short of the total embargo on trade.

We still trade extensively with the Soviet Union. It is true that we cut off a very substantial amount of grain and it is true that we are scrutinizing technology transfers much more severely than we did, and with the general presumption against them than we did before the invasion of Afghanistan. But even with those two conclusions, there is still an extensive amount of trade by the United States and even more by other countries.

As the chairman said a moment ago, this is an issue in which Europeans have at least as great a stake and concern as we do, and we should, as we did before, try to do whatever we do in a collective way, not just the United States acting alone, but also, as is too often the case, they would look to us to take the initiative to make the proposals and so on.

Senator DANFORTH. Do you think that sort of collectivity would be followed?

Mr. COOPER. It depends on what exactly one is talking about, and I certainly can't speak for the Europeans; but I think a Soviet invasion of Poland would have a profound effect on Europeans and that they would appreciate the importance of some kind of very strong reaction to that, and would be willing to engage in collective action; and then we would have the usual argument about how far we should go.

Senator DANFORTH. You still are not wildly enthusiastic about economic sanctions as a means of foreign policy? As I understand it, you are saying we have a very limited range of things to do. This is one. But you are not very enthusiastic about it?

Mr. COOPER. My lack of enthusiasm about economic sanctions was a more generalized one, not applying especially to the Soviet Union. We have had sanctions against Rhodesia; we have sanctions against Cuba; over 20 years against China. In the case of the Soviet Union we have to recognize the realities. It is a largely self-contained economy both by its structure and size and by its policies and, therefore, our ability to hurt—and by our I mean not just the United States, even enlarge it to include all the industrial countries, is limited; it is present but it is limited in the case of the Soviet Union whom we cannot hurt very much in that way. We can make a political point in that way. It happened in the case of grain by virtue of the circumstances obtained in January 1980 that we were in a position to hurt. That was unusual and we took it.

Senator DANFORTH. Thank you very much.

We have to move on, but one further comment, and that is, that neither Senator Bradley nor I would view Harvard or Yale as the other university.

Senator BRADLEY. Thank you very much, Mr. Cooper. If you could stay here while we have Mr. Zarb come up and testify, I think we might be able to have a discussion further, if you can stay around until after 11.

Our next witness is Mr. Frank Zarb, general partner of Lazard Freres & Co.

Senator BRADLEY. Welcome to the committee, Mr. Zarb. If you would you may summarize your statement or if you read it very fast you may read it. Whatever you wish to do.

## STATEMENT OF FRANK ZARB, GENERAL PARTNER, LAZARD FRERES & CO.

Mr. ZARB. The statement has been here a bit, so I don't think I have to read it. I don't know that I have to summarize it. Since you have questions, if you want to go to questions that is fine with me.

Senator BRADLEY. Fine, why don't we do that.

[The prepared statement of Mr. Zarb follows:]

STATEMENT BY

FRANK G. ZARB

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

COMMITTEE ON FINANCE

DECEMBER 5, 1980

What is a developing country? Who is the Third World? ...... Never before has there been an area which so clearly endorses the old axiom "Where you stand depends upon where you sit." I expect it is normal for diplomats to think in political terms, while bankers think in credit terms, and economists try to look at both without much success. Well, I would like to leave the definition of "developing countries" up to you. I don't intend to turn this discussion into a world political debate, nor am I going to try to tackle the total subject of financing nations which need help to properly develop their economies. Instead I would like to concentrate on the narrow issue of energy, which has contributed to massive economic dislocation throughout the world, visiting special damage to those countries least able to handle it. Even though I have narrowed my subject down to this small segment, I know I am running the risk of slipping into political hot water.

I read recently a NEW YORK TIMES story which pointed out that a group of nations--considered poor by anybody's standards--had refused to list the price of oil as one of the major contributors to their current economic dilemma. Perhaps that could be understood as, in world diplomacy, just as in the world of Washington politics, one does not put one's finger on political allies in a way which could embarrass them. Well, I would like to sweep all of that away today, and try to spell out some international energy facts, relate them to the challenge of financing developing economies and then attempt to list several recommendations to all who may be concerned with this enormous problem.

FACT: The real price of crude oil to importers will be more than 85 per cent higher in 1980 than it was in 1978. As a result, oil-exporting nations will have a current account surplus of over $110 billion (U.S.) this year. A large part of the balancing deficit to those surpluses will be placed with poorer countries who do not have the ability to easily borrow the offset, and if they do they will have to reshape their existing balance sheet or end up with impossible debt service ratios.

FACT: Even the so-called high dynamic countries (those with large economies and great potential) will not find it as easy to borrow their way out of this oil shock as they did in 1975-1976.

FACT: Mature industrial economies which are oil importers are in shaky condition themselves, and will find it more difficult to render assistance.

FACT: New worries about credit risks and legal limits will constrain new bank lending to the countries which need it the most. New money will be limited in size and expensive in cost.

FACT: In real terms, aid given by oil-producing countries to countries who are in the most trouble because of oil prices is down to almost one-half of what it was in 1975. "Developing countries" (regardless of your definition) are in a more difficult position today than they were three years ago. The need to do something about the problem has certainly not lessened.

FACT: Industrial nations will find that new, interesting markets could dry up, and political upheaval, brought on by economic hardship, will add to the deflation burden of the big industrial economies.

FACT: OPEC and OAPEC have every reason to want to see the problem resolved with some degree of order. Their responsibility in this sector is as important, but not more important than that of the industrialized nations of the world. Oil exporters and industrial oil importers should be natural allies in dealing with this issue, and they had better both realize it, or both groups will suffer the penalties.

FACT: The reason oil-importing countries have resented world efforts to encourage a higher level of aid to the developing world is two-fold:

(1) First, there are some who would try to place all of the blame on today's difficulties on the price of oil, thus placing an extra burden of responsibility for aid with those producers. Oil producers believe that an increase in oil prices was absolutely warranted in order to reflect its real value and that not to raise prices would have simply aggravated the uneven distribution between the "haves" and the "have-nots."

(2) Secondly, and very important: oil producers, particularly Arab oil producers, have been kept out of the mainstream of the world-wide investment community. With all of our good intentions related to recycling petro dollars, we in the west have been doing a miserable job of making oil dollars welcome in the center of the investment universe.

FACT: Further on the question of who has a stake here. Commercial bankers are already deeply committed to the developing world and have real requirements to make their commitments good, so there is no way they can or will turn their backs during this new moment of crisis.

Because energy seems to be an important piece in this economic puzzle, I should like to present a few additional energy facts:

FACT: The real price of oil will continue to increase at a rate of 3 to 4 per cent a year on average. Keep in mind that our current energy requirements, as a world, are 140 million barrels a day of oil or equivalent, which will rise to over 200 million barrels a day by 1990.

FACT: The structural changes required by all oil importers are very substantial and will require meaningful investments. But more importantly, they will require time. When we examine the financing requirements of a given country it makes little sense to act as though the required structural changes will occur within twenty-four months when we all know that they are going to require ten to twenty years. All countries have only a few tools to work with in order to achieve fundamental energy structural changes. They are:

...conservation;

...and production of domestic supplies of coal, oil, gas, hydro-electric or other conventional fuels;

...and a significant increase in the development of other exports which can be used to compensate for much higher energy import bills.

FACT: With that in mind, we are likely to see more rescheduling of international debt, and I should like to further emphasize that "rescheduling of debt" is not a dirty phrase. The purpose of rescheduling is to give countries' economic managers enough flexibility to develop the positive side of their economy, and at the same time service their debt.

FACT: Conservation is already occurring. It is happening primarily because of price. The higher price of conventional fuels has prompted all countries to do what they can to reduce consumption. Conservation, however, brings you to the inevitable objective of making sure that domestic prices are not subsidized or else the full impact of conservation is not realized; and secondly, significant investments are required to increase the efficiency of energy consumption. Unfortunately, it is those countries who can least afford these investments who need them the most. As things stand now, rich countries will achieve a higher level of energy use efficiency many years ahead of the lesser developed group.

FACT: An increase in oil production is still possible in many parts of the world. The People's Republic of China and the Republic of Turkey show varying opportunities for increasing oil production. Apparently, there are sizable natural gas opportunities in Africa and Asia and Latin America. My own estimates of what will be required to develop new opportunities for oil and gas is well over $100 billion (U.S.)

FACT: The latest surveys show that there are approximately 700 billion T.C.E.s of economically recoverable coal reserves on a world-wide base of 10,000 billion T.C.E.s of geographical reserves. To make some progress in developing the coal which can be economically recoverable (much of which is in the LDC community) will require approximately twenty years and well over $250 billion.

FACT: New opportunities for hydro-electric power seem to be limited to select circumstances, and do not offer important relief. However, where it is available it should be noted that new hydro-electric facilities are very capital intensive, and the capital has to come from somewhere.

FACT: The search for new alternative energy sources, goes on throughout the world, and because there are sizable amounts of shale, biomass, wood, gasafiable coal and even dung available in the developing world, we should not neglect that sector in the immediate years ahead.

One more comment in this general section of energy fact. Even developing countries are investing in storage programs, because they fear (with good cause) new cutoffs in the flow of oil exports as a result of any number of unanticipated violent events. I mention this in passing because emergency stockpile measures are important and are a significant part of national energy programs......

What I have said thus far is that energy is a material part of our international economic problem, that the facts indicate a long period of restructuring the world's energy sector lies ahead, that energy will continue to be very expensive and that anyone looking at the problem of financing the development of a national economy must set out a special in-depth section to analyze the energy sector, and I am not talking about the shallow review of the obvious, which unfortunately, has been the basis of many recent studies. Having laid out the problem as I see it, I should like to summarize with ten recommendations which I believe should be focused on by all who are interested in the financial survival of the developing world.

RECOMMENDATION NO. 1 - Face up to the truth about oil prices and their impact. The price of oil is a major part of the international financial problem and will continue to be so. Since prices of crude will continue to rise in real terms, we cannot treat the energy sector of any nation in the same mechanical way in which we project next year's wheat crop. This problem is here to stay until it is solved, and the solution is many years away. It is not going to do any of us any good to ignore that fact. Similarly, it is neither realistic nor appropriate to request oil-producing countries to lower their prices even for the developing world. I won't get into the details of that observation except to say that artificial subsidies for lowering the price of energy in the world, below its real value, only worsens the problem and prolongs the solution.

RECOMMENDATION NO. 2 - A thoughtful energy plan must be present in any economic development program for a developing country. Some of the work I have seen recently in this sector has been of poor quality, not nearly deep enough, and surely not thoughtful enough. Unless a developing country has a detailed energy plan it does not have a plan to develop its economy.

RECOMMENDATION NO. 3 - Face up to the debt rescheduling needs of the 1980s. Rescheduling is an essential part of some economic plans. It does little good to press a developing country into terms which they cannot possibly maintain or keep them on such a short economic leash that they cannot program for the long-term energy changes required. Under each rescheduling beats the pulse of a real economy, and with few exceptions, that economy is going to have a serious energy problem. However, while rescheduling of debt will continue to be necessary, the lender has every right, and indeed the responsibility, to insure that a responsible energy program is being implemented by the borrower.

RECOMMENDATION NO. 4 - Commercial banks must stay in the business of financing developing economies. Regardless of the bleak projections for the next two or three years, it is those economies which will form the markets of tomorrow. Further, the notion of turning this problem over to the international institutions is not sound.

RECOMMENDATION NO. 5 - Develop the plan under discussion to allow commercial banks to lend with I.M.F. guarantees. In my view, the concept makes a good deal of sense. In itself, this can be the subject of another paper, but I am absolutely convinced that this possibility offers real potential for the kind of borrowing which will be required to support energy change.

RECOMMENDATION NO. 6 - Support a World Bank expanded energy program, with some modification to better utilize the private sector.

RECOMMENDATION NO. 7 - OPEC should make more significant contributions to financing the structural changes in the developing world. Having said that I should point out that if we are going to expect OPEC to participate more fully we had better begin to welcome petro dollars into the mainsteam of the investment community.

RECOMMENDATION NO. 8 - Establish joint OPEC/industrial nations energy development funds. If we first attend to the question of hosting petro dollars in a more welcome manner, then it would seem logical for large oil-exporting countries to join in the formation of special energy development funds with industrial nations which could focus on essential energy investments. Such funds could be used to help develop the natural resources of countries. The more energy we can bring into the marketplace the better off all of the world will be.

RECOMMENDATION NO. 9 - Establish special joint funds for advanced technology. The development of advanced energy technology will benefit both oil producers and oil consumers. The expeditious development of alternative forms has universal benefits. I would ask you to consider the formation of separate joint venture projects between nations which would advance the state of new energy technology at a faster rate than if we all go it alone. For example, why shouldn't the United States, the United Kingdom, USSR and Saudi Arabia combine technologies, capital and natural resources, and build the first generation of high B.T.U. coal gasification systems in, say Africa, Asia or Latin America, where the host country may be one which is most in need of this assistance. I know that this cooperation sounds unrealistic considering the state of this battered old world. But, consider the benefits.

Consider oil-producing Arabia. Some might think that the level of Saudi interest in seeking practical alternatives to oil is relatively low...but, that conclusion is wrong...It is clear to Saudi Arabia, as it is to other major producing countries, that the value of their oil will not decrease with the orderly development of alternative forms of fuel--

They realize more keenly than others that their crude oil supplies are finite. Whether it is forty years or sixty years, the day will come when Saudi oil reserves, as we know them, will disappear...and they will be left with what? ...a store of dollars, ...legal claim on the wealth of a prosperous world economy, or the shambles of a fallen era. The Saudis know that the time to begin preparations for tomorrow is NOW--using today's financial strength to "buy into" the future. All petroleum-exporting countries have a material stake in the development of new energy sources for the post-2000-year period.

Needless to say, developing countries will have an improved opportunity to develop when their energy cost, per unit of output, can be put back into reasonable proportion relative to other economic values. This new balance can be reached only when they lessen their dependence on high-priced imported oil in favor of new energy sources.

Contrary to the conclusion of some analysts, let me assure you that the Eastern-block countries, led by the Soviet Union, also have a significant need to diversify energy sources away from conventional oil and gas....It's important to remember that the Soveits now supply oil and gas to Hungary, Czechoslovakia, Poland, Bulgaria, East Germany, Mongolia, Cuba, Vietnam, and North Korea. In addition, the USSR exports oil and gas to the west in order to obtain an important amount of its hard currency earnings. At the moment, the Soviets have a surplus of more than 100 million tons of oil and 25 billion cubic meters of gas. But signs of a declining growth rate in annual oil and gas production are beginning to show.

RECOMMENDATION NO. 10 - The private sector should take a new look at the developing world. There is opportunity in all of this. In my experience, I have found host countries more receptive to private investment opportunities because other sources of capital have tightened severely. I have seen extremely interesting private investment opportunities in developing countries described as economic basket cases. So, the role for the private sector in making a contribution here is still very significant. Actually, I believe that the real role of international institutions, such as the IMF, is to help facilitate private invesment. It is the private sector which is going to make the difference in the future.

A moment ago I mentioned the notion of joint ventures between nations that have historical reasons to argue rather than join forces. If there ever was an area in which we should join together it is to assist poor nations to cope with the energy changes that must come. Can we make an exception here and deviate some of the time and effort of world forms to team up and deal with this challenge? ....Or, will it be business as usual -- finger-pointing, bickering, posturing -- all of which have never produced one B.T.U. or fed one hungry mouth.

Senator BRADLEY. You have heard the discussion that we have had up here on financing Third World debt. I am curious as to what is your reaction to some of these questions raised. I can be specific or simply let you react to what you have heard. You have been here for a half hour.

Mr. ZARB. I would like to get specific. I will comment on just a couple of points. I will go to the last one first.

The entire area of economic sanctions in the view of the nongovernment, poor little businessman in the country, does not look like it has worked. Whenever we do things on a global scale, particularly with the world looking at us, we should try to succeed. In most instances in implementing economic sanctions, we have paid a dear price, much more significant than Mr. Cooper might know in terms of the view of many outside, with respect to the safety and security of investments here, which I think is terribly important. I think the damage done there has been considerable. I don't think economic sanctions have nearly caused the benefits that outweigh the costs that we pay as a nation. I will go further into that.

The issue more significant and one that is more in my line of study relates to the world energy situation and its impact on everything you have been talking about. I must say that I see absolutely nothing in evidence that would indicate that the energy situation impacting Third World countries that are now oil producers or don't have energy as a significant part of their difficulty, I don't see anything that is going to solve their situation or prevent it from getting worse over the next 10 to 15 years.

I think expectations that this problem will stabilize over the next 3 or 4 years can add to some bad decisionmaking with respect to the short-leash kind of financing and financing attitudes that I have seen coming out of international institutions and sometimes commercial banks on individual political issues. If you take any individual country that is significantly involved in energy imports, and you can pick any of the ones you have mentioned—go back to Turkey and see their oil imports by necessity are going to be more than a hundred percent of the total value of exports over the next couple of years and one could go down the line and stay away from the real successful developing countries, which really should not fall in the developing country category to begin with—I don't see that problem alleviating over the near term.

I think it is a subject that is not focused on sufficiently in delivering assistance by our international institutions.

Senator BRADLEY. Let us focus on it a bit. Do you think the hydrocarbon fund of the bank is a good thing?

Mr. ZARB. Yes.

Senator BRADLEY. Do you accept the projections of the World Bank that by 7 years of investment of $12 billion you can get 3 million additional barrels a day from non-OPEC countries?

Mr. ZARB. I can't accept the 3 million barrels of oil a day.

Senator BRADLEY. What do you think is a good number?

Mr. ZARB. I think you are looking at one third of that. I don't know what they are counting in terms of where it will come from. If they are talking about 3 million of oil coming directly from their investments, then I think they are wrong. If they are talking about oil that comes, for example, out of the People's Republic of China, largely from investments by multinational oil companies in joint venture agreements, then they may be right in terms of increasing that number from that sector, keeping in mind that that sector will be using more oil during that period and that the rest of the old oilfields of the world will be depleting. So that does not give me an awful lot of comfort. I think the World Bank's view in that direction has been good and I support the notion of an energy fund expanded.

I haven't supported the notion that more and more of what they do should not be tied to what the private sector is doing. Like all institutions, including the U.S. Government, sometimes the programs have a way of operating themselves rather than in conjunction with the private sector out there that has the most impact.

Senator BRADLEY. Your eighth recommendation is to establish joint OPEC-industrial nations energy development funds. In conversations that I have had with energy ministers in the OPEC countries their response is frequently, "Look, we are doing all we can to develop our own reserves. We think it is great to have developing countries get oil, but we think the industrialized countries should contribute the bulk of those funds."

Do you see this as an insoluble dilemma or do you think we should contribute all the funds?

Mr. ZARB. I don't think it is an insoluble dilemma. I don't even think it is an accurate description of the mental set of the decision-makers in the oil part of the world.

One of the reasons that the OPEC part of the world resents, and the OPEC part of the world particularly resents, our pressing them on some of these questions, aid to developing countries, more assistance to institutions that are delivering these aids, do your part, one of the reasons is that the West does not let them into the club.

Their ability to invest OPEC funds in the main stream of world enterprises is rèally precluded in many ways. They are not really invited into the system.

Senator BRADLEY. Could you for the record describe some of those cases?

Mr. ZARB. You can take any number of news stories which you have read recently, ranging all the way down to an Arab who wants to buy a hotel and suffers 3 weeks of anguished newspaper print and picketing and all the way up to their interest in getting involved in the financial community and some of the natural resources. In the industrialized world they have not been let into the main stream investments. One of my recommendations, you will note, suggested that we commingle OPEC funds with some U.S. and Western funds, not only United States, for example, the U.S. insurance companies who are investing in long-term projects, American Express kind of funds, and put together a separate fund that we commingle the Saudi-Kuwait dollars with Ecuador, and Peru, and they would be jointly managed by a board of directors and the investments would go in the main stream of the world.

That would help. They won't be identifiable Arab dollars that will go into the lending long-term mortgage of this office building in Washington, D.C., which otherwise might attract more visibility and criticism than they are willing to tolerate.

We have a problem now with some of these OPEC dollars that might be invested here being subject to takeover at some later date because of the Iranian thing that you talked about a moment ago. In my conversations with some of the oil-producing ministers I have found a high degree of interest in using their dollars today to buy into tomorrow. The notion of their cutting into the development of the forward edge of new technology I find very attractive to them. I go so far as to say if this Government creates some leadership whereby there were such joint ventures promoted, that within the next 5 years we would see several occur and there are two or three that I particularly think would have some joint merit.

Senator BRADLEY. You are saying that it is your impression that the OPEC states are interested in investing in the long term. It has been my impression that they prefer to keep their investments short term.

Mr. ZARB. They are interested in keeping their investments short term unless they are permitted into the long-term marketplace. My view of the thinking people in that part of the world is that they see the end of their natural resources, maybe in the time of their grandchildren, and they have already calculated that they are either going to have nothing left and have developed nothing with it or else they are going to buy into the world and now. I know the traditional view but I don't think it is correct.

Senator BRADLEY. To create a joint fund in the private sector, what else would have to happen? Couldn't it be created today? Couldn't Prudential set up funds now and say "OK, OPEC, give us your money and we will invest it as a Prudential fund?"

Mr. ZARB. You see, they are not prepared to do that. They are either partners or not partners. They are prepared to say "We will come in with $2 for your $1 but we would like to have at least one member on the board."

Senator BRADLEY. The first thing is board representation?

Mr. ZARB. Effective part of the management of the decisionmaking process I think is a prerequisite. Another question I am sure that they have raised is how does the U.S. Government view this total concept? I know as a fact that this question has been raised from time to time. So they want some U.S. Government umbrella, not particularly an official one, but an indication that there is some U.S. Government leadership and acceptance of this overall enterprise and without giving them a degree of comfort that I practically don't understand because I usually seek to avoid the U.S. Government's umbrella.

Senator BRADLEY. In discussions I have had OPEC ministers have indicated an interest in having their investment guaranteed above inflation. You think that is not something that they would hold to? That is a kind of negotiating position?

Mr. ZARB. Particularly if these investments are commingled where this board is making the same decision they are making today. We fund that new hotel, we create a long-term investment for a New York City office. Will we fund that corporation that is thinking of expanding its widget-making capacity? These are investments that are both debt and equity kickers that we see all the time. There would be recipients. That is a good way to start instead of recycling, which has dismally failed up to now.

Senator BRADLEY. The question of assurances from the Government I think is fairly central and to the degree you can be precise I think would be helpful for the record. Given the experience of the Iranian assets, how could they believe any assurances that were given by the Government?

Mr. ZARB. I think that that was catastrophic from that point of view. It is more catastrophic. I know that is Monday morning quarterbacking and I might have made the same decision.

Senator BRADLEY. How can they believe our assurances and, if they can't, what additional degree of risk does that entail for an OPEC investor and is that a legitimate risk to ask them to assume?

Mr. ZARB. I think it is a new obstacle that needs to be overcome with some creative thinking in this entire area and I think some fresh thinking in all the subjects that you have been discussing during these hearings. Here in terms of giving them the comfort they want, legally, legislatively, if necessary, that would tend to preclude in selected situations the possibility of the U.S. Government seizing those assets under certain circumstances might be useful. I think it needs to be explored and we should not abandon the concept simply because of that particular problem. I think there are more difficulties in that to be overcome.

It would please me to see an official of this Government take the leadership in conducting unofficial discussions with the principals and seeing if this is a notion that can be moved forward.

I heard you talk about economic sanctions and they sound so good. They almost always fail and they remove one dimension of communication. One of the more outstanding dimensions of communication between countries is the commercial sector. Once these economic sanctions start to close in, then the commercial sector closes down and you don't get businessmen communicating with each other and you remove one avenue that later on you really desperately need when you are back on the upside of developing relationships with the same country that you just hit on the back of the head with a 2 by 4.

Senator BRADLEY. If we were able to create this kind of vehicle your assumption obviously is that that would mean a lot of petro dollars will flow into long-term investment in the United States. What effect would that have on the Euro-currency market in your view and would that effect be positive?

Mr. ZARB. I think on balance it would be positive. In terms of the Euro-currency markets en toto it would take out of the Euro-currency market some of the short-term money that has been lying there. Incidentally I can stay until 11 if you want me to stay until 11. I did not mean to limit it only to U.S. investment. The concept, the notion that we have just discussed could be employed with other joint funds. You know, the Japanese have funds of their own similar to our own although somewhat different. Now if you extend that to advanced technology and if you agree with me, and many people don't, that this community of thinkers in Saudi Arabia, for example, worry about tomorrow and worry about having new energy sources tomorrow and having a piece of that action when it really is developed, whether it is a space energy system or coal gasfication system, then I think you would see that we would be moving these two worlds together and that this recycling question becomes a lot more legitimate.

I know I am oversimplifying it but I for one would like to see both of these efforts undertaken.

Senator BRADLEY. I am not quite sure that I heard the answer as to what effect do you think that would have on the Euro-currency markets.

Mr. ZARB. I don't see any direct effect that would be negative on the Euro-currency markets. Some of the new money which would be flowing from here to the Arabs into short-term London banks would not be doing that. There would be a readjustment back to where they were when this all started. I think it would be positive from my view.

Senator BRADLEY. Given your statement that the OPEC countries are interested in long-term investment, and given the degree of exposure the world banking system has now to further extension of loans, notwithstanding what Under Secretary Cooper said, does that same appeal for long-term investment apply to investments in Third World countries along the lines of the kind of investment vehicle that I described, where you pool a number of basic public work projects and give investors equity interest and guarantee a rate of return that is some percentage above the London interbank rate?

Mr. ZARB. They are not exactly the same, I don't think. The petro dollar country does not view the Third World investments with the kind of excitement that some others might paint. They see other opportunities. I think if they had an opportunity to make their investments in the kinds of ways I have just described——

Senator BRADLEY. What if Prudential is managing it?

Mr. ZARB. You see, Prudential does not manage that. The return on those investments is not what they are looking at originally. I am saying they view that more as their need publicly to do good. Unless they are doing something in a developing country like investing in a great natural resource mine, they are going to have a good piece of the equity in. Other countries that invest in Third World countries, directly incidentially, as you pointed out, other than the United States, invest with a project in mind. The Japanese Government does great banking financially of Third World country projects, particularly where there are natural resources, but guess who does all the work and who does the joint venture contract? A consortium of Japanese companies.

So their outlook is completely different. I don't think the Arab world is going to look at that particular kind of investment as a triple A investment for the moment. But they would be prepared to do their part, I think, if they saw themselves as full-fledged citizens of the commercial world, which at the moment they don't see themselves as.

Senator BRADLEY. Your view conveys that they do not see the interrelationship among investments in the Third World, investments in the industrial world, and their own economic security. It is not just charity to try to finance the Third World oil debt.

Mr. ZARB. You know, you can't in our terms I think describe the thinking that is done in their terms. Our perspective and their perspective are somewhat different. As I said in my testimony, in this situation where you stand depends on where you sit. Their view of the question you have just raised is that the lesser of the benefits to us from these activities you have described is the one where we are going to take some of our money and help those countries who need to pay for their oil bill. The better projects are the ones you described as Nos. 1 and 2. So, I am really talking about setting up an atmosphere and total relationship that will make it possible for OPEC dollars to find their way back into the Third World where they are really needed.

I say this in the context of a view that says that these countries that are in a position of having to import large amounts of oil are going to continue to pay a higher real price for it in meaningful escalating terms, not because anybody wants to penalize them but because the Arab and other producers see their oil as a diminishing supply and they will continue to raise the real price of that oil. That leaves us with an increasing size of problem in the developing countries. That means we are going to have to tap those OPEC dollars to help solve that problem. I don't think we are going to do it simply by articulating the need for them to do good in the world or else the world is going to burn.

If they had taken that large a view they would have supported our stockpile program. We stated we wanted to stockpile oil to protect the Middle East in case something bad happens there. But they take a different view of their activity and they view these things with some suspicion.

Senator BRADLEY. What I wondered is if you could comment at all on this question: if OPEC is not going to do that, is not going to finance the Third World oil debt, who is?

Mr. ZARB. If they are not, then a lot of it is going to be done indirectly. The commercial banks are still going to be in the main frame of all of this. The notion of the commercial banks lending to IMF or lending to Third World countries with an IMF guarantee is not one that should be eliminated.

Senator BRADLEY. You are referring to another one of your recommendations?

Mr. ZARB. Yes. I can't take credit for that.

Senator BRADLEY. The solution you suggest?

Mr. ZARB. That is correct. I was referring to that. My notation on that suggestion and I think it has a great deal of merit, particularly during this short-term period where we are going to have instability. These larger countries that have enormous economies, that borrowed their way out of the last oil shock a moment ago, are not having such an easy time this time around. The commercial banks are pressed. They are up to the legal limit. The United States is going through inflation. With a lot of inflation, trying to squeeze down the budget, it is not so magnanimous in what it is able to do for some of these countries. The problem is one that has more durabililty than some financial money managers are willing to admit.

The longer term view is what is going to be needed.

Senator BRADLEY. Let me ask you one more question, and then I would like Secretary Cooper, if possible, to come up and have a few minutes of interaction among us.

Another partner in your firm, Felix Rohatyn, suggested that a way to pay for OPEC oil, to given them some certainty against the potential depreciation of the dollar, is to pay in gold-backed bonds, to try to secure their assests for the long term. Do you think that makes any sense?

Mr. ZARB. I really don't know. Felix is one of my partners and he is an awful bright guy. He knows a lot more about that part of our business than I do. I just don't know enough about the gold-backed bond system to know its intricate details. He has studied it, spent a lot of time working on it, and he is convinced it is a correct approach. I can say this, I would hope that those kinds of ideas and others which may even seem more remote are open to debate in the next several years because we are really going to need some creative thinking.

I do an awful lot of work in the Third World. In some of these countries it is not going to be a problem because they have what it takes in terms of labor, geographical position or for whatever reason they are going to be able to make it.

Some other countries "ain't" going to make it. They are going to need a lot of help. But the help we deliver should be more designed with a permanent end, to eliminate some of those problems. That is why I focused on energy. Some of these countries that are 100 percent oil importers and have very little in terms of natural resources of their own are going to need an awful lot of energy help and they are conserved down to the nub already. They are really conserved down to the nub with IMF help. They will need a lot of long-term assistance to help on the supply side of the equation and other kinds of exports to help pay for it and this is not a 2- or 3-year project for the ones I know about.

Senator BRADLEY. Could I ask Secretary Cooper to come to the table. I would like to ask each of you the same question. It relates to Third World energy sources. Both of you have said that one of the ways to solve the problem of debt and the economic problem is to solve the energy problem of the Third World.

Secretary Cooper has said this means the introduction of alternate sources of energy into Third World countries. You have said that they have conserved their way to the nub, they can't conserve any more, and they are 100-percent oil importing countries. I wonder if that argues for the development of renewable energy sources in those countries and whether either of you has experienced the phenomenon of Third World countries saying, "Well, isn't it ironic that you want to sell us the solar energy that you won't put in. We want harder energy. We want coal exports, we want nuclear."

When you talk about energy development in those countries what specifically are you referring to?

Mr. ZARB. I think we have to deal with some reality here. The problem is fairly urgent and the patient is already dead. To think in terms of solar energy for some of these countries is just criminal. There is no way we can solve their problems with what we have today both in terms of technology and even basic economics to make a dent. We can be damned helpful by helping them convert some of those boilers that are now using oil over to coal, because on a Btu basis coal is going to continue to be a lot cheaper than imported oil, and some of these countries we have been talking about have a supply of coal themselves.

Yes; I think too that nuclear power in certain countries where the industrial base is large enough to support it also is an interesting area of rendering assistance. But if we look for renewable sources—look at them in this country. They are growing awful fast but the percent of our total energy consumption from renewable resources it not even measurable yet. I don't think this problem can be treated with that kind of solution.

Mr. COOPER. I basically agree with that. Let me parse the problem a little bit.

I think this is a problem which all countries have, one that is not a problem at any given moment in time but as a problem over time. I don't think there is any single solution to this problem. It is a question of how best to allocate our capital and our knowledge essentially, our human resources, to solve the problem next year, 5 years, 10 years from now, 20 years from now, so that we should be operating on several fronts at once, none to the exclusion of the other. Solar energy neither in this country nor in the LDC's will be an important part of the solution in the next decade. We ought to be paying attention to solar energy as an investment in the future.

You mentioned renewable resources of energy. Brazil has an ambitious alcohol program. It looked a lot more attractive before sugar prices went up, but presumably sugar prices will come down. Reforestation I think for some countries is going to be an important part of their energy program. It is not expensive. On the other hand it does not have a payoff for 8 or 10 or 15 years. I agree with what Frank Zarb has said about changing boilers over to coal.

Senator BRADLEY. What percent of present Third World oil imports could be displaced if boilers were to change from OPEC oil to American coal?

Mr. ZARB. I am going to give you a guess. This will be subject to examination, but I would say a minimum of 30 percent because of my total knowledge of where the oil is delivered in the world. I would say a minimum of 30 percent. Let me extend that to your view of the next step in technology.

Brazil, for example, has interior coal supplies that most people have considered have been lying there and it is pretty junky stuff in terms of high quality coal, but the notion of that being turned into a methanol or methacol I think has some merit, at least in terms of examination. Now there is a place where we can assist in terms of technological development. There is a country that will be able to see the end of the line with respect to its energy difficulties. Its alcohol problem, as Dick has said, looked a lot better before sugar prices took a turn. Now its only advantage is that it does affect foreign exchange in a modest way.

Mr. COOPER. If I could just conclude what I was saying. I think in the short run the most important help we can give to the developing countries on the energy front is through our own energy programs. We, after all, and by we I mean now the IEA countries, the industrial countries, are the major consumers of energy and oil by far, and it is a world market, it is not a perfect world market, it has its fractures and so forth, but it is tied together. So that whatever we can do in the United States, in Europe and Japan to augment supply and cut back on demand for energy will be helpful to the LDC's in the short run.

Through our aid program and through the World Bank energy program and so forth we can help assure a balance in the world oil situation out a decade through the LDC's, but quantitatively speaking most of it has to come from the major consuming area because that is where most of the consumption is.

Mr. ZARB. Could I smilingly disagree with that because we seem to be agreeing on most everything.

Senator BRADLEY. I was going to disagree with both of you.

Mr. ZARB. Maybe we should listen to you first.

Senator BRADLEY. Go ahead and make your point.

Mr. ZARB. The impact that we, the IEA countries, are going to make on total world supply in relationship to the ability of the suppliers of oil to continue to control supply and thereby control prices is an oversold concept. While I obviously agree that the more we take out of the demand side of the equation the better off the whole entire world is, and that is why I would even help the Soviet Union find oil if we could help the Soviet Union find oil, but I think when we look at the precise problem of the LDC's we have people out there starving, and I mean literally their economies are starving, they need immediate treatment for the long term.

If we can direct some of our assistance and redirect some of the existing assistance rather than building a bloody cement mill that is never going make cement and instead, use some of those resources to convert existing LNG plants or gas plants or oil plants to coal to generate electricity as a first step, I think that is a better order of priority.

Senator BRADLEY. Both of your comments about Third World energy sound not too dissimilar from comments about energy in this country and that is the real distinction between short and long term. Everything you have stated, particularly in view of your last disagreement, means long term, 5 years minimum. You are talking about nuclear and coal, you are out sometimes 10 years, 12 years.

Mr. ZARB. That really is not true.

Senator BRADLEY. It is with nuclear.

Mr. ZARB. Not with coal.

Senator BRADLEY. With coal we are talking about——

Mr. ZARB [continuing]. Two-year conversions.

Senator BRADLEY. Fine. I will accept that. Let us compromise. I say 4. So let us say 3. Three for conversions.

Mr. ZARB. You are the chairman.

Senator BRADLEY. So we are talking about the next 3 years and we are talking about within the next 3 years the possibility of these Third World countries not having the funds to pay for oil, the possibility of that creating a domino effect in the world economy and the banking system. What would you recommend as an emergency support structure for these Third World countries to get over the time, the next 3 years, in which from your own words they cannot get any relief? In your earlier comments you said, recommend filling rapidly the U.S. Strategic Reserve. But the Arabs don't like the U.S. Strategic Reserve, and that is part of the problem. Though, as you are aware I think that is part of the solution. From our own perspectives what do we do to help these countries get over the next 3 years, considering that there are people who are starving and that since we do live in an interrelated world, it is directly affecting our own economic well-being as well?

Mr. COOPER. I gave at least part of my answer earlier. On the financial side it seems to me we have in place the machinery to deal with this problem. It needs to be reinforced, augmented, the IMF quota increased, a component of that, between the private banking system and the IMF, supplemented by the World Bank. There is a mechanism taken together in place which can get funds out to developing countries under conditions which try to bridge the gap between the exigencies of right now and the longer term 3 years, if that is our compromise, whatever it is, 3 or 4 years, in which one can make a real dent in their demand for oil. That is the financial side of it.

The other side of it is in the short run, in the very short run we do not have a lot of flexibililty in terms of the oil situation. There is potentially adequate oil production to serve demand. That potential is denied at the moment by a war between Iran and Iraq. It is not economic policy, it is politics, political policy to do what we can to wind that war down and get the oil flowing again. Our influence on that is limited.

Insofar as we have it, it should be pushed in a position direction. If one could get even half of Iraqi production and exports back to where they were last August, at today's level of demand there would not be a "shortage" of oil.

Second, even failing that, because that is something that will happen in the next few weeks, although the Iraqis have begun to move oil through the pipeline again, we have very large stocks in the world seasonally corrected. We have exceptionally large stocks, even allowing for the fact that we are entering into the highest use season of the year. Those stocks should be managed in a way to bridge the period between now and the unknown moment in which Iraqi oil can be gotten going again. In the meantime the Saudis are doing what they can to help. The Kuwaitis are doing what they can to help in their peculiar way. These are the very short run things that can be done.

Senator BRADLEY. Could I interrupt right there just to follow up and then I wish you would comment on this too. Your analysis assumes supply. If supply goes, if from Iraq and Iran you don't get half of it back on, or if indeed you have a greater loss of oil, then what happens? You have, say, taken care of the major industrial countries through the IEA, insufficiently in my judgment, but what happens to these Third World countries? If we lose, say, not the 2 million barrels that we have lost or 2.5 million, but say we lose 4 or 5 million.

Mr. COOPER. I misunderstood the question. You are going into a kind of semidoomsday scenario?

Senator BRADLEY. I did not say that.

Mr. COOPER. I know you didn't but you did mention 5 million barrels a day. I call that a semidoomsday. If we lose 5 million barrels a day, we are in trouble. The way we get out of that trouble, looked at realistically because we have no alternative way to deal with it apart from drawing on the stocks, which as I say are high at the moment, is to close down activities that use energy.

That is the only short-run means; slower growth or even negative growth. So, the policy task is to avoid that contingency.

Mr. ZARB. On the short term, existing institutions are all we have to work with and we can't create miracles and miracles are not going to be created. I think we can improve some of the mechanisms. I think we can have a little more enlightenment on the world. A rescheduling of debt is not the end of the world and it is going to become more and more reality and more of these countries will reschedule debt. Rescheduling debt is designed to revamp a balance sheet so that a country can afford to build its economy and at the same time service its debt. We have seen a number of them. We will see a lot more of it.

That is one technique that has been used and should be used as a long-term tool so long as at the same time we are implementing or there is being implemented in these countries the long-term programs for a solution. We can't let go by the question of the availability of oil in the world to accommodate shortages.

Senator BRADLEY. Before you get to the supply question would you apply the rescheduling of debt to nonmarket economies as well?

Mr. ZARB. Sure.

Senator BRADLEY. If invasion of Poland takes place and the $20 billion in debt they can't make good on, you would reschedule that? Would you reschedule the Soviet debt too ad infinitum? At what point do you draw the line?

Mr. ZARB. I tend not to link the world political developments to our economic relations because it has never worked.

As a matter of concept I would say that the rescheduling of debt should be looked at as an economic question and not a diplomatic question. If there were war and we were moving troops around the world, obviously it is not going to be a good political atmosphere at home to reschedule the debt of the enemy or if, under circumstances you just described, we put different stresses into the situation.

By and large I would be rather liberal in my attitude toward rescheduling just so long as simultaneously there were programs being put in place which would answer the long-term underlying difficulty.

I get back to my question of the underlying difficulty of energy problems in some of these countries that won't go away for 10 or 15 years.

Now with respect to shortages in the world, we have had in my times since 1973 now three disruptions and we are going to have more. It is my guess that we are going to have one that is going to be a lot worse than the ones we have had just recently. I can't tell you what it will be or who will do the mischief. I don't know if it comes from political embargoes, or if it will come from beyond the control of oil managers in the economy of the world.

I don't think we have an oil stockpile in the world that is designed to take care of that kind of difficulty. I think the Japanese in moving to their 120-day level have been pretty good. I happen to know a number of developing countries who have stashed some away. The United States has done the worst job. The day will come when we are going to have to tap those reserves. While we are at it we ought to mention these IEA commitments which were done during my administration which in my view cannot be fulfilled if we have the kind of difficulty that could occur along the coast of Iran and by a group of terrorists that wants to cause disruption for a while.

Senator BRADLEY. With that assessment, how much oil should we put in the strategic reserve?

Mr. ZARB. We ought to have 300 million barrels in the ground. We only have 90. We ought to have a half billion barrels in it. That means we ought to put 150,000 to 200,000 barrels a day minimum into the storage facility.

Senator BRADLEY. 150,000 barrels a day into the storage gives you in 1 year about 50 million barrels?

Mr. ZARB. Right.

Senator BRADLEY. That would take, to get your goal of a half billion barrels in storage, 10 years?

Mr. ZARB. I said 100 to 200. The original program was designed to go up and down during periods of availability and nonavailability. We would be at 300 million barrels a day if we had stuck to the original schedule.

Senator BRADLEY. Yamani on the radio said in 1982 the world oil market would be in glut. In that situation what should be the level of fill?

Mr. ZARB. Much higher rate. I don't believe the oil will be in glut. I don't think the infrastructure could be designed to accommodate that. I think you could get to 400,000 barrels, 500,000 barrels a day to reach the target. I don't believe the glut question. Nor do I believe the argument that the OPEC countries would politically take revenge if we went ahead and more vigorously filled those salt domes.

Senator BRADLEY. Let me ask Mr. Cooper his opinion of the gold backed bonds for the purchase of oil.

Mr. COOPER. I believe that private markets should develop whatever instrument they want to develop and think they can sell. I would strongly oppose the issuance by the U.S. Govermment of the gold backed bonds. There is some history on this actually. The French Government issued the gold backed bonds some years ago and has regretted it ever since. If I were advising the Treasury I would advise them strongly against it. If Mr. Rohatyn wants to issue a piece of paper and tries to sell it between one private party and another for gold, that does not bother me. I don't incidentally think it is a solution to any of our particular problems.

Senator BRADLEY. Let me thank both of you for your participation in this. If you can stay, fine. If not, feel free to go. Not that I could retain you if you weren't inclined to stay.

I appreciate your participation today and think it is really an important subject. Even though the members weren't here they will have the opportunity to read the record.

Mr. Cooper, this is probably one of your last official appearances on Capitol Hill. Since I know Mr. Zarb has once experienced that feeling I would encourage you to have a conversation with him to see if the departure leads to a great depression or to a certain optimism.

Mr. ZARB. It lasts about 30 seconds.

Mr. COOPER. I was going to say, exhilaration is what I am looking forward to.

Senator BRADLEY. Thank you very much.

Mr. ZARB. Thank you.

Senator BRADLEY. Our next witness is Dr. Thomas Trebat, chief Latin American economist, Bankers Trust Co. in New York.

Dr. Trebat, we have had the macropolicies here, people who have dealt with the problem at the macrolevel and I think you have had a little more specific experience, a case study in Latin America. We will be interested in your testimony. If you could, I would suggest that you summarize your statement and then we will go to questions.

## STATEMENT OF DR. THOMAS J. TREBAT, CHIEF LATIN AMERICAN ECONOMIST, BANKERS TRUST CO.

Mr. TREBAT. I am very honored to have the opportunity to talk to you. I did, as you mentioned, submit a lengthy statement, including a case study of Latin America with emphasis on Brazil. Primarily, for the record, the first 10 pages of my statement constitute a summary of the major points which hopefully then are illustrated in a case study. So in my oral remarks I will simply summarize the major points.

I speak to you as an analyst for a commercial bank with a long history of lending in Latin America and throughout the developing world. I speak primarily as an analyst, someone who has by background and training, specialization in the Latin American economy with emphasis on Brazil. I am not a policymaker in our bank. I am in a position to show how the trends we have been discussing this morning are viewed from the point of view of the commercial bank.

I feel that we have used the phrase "interdependence" frequently this morning. It is very true in my view that the way in which some of the more affected LDC's solve their oil and debt and general energy problems will affect the United States. My main statement to you this morning is one that is not an argument perhaps of doomsday, it is one that we can take actions, we as a Nation can take actions that can forestall it, prevent a very undesirable future. I am not talking about rescuing floundering bankrupted economic strategies. I am not talking about bailing out and rescuing private creditors when they have made faulty assessments. I am not going to assess primarily foreign aid although this does have a very important impact on some of the smaller countries in Latin America and throughout the world.

Rather, I will suggest policies that Mr. Cooper has already mentioned that the United States could and should pursue and that is controlling our inflation and reducing our oil consumption. I think we know the impact of inflation. We must remember too, our oil consumption affects the world price of oil. Our oil consumption imposes a cost on many of these countries. We should have that as an extra dimension of our energy effort.

The second point is that I agree with your initial remark, an increased volume of fair and free trade with these countries is absolutely essential. My strongest argument will be as they have already been mentioned this morning, so I simply reaffirm them. We need new machinery in the international economic system. The IMF is all out of date. It needs to be updated to the problem of 1980. It is more attuned to the problems of the 1940's and 1950's. I argue we should support efforts to strengthen, evaluate and fund the IMF and World Bank and similar programs and other developing institutions. Very briefly, Senator, I will move to a summary of the major points I have made. Some of them, previous speakers, have saved me the trouble of reviewing indepth.

I am talking about helping LDC's make structural adjustments in the 1980's. What does structural adjustment mean? Well, the permanent increase in the relative price of oil since 1973 seriously affected one very successful pattern of economic growth, so that countries in order to continue to establish a sound basis for medium term growth in the 1980's and 1990's need to establish new patterns of growth.

This involves two things. No. 1, in a short-term austerity, belt tightening, controlling money supply, these policies come to mind immediately, but more importantly structural adjustment with emphasis on supply side economics. This is the fact that faces large oil importing countries. This is investment in energy efficient capital, alternative energy sources, increased exports. In many countries there is a shift from emphasis on industralization to emphasis on the agricultural sector, a shift from the general policy of import substitution in Latin America to policies of export promotion.

All these require large amounts of investment in and of themselves. The impact then—what has happened since 1973 in these countries? The impact of rising oil prices since 1973 and these large investment requirements, structural adjustment requirements, have made Latin American countries the largest single group of borrowers in the international system.

Latin American countries as a group, and these include some with good energy situations are the largest group of borrowers by far, reflecting the fact they have the largest economies, I think in the short and medium term best growth prospects as well. The countries that we need to be concerned about basically are two types. One type is Brazil with a very large economy, large external debt, which is a category by itself, and second the smaller countries of the Central American and Caribbean region. Many of the middle size countries in Latin America have more time to adjust or they have better natural endowments of petroleum. Some of these countries face problems as well but they are further down the road.

Why should we be concerned now if indeed the process has been going on since the 1970's, the recycling process? All LDC's continue to muddle through in some way or another. Won't the banks have substantial liquidity? What is the problem?

Again I think we are dealing with a completely different context in the 1980's. First of all countries such as Brazil, and by the way many of my remarks that follow will refer to a large country case in which analogies with Brazil are best made with countries outside Latin America such as Korea, the Philippines, Thailand, and others rather than, right now, countries in Latin America, but countries such as these have already borrowed substantial amounts of money in the 1970's. They are reaching limits that they themselves are imposing on themselves for additional loans from commercial banks. Yet they have not really accomplished structural adjustment. Their financial requirements under the best of circumstances in the 1980's will be very large for a number of years.

I agree with Mr. Zarb's assessment that this is a long term 5- or 10-year program we are talking about, not the next 2 to 3 years. In addition the risks that these countries face in the 1980's with a very high probability will increase the cost of structural adjustment, make it more expensive, make it more uncertain and slow. This is an aspect that needs to be brought out, the uncertainty aspect.

Let me reiterate the strong opinion of Mr. Zarb on the real pricing of oil in the 1980's. We have new mechanisms for supplying and pricing oil which were not in place in the 1970's which indicate the real price of oil will be rising steadily. We have world inflation, including our own poor performance, pressing world interest rates which feed directly into the world service requirement of countries like Brazil. We have political instability in the Middle East and its obvious impact. We have a very somber prospect of slow growth in world trade. All of these are risks for the 1980's, risks for the countries, risks for the commercial banks who have been financing most of the financial requirements in the 1970's.

These are risks that neither the banks nor the individual countries can control. They are risks that are completely beyond the control of either one of them and they require action at levels beyond the level of the commercial bank.

Senator BRADLEY. Could you go down the list of dangers again?

Mr. TREBAT. We are in a completely different starting position than 1973–74. We have less requirements in any case. Borrowing from commercial banks is a less attractive alternative to Brazil. I am pointing to four very substantial risks that will increase the cost and make the outcome more uncertain. These are rising real prices of oil throughout the 1980's. I do not feel that there will be a glut. I believe that OPEC will use its ability to control supply to make certain that the price of oil rises in real terms and that is the problem that we didn't have to confront in the 1970's until December of 1978.

No. 2, world inflation, much higher now than it was in the 1970's. Remember that prime interest rates are tied directly to inflation with prime rates reaching what we once considered astounding high levels. Most of the banks' debt is tied to prime. It is one thing to contract a large volume of external debt when the prime was at 8 percent and another when it is at 18 percent.

The third is political instability in the Middle East which is very obvious and the fourth is the one you mentioned, slow growth, the likelihood of slow growth in world trade in the 1980's which will block the export outlet from any of these countries.

What are the implications in the 1980's? Faced with these risks, the uncertain outcome, what will happen? I think not enough emphasis has been placed on what the developing countries themselves will be doing. I believe that faced with these risks and the rising cost they will retreat increasingly into belt-tightening austerity, slowing the rate of growth. This means postponing adjustment, stretching out even further than it would ordinarily take, despite the fact that they have viable development plans.

It means increasing unemployment, it means stagnating or declining standard of living. It means for the United States, for these countries first of all but also for us, the political and security risks that you mentioned earlier.

Again for the United States, what do these rates mean for the United States? I could very briefly state an economic argument which you yourself have made. These countries are potentially extremely poor markets for U.S. goods and services, including technology, and we are foregoing that in the event of a slow adjustment in the LDC's.

The political costs are going to be even higher. Remember, we are talking about many of these countries in Latin America. I think it does not require much elaboration on my part to realize the political complications for the United States should these countries encounter greater political difficulties in the 1980's.

Senator BRADLEY. You mean security problems?

Mr. TREBAT. That is correct, economic crises I am assuming more than likely associated with social and political crises as well.

Senator BRADLEY. Did you agree with Secretary Cooper on the role of the IMF and is that helpful in these circumstances?

Mr. TREBAT. I think the IMF is poorly designed right now. Secretary Cooper mentioned it is more an outlet than a squeezer. I agree with what he said but it is not the complete story, I don't think. Countries don't tend to resort to the IMF until they are in the worst of situations because they are fearful of approaching the Fund. I would like to cover that in detail as a way of conclusion. I agree with him but I would go a step beyond that belief.

The final cost to the United States if developing countries in the 1980's experience difficulties. I think we should remember especially in Latin America many of these countries are developing political and economic institutions that are very similar to our own. It is slow, it is sporadic in some cases. It is difficult sometimes to see the progress. But they generally are and based on a profound respect for political institutions. It seems to me we should do everything possible to encourage that.

I will illustrate my argument very briefly in the case of Brazil. Brazil, the largest and most important economy, not only in Latin America but the most important developing economy in the world, imports 85 percent of its total petroleum requirements. Its daily requirement of 900,000 barrels per day are twice as large as the next largest oil importing LDC, which is Korea. About 50 percent of the oil is imported from Iraq or was before September. Oil is now accounting for 50 percent of Brazil's total imports. You can see the squeeze that Brazil has been in.

One implication for us is that the value of our trade with the most developing country in the world has declined since 1973. Brazil has erected barriers in order to protect its sparse foreign exchange resources. This has closed off the Brazilian market to growth in U.S. exports.

Again in the case of Brazil, Brazil has a very large external, very large financial requirement. Indebtedness has increased from $12 billion in 1973 to $57 billion by 1980. It has experienced a steady decline of one-third in export growth.

Oil payments plus interest on Brazil's external debt easily absorb more than 100 percent of export earnings.

Senator BRADLEY. Say that again. It does what?

Mr. TREBAT. Oil payments plus interest on Brazil's external debt absorb more than 100 percent of Brazil's export earnings. So that for all other import requirements Brazil either must contract new debt or draw down on its international reserves. Each one dollar increase in the price of oil adds $300 million to Brazil's annual import bill. Each 1-percent rise in world interest rates adds about $350 million to Brazil's annual debt service requirements.

So I paint a fairly dramatic picture as is fairly known. The irony of it to my mind and why we should do something about it is that beyond these difficulties and large external financial requirements Brazil still does have excellent development prospects.

I say that as a person who has looked for a long period of time at the Brazilian economy. It has adequate management structures with which to bring those development prospects to reality. Some of the previous speakers have mentioned the case of Brazil but if we look at the agricultural sector, alternative energy, Brazil's profits from manufactured exports, they have ample basis for restoring sound medium-term growth. As far as their petroleum dependence is concerned—this point was mentioned earlier—Brazil is not going to reduce substantially petroleum dependence, absolute petroleum dependence, by the middle 1980's although its relative dependence on petroleum will be declining.

I have estimated that even for Brazil to continue to grow at what I would consider a fairly modest rate through the 1983 period, it will have to build its external debt to in the neighborhood of $90 to $100 billion.

Senator BRADLEY. $90 to $100 billion by what date?

Mr. TREBAT. By the end of 1983. They are starting at about $57 billion now.

Senator BRADLEY. So, it would have to almost double its present external debt?

Mr. TREBAT. To grow at what I would consider a modest rate of growth in the Brazilian concept.

Senator BRADLEY. Where is this growth going to come from?

Mr. TREBAT. Again the large numbers can sometimes frighten us. They should be seen in terms I believe of what is being required from Brazilians. Two sources of external finance. I think if the banks could have a greater degree of security on some of these external risks, which are beyond Brazil's control, beyond the banks' control, as I mentioned earlier, I think Brazil's financial requirements would be manageable, could possibly be manageable along pat patterns. It would require banks to increase their exposure to Brazil by 20 percent from now to 1983. Their exposure would have to increase 20 percent per year in order to finance this. I believe that the risks that we face today are that even these financial requirements may be underestimated or that external events will force Brazil to adjust even more slowly and this may make the final outcome of Brazil's structural adjustment more worrisome to the banks, therefore banks are likely to limit the amount of new lending they do to Brazil.

I for one do not believe that we should be frightened or concerned at all about renegotiation but I think the point that has not been made is that renegotiation is really not the answer. Renegotiation deals with past debts and the problem of the 1980's is new debt. Renegotiation is a way by which banks can protect themselves and they will but it does not help countries such as Brazil over the longer term. I am arguing it does not help the United States over the longer term.

Senator BRADLEY. Doesn't it worsen the predicament of countries such as Brazil?

Mr. TREBAT. It worsens them in the following regard.

Senator BRADLEY. You have to have bigger growth sooner in order to pay it all off.

Mr. TREBAT. It worsens prospects for Brazil in the following sense. It makes it almost impossible for Brazil to get new money from commercial banks. You can stretch out the debt-service renegotiation for as long as you wish. I am not saying this is going to happen in the Brazilian case but I am pointing to the fact it is not that important an issue for us to be considering today. It does not necessarily make it any worse for Brazil. It can be stretched out for the number of years required for Brazil to pay it back. We have seen countries in a much worse condition than Brazil undergo successful negotiation.

Senator BRADLEY. The argument that it is bad for the United States is the one I made earlier about potential markets.

Mr. TREBAT. Also political costs as well. I am arguing what is wrong with the international economic system in the present circumstances of Brazil? There is really nowhere else for Brazil to go now with its excellent development prospects if commercial banks react in ways which the commercial banks see it, protecting their own vital interests.

The IMF is a lender of last resort as presently structured. Countries such as Brazil and others are very reluctant to approach it because it involves frequently—very little in the case of Brazil—sacrificing considerable policy autonomy. It is often associated with a very short-term balance-of-payment problem. The problems of Brazil are not short term. Again that is one reason why the IMF is very useful but perhaps not as useful as it should be.

To refer to your earlier question, what cost to the United States? It is a very important cost to us in terms of exports, extremely important. I think you made that argument; I need not repeat it. I think it is a very important political argument in that Brazil, although it did not get the attention it deserves, engaged in an exciting program of redemocratization. It does not receive the attention it deserves to the extent that any program of democratization is easier in a climate of economic prosperity and rising standards of living.

It is my argument that we should do everything that is within our means, within our power, to see that those conditions exist in countries such as Brazil. That is, for me, the political risk I see.

I just want to conclude, Senator, repeating my argument of what we can do which is within our capability in the near run in the 1990's. Basically I am making four points. One is for increased and very strong support for increased foreign aid for those countries in which foreign aid can make a big difference. By that I mean smaller countries such as in the Central American and Caribbean region including but not limited to Honduras, the Dominican Republic, Costa Rica, and others. That is one.

Since the bulk of my remarks have been directed at the larger nonoil countries, what can we do for these countries? Obviously there is not much in the way of direct foreign aid we can do for Brazil. Here I recall my recommendations about our demand-management policies, particularly with regard to lowering our rate of inflation in the United States and lowering our oil consumption.

Second, we should increase their trade with nonoil LDC's who will be finding export promotion techniques in the 1990's. Their principal hope for alleviating some of their problems. We have to find ways of increasing, I would say accommodating, their need for increased exports while at the same time encouraging them to open up their markets to our goods.

There is a final recommendation that I am making and I want to maybe be on record as reaffirming the recommendations made by Secretary Cooper that the United States should strengthen and support vigorously rather than half heartedly the strengthening of the IMF and the World Bank and other institutions that can play a key role in financing and evaluating and monitoring programs of structural adjustment in the LDC's. Certainly we have to insist before we commit ourselves to strengthening these institutions that they will be properly set up to accomplish structural adjustment.

In other words, we don't want to strengthen them simply so they will keep bankrupt economic strategies alive or that they will simply be a means of helping private creditors who may have made bad loans. That is not the purpose.

Senator BRADLEY. Do you think, and again I don't want to crowd the conclusion, but do you think we can use the present institutions in the role of lender of last resort? We don't need a new institution?

Mr. TREBAT. Yes and no. We need the present institutions transformed. I would make three suggestions there.

We need to strengthen the staff and monitoring capability of the IMF. It is very much focused on the short term. Its charter limits it to looking at solving short-term balance-of-payments problems. It faces a fundamentally new challenge of payments imbalance that will last for many years and are beyond the direct reach of policy controls in a country.

The IMF, as I say, and also the World Bank, primarily the IMF, needs a staff that will allow it to identify where it is a viable program of structural adjustment, to finance it and then to monitor it. We have a right to support the IMF to be certain that that is indeed the thrust of its operation.

Second, why IMF needs to be transformed? We need in line with this to make its lending conditions much more flexible. I am arguing in favor, I would say, of less conditionality.

Third, we need to greatly increase the available resources which the Fund has. Despite the recent increase in the Fund's resources—and even that increase in resources has found opposition here in the United States—despite that increase, it really does not have adequate resources at hand in order to keep up substantially with the development and structural adjustment problems of these countries in the 1980's.

What I am saying is that we have all the creaky machinery in the international monetary system and we need to streamline it in view of the problems we face in the 1980's.

Thank you very much, Senator.

[The formal statement of Mr. Trebat for the record follows:]

Indebtedness Problems of LDCs and U.S. International Economic Policy:

The Case of Latin America

Testimony of

Thomas J. Trebat

International Economist

Bankers Trust Company

New York

before

Subcommittee on International Trade

U.S. Senate Finance Committee

December 5, 1980

1. <u>An Overview of the Problem</u>

The interdependent nature of the world economy means that the U.S. cannot avoid being affected by the very serious challenges facing most non-oil LDCs in the 1980s and by the degree of success with which these countries deal with their difficulties. At the same time, we as a nation have the ability to influence world economic developments in the 1980s in ways that will not only ease the adjustment problems of LDCs, but will further as well our long-term economic and political interests.

Oil-dependent developing countries, including most of those in Latin America, need international cooperation in order to restore a sound basis for medium-term economic growth. The most important cooperation the U.S. can provide is not by way of an increase in traditional foreign aid, although this may be very appropriate in the case of the poorer countries. The U.S. can assist the process of LDC structural adjustment in the larger non-oil LDCs by pursuing policies which result in:

(1) reduced inflation and oil consumption in the U.S.;

(2) an increased volume of trade with these countries; and

(3) strong support for the strengthening of international institutions, such as the IMF and the World Bank, which can help LDCs manage successfully their adjustment programs.

The Need for Structural Adjustment

I would like to speak with you today about the case of Latin America, with emphasis on Brazil. The permanent shift in relative energy prices since 1973 has forced many developing countries to adjust previously successful patterns of economic growth. In the process these countries have experienced heavy balance of payments pressures, not only because of higher imported oil costs, but also because of the restructuring process itself which involves large-scale investment in energy-efficient capital stock, synthetic fuels projects with long lead times, and, frequently, the opening up of sectors of the economy, such as agriculture, which are less intensive in the use of petroleum.

These balance of payments pressures since 1973 have been relieved by a greatly stepped-up level of borrowing from international commercial banks, about 40% of which has been provided by U.S. banks. The non-OPEC Latin American nations have been the most important group of borrower countries. (See attached Table 1.) Although most Latin American countries have been borrowing from international banks, just four countries -- Argentina, Brazil, and Mexico in the non-OPEC group and Venezuela among the OPEC countries -- account for 80% of total Latin American borrowing from private banks. For these countries, and others in Latin America, borrowing from private banks is the most important external source of capital.

While commercial bank borrowing helped many Latin American countries to manage balance of payments problems in the post-1973 period, it was a means of stretching out, rather than accomplishing adjustment. Thus, the second round of oil price increases in 1979-80 found these economies not only still dependent on oil imports, but burdened as well by mounting debt service obligations. The debt problem is, of course, particularly acute for the non-oil exporting countries of the region which can be divided into three groups:

- Brazil which, because of the size of its economy and debt, is a category by itself;

- medium-size borrowers such as Argentina, Chile, and Colombia;

- small oil-dependent countries of Central America and the Caribbean, such as Costa Rica, Panama, and the Dominican Republic.

The medium-size borrowers face important re-structuring challenges in the 1980s, but their petroleum dependence is low and their financial needs are less acute. These countries have time to re-structure. Structural adjustment is a much more pressing priority in Brazil and the small countries of the region. Though the situation in Central American and the Caribbean is no less dramatic in relative terms, it is the case of Brazil and those of countries with similar problems such as Korea, the Philippines and Taiwan which demand our attention and concern today.

Structural adjustment in large non-oil LDCs means that countries such as Brazil and Korea will have large financial requirements which could not be reduced easily for years under the best of circumstances. On top of this, these countries in the 1980s will remain highly vulnerable to external shocks which will almost certainly raise the costs of adjustment. These external shocks include:

(1) oil prices that will be rising steadily in real terms rather than declining as they did after 1973-1974;

(2) mounting world interest rates which make debt servicing more difficult;

(3) political instability in the Middle East which threatens oil supplies; and

(4) slow growth in world trade which darkens prospects for export growth.

These elements provide us with new risks for the 1980s. In this fundamentally different world, questions will arise as to the ability of these countries to attract the financing needed to continue the re-structuring process. Will international banks be willing to continue increasing their loans to non-oil LDCs at the rate of 30% or so each year in the face of rising uncertainty about

70-794 O - 81 - 6

the functioning of the international economy? Despite their excellent development prospects, can the large LDCs afford to continue accumulating debt if rising oil prices and interest rates and sluggish exports prevent output in these countries from rising fast enough to permit servicing of the additional debt? Faced with these same questions, I think that many non-oil LDCs in the 1980s will respond by postponing or greatly slowing the process of strutural adjustment. This will lower financial requirements, but also expose these countries to periodic balance of payments crises as long as structural adjustment is postponed. More importantly, slower growth paths in these still poor countries will bring enormous human costs in terms of unemployment and stagnating or even declining standards of living.

How is the U.S. affected?

Sharply reduced rates of growth in the major non-oil LDCs in the 1980s would have important economic and political consequences for the U.S. Economically, these countries represent important markets for exports not only from the U.S. but from all O.E.C.D. countries. A sustained slowdown in export demand from these countries would affect the US. directly, in terms of our own exports, and indirectly through its recessionary impact on growth in the other industrialized countries. Politically, the costs are likely to be even higher for the U.S. Brazil and other large LDCs in Latin America are headed for major roles in world affairs in the near future. Many of the most affected LDCs, in Latin America and elsewhere, have made important development strides in recent decades. Albeit slowly and sporadically in some cases, these countries are developing economic and political institutions quite similar to our own on the basis of shared ideals and values. Continued movement in these directions is now imperiled by the spectre of grave economic difficulties and, possibly, rising social unrest in the 1980s. To the extent that we as a nation can act to increase the odds that non-oil LDCs in Latin America and elsewhere can adjust their economies successfully in the 1980s, we are acting, in my opinion, in our highest self-interest. In an attachment to this statement, I have used the case of Brazil, one with which I am very familiar, to illustrate both the nature of the structural adjustment problem in a large, non-oil LDC and my conviction that the U.S. can lend important assistance to such countries in the 1980s without large, open-ended commitments of taxpayer funds.

3. Conclusions: What the U.S. Can Do

If Brazil and similarly affected LDCs continue to follow appropriate adjustment policies, the financing problems in the 1980s will be manageable. The risks that I see are that developments in world economics and politic system beyond the control of the non-oil LDCs will make the adjustment process slow and uncertain in outcome. In this case, the commercial banks will need the support of the U.S. and other governments in order to continue the recycling process. In order to reduce the systemic risks of recycling, I feel that the U.S. should consider the following guidelines for its international economic policies in the 1980s:

1. The most important cooperation the U.S. can provide to non-oil LDCs faced with large restructuring requirements in the 1980s would be the vigorous pursuit of internal policies that result in lower inflation and reduced petroleum-dependence in the U.S. Rising U.S. inflation forces up international interest rates which add to debt service problems for the non-oil LDCs and may also worsen the terms of trade for these countries. Our dependence on imported oil affects non-oil LDCs directly since rising consumption of oil in the U.S. gives OPEC added flexibility to raise prices and curtail supplies. A major concern is that our internal consumption of oil will once again rise sharply as the economy pulls out of recession. The U.S.

has many reasons to guard against this possibility but one of these is the dramatic consequences rising U.S. consumption would have for oil dependent LDCs. Thus, we should continue to support oil price decontrol policies and seriously consider taxes on oil consumption.

2. U.S. trade policies for the 1980s should avoid bringing restrictive measures to bear against imports from non-oil LDCs. Countries such as Brazil with a vast potential for increasing industrial and agricultural exports on the basis of legitimate comparative advantage will be finding in export promotion policies their best means of avoiding severe economic and social difficulties. We should redouble efforts to anticipate which industries and workers in this country would be affected adversely by increased fair trade with LDCs in the 1980s and continue efforts to encourage these affected industries to adjust. At the same time, we must continue encouraging the non-oil LDCs to open up their economies to U.S. exports. We stand to gain directly from these policies in at least two ways: first, by promoting structural adjustment in the U.S.; and, second, by allowing U.S. consumers the benefits of freer trade.

3. The U.S. should take every opportunity to reform and strengthen the international institutions that are in the best position to evaluate, finance, and monitor programs of long-term structural adjustment in developing countries. We should, of course,

continue to support very strongly an increase in low-cost lending to the smaller, poorer LDCs in Latin America and elsewhere through such institutions as IDA and the IADB. This lending is warranted by humanitarian concerns alone. But I am referring specfically here to lending for structural adjustment purposes to countries with viable development strategies which will be buffeted by external shocks in the 1980s. The IMF is the key institution, but its present charter restricts its usefulness in solving the major international financial problems of the 1980s. We should devise and propose measures that will help transform the IMF from an institution too narrowly focussed on short-term balance of payments problems at a time when the major problem confronting Brazil, Korea, and other countries is one of long-term structural adjustment requiring large scale investments. A precondition for our support must be that these institutions support efficient structural adjustment programs in the non-oil LDCs. Our national interest rests in promoting sound medium-term grwoth in these countries, not in extending financial lifelines or rescuing private creditors. Once we are confident that a strengthened IMF and World Bank will promote structural adjustment, we should contribute our full share to increasing the lending resources of these institutions.

2. Brazil: A Case Study

The pressures for adjustment are particularly acute in Brazil's case. Brazil is, by far, the largest petroleum importer in the developing world. At 850,000-900,000 barrels per day, Brazil's petroleum imports are almost twice as large as those of South Korea, the next largest LDC oil importer. Brazil's production of crude accounts for only 15% of oil requirements; the prospects for increasing domestic crude production are not encouraging. The first round of OPEC oil price hikes in 1973-74 effectively put an end to the remarkable 1968-73 expansion of the Brazilian economy. Brazil's adjustment to the 1973-74 round of oil price increases was slow and partial, but policymakers were obviously reluctant in 1973-74 to depart radically from an economic model which until that time had been considered highly successful. Thus, Brazil adjusted to the first "oil shock" by squeezing non-oil imports, including many equipment and raw material purchases from the U.S., reaffirming subsidized export promotion schemes, and encouraging inflows of foreign capital. But policymakers did relatively little to restrain overall spending in the economy and, aided by fairly strong export growth, the Brazilian economy performed relatively well in 1973-79. Major public sector projects were carried out, the industrial sector continued to expand, manufactured exports continued to grow and substantial job creation occurred. Overall GDP growth exceeded 6% per annum in 1974-79, low by comparison to the 1968-73 period, but much higher than the rates recorded in the last five years by the O.E.C.D. countries or by other countries in Latin America.

This performance, however, brought adverse consequences for domestic prices and the balance of payments which have left Brazil even more vulnerable to OPEC price increases. Current account deficits, which measure a nation's need for new borrowing, averaged about $6 billion in 1973-77 and have increased steadily to an estimated $13 billion in 1980. Brazil's external debt increased from about $12 billion in 1973 to an estimated $57 billion by the end of 1980.

Other serious economic problems also cropped up in the 1973-79 period. In the absence of effective policy restraints on aggregate demand, inflationary pressures grew from about 30% per annum to about 110% in 1980. Measures to protect the balance of payments caused a bias in favor of inefficient, capital-intensive import substitution. Such measures were well received by domestic producers, but hampered Brazil's export efforts. A proliferation of government controls, incentives, and subsidies complicated decision making throughout the economy. Importantly, little was done to cut the economy's dependence on imported oil. Despite high gasoline prices and a widely acclaimed alcohol program, petroleum imports actually increased by more than 30% between 1974 and 1980.

An important consequence fo the U.S. has been a decline in the importance of our trade with Brazil. Brazil's renewed emphasis on import substitution has cut dramatically into the export growth to Brazil that U.S. producers might have expected. At the same time, the growth of Brazil's export of manufactured goods to the U.S. was hindered by the anti-export bias of its own policies and by U.S. countervailing duties.

. Increasingly, trade between the two countries is being dominated by trade in agricultural commodities in which the bilateral trade balance favors Brazil. (See attached Table 4.)

Brazil's problems have come to a head during 1980 and continued difficulties can be anticipated for 1981 and beyond. Inflation may remain in the 80-100% range. The value of petroleum imports almost doubled from $6 billion in 1979 to $11 billion in 1980 and may exceed $13 billion in 1981. Debt servicing payments (principal plus interest) will require more than $14 billion in 1980.

All of this implies Brazil's extreme vulnerability to events in the international economy that are essentially beyond the control of policymakers. For example, each $1 increase of oil now costs Brazil an additional $350 million each year. Given the high level of bank debt, each 1% increase in world interest rates adds about $400 million annually to the import bill. Between oil imports and debt service payments, Brazil this year must use the equivalent of more than 100% of its export earnings, and it is difficult to see how this ratio can be lowered substantially over the next few years. This means that in order to meet all other foreign exchange needs, Brazil must either use reserves or borrow additional funds.

Whether or not Brazil will adjust in the 1980s is uncertain, but the country very clearly does have excellent development prospects. The key issue, as I see it, is whether Brazil will adjust smoothly over a period of years in the 1980s or, instead, move from one economic and social crisis to another. Brazil's internal policy has not been error-free; certainly mistakes have been made which have led to considerable debate within Brazil and to subsequent changes in policy direction. For the most part, however, I feel very strongly that the management structures in Brazil are adequate for the adjustment challenge. In the near-term, policymakers recognize that a priority emphasis must be given to slowing growth by placing restrictions on the government budget and consumption spending. Such restrictions on domestic spending will lower the demand for imports and foreign credits, limit money growth, and permit increased exports.

"Belt-tightening" or austerity are not sufficient to solve Brazil's problems and policymakers recognize the need to implement a strategy of investment that will restore the basis for sound medium-term economic growth. Furthermore, austerity policies have very dire social effects in a country such as Brazil which, despite its evident development progress, is still characterized by widespread poverty and high rates of population growth.

Thus, adjustment in Brazil means emphasis on "supply-side" economics: restructuring the pattern of Brazilian economic growth. I am convinced that viable strategies to achieve this goal are available and are being implemented, if only gradually for now. In general lines, Brazil's "supply-side" economics in the 1980s would emphasize three large areas in which Brazil has obvious resources and development potential: agricultural growth, alternative energy development, and a more internationally competitive industrial sector.

The major emphasis in Brazil's future industrial policy should be to continue using the exchange rate and other policy tools to stimulate increased exports of manufactured goods. Brazil already produces a vast range of industrial products which it could sell competitively in world markets given proper policies. Noteworthy success has already been achieved in the export of such products as soluble coffee, shoes, office machinery, automobile parts, metal products, and orange juice. Manufactured exports have continued to grow at 30% rates in recent years. (See attached Table 5.)

The gradual weeding out of inefficient producers of non-essential goods should be another element of future industrial policy. Many firms in Brazil have survived in the past because of high tariffs, import restrictions, subsidized credit, and cheap petroleum. At the same time, increased support is vital for the rehabilitation and modernization of traditional industries producing essential consumer goods such as food, clothing, and low-cost housing. Increased output by these less sophisticated and labor-intensive industries will fit in well with social goals of increasing employment and lowering the price of essential goods.

Agriculture has emerged as the leading sector of the Brazilian economy in the last year or so, but it will take years of consistent policy and large investments before agriculture's potential can be more fully exploited. Substantial export capacity, in soybeans, meat, and other primary products has been developed. Given appropriate policies, Brazil clearly has the potential to capture an increasing share of world trade in food. Brazil already ranks among the three largest food exporters in the world and is the only exporter with a still large agricultural frontier.

In the energy area, transportation is Brazil's chief vulnerability. Seventy per cent of all cargo transported is moved by trucks on highways. Despite crash programs to rehabilitate the ancient railroad system, little can be done in the medium-term to relieve this problem. Further, the dependence on petroleum throughout the industrial structure is deep-rooted. Large public and private investments will be needed to adopt the capital stock of the economy to the new era of more expensive energy.

Brazil has other options to reduce dependence on foreign oil. Massive programs have already been launched in hydroelectricity, coal, oil exploration, and alternative fuels. But the going will be slow and the oil import bill will continue to mount. A greater stress on conservation and more efficient administration of ongoing energy projects could yield significant benefits.

Summing up this view of longer-term adjustments facing Brazilian economic policy, the present difficulties provide incentives for needed change and,thus, bring opportunities as well as risks. The ability of policy makers to exploit these opportunities is one of the key questions for Brazil and the international financial community in the 1980s. Another is the availability of the external resources to support Brazil's adjüstment program. I have made rough but reasonable "base case" estimates of the resources needed to support Brazil's adjustment over the next few years, including financing from commercial banks. (See attached Table 6.)

The projections are based upon assumptions regarding Brazil's rate of economic growth through 1983 (4-5% annually), world oil prices (increasing about 3% in real terms), and world interest rates (averaging about 12%). The rough estimates for 1981-83 assume that Brazil's current account deficit will average about $15 billion each year. This implies that Brazil's external debt in the "base case" would expand from about $57 billion in 1980 to almost $100 billion by 1983. When amortization payments on Brazil's existing international debt are also taken into account, Brazil's gross financial requirements will be on the order of $25 billion annually. Based upon past patterns of financing, Brazil would look to the international banks to provide about $18 billion annually. Since commercial banks would also be "rolling over" maturing loans, only about $9-10 billion would annually constitute new loans from the international banking system. This signifies an annual increase of about 20% in average commercial bank exposures to Brazil.

Is such a level of increased lending manageable? And what happens if it is not? Again, a major concern for the banks is that Brazil demonstrate a viable strategy for adjustment, i.e., a strategy that, if supported via new international lending, will generate the output necessary to repay the loans. On this score, Brazil has probably several viable strategies as well as abundant managerial talent. Yet other considerations will also play a role in bank financing decisions: will regulatory authorities in the U.S. or other countries permit bank lending to Brazil to expand more rapidly (in all likelihood) than bank capitalization over the next few years? Quite apart from regulatory concerns that the banks may have, will they find it desirable to increase the proportion of Brazilian loans in their overall portfolios from the point of view of prudent diversification of risk?

These are important questions, but ones that could probably be answered affirmatively in view of Brazil's obvious long-term development potential. But still other considerations enter, and these go to the heart of the matters I wish to bring to your attention today. These relate to dangers for Brazil posed by the precarious state of the international political and economic system in the 1980s and include wasteful patterns of energy consumption in the U.S. and political instability in the Middle East, i.e., factors which tend to raise the price of Brazil's oil. Other systemic risks include half-hearted anti-inflation measures in the U.S. and elsewhere which result in sharp rises in world interest rates and in Brazil's debt servicing burden. A related risk is that U.S. and world economic growth will be sluggish in the 1980s and, thus, Brazilian exports will not grow as rapidly as they must to assure timely servicing of its external debt.

How might banks react to a perceived worsening of these systemic risks which, it bears repeating, have absolutely nothing to do with the long-term viability of Brazil's adjustment program or the quality of its economic management? It is my feeling that banks, faced with suddenly expanded borrowing requirements from Brazil or other oil-importing LDCs will respond in a way consonant with prudent banking practices by limiting, possibly sharply, new lending.

What then would be the alternatives for Brazil? Brazil would in all likelihood react in two ways. First, by seeking additional funds from international agencies, mainly the IMF and the World Bank, and, second, by reducing its borrowing requirements in the only way it can: i.e., by slowing down or postponing its structural adjustment.

Such an outcome, which is certainly not in the best interests of Brazil's long-term social and economic develpoment, is almost as certainly not in the best interests of the U.S. either. From the point of view of Brazil, the IMF and the World Bank, as presently constituted, would be poor substitutes as sources of financing for Brazil. The IMF, for example, has relatively little to offer to Brazil financially, would impose harsh conditions for the minimal amount of lending, and, most importantly, is not equipped at present to help finance and monitor the type of long-term structural adjustment that Brazil requires. Along these same lines, a prolonged period of austerity and slow growth in Brazil would greatly and, possibly, needlessly impose severe additional hardships on the millions of rural and urban poor in Brazil.

Why would severe financing restraints imposed on Brazil not be in the best interests of the U.S.? Economic arguments can be alleged, e.g., the sacrifice of potentially important trade ties with one of the world's most important economies. Yet these arguments are not the strongest. Beyond this, we should recognize that past failures of U.S. policy, particularly in regard to energy use and inflation, have imposed heavy costs on countries such as Brazil. More importantly, severe economic difficulties in Brazil in the 1980s would risk social and political instability in that country. Brazil is, of its own volition and in accord with its own values and traditions, developing economic and political structures that are similar to our own. Politically, Brazil has made important strides in recent years toward re-establishing an open, pluralistic society based upon respect for individual freedoms. This process of re-democratization springs from authentic Brazilian traditions, but it has been helped along by the example and open encouragement of the U.S. To the extent that a process of re-democratization is vastly easier in a climate of economic prosperity and rising standards of living, we as a nation should do everything within our power to assure that such conditions prevail in Brazil.

70-794 O - 81 - 7

Table 1.

Latin America in
Net Lending of International Banks
to Non-OPEC LDCs
(in billions of U.S. dollars)

| | 1978 | 1979 | 1980[1] |
|---|---|---|---|
| **Bank Claims on:** | | | |
| Non-OPEC LDCs | 120.8 | 157.1 | 172.2 |
| Latin America | 79.9 | 103.5 | 114.0 |
| **Bank Liabilities to:** | | | |
| Non-OPEC LDCs | 76.6 | 89.6 | 92.2 |
| Latin America[2] | 33.2 | 38.4 | 35.6 |
| **Net Claims on:** | | | |
| Non-OPEC LDCs | 44.2 | 67.5 | 80 |
| Latin America | 46.7 | 65.1 | 78.4 |
| Rate of Growth | | 39.4% | 44.0%[3] |

Source: Bank for International Settlements "International Banking Developments -- Second Quarter 1980", November 19, 1980, Table 6.

[1] June data.

[2] Excluding off-shore banking centers and Venezuela.

[3] Jan-June on annual basis.

Table 2.

Largest Latin American
Borrowers from International
Banks as of end-1979
(amounts in billions of U.S. dollars)

| Borrowers | Gross Bank Claims | As % of Total Claims on Latin America |
|---|---|---|
| Argentina | 13.4 | 10.2 |
| Brazil | 38.6 | 29.4 |
| Mexico | 30.9 | 23.5 |
| All Other | 20.8 | 15.8 |
| | 27.6 | 21.1 |
| Total | 131.3 | 100.0 |

Source: Bank for International Settlements, "Maturity Distribution of International Bank Lending -- end-December 1979", July, 1980, pp. 2-3.

Table 3.

U.S. Banks: Cross-border and Non-local Currency Claims on Non-OPEC Latin American Countries
(in millions of dollars)

| | 1977 | 1978 | 1979 | 1980 (June) |
|---|---|---|---|---|
| Large Borrowers | | | | |
| Argentina | 2639.7 | 2752.5 | 4824.4 | 5643.7 |
| Brazil | 11992.5 | 13438.1 | 13583.8 | 13991.8 |
| Mexico | 11213.2 | 10657.3 | 11451.6 | 12760.3 |
| Medium Borrowers | | | | |
| Chile | 821.1 | 1527 | 2460.2 | 2645.9 |
| Colombia | 1293.1 | 1497 | 2168.9 | 2128.5 |
| Peru | 1831.3 | 1664.7 | 1399.8 | 1476.2 |
| Small Borrowers | | | | |
| Bolivia | 446.2 | 590.1 | 548.9 | 479.9 |
| Costa Rica | 424.7 | 432.8 | 567.2 | 618.7 |
| Dominican Republic | 283.5 | 386.2 | 376.6 | 419 |
| El Salvador | 188.2 | 316.7 | 198.4 | 117.2 |
| Guatemala | 226.4 | 241.4 | 336.9 | 359.4 |
| Honduras | 253.3 | 312.5 | 291.8 | 268.0 |
| Jamaica | 247.3 | 229.3 | 236.7 | 215.9 |
| Nicaragua | 562.5 | 571.7 | 410 | 397.3 |
| Paraguay | 33.2 | 84.8 | 114 | 154.5 |
| Trinidad & Tobago | 44.5 | 87.2 | 100.2 | 74.8 |
| Uruguay | 203.3 | 150.8 | 279.4 | 338.2 |
| Other | 830.3 | 590.0 | 1470.3 | 891.6 |
| Total | 33535.1 | 35531.2 | 40820.3 | 42981.8 |

Table 4.

U.S. TRADE WITH BRAZIL

| | 1974 | 1978 | 1979 |
|---|---|---|---|
| EXPORTS | | | |
| Total | 3,067 | 2,978 | 3,217 |
| Non-agricultural | 2,827 | 2,444 | |
| Agricultural | 240 | 534 | |
| IMPORTS | | | |
| Total | 1,671 | 2,827 | 2,941 |
| Non-agricultural | 641 | 1,290 | |
| Agricultural | 1,030 | 1,537 | |
| TRADE BALANCE | | | |
| Total | 1,396 | 151 | 276 |
| Non-agricultural | 2,186 | 1,154 | |
| Agricultural | - 790 | -1,003 | |

Table 5.

Growth of Brazil's Manufactured Exports, 1973-80
(in millions of dollars and per cent)

| | Value | Annual Growth |
|---|---|---|
| 1973 | 1.434 | |
| 1974 | 2.262 | 57.8 |
| 1975 | 2.584 | 14.2 |
| 1976 | 2.776 | 7.4 |
| 1977 | 3.839 | 38.3 |
| 1978 | 5.083 | 32.4 |
| 1979 | 6.683 | 44.8 |
| 1980 | 9.156 (est.) | 37.0 |

Table 6.

Brazil: Major Balance of Payments Trends, 1977-80
(in millions of dollars)

| | Petroleum Imports | Balance of Trade | Current Acct. Balance | Foreign Debt |
|---|---|---|---|---|
| 1977 | 3,518 | 96.8 | -4,038 | 32,037 |
| 1978 | 4,615 | -980.2 | -5,888 | 43,511 |
| 1979 | 6,091 | -2,717 | -10,497 | 49,900 |
| 1980 (est.) | 11,096 | -3,196 | -12,856 | 57,056 |

Table 7.

Brazil: Actual and Projected Total External Financing
1977-1983
(millions of dollars)

| | Gross Financial Requirements | of which, From Commercial Banks |
|---|---|---|
| 1977 | 8,138 | 5,162 |
| 1978 | 11,161 | 11,840 |
| 1979 | 17,797 | 10,886 |
| 1980 (est) | 20,156 | 11,197 |
| 1981 (proj) | 21,879 | 15,056 |
| 1982 (proj) | 23,379 | 15,464 |
| 1983 (proj) | 26,484 | 18,626 |

Senator BRADLEY. Thank you very much for your testimony, Mr. Trebat. I think that it was extremely helpful to go into some detail about the experience of one country and not spend all the time talking about the problems of the whole world.

Now I wonder if you could tell me, would the Latin American countries be interested in putting together a package of projects, dams, other hydroelectric projects, whatever, and providing the equity or some equity to oil-producing states as part of their payment for oil? The assumption when this idea is brought up is always that the oil states are not interested in it because of the unsure investment. Yet in the Third World countries there is also a political question as to whether they actually want to sell part of their natural patrimony in effect, to a foreign state or an OPEC state. What do you feel?

Mr. TREBAT. What you are suggesting is that we revert to earlier patterns of economic development in Latin America. At the beginning of the century for most of the hydroelectric projects they went through almost 50 years of political difficulties to remove foreign ownership. In Latin America today most economic infrastructures, including the energy infrastructure, are a hundred percent owned by the state in each case. That is one point.

No. 2, I would claim that for most dams and hydroelectric projects and so forth adequate financing is available already.

Senator BRADLEY. You are saying only the turkeys are gong to be on the list of projects? If it is a good project, you can get financing for it now?

Mr. TREBAT. You can get financing for it already. I believe there would be serious political difficulties to surrender ownership and control——

Senator BRADLEY. Any percent of ownership, say 10 percent in order to pay for oil?

Mr. TREBAT. It could be of some use. My guess is that there would be serious political difficulties, especially when it came to guaranteeing a rate of return, which I understand OPEC would naturally insist upon. That was a pat pattern of development of the infrastructure in Latin America and has been soundly rejected.

Senator BRADLEY. What about cofinancing, combining World Bank and private bank resources?

Mr. TREBAT. I think measures along those lines are welcome. We are seeing examples of it in the large hydroelectric projects right now in Brazil which is a very feasible approach to developing energy resources. Again I do not know how important it is for the equity stake to be there. I think the primary concern of the Latin American countries is for financing.

Senator BRADLEY. Concerning increased foreign aid to Latin America, is there any other specific recommendation about the foreign aid that you would like to make, either to make it more effective for Latin America or to make it more palatable here? The second question is my problem.

Mr. TREBAT. I heard you mention earlier, Senator, the aspect of tying aid to U.S. exports. Again as a nation we made a major issue in our relations with Latin America doing away tying our aid to external exports in the early 1970's.

Senator BRADLEY. I did not make the recommendation of tying our aid to exports. I suggested that we might provide our aid in such a way as to design projects and create markets that favor U.S. products and services. It is a story that we heard about during our consideration of tax legislation last year, that if you have French working in a country they will buy French products. If you have set up the conditions so that they are American personnel and designs, then the products that can be purchased are likely to be American.

Mr. TREBAT. I understand that. If that is the way it can be made politically more palatable, that is something we should be considering. I am arguing that foreign aid, not across the board in Latin America, but those countries which in small amount they can afford in the 1980's, will make a difference. So, the effect on exports would be small anyway.

Senator BRADLEY. If you were going to a town meeting in New Jersey and the audience were hostile to foreign aid generally, how would you make it clear then that it is directly related to their own well-being?

"Why should we increase aid to Nicaragua? It is a Communist state, isn't it," so the argument goes.

Mr. TREBAT. That is a special case. I won't handle it in the context of my remarks.

Senator BRADLEY. Why should we provide aid to a country which is a dictatorship?

Mr. TREBAT. I have struggled with this question before. It is difficult. I think the most important argument we can make is the humanitarian argument regarding standards of living. I think that is one.

To depart from that and to proceed to another level, I think we can tell people again at the town meeting in New Jersey that it is in our long-term political interest as well. We are seeing already the impact of low standards of living and high rates of population growth in many of these countries, the impact it is having on immigration. This is something that is in the newspapers every day.

Foreign aid should be sold more as a way of improving dramatically, in the case of some countries, economic conditions within those countries. That is an argument that makes sense today. The argument about increasing our exports appeals basically to a small group and not to the average voter.

Senator BRADLEY. Are you familiar with the generalized system of preferences? The purpose of the generalized system of preferences was to try to encourage the developing countries to produce more, export more. Five countries now get 69 percent of the benefit, Taiwan, Korea, Hong Kong, Mexico, and Brazil.

In an effort to help the poorer developing countries to export more to our markets we took measures to alter that, measures designed to reduce benefits under that preference for Brazil, how do you think that would sit in Brazil? Do you think "graduating" Brazil and other NIC's would be effective in increasing the standards of living in the less developed countries?

Mr. TREBAT. I am not familiar with the details of the legislation, Senator, but let me make a general statement about that. Brazil is a country that can compete fairly with us without the United States having to subsidize them in general. I am not saying specific programs are not worth having with Brazil. Increasingly we should look on a Brazil that does not require large favors from us. It is a country with large and diversified industrial plants, lower wage costs than in the United States, a skilled managerial talent, skilled labor. Indeed it is still a very poor country.

In many respects it is able to compete on its own. We have an increasing volume of manufactured exports which come out of Brazil which are not subsidized in any important way by U.S. taxpayers. I would tend to put much more importance on the poorer countries.

Senator BRADLEY. You don't think Brazil would take this as an attack?

Mr. TREBAT. I can't say.

Senator BRADLEY. I want to thank you very much, Mr. Trebat, for your testimony. It has been very helpful.

I submit for the record a policy statement that was sent by the National Foreign Trade Council. They asked that it be inserted in the last set of hearings on these issues. It came too late. So it will be inserted in this series of hearings.

[The policy statement of the National Foreign Trade Council to be supplied for the record follows:]

## POLICY STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

### PROTECTIONISM

Nations throughout the world, including the United States continue to adopt protectionist measures to restrict competitive imports, despite the conclusion of the Tokyo Round of the Multilateral Trade Negotiations last year. The National Foreign Trade Council views with concern the efforts of governments worldwide to protect selected domestic industries from fair compeition of foreign goods and services. Unless checked, such protectionism can lead to a spiral of retaliation and counterretaliation, which will inhibit international trade and investment and slow worldwide economic growth. Furthermore, such barriers against imports can increase inflationary pressures, inhibit the transfer of capital and labor into more productive enterprises and restrict international competition.

A free and open international trading system, characterized by minimal government intervention in trade flows, offers the best hope for continued economic growth in developed and developing countries. The United States must continue to exercise leadership in trade liberalization and the reduction of obstacles to trade flows.

The term, "protectionism," refers to measures employed to restrict fair and competitive imports. The primary means of restricting imports include increased tariffs, negotiated orderly marketing agreements, mandatory quotas, administrative measures, non-reciprocal trade practices and voluntary restraint agreements. However, measures to counteract dumping and export subsidies which are not in line with international agreements, when properly applied, are legitimate actions to prevent unfair competition, and should not be considered as protectionist devices.

The Council considers that the first line of defense against protectionism is healthy and expanding local economies. Nevertheless, it recognizes that occasionally when a country is experiencing difficulties, import injury relief may be necessary to cope with exceptional dislocations in certain industries as a result of injurious increases in fair and competitive imports.

Given the current weakness in the United States domestic economy and recognizing that imports have surged to the detriment of some industries, the Council acknowledges that selective relief may be needed. It believes that the best second line of defense against protectionism is adjustment assistance to the affected workers, companies, and communities. The objective of our nation's assistant program should be to continue to provide financial aid as well as technological help in promoting production efficiency and new production methods. Since these programs are costly, efforts are needed to hold expenditures at levels absolutely necessary to achieve the objectives.

At times, nations may consider it necessary to go further and in limited cases to employ import restrictions to moderate the impact of increased imports on injured industries. The Council then recommends that consideration first should be given to tariffs before employing non-tariff measures. Unlike non-tariff measures, increased tariffs, unless at prohibitive rates, allow domestic and foreign producers to compete on price and other terms with minimal government interference and maintain both the consumer's freedom of choice and the producer's incentive for increased productivity.

Protectionism should only be employed when the need is clearly demonstrated and when adjustment assistance does not provide adequate relief. The measures taken should satisfy the needs of those injured and be developed in consultation with the other trading partners. They should be temporary, have a definite termination date and be phased out as rapidly as possible. While in force, they should provide growth in imports as domestic consumption increases.

Protectionism should not be used to preserve over the long term a non-competitive or non-strategic industry. Costs should be kept as low as possible and made known to the consumer and taxpayer.

In conclusion, the Council reaffirms its long-standing commitment to freer trade and a more open and equitable trading system. The Council believes that the United States should assert its leadership in combating protectionism and non-reciprocal trade practices and together with its major trading partners should continue to move forward in liberalizing all tariff and non-tariff barriers and assure that international trade is being conducted on fair, reciprocal, and mutually acceptable terms.

Senator BRADLEY. Thank you very much, Mr. Trebat.

Mr. TREBAT. Thank you, Mr. Chairman.

Senator BRADLEY. The committee is adjourned.

[Whereupon, at 11:50 a.m., the subcommittee hearing was adjourned.]

# U.S. INTERNATIONAL TRADE STRATEGY

---

TUESDAY, DECEMBER 9, 1980

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
COMMITTEE ON FINANCE,
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 4:15 p.m., in room 2221, Dirksen Senate Office Building, Hon. Bill Bradley presiding.

Present: Senators Bradley and Roth.

[The press release announcing this hearing follows:]

[Press Release, Dec. 3, 1980]

FINANCE SUBCOMMITTEE ON INTERNATIONAL TRADE ANNOUNCES FIFTH HEARING ON U.S. INTERNATIONAL TRADE STRATEGY

The Honorable Abraham Ribicoff (D., Ct.), Chairman of the Subcommittee on International Trade of the Senate Committee on Finance, announed today that the Honorable Bill Bradley, (D., N.J.), will chair the fifth in a series of hearings on the trade and economic issues confronting the United States and on an international trade strategy for the United States. The series of hearings was described in Finance Committee Press Release No. H-35 of July 3, 1980. The fifth hearing will be held on Tuesday, December 9, 1980, in Room 2221 of the Dirksen Senate Office Building, beginning at 2:00 a.m.

This hearing will receive testimony on trade and investment policies of other industrialized countries and the implications of these for U.S. trade.

Testimony will also be received regarding the role of international studies programs (especially language training) in international trade.

The witnesses who will appear are as follows: Professor Ezra F. Vogel, Professor of Sociology, Chairman, Committee for A.B. Degree, East Asian Studies, Harvard University; Professor Peter Katzenstein, Professor of Government, Cornell University; Dr. Edward J. Bloustein, President, Rutgers University; Dr. Lee Nehrt, Director, World Trade Institute (New York); and Mr. Samuel L. Hayden, Executive Director, The Council of the Americas (New York).

Written statements.—Persons who desire to present their views to the Subcommittee are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be submitted to Michael Stern, Staff Director, Committee on Finance, Room 2227 of the Dirksen Senate Office Building, Washington, D.C. 20510, not later than Friday, December 19, 1980.

Senator BRADLEY. The subcommittee will come to order.

And to all of those who have waited for this, I owe my apologies. The floor session is unpredictable today. It is revenue sharing; we are still on revenue sharing. We now have an amendment on the floor for which my presence is not required; therefore, we will have an abbreviated hearing. For that I apologize to all of you, but given the nature of the session, the time expiring, I think it is best that we have the meeting and get things on the record and proceed. We will have an abbreviated meeting.

First, let us call Professor Vogel and Professor Katzenstein to the stand.

Your testimony will be submitted for the record as written. I wonder if we want on this panel, in addition, all of the other people? Why don't we do that and try to integrate both OECD and language requirements.

Let us have Dr. Edward J. Bloustein, president, Rutgers University; Dr. Lee Nehrt, director, World Trade Institute; and Dr. Samuel L. Hayden, executive director, The Council of the Americas.

I will submit my opening statement for the record, in recognition of the time.

[Full text of opening statement of Senator Bradley follows:]

OPENING STATEMENT BY SENATOR BILL BRADLEY

The 1970s have been a time of economic turbulence and stress for the countries of the developed world. Inflation has been virtually unrelenting, only briefly stalled by painfull periods of recession and unemployment. Oil prices have soared suddenly, destabilizing our unprepared economies. Chronic U.S. deficits have hemorrhaged dollars into international money markets, setting conditions conducive to currency instability. Generally, business climates throughout the developed world have produced low levels of investment, bulging overcapacity, lagging productivity and failing basic industries. All in all, the 1970s did not produce a climate conducive to economic harmony and political security for the western alliance and Japan.

We must prepare to make the 1980's better times. Among nations of the industrialized world there is deepening awareness that we must better manage our resources, individually, and in cooperation with one another.

The eighties won't offer us a breathing space. On the contrary, pressures are likely to build and room for maneuver may narrow. Oil supplies from OPEC will remain highly uncertain, and unless we rapidly strengthen our energy security, the economies of the West and Japan will remain dangerously vulnerable to supply disruptions. New traders from the developing world will crowd international markets which previously were the preserve of the older industrialized nations. Their entry into international markets can and should provide more trade opportunities than constraints. But their entry also means more competiton for developed countries, not only with them, but among ourselves for the band of goods and services in which we continue to hold a comparative advantage.

Trade tensions could rise and the ties that bind us in interdependence will be drawn taut. Citizens and diplomats will demand better management of the world economy. This will require imaginative long-term thinking, better coordination of domestic and international economic policies, more efficient use of resources, adjustment to changes in the structure of the international economy, and a fair distribution of the costs and benefits associated with structural adjustment.

The urgency with which people feel the need for better economic management is spurring interest in the approach of "Industrial Policy" to economic revitalization. Industrial policy means many different things to different people, but at root it suggests deliberate government actions to influence the structure of industry. Beyond this, objectives, strategies, levels of policy intervention, and the degree of deliberation, vary widely in theory and in practice. But it is becoming evident that industrialized countries have entered a stage of groping for industrial policies that combine free markets and government intervention in mixes appropriate to different societies. Now it is not the case that free markets and government interventions are always antagonist, as we know from our own experience with antitrust laws. Indeed, one could argue that the hallmark of a positive industrial policy is that it aims to improve the workings of the market-place by reinforcing the disciplinary effect of competition.

In themselves, industrial policies are neither good nor bad. They are a means for organizing government actions that can be wise or foolish, progressive or reactionary, fair or unfair, and rewarding or costly to the other countries.

What should interest us is how other industrialized countries are going about organizing, or not organizing, their policies that affect national industry and international economic structure. This includes broad macro-economic measures as well as sector-specific actions. What objectives are they setting? What strategies are they adopting? What instruments are they using? To what pressure are they responding? And what expectations do they have for the future?

The answers to these questions should interest us because they offer us the opportunity to compare our own experiences with those of our allies, to judge what has worked for them, what we should and can adopt from their experiences, as well as what we should or cannot adopt, and to draw the consequences for our welfare and security of living with them in a world of national industrial policies.

Industrial policy, loosely defined, is likely to become a major, if not the major, force determining the composition of trade and the deployment of industry internationally. Because industrial policies arise from a perspective that essentially is national, they pose a potential danger to international relations, particularly among countries of the developed world. But because industrial policies can be used to improve economic management, they also can create potential for greater harmony and material gain.

I invite our two distinguished witnesses to help us understand where our friends in Western Europe and Japan are going so that we can do our best to keep us all on a track of prosperity and harmony.

After we hear their testimony on the international economic policies that affect trade and investment positions of other industrialized countries, we will hear testimony from a distinguished panel on measures we can take in a specific area to improve U.S. trade performance in the world. The area is international studies programs, paricularly language studies.

Perhaps we should think of government support to international studies as a much neglected element of a sound industrial policy. Certainly it is a neglected element of trade policy. Surely all too often U.S. businesses have lost opportunities to better-prepared foreign competitors because Americans did not speak the right language or were unfamiliar with important indigenous practices. I look forward to hearing comments from our second panel on the role of international studies programs in a U.S. trade strategy, perhaps even as part of a broader industrial policy.

Senator BRADLEY. I would like to see if we can integrate this. As you know, the two gentlemen on my right are Professor Vogel, professor of sociology at Harvard, and Professor Katzenstein, professor of government at Cornell. They are here today to discuss industrial policies of the industrialized Countries.

The other witnesses, Dr. Bloustein and Mr. Hayden and Dr. Nehrt, were here to discuss language requirements and facility in foreign language as a part of a trade strategy.

So, I think what I would like to do is to submit your statements for the record and have each of you give a very brief summary of your main ideas, and then get as quickly as possible to questions.

Let us begin with Mr. Vogel.

## STATEMENT OF EZRA F. VOGEL, PROFESSOR OF SOCIOLOGY; CHAIRMAN, COMMITTEE FOR A.B. DEGREE, EAST ASIAN STUDIES, HARVARD UNIVERSITY

Mr. VOGEL. Would you say about 3 or 4 minutes?

Senator BRADLEY. I think that would be fine.

Mr. VOGEL. I am a Japanese specialist. I have been very concerned that the United States has not been responding effectively enough to the competition that comes from Japan.

We all know the wide range of individual products that Japan makes that has been very effective in competing in the American market, but we have not adequately given recognition to the aggregate problem that is caused by their successes. In 1978 our GNP was about twice that of Japan. Japan has about half the population, so it is about the same per capita; but in the manufacturing field Japan was producing about three-quarters the amount of industrial goods that the United States was, with half the population or about one and a half times per capita.

In 1978 the absolute investment in new plant and equipment was the same as the United States or about twice that per capita.

This suggestion, that given the average growth rate of Japan as 5 or 6 percent per year, the United States is something on the order of 2 to 3 percent per year, that we can expect the Japanese to be even larger in their new investments in plant and equipment than the United States in absolute terms. I think this means that not only in automobiles and a whole range of other products, but also in new high technology—robots, airplanes—we are going to have very stiff competition, and this is going to create even greater problems for the United States.

It may be necessary in the short range to find expedient tools to protect ourselves from this, but in the long run these are the only effective responses if the United States is to be able to compete effectively.

I think this is going to require far more change in our way of doing things than we have thus far acknowledged.

I think the first thing we have to do in addressing the problem is to find groups of leading businessmen in each industrial sector meeting with labor leaders and people in the Government to begin to think together about strategies, long-range problems, long-range things that can be done to promote the kind of policy that will make their field competitive internationally.

We have not the ability at the present time to put into effect an industrial policy. It is desirable, as I think it is, for the United States to have an industrial policy where we promote the most competitive industries in the future. We are not going to be able to do that effectively until we have a basis of concensus, a well thought out program that can result only from very effective cooperation between leading business, labor and government leaders.

Perhaps that is enough to provoke a discussion.

[Prepared statement of Professor Vogel follows:]

### THE CHALLENGE FROM JAPAN

(By Ezra F. Vogel, Harvard University)

As a Japan specialist and loyal American, I feel a responsibility for calling attention to Japan's superior competitiveness and the depth of America's economic decline. When I began calling attention to these problems two years ago, I felt like a voice in the wilderness.

I am pleased that we increasingly recognize the failure of American products in international competition, but in my view we have not yet acknowledged how much change is required to meet the challenge. The danger is that politicians will degrade admirable phrases like "reviving the economy" or "reindustrialization" by attaching them to programs designed to satisfy immediate demands from political constituencies without making the needed long-range changes. I fear that businessmen, politicians, labor leaders, academics and media spokesmen who recognize the need for other groups to change will remain so wedded to their own narrow interests or their particular ways that they will not be willing to sacrifice to achieve the necessary national consensus.

In considering the relative economic competitiveness of Japan and the United States, it is perhaps useful to keep a few basic figures in mind. In 1978, America's GNP was roughly twice that of Japan, and since our population is twice as large, per capita GNP in Japan was about the same as in America. However, the value of industrial production in Japan was already ¾ that of the United States or about 1½ times ours per capita. In the same year, we imported $5 billion more industrial goods than we exported, but Japan exported $76 billion more than they imported.

Japan's personal savings rate, which had been about 20 percent per year, has now risen to about 24 percent, where America's, which had been about 6 percent per year, has now declined to less than 4 percent. By 1973, the average industrial plant in Japan passed that of the United States in modernity of plant equipment, and the gap continues to widen. America has enjoyed a substantial lead in R & D expenditure compared to GNP. In 1961, U.S. R & D expenses were 2.74 percent of GNP, about twice Japan's rate of 1.39 percent. By 1974, the American rate had fallen to 2.32 and the Japanese had risen to 1.95; since then, the American rate has gone down, the Japanese rate has risen. Because Japanese GNP grows an average of about 5 to 6 percent per year while America's grows about 2 to 3 percent, Japanese investment in absolute terms grows more rapidly than ours. By 1978, Japan's investment in new plant and equipment was already equal to America's in absolute terms, or twice our per capita rate. Japan's investment is more concentrated in areas of future growth. If one had to make predictions on the basis of these facts, the shift in economic power is all too clear.

To illustrate the depth of response that is required for America to remain competitive, let me offer six basic reasons why Japan is surpassing the U.S. as an industrial power and is likely to extend that superiority for the foreseeable future.

1. *Superior information.*—The nation: government, business and media do a better job of getting information and circulating it to organizations that can make good use of it.

Although large American firms and banks may have their own good information networks, Japanese firms benefit from three other sources of information unparalleled elsewhere. One source is government bureaucrats, who in the economic sphere do an impressive job of scouring the world for ideas and trends. Many academics in the United States on the forefront of new technology and economic forecasting find that they are visited and courted as often by Japanese bureaucrats as by American ones. These Japanese bureaucrats also seek out outstanding specialists in Europe and, of course, in Japan.

A second source is JETRO, Japan's External Trade Promotion arm. JETRO officials not only give direct assistance to Japanese firms trying to penetrate markets, but they also make a major effort to keep abreast of commercial and industrial developments around the world.

Thirdly, are the large Japanese general trading firms. As you probably know, the six largest trading firms in the world are all Japanese. The largest trading firm in the United States is Mitsubishi International. Each of the six companies has offices in about 500 cities around the world in over one hundred countries. They excel in the breadth of political and economic contacts and in the modern communication techniques which permit the information to be relayed quickly to the home office. For economic information around the world, no foreign government, including the United States, can compare with any one of these six trading companies. Large Japanese firms can use the trading firms to supplement their own information networks, but even small companies can work closely with the trading companies to keep up-to-date on foreign developments.

2. *Government strategy.*—The key Japanese ministries like MITI have a sense of responsibility for the overall success of Japanese industries in their particular sector. Their job is not to dictate to industry, but to work with knowledgeable people in the industries to provide the external environment conducive to Japanese companies' long-term success.

The United States has no conscious industrial policy, and, surprising as it may be, nowhere in the United States Government is there even the analytic capacity to begin to guide an industrial policy. The result is an industrial policy by default. Without a conscious strategy, our government becomes the victim of political pressures without having any counterweight. The political pressures are, of course, strongest for companies that are weakest in the marketplace and, instead of supporting the promising companies of the future, we end up using our political leverage to support declining sectors like textiles and our economic leverage to support weaker companies like Chrysler.

3. *High quality government specialists.*—I am convinced that man for man we have at least as many talented and hard-working people in Washington as Japan has in Tokyo. The raw talent among congressional aides, among White House staff, among clerks at the Supreme Court, among partners of law firms, and sprinkled throughout the Government agencies is fully as impressive as anything one finds in Tokyo.

The difference is that the ablest talent in Tokyo comes into the key ministries, especially the key economic ministries like Finance, International Trade and Industry, the Economic Planning Agency, and these people stay in the ministry until they retire in their fifties. Their careers are guided by the ministries so that they get the best of foreign education, carefully selected apprenticeships, and broad experience. This continuity and professionalism of key Japanese ministerial groups permits greater continuity and collective memory, and more seasoned judgment than one finds among many White House aides, who sometimes lack professional experience and may not even have the files of their predecessors needed to make important decisions.

4. *Long-term investment.*—Because Japanese companies borrow a higher proportion of funds from banks rather than from stock equity, they are under less

pressure from stockholders to show profits each year or each quarter. They work for long-term market shares to achieve high profits in the long run. American business schools in recent years have been teaching how to rationalize management to improve the bottom line, even if this means diversifying into areas unrelated to the main line of production and avoiding investments that might pay off in the long run.

5. *Flexibility for management to concentrate on basic problems.*—The volume of Federal regulations is currently growing by over 20 percent a year. Of course, we must reduce the number of regulations to give companies more freedom, but our public has been properly concerned with basic issues like pollution, product safety, and equality of employment opportunity—issues which management sometimes neglected. We need to find new mechanisms to represent public interests without causing rigor mortis. The Japanese have used laws in a more limited way, but have created more social pressure for business to police its own house, mediated by pressure from government and the media. With fewer regulations, companies have more flexibility in responding to difficult problems and can concentrate more on dealing with the issue at hand.

The problems in dealing with labor are often similar. Japanese have even a higher percentage of unionization than we do, but management devotes more effort to responding quickly and informally by remaining informed and sympathetic with the key problems facing workers. American management-labor relations are more rigid and adversarial.

6. *Worker motivation.*—On the average, the Japanese employee is more dedicated to his company than his American counterpart. In large Japanese companies, which set a tone for employees throughout the society, regular young employees who join after leaving school expect to remain in the company until they retire at somewhere between 55 and 60. The company does not guarantee employment in any legal sense, and it is clearly understood that if the employee does not exert himself or if he commits serious improper acts, he may be quickly and easily dismissed. Japanese managers believe they must have this right in order to maintain the morale of those who do work hard, and ordinary workers accept it because they believe high standards of work are needed so their company can remain competitive and they can receive higher pay.

In Japan, unemployment insurance covers far less than in the United States. Japanese management prefers to pay less government insurance, to avoid government overhead to run an insurance system and to administer their own internal system of commitment to employees in time of recession. They believe this modern corporatism reinforces loyalty to the company. The Japanese government also acknowledges that for a worker's sense of belonging and self-respect it is better to have him report each day to work rather than to remain at home unemployed. For declining industrial sectors, the government even makes grants to the companies in order to provide training within the company, keeping the worker's sense of identity with the company. In a recession, it pays the Japanese company to do all it can to keep the employee working, even if it means starting some new product line where they may operate at a slight loss. In the 1960's, many Japanese managers talked of the need for adopting the American system of laying employees off when they went in the red, but they decided that the devotion of the employees who remain is more precious, and they ended by retaining the Japanese system. In their view, devotion and high quality labor are not possible if a worker or manager is treated as expendable.

A Japanese worker knows that if he leaves his company in mid-career he will have difficulty getting a job as good as he currently holds and that his future, therefore, is closely tied with his company's. It thus makes sense to put in extra effort, even in spare time, to keep the company more competitive in the long run. He is anxious to absorb new technology because he need not worry about his relative position even if he needs to be retrained, for he will personally prosper if his company keeps up with international standards.

I am not arguing that we should automatically adopt Japanese practices any more than Japanese automatically sacrificed their culture in importing Western technology and management systems. But I am persuaded that many things we consider cultural traits need to be reexamined. I am told, for example, that Japanese have always been export conscious and that this therefore creates a different attitude that we cannot expect to duplicate in America. I would like to quote from a letter President Millard Fillmore wrote to the Emperor of Japan, dated 13 November 1852: "We know that the ancient laws of your imperial majesty's government do not allow foreign trade, except with the Chinese and the Dutch, but as the state of the world changes and new governments are formed, it seems to be wise, from time to time, to make new laws. . . . If your imperial majesty were so far to change the ancient laws as to allow a free trade between the two countries it would be extremely beneficial." I am hopeful that if America were to recognize the depth of our competitive problems and reach a new consensus as to how to deal with them that we have great potential to make the changes needed for revitalization.

Senator BRADLEY. Dr. Katzenstein?

## STATEMENT OF PETER KATZENSTEIN, PROFESSOR OF GOVERNMENT, CORNELL UNIVERSITY

Mr. KATZENSTEIN. Our economy has until recently been closed and, therefore, the awareness of consideration of competition is not very wisely expressed, and even the debate on the Hill and elsewhere in Washington shows that everybody is interested in this policy, for very different reasons.

The second reason is that America has located a major part of its industrial base abroad through a series of policy decisions which go back at least two generations, and that itself makes it very uncomfortable now for policymakers to think about industrial adaptations at home. This is not unique to America. The same kind of difficulty and unease is experienced by countries like Britain and Switzerland.

Switzerland has, in proportionate terms, proportionate GNP per capita, a much higher proportion of its industrial base abroad. For the last 20 years our industrial policy has been to locate our plants abroad. Britain has in tortuous political debate in the last few years thought about creating industrial policy.

As we think about policy in this country, the debate about the nature of foreign investment undertaken is going to be part of that debate.

The third reason is that the political leadership which America has enjoyed exercising over the last generation in the international economy has led it to cause a change in other countries. Whenever there was a particular economic problem, we have always exported that in the form of voluntary control agreements, the first one dating back to the 1950's, with Japan, and which increased the ability of other countries to adjust economically to change.

What we are getting in the 1980's is a competitive rate among advanced industrial countries about who can adjust most quickly to demand in the country.

Senator BRADLEY. Conditions that come from a variety of sources?

Mr. KATZENSTEIN. Yes. It is general awareness of the change, and we have to cope with it, and our institutions are not attuned to that.

If one looks at West Germany, West Germany has an industrial policy like Japan, like Britain, like most other countries. That industrial policy has three circles. To understand how it works, one has to understand the role that West German banks play in German industry, as a kind of supervisor in an informal, coordinated function.

The German equivalent of Chrysler in this country was the financial trouble of the AEG, which was close to bankruptcy. The West Germany Bank told the government not to worry about it, that they would refinance that empire—150,000 jobs. When the Shah of Iran took over—he was going to take over in 1974—it was a consortium of German banks which defended German property.

The chancellor nodded his head and said, "Good work." There is an array of institutions which conducts financial policy without the government having to worry about it.

Senator BRADLEY. Are there private equity markets in Germany?

Mr. KATZENSTEIN. Yes. The reason the banks can do it is for a variety of reasons. They own stocks and they vote the stocks, the shares of individuals who own stock, and it gives them enormous exercise of power. The government in the last ten years has involved itself more in industrial policy, both in declining sectors and growth sectors.

I think the way of doing it roughly compared to the Japanese model, and of trying to create a consensus in existing institutions which are less formal than Japan but that policy agreed on for the coal or nuclear industry will, in effect, be carried out over a longer term.

West Germany, like Japan—and if one thinks about industrial policy in the next 15 years, one has to think of institutions which create the consensus first—one should not look at industrial policy in this country as what it can do for the country in the initial phase in the next 3 or 4 years, but what might it do to the fabric of the institutions.

Senator BRADLEY. Which institutions?

Mr. KATZENSTEIN. In Germany and Japan, involved at the sectorial level are regionally defined representatives of the government, the industry, and labor unions.

[Prepared statement of Professor Katzenstein follows:]

## EUROPE AS NUMBER TWO?

(By Peter J. Katzenstein, Professor of Government, Cornell University)

Europe has had an interest in the development of industrial policies (defined here as policies adopted with the intent of affecting directly a country's industrial structure) and trade policies which antedates by decades the recent outburst of American curiosity in and animosity towards "Japan as Number One." In this field, as in many others, Europe is little more than a figment of our historical imagination which conceals a broad array of political experiences. West Germany and France illustrate a political contrast which in the area of industry and trade challenges the United States often in the form of an unfathomable process of supranational logrolling in Brussels. The unabashed spirit of innovation and experimentation which has accompanied the growth of the social welfare state in the small European states does not offer a challenge to America; but like the West German and French experiences it may offer some lessons worth pondering as America contemplates the shape of its industrial future.

### I. THREE REASONS FOR AMERICA'S SLOW RESPONSE

There exist three reasons for America's slow response to its industrial crisis: relative economic closure, direct foreign investment, and political strength. The European countries are distinguished by a very high degree of openness to the international economy. Openness has reinforced the political awareness of the intimate links between domestic industrial policy and foreign commercial policy. As a proportion of gross domestic product (GDP), exports account for less than 10 per cent in the United States, as compared to 20–25 per cent in the large European countries and 35–60 per cent in the small European states. At their own peril European countries have been able to think of their domestic economic and industrial policies apart from questions of international competitiveness for only short periods. America's recent interest in "reindustrialization," by way of contrast, has been fed by divergent political objectives with no clear indication yet that the issue of international competitiveness has been accepted as the overriding concern. Numerous protestations notwithstanding, our mentality remains insular.

A second reason for America's delayed and variegated interest in industrial policy lies in our past political choices. For the last two generations America has stressed direct foreign investment abroad rather than industrial adjustments at home. Having followed a similar strategy of direct foreign investment, European countries such as Switzerland or Britain have exhibited a mixture of hostility (as in Switzerland) and strain (as in Britain) which is quite compatible with the American experience. A strategy of direct foreign investment leaves all major decisions about industrial redeployment (affecting employment, regional developments, product mixes, research and development and trade strategies) to large corporations. For this reason alone countries which, like the United States, have located a sizable portion of their industrial capacity abroad have a much harder time in the development of an industrial policy.

Finally, a third reason for America's slow response lies in the dominant political position which America has occupied in the international economy since 1945. On questions of international trade America has used its political strength unabashedly in the attempt of shifting the costs of adjustment abroad. That policy was initiated in 1955–56 with the negotiation of the first voluntary export restraint program with Japan. Short-term political calculations of countering protectionist political coalitions at home have had long-term political consequences for the capacity of American industry to adjust to economic changes abroad. America's political strength has bred economic weakness.

## II. EUROPEAN EXPERIENCES

The secret of West Germany's industrial policy is its invisibility. There exists a division of labor between the public and the private sector understood and appreciated by almost everyone. Throughout the post war years the West German government has followed liberal policies of non-intervention in the economy which have been compatible with political interventions in particular sectors. As far back as the mid-1950's, for example, the West German government decided to develop a nuclear industry with a significant export capacity. Two decades later that decision had become a severe economic and political challenge to America. In the 1960s, the federal government orchestrated a sharp but orderly reduction in the size of West Germany's coal industry which, at the threshhold of the 1980s, has placed the government in an excellent position to shape actively the future of that critical industry. And the aircraft and computer industries offer similar instances of targeted government intervention.

The government's intervention is supported by the important role which West Germany's banks play in industrial policy. Industrial reorganization in the 1970s relied heavily on the coordination and supervision provided by the banks. The transformation of West Germany's moribund textile industry in the late 1960s, the defense of Daimler against foreign acquisition in the mid-1970's, and the refinancing and reorganization of industrial giants such as AEG and Klöcker in the late 1970s are episodes which illustrate the bank's deep enmeshment in West German industry. Equally important, in their joint roles as guardians of stockholder interests and owners of capital, the banks monitor closely and influence the strategic decisions taken inside industrial board rooms. These private institutional links between industry and finance are effective. And they free the government from a deeper involvement in the affairs of West German industry.

The limited range of the government's direct involvement in West German industry has been both cause and consequence of a liberal foreign trade policy which has resembled and converged with American policies with the notable exception of agriculture. West Germany's "private" industrial policy anticipated and corrected for economic change in international markets thus weakening protectionist pressures. But the apparent lack of protectionist forces in Bonn is deceptive. West Germany's trade policy could afford to be so liberal because Brussels, not Bonn, offered the institutional arena for striking a protectionist bargain with other European partners across national boundaries.

In contrast to the Federal Republic, France has always favored a "political" rather than an "economic" approach to questions of industry and trade. In the 1960s in particular, European and American observers studied French (rather than Japanese) policies of transforming industrial sectors. The political approach of de Gaulle was predicated on the existence of numerous institutional links between government and industry as well as the political control of sizable segments of French investment capital. Furthermore, the protectionist policies of the Third and Fourth Republic had cued the response of French business to political incentives and the states as much as to economic incentives and the market. To make France strong, particularly in modern growth industries such as computers or aircraft, or to reinvigorate lagging sectors, such as steel, required selectivity not only among industries but also among firms within industries. The French government actively encouraged the merger of competing firms into "national champions" large enough to withstand "the American challenge." National security, long-term economic interests and pride at times necessitated political interventions which sought to stem the logic of the marketplace, as was true, for example, in the Machine-Bull affair.

The lesson of the mercantilist policies of the 1960's, however, unambiguous. Both the degree of economic isolation and the magnitude of resources required for such an industrial strategy were simply no longer to be found in the political economy of the 1970's. During the past decade French policy has abandoned the costly attempt of politically fixing market relations. Now market forces, including foreign corporations, are politically exploited rather than resisted. The growing selectivity of intervention has moved from industrial sectors and firms to product categories and individual products as the preferred target of government policy. Furthermore, since the mid-1970's the Barre policy has aimed at increasing the competitive pressures operating on medium-sized firms which, unlike France's larger corporations, still lack an aggressive orientation towards foreign markets.

French commercial policy expresses the political orientation of this industrial policy. The government often becomes an active mediator and financier in large-scale bilateral trade arrangements designed to strengthen particular segments of French industry. French policy towards the Mideast, Africa and the Soviet Union illustrate this inclination. At the same time the French government, more than its West German counterpart, is receptive to adopting protectionist measures. France's political orientation towards domestic industry goes hand in hand with its political orientation toward foreign trade. The very concept of "organized free trade" which the French government has championed in the late 1970's emphasizes a symbiosis of economic liberalism with political intervention.

French policies in the 1970's have begun to resemble the manner in which the small European states have always used industrial policy: a useful instrument for pacing the structural changes which international markets impose on the domestic economy. The very openness of the small European states to international markets precluded the kind of systematic, large-scale reordering of specific industrial sectors which became the hallmark of government policies in France and Japan. Instead of any systematic and overarching strategy of industrial redeployment, the small European states have paid political attention to selective responses and particular problems. Industrial policy, and here is a decisive difference compared to France, was part of a much broader array of political responses (including incomes policy, economic planning, regional policy and research and development policies) through which the small European states have succeeded in compensating a home for economic changes abroad.

Unlike the large European countries, the industrial policies of the small European states do not typify a new form of economic nationalism and diffused protection. Small, open economies have only one overriding political interest: a liberal international economy. And they have always backed their words with deeds. During the past two decades tariff levels, for example, have been well below those of the large industrial countries including the United States. And despite their large and active public sectors, Sweden, Norway and Austria have assigned the formulation and implementation of trade and industrial policy to different ministries. Neo-mercantilism is not an option which the small European states have in this or any other field of foreign economic policy. Their openness to the influences of the international economy forbids indifference to questions of industrial adaptation on the one hand and enforces, on the other, the changes in industrial structures which larger states, like France or Japan, try to impose through carefully worked out broader political strategies of sectoral transformation.

## III. CHALLENGES FOR AMERICA AND THE INTERNATIONAL ECONOMY

While the distinctiveness of the West German and French approaches to questions of industry and trade will remain, the differences in approach have narrowed. In its defense of employment and productivity West Germany may become more political, particularly when challenged by Japan. The French stance, on the other hand, reveals a growing awareness of how market dynamics condition selective political interventions. Enduring national distinctiveness, on the other hand, points to the difficulties which the European Communities (EC) will face in fashioning an overall political strategy in the international trade system. But the narrowing differences (and, one might add, the spectre of Britain's industrial decline) make tactically motivated, short-term political accomodation more feasible, especially in declining industrial sectors. It is entirely conceivable that European trade policy will evolve along a two-track system in the 1980's. Forward-looking industrial policies and liberal trade policies will be fashioned in national capitals; defensive, protectionist battles will be waged at the supranational level in Brussels.

Familiar with the bifurcation between a free-trade oriented Executive and a protectionist Congress, Americans should have little trouble to comprehend a political development which would reinforce further the trend towards a sector-specific regime for international trade. Unlike the 1880's and 1930's regional closure, mercantilism and tariff wars between America and Europe are improbable for the simple reason that American corporations are an inextricable part of Europe. America's presence in Europe confuses the alignments in domestic politics and muffles protectionist and nationalist voices. Japan and the newly industrializing countries, by way of contract, will probably be in for rougher treatment. On questions of international trade the economic strength and adaptability which beget political imagination and leadership will be most sorely needed to prevent a trans-Atlantic merger of a dual trade policy which relies on its liberalism for organizing trade among the old industrial states and reserves its protectionism for trade with the newly industrializing countries.

Senator BRADLEY. Dr. Bloustein, welcome. Sorry you have had to wait.

## STATEMENT OF EDWARD J. BLOUSTEIN, PH. D., PRESIDENT, RUTGERS UNIVERSITY

Mr. BLOUSTEIN. I thank the Senator and the subcommittee for the privilege of appearing today. I know what a burden it is on you to take this time. I appreciate it deeply.

My testimony today has the endorsement of the American Council on Education, the American Association of Universities and the American Association of States, Land Grant Colleges and Universities.

Essentially, our message is very clear. I link it to what our colleagues have said. Whatever international policy and trade this Nation adopts, it must begin to use more effectively than it has in the past the resources in language training and skills and area studies that currently exist in our universities and colleges throughout the country but are relatively unconnected with the processes of international trade.

They are in some senses a very recent addition to the intellectual armamentarian of the Nation, but they are a very poor resource in American universities and colleges. But American industry and American corporations doing foreign business have not yet learned effectively to relate to that resource.

American colleges and universities have not themselves made sufficient effort to make this resource available in terms that can be used effectively by the corporate base and by the industrial base of America in international trade. This, I think, is an intolerable condition in the light of the need of this Nation for reindustrialization and great advance in our international trade.

So we must find, it seems to us, a new mechanism to further integrate the resource of our educational institutions and the need of our international corporations.

We suggest in the testimony that I have provided today that rather than think in terms of a new bureaucratic enterprise and a whole set of regulations that might foster this development, that we look at tax incentive programs. Such tax incentive programs, I know, are on your mind and on the minds of a lot of the Senate and House colleagues in respect to furthering the development of the research potential of American universities in relationship to American corporate and industrial needs.

We think very much the same policy might be pursued in terms of advancing and developing the relationship of language skills and foreign area programs in American universities and colleges.

So we urge, rather than a new bureaucracy and a new set of regulations, that we think in terms of a tax incentive program. I quickly add that it would be a very, very different tax incentive program than the tax incentive program necessary for the research institutions, development of research relationships of American corporate redevelopment, for very often that resource is used in different ways by corporations and it exists in different ways in American institutions of higher education, but the same principle of tax incentive might well be useful in two instances, even though it would be useful in different ways.

Besides avoiding the bureaucratic and regulatory mechanism, the advantage of the tax incentive also is that it gives an opportunity for the extraordinarily varied range of corporate needs to fit much more effectively with the extraordinarily varied range of collegiate and university resources to meet those needs than any regulatory scheme you can envisage.

So we think if you want the flexibility that this variety of need and resource requires, a tax incentive program would work most effectively for that purpose.

Very fortunately, the recent Presidential Commission on Foreign Language and International Studies has documented this problem effectively, I think, and I strongly urge upon you and your colleagues that Congress begin to think effectively of implementing the need found by that Presidential Commission, and do it through this tax incentive program.

Senator BRADLEY. Why do you think that business and the academic community have not gotten together a little better than they have in the past? Why haven't you used business better, or vice versa?

Mr. KATZENSTEIN. A great variety of reasons, among them the general hostility that existed in the universities in the 1960's, most forcefully going into the 1970's, hostility toward business enterprise generally, suspicion of that business and corporate community. Fortunately, that for the most part has left college campuses.

I think there was a great deal of skepticism on the part of many business and corporate leaders regarding the effectiveness of the help they could get out of the university community. I think that skepticism is unfounded, because if you look at the experience of the Defense Department, I think one of the great areas of development of our language programs in America came through the very effective use of the Defense Department of our universities and colleges for their own purposes. So, we have a model in that at least of a vast enterprise making effective use of college and university resources.

[Prepared statement of Dr. Bloustein follows:]

## Prepared Statement of Edward J. Bloustein, President, Rutgers, the State University of New Jersey

### INTERNATIONAL STUDIES AND INTERNATIONAL BUSINESS—A STATEMENT OF INTEREST [1]

America's colleges and universities maintain a vast resource base in foreign language and international studies.[2] I am here on behalf of several members of the higher education community to restate our interest in increasing appropriate relationships between these academic resources and the needs of international business.

The great resources in foreign language and international studies on our nation's campuses constitute one of the most important segments of this nation's higher education system. Established largely over the last 30 years, they range in form and content from the extensive foreign language offerings, which insure that instruction in virtually every contemporary foreign language is available somewhere in the United States, to the enormous area study strengths at our nation's major research universities, to the distinguished international offerings in the professional school of law, business, agriculture, and other areas. This resource base has been created by college and university funds committed to teaching positions and library support, some $300 million in Ford Foundation funding awarded during the period 1960–1968, and some $250 million in federal funding awarded under the auspices of NEA Title VI since 1958. By any measure, this vast resource is truly one of the success stories of higher education in our generation.

In terms of the interests of this Senate Subcommittee, I think it fair to say that the current relationship between this resource and the needs of America's international business community remain as a potential instead of an accomplished fact. There is now rather clear evidence that America's enormous expansion in international business has been carried out without substantial connections between the academic resource and business needs. The recent efforts of the President's Commission on Foreign Language and International Studies document this lack of interchange all too well. The major Rand Corporation study for the Commission found almost no current business use of the personnel and information available in our colleges and universities. The two additional papers authored for the President's Commission on "Foreign Language and the Multinational Corporation," and "International Business, Foreign Language and International Studies/Analysis of Relationships and Recommendations," find that America's businesses have almost no awareness of the international resources available at colleges and universities and that business has turned for its international needs to foreign students, host country information sources, and such proprietary enterprises as the Berlitz School.

I welcome the presence of the private sector representatives at these hearings, and I am sure they will discuss more thoroughly their interest in closer cooperation with us. However, I sense there is now some reason to believe our resources could be of significantly greater interest to America's international business community. And the development of closer relationships between universities and business could allow for the development of a whole new area of support for international studies while serving real business needs. Indeed, the Presidential Commission's findings in international business-international studies cooperation have already served as a base for one piece of legislation—Section B of Title VI of the Higher Education Act signed into law on October 3, 1980. Under this legislation, $7.5 million would be available for America's colleges and universities to develop cooperative programs with America's international businesses. The money would be awarded on a matching basis with business contributions. This piece of legislation is clearly an exciting first step. However, it does rely on new, albeit small, Congressional appropriations at a less than auspicious time.

I should like to offer one additional potential for enhancing the relationship between business and academe in this area. I would like to suggest this Committee consider some system of providing tax incentives to business for cooperating with academe in the development of international programs.

There is much current discussion about the potential of enhancing business-university relations. Most of this has come about as part of the discussion on the need to reindustrialize America and the realization that only America's colleges and universities and America's businesses have the research base for maintaining and expanding our enormous gains in research and technology development. I believe

---

[1] This testimony has been endorsed by the American Council on Education, The Association of American Universities, and the National Association of State Universities and Land-Grant Colleges.

[2] The term international studies as used in this testimony is defined to include research and instruction about the economic, political and social life of other people conducted in the social sciences, the humanities, the arts, and the professional schools of this nation's campuses.

there is agreement that it is in the national interest for the government to enhance this research base through fostering business-university cooperation. There has been much discussion on the best government policy to accomplsih this and some of that discussion has involved the creation of another government program which would allow the government to serve as an agency-partner in this area.

I would like to suggest the appropriateness of tax incentives as a means of accomplishing greater business-university cooperation in the international area. This approach has two major advantages: it allows the government to further the national interest without the bureaucratic and regulatory aspects of an agency and it allows maximum flexibility in the design of individual programs between business and universities. It is difficult in my estimation to underscore the importance of this last point. America's 3,000 institutions of higher education are enormously diverse. They are public and private, large and small, two-year and four-year, and graduate institutions. Likewise, America's international business interests are incredibly diverse, ranging from the enormous international dimensions of Fortune 500 companies to the export-import interests of small business. If we are to establish closer cooperation between these two communities, it is imperative that we recognize this diversification. I believe that tax incentives might best allow for match between some diverse entities. Let me add that tax incentives for cooperative efforts in international education and tax incentives for business support of university research should not be combined in the same legislation in a way which causes confusion. Obviously their purposes differ and criteria for determining which costs would qualify for credit also would differ. I think that the parallel between the two incentives, however, is clear.

Whatever final form the federal policy takes in enhancing business-university government cooperation, I want to reiterate my strong sense that colleges and universities look forward to establishing closer links with business in the future. And we are certainly willing to continue working with the federal government to development appropriate public support for this cooperation.

Senator BRADLEY. I would like to have Dr. Nehrt address that as well. Why do you think we have not had cooperation between universities and the business community as we would ideally like?

## STATEMENT OF LEE NEHRT, PH. D., DIRECTOR, WORLD TRADE INSTITUTE, NEW YORK, N.Y.

Mr. NEHRT. The major difficulty is that the business community is not usually identified as people; it is just a company. Why does a company help or not help a business school, for example? Again, the company doesn't do anything. It is individuals in the company. So, for a given company, which individual is it who has relationship with the universities? Usually it is somebody in the Public Relations Department who knows almost nothing about international business. He therefore does not identify the need of the company in this area and is not able to identify the kind of help that would come from the university.

The same thing is true of the student who might have international training. Recruiters who come out from the Personnel Department are not familiar with the need of the international divisions of the company. Even though the heads of the international divisions may wish to hire people with those needs, this does not get through the personnel and the recruiting areas.

Senator BRADLEY. What kind of programs do each of you see as possible to promote greater cooperation in both business and Government working relationships? In Japan you have that to a degree that is probably impossible in this country, but we nonetheless can do some things.

What would you do to promote that relationship and, in particular, what would you do to specifically promote foreign language facilities?

Then I would like to ask each of you if you think that has something to do with world trade. When you learn your first foreign language might be the best way to begin that.

Mr. BLOUSTEIN. The other reason I think the relationship has not prospered as it should is that it is a relatively new resource in the university and collegiate community. The industrial base has not come to learn to use it as effectively as it might.

A perfect example of an integrated mechanism is the mechanism of the agricultural extension stations of the Nation. Here we have a delivery system that was used for centuries that works very effectively with the farm community, and we in our university, and I know some of my colleagues in other universities, are thinking of developing industrial liaison corporations in other universities to serve the purpose of research extension comparable to that purpose as it is served in the agricultural extension station.

I don't know what you might think of that as a device, but you are perfectly right; the ordinary public relations officer, the ordinary fundraiser, is not equipped, and neither is the ordinary personnel officer, to make that kind of exchange work.

Senator BRADLEY. In your testimony do you go to some length about these tax proposals that you have suggested?

Mr. BLOUSTEIN. We have not attempted to draw any statutory language or even suggest the statute beyond saying that we look favorably on a tax incentive program.

Senator BRADLEY. Let me ask Mr. Nehrt and Mr. Hayden, and then I would like to hear Professor Katzenstein on this subject, do you feel that foreign language facility is directly related to the success of our export business?

## STATEMENT OF SAMUEL L. HAYDEN, EXECUTIVE DIRECTOR, THE COUNCIL OF THE AMERICAS, NEW YORK, N.Y.

Mr. HAYDEN. Is that directed to me?

Senator BRADLEY. Yes.

Mr. HAYDEN. Let me explain something first. The Council of the Americas—I may have the only corporate viewpoint here—is a business association of 200 corporations, all with investments in Latin America. Each of these 200 comes from the Fortune 500 list. We do not spend an inordinate amount of time talking about these kinds of subjects, but I think what we are talking about here is the opportunity cost question and fine-tuning in terms of exporting. How much better could a company do if it spent a lot more time in developing an internationalized personnel. You take a company like IBM that has been in Brazil since 1917, they have a very developed cadre of Brazilianists in that company.

We are talking about a whole new array of companies that must get involved in exports from this country. We, in 250 firms in this country, act for about 80 percent of the total exports. I doubt that there is very much that the university community can do to support the efforts of a General Electric; however, what do you do about the other 20 percent that are probably relatively new to the exporting game or to the vast number of corporations that we would like to get invoved in exporting?

If they are small- and medium-size businesses, they are characterized by the same kind of problem of small- and medium-size businesses anywhere in the world, shortage of management. So, the question is, for me at least, what is the link between the university community and those corporations?

You can go a step further and ask questions about international studies and not just foreign languages. Most corporations that are invested overseas and in Latin America—you are talking about more or less $40 billion net book value from this country—are very concerned about the drift politically and socially and culturally in each one of the countries where there are major investments. Who analyzes that? Who adapts corporate operations to the foreseeable changes, and who makes those forecasts. We do that as an organization for our client companies. We have to rely on university people to do that. That does not happen within the corporation.

So there has to be some way—and some corporations are experimenting with this—to try to make a link between the enormous amount of information that exists in universities, probably very disorganized for corporate use, and the tremendous demand for information, organized information, from the corporate side.

How do you make that connection without destroying the integrity of academic research is a rhetorical question, but one we are asking all the time, and always in search of first-rate academicians who understand environments overseas.

Senator BRADLEY. I see Professor Katzenstein smiling.

Mr. KATZENSTEIN. I worry about the integrity of the university, too. I don't think there is a direct link between language training and trade policy or performance.

In the last 2 years the university climate has become highly vocational in outlook. In general we are in a phase of drawing on the general capital of education which corporations that Cornell is talking to are beginning to worry about. They say you are producing all the specialists; you are not producing the kinds of persons we need.

It would require for the business community a different attitude toward liberal arts, in fact, investing in the long-term future, but I don't see much evidence of that.

In talking to the funding officers of Cornell, people say that is the job of the university to create that in the 1980's.

Mr. BLOUSTEIN. Seeing many, many corporate officers and spending a great deal of time with corporate officers, they have a much sounder view of the nature of liberal education and its importance to them and importance to their foreign trade than our students do.

The impression that many of our students, vocationally minded students, have is the distortion of, I think, the level of thinking in corporations I visit with and talk to. I agree with you that what they most need is what the traditional strength of the universities has been, very basic direction in economics, foreign economics, foreign area studies, and not some pat vocational technique. But they are well aware of that.

I would answer in respect to your comments that the mechanism is at hand; there are now mechanisms within a number of universities which provide consultancies, a very free atmosphere that does not threaten academic freedom, on a regular basis to corporations who enter into, in effect, a kind of partnership, an industrial liaison corporation.

If that industrial liaison corporation would be fostered by a tax incentive program, I think we would be building a mechanism for the future development of a sound process of using the best in our universities without threatening academic freedom at all.

Mr. KATZENSTEIN. I see it from a different perspective than you, obviously. In the last 7 to 10 years I have seen the university base of international studies shrink.

Mr. BLOUSTEIN. I think that is why I am here today.

Mr. KATZENSTEIN. In the last year, for example, there was one thesis submitted and accepted in this country on European politics.

Senator BRADLEY. That is one of those things that we politicians call the startling statistic which you use to begin a speech.

Mr. BLOUSTEIN. One piece in the Center for European Studies at Harvard. Professor Putnam told me about that. I think it may well be that the business community is aware of the general need, but I certainly haven't seen an influx of funds in international studies.

Universities are behaving like the Germans in the 1930's; they are cutting corners in every direction.

Senator BRADLEY. Let me see if I can shift gears slightly, because when the buzzer rings I am going to turn it over to Senator Roth, if he would not mind.

I would like to ask Professor Vogel a couple of questions on Japan.

In Japan they have used, I think, protections, subsidies, and preferences effectively as part of their industrial policy. Normally, when you talk about those policies, protections, subsidies, tax preferences or preferences, you don't really foster competitiveness; you use it to protect your own declining industries.

How do the Japanese manage to foster competitiveness with these policies?

Mr. VOGEL. First of all, they have a well-understood strategy for development that goes from protecting infant industries while you acquire technology, know-how, experience, so that they can begin producing large numbers of goods at low cost.

It was, incidentally, very similar to the policy of Alexander Hamilton after the Revolutionary War, to build up the textile industry so that it could compete against the British textile industry. Once the industry has developed so that it is terribly competitive, then they can relax and open up to international competition.

In the meantime, the bureaucrats put greater pressure on those companies to move as rapidly as they can so that they can grow up as you would and be let out of the chicken coop and compete on their own.

The problem in the United States, it seems to me, is that we do not have that overall consensus about industrial strategy and as a result to consider protectionism we lay ourselves open to the pleas of the least competitive companies who will seek protection rather than from the companies that are going to be using it to compete in the long run.

Senator BRADLEY. Could you draw a distinction between protection policies for infant industries and protection policies for restructuring or industrial policies for restructuring, and argue that the Japanese have never had to restructure because they have only built since it was all destroyed in World War II?

Mr. VOGEL. They have had to do a lot of restructuring of industries after World War II that had developed prior to World War II; so they have been involved in restructuring.

I can imagine that in this country now we are in a peculiar situation where we have to restructure certain industries, that we may need a process something like Japan has for infant industries. When we create a consensus about targets for things that need to be done, what has to be done to really modernize these industries with a clear prescription in a short number of years, with understanding and a widespread consensus that this protection or special subsidies or special preferences will end in a short number of years, it seems to me that particularly in the case of steel and automobiles, which are so basic to our Nation's capacity to export manufactured goods and to have enough to export so that we can meet the import requirement for petroleum and other goods that we now need, that we may be in a special situation of providing that kind of protection if we could have the consensus and guarantee that it will come to a quick end.

If not, we are in danger of moving into a very long-range protectionism which seems to me guaranteed to keep our country free from international competition and therefore behind in the international race to keep up.

Senator BRADLEY. You see so often the question is asked, why aren't we more like Japan? The answer is that we are basically different. Societies are different and you know that better than most. But I would like to ask each of you, Professor Katzenstein and you, four policymakers in this country, is there anything that we can do specifically? What specific recommendations for legislation would you offer for America based upon your knowledge of West Germany and Japan, if you believe that there are no lessons to be learned?

Take license and offer your recommendations anyway as to what we should do.

Mr. VOGEL. I think the Japanese and the Americans are not as different as is commonly believed. I say that as a sociologist and social psychologist who originally went looking for cultural differences. The more I study the more I am convinced that what Japan has done, is because they have been in the habit of searching around the world for the best possible solutions to the basic problems, and then try to arrive at a solution—I would not rush in too quickly with proposals for Congress to pass, because it seems to me the essence of what they have done is to study the international market and to arrive at a general agreement that everybody is prepared to implement at the time when it is decided upon, and we are not yet at that stage.

I think that before long we ought to develop an industrial trade policy that rewards future industries that are of great importance and that provide less support for industries like textiles.

I believe we ought to provide tax incentives to make that possible, and when we provide policy to have selective tax incentives for those industries which are more important for revitalizing or building up in the future, I think we ought to expand the opportunity for companies to work together in a sector to develop trading companies without worry about antitrust legislation.

As a starter, I think those are some of the fundamental areas that I would move in. I don't think that any of those have any distinctive characteristics of Japanese culture that makes them work where they wouldn't work in another country if they decided they needed for the national good the cooperation of a lot of sectors to produce industries that are really effective international competitors.

Mr. KATZENSTEIN. It is obviously hard to prescribe. Looking at the European experiences, which are diverse in general, I draw three lessons, I guess, in the last 20 years:

The first is that the Europeans, the French in particular, but also the small European countries, have learned that it is not useful any longer to fight politically the logic of the market.

Senator BRADLEY. To do what?

Mr. KATZENSTEIN. It is too expensive and not useful to fight the dynamics of the market. That is what the French tried to do in the 1950's and 1960's. The Japanese have avoided doing that, political intervention in that sense of doing something in industrial policy.

Certainly, America should not try to repeat the mistakes of the 1960's.

Senator BRADLEY. This would argue away the allocations?

Mr. KATZENSTEIN. Yes.

The second one is that one should not worry about the proper level where one wants to intervene, whether that is the sector or firm groupings in sectors, or products levels. In Europe the level has been to a greater level of specificity.

Senator BRADLEY. Is that a contradiction, trust the market and yet intervene?

Mr. KATZENSTEIN. It is based on a sense of knowing what the market dynamics are. The competitive race pushes everybody in the advanced industrial world in the same strategy. Everybody wants to be in high value-added products with high profits. The only way of having reliable data, and that is to be more precise. Obviously, there will be a debate in this country about the level of specificity at which the law operates.

Thirdly, I think American policymakers will have to confront the problem of which policy instrument to use. I think that instrument will in one way or another be management and allocation of capital, investment capital. I don't think we will be able to confront the issue without addressing the problem of a foreign investment strategy.

Senator BRADLEY. Foreign investment strategy on our part?

Mr. KATZENSTEIN. Yes, that we have engaged in.

Senator BRADLEY. Since 1945 we have had a foreign investment economy. Alluding to your earlier statement, are you arguing that we have to alter that process and become an export lead economy?

Mr. KATZENSTEIN. If you want to take the hypothesis that industrial economies mature and the third stage of maturation which West Germany and Japan are entering now, we may want to consider going back in certain sectors for the second stage.

Senator BRADLEY. I agree with you. That is one of the major things I have been trying to prove in these hearings.

70-794 0 - 81 - 9

I don't know what your schedules are. The five buzzers mean I have 5 minutes to go vote. I will be pleased to come back to continue for a little bit. If you have to go, please know that I appreciate your attendance today and your testimony.

Do you two gentlemen have to go, as well? If you have a few minutes, then I will come back and we will talk, you and I.

Thank you very much. Again, I apologize for this disjointed process, but that is the U.S. Senate. For some of you, I am your senator, so you understand the process. Thank you very much.

I will not close the hearings now, so that we can continue to talk when we come back. I will be back in 5 minutes. Thank you very much.

[Brief recess.]

Senator BRADLEY. The subcommittee will return to order.

Before ending today's session on the hearings on prospects for a U.S. trade strategy, I would like to thank my distinguished colleague from Connecticut, Senator Ribicoff, the chairman of this subcommittee, for having allowed me the privilege of chairing these important hearings.

Senator Ribicoff has been the ideal chairman and the ideal Senator. As a chairman and a Senator, he has always been informed, keenly intelligent, fair, and committed to protecting the broader national interest. His dignity and eloquence will be sorely missed.

I would also like to thank the subcommittee staff, Dave Foster and Jeff Lang, of the current majority, and Claud Gingrich of the minority, for their professionalism which was evidenced throughout the course of putting these hearings together. Members of the subcommittee are fortunate to have so excellent a subcommittee staff.

Finally, I would like to give special thanks to Dr. Ava Feiner of my own staff, who developed the framework for the hearings and brought them to fruition, and whose intellectual grounding in this broad subject gave them coherence.

[Prepared statements of of Mr. Samuel L. Hayden and Mr. Lee C. Nehrt follow:]

PREPARED STATEMENT OF SAMUEL L. HAYDEN, MANAGING DIRECTOR, COUNCIL OF THE AMERICAS

Mr. Chairman, thank you for the opportunity to testify on the relationship between international studies at U.S. universities and the export and foreign investment performance of U.S. corporations. Certainly, any reasonable attempt to ensure a strong U.S. international business posture both in exporting and direct investment is desirable. It is desirable because the sale abroad of U.S. goods, services and technology contribute positively to a more sound financial and economic condition in the United States in terms of international payments, inflation, employment and growth. Our market share abroad—as reflected in our balance of trade—is one measure of our health and competitiveness in the world economy.

Much of the dialogue about increasing exports, meeting the challenge of foreign sales in the United States and thereby reducing our trade deficit has been between the government and industry. The President's Commission on Foreign Languages and International Studies has done much to bring other participants—primarily universities—into the national dialogue. But it is fair to say that business has not overwhelmingly responded either to the President's Commission Report or to any dialogue with universities. Nevertheless, all institutional resources should be mobilized in appropriate ways to assist in the short and long-term requirements to improve this country's international business performance.

The burden will fall squarely on business itself to find a new mix of goods, services and markets, as well as more effective marketing strategies and practices. In the short-term, there is much that the U.S. government can do as well. As the

Administration and Congress have been considering, a reorganization of the government's export promotion and control activities is a positive sign. Legislative amendments would also be helpful. For example, because business—especially exporting—is a people-intensive function, Section 911 of the tax code should be radically changed. This legislation places a great tax liability on overseas Americans. Some U.S. corporations report that it often costs eight times as much to hire a U.S. citizen abroad as it does a host country national. This significant added cost has resulted in severe declines in worldwide market share for several U.S. industries since 1976, the year in which Section 911 went into effect.

It is this kind of change that will benefit U.S. exporters who are primarily large, experienced firms. The U.S. Department of Commerce has reported that 250 firms account for about 80 percent of total U.S. exports. There is probably not much that universities can do to assist directly in increasing the exports of these large firms in the short run.

In the long-term, however, I believe that there is a lot that should be considered, discussed and acted upon. U.S. corporations, and the U.S. government have both been criticized as having a cultural myopia in their overseas activities. Examples exist of government and corporate professionals stationed abroad, incapable of speaking the local language or perhaps of truly understanding the local culture. Why, then, don't corporations at least make personnel decisions to rectify these problems where they exist? The answer probably lies in the tendency for corporations to improve products and processes, rather than to invest heavily in cross-cultural training. While some corporations do have foreign language policies for their overseas employees, most corporate decision makers do not estimate the opportunity costs of not investing in internationalized personnel. Indeed, most have tried to solve the problem by hiring host country nationals for key overseas managerial positions.

With the proper financial support from the government, universities can begin to organize themselves to assist in the long-term effort to increase economic performance. For example, the passage of S. 2306 would be helpful in providing monies for experimental university programs, that are realistically designed. But the major emphasis should be on international education and not merely training. Business, and the entire nation, expects that the government will help universities produce internationally competent graduates. In the attempt to become relevant, fads and academic hucksterism can be avoided by involving corporations in the planning of these programs. It makes sense that students whose undergraduate and graduate programs are infused with international content can more easily be acculturated overseas than can individuals who have had only short training courses.

Certainly, one broad area of unexplored concern that S. 2306 could address is a possible, closer relationship between academic research and the corporate need for information. Any company invested abroad needs constant reliable information and analyses to monitor environmental changes—social, political and economic—so that corporate operations can be appropriately adapted. The question is how can university research be made more useful to corporations without damaging the integrity of that research. Other countries have made this connection, several U.S. corporations have established contractual relations with universities here for research and briefings on various world regions, and the U.S. government could promote these worthwhile experiments.

Another major problem is that there is little opportunity for U.S. citizens to get international experience. There has been a gradual, real withdrawal of support from educational and cultural exchanges in this country. For example, since 1970 there has been a 60 percent decrease in real dollar terms in the Fulbright-Hays program. In another example, there were 34,000 individuals in 1979 involved in other U.S. government sponsored visitor exchanges; only 2,000 of this number were U.S. citizens. There are other examples, but these should suffice to demonstrate briefly that we are not adequately providing international opportunities for future business executives as well as academic professors and researchers. In fact, we provide on a proportional basis only about 10 percent of the amount that West European governments spend on exchanges. This is an activity that we simply should not minimize.

In conclusion, I'd like to say that now is the time to invest in a variety of activities—some direct and some indirect, some short-term and some long-term—that will produce perhaps the most valuable resource for improved U.S. international business. And that is internationally competent professionals.

Thank you.

PREPARED STATEMENT OF LEE C. NEHRT, DEAN, FELLOWS OF THE ACADEMY OF INTERNATIONAL BUSINESS

Mr. Chairman, members of the committee, I sincerely appreciate this opportunity to appear before you. Most of my career has been devoted to the international aspects of management education and, in my current position as Director of the World Trade Institute, located in the World Trade Center in New York, I am fully involved, on a day-to-day basis, with the field of education for careers in international trade. Consequently, I am vitally interested in the work of your committee.

I wish to emphasize, however, that I am appearing here today as an individual and as Dean of the Fellows of the Academy of International Business, and that my testimony does not necessarily represent the view of The Port Authority of New York and New Jersey, of which I am an employee.

In 1976, the American Council on Education created a national task force, made up of about forty international businessmen, government officials and academics. I had the pleasure of chairing that group. It was our charge to study the needs of international business and determine how higher education might best respond to those needs. The task force, working over a period of eighteen months, carried out a series of eleven surveys and studies. These identified the shortcomings of our current educational system and made a series of recommendations for changes. The report of the task force, Business & International Education, was published by the Council in 1977. It should serve as necessary background reading to the members of your committee.

As you are aware, Mr. Chairman, Title VI of the Higher Education Act was passed by Congress and signed by the President in October of this year.

Part B of Title VI relates to international education programs specifically of interest to business. It provides for government funding of $7.5 million for a variety of eligible activities, such funding to be matched by contributions from business. In my opinion, this is an excellent piece of legislation. However, its resources are, I feel, inadequate to meet the need.

There are, in the United States, about 1,300 business schools. Over 60 years ago they created an accrediting organization, the American Assembly of Collegiate Schools of Business (AACSB). This past summer, at its annual meeting, the AACSB finally agreed on a change in the accreditation standards which states that every student must have some exposure to the international aspects of business. All of these schools are going to have to respond to this in one of two ways. Either every student will be required to take an international business course—or, some of the currently required courses, which have been taught from a purely domestic viewpoint, will have to be internationalized. Either of these approaches will require the development of new courses and the retraining of many faculty members in almost every business school. Most university budgets are not in a position to finance this sort of retooling of curriculum and faculty. If one modestly estimates the sort of outside assistance needed at $50,000 per year per school, this alone would require over $60 million per year for the next three or four years.

One of the recent thrusts of higher education, and one of the crying needs to prepare tomorrow's business leaders, is cross-disciplinary education. An example of this would be where an area studies major would combine his or her geographic area and language studies with a minor in international business, or a business major could have a minor in area and language studies. A dozen or so universities have developed this type of program and found it highly attractive. It should be developed in all 1,300 universities and colleges which have business schools. This would also involve curriculum development and some faculty retooling and require financial support at a level of $60 million per year, or more, nationally.

I have mentioned only two of the many types of activities which Title VI is designed to encourage and support. It is clear that the $7.5 million of government support matched by $7.5 million of private funding is inadequate to the need.

The only way around this dilemma is for the government to encourage a much higher level of support from the private sector. This can be done as an amendment to the tax legislation which would allow tax credits for private donations to higher education in support of the eligible activities specified in Part B of Title VI. The Congress could retain control of such donations, to make sure that they do not get out of hand, by specifying in the tax legislation that credit would only be given for donations in support of programs which has been approved by the Advisory Board created by Title VI to administer Part B. This would avoid any wholesale give-away of tax money which some people fear would accompany a tax credit provision.

All of the above presupposes that Title VI of the Higher Education Act will be funded by the next Congress. I certainly hope that it will. However, some people are skeptical about this happening. Let's suppose that it is not. What is the best way to approach the problem?

In the event that Title VI is not funded, I should like to suggest a three-pronged attack.

The first would be that an amendment be attached to the tax legislation, in the next session of Congress, which would permit tax credit to business for contributions in support of the eligible programs, similar to my preceding mention of this subject.

Secondly, that the "eligible programs" as stated in Part B of Title VI be amended and expanded.

Thirdly, that an International Business Education Foundation be identified by the tax amendment as the controlling body to assure that tax credit would only be given for contributions in support of the eligible programs. This International Business Education Foundation would thus play somewhat the same role as the Advisory Board specified in Title VI.

However, this Foundation would play roles other than that of approval and screening of programs brought to it. It would also have the capacity to continually survey needs and suggest programs of education, training, and research to institutions of higher education, and even fund some of them.

In the absence of funding by Congress, how would such a Foundation be created and obtain financing?

My suggestion is that the Foundation be created by the President and that its Directors be appointed by him. However, once created, the Foundation would be responsible for determining its operating budget and obtaining its financing via contributions from the private sector, for which tax credits would be available.

It should be noted that the idea for such a Foundation comes from the House bill H.R. 4526, which was the House version of Section B of Title VI, and was introduced on June 19, 1979 by Representatives Simon, Gibbons and others.

Attached, as an annex to my testimony, is a draft amendment which would carry out the above suggestions. It would: (a) provide for the creation of the Foundation; (b) permit a 50 percent tax credit for contributions in support of the Foundation and in support of "eligible programs", as approved by the Board of Directors of the Foundation; and (c) specify the types of programs which are to be encouraged by the legislation.

Finally, I should state that the list of eligible programs is based primarily on those shown in Part B of Title VI, with additional ideas from H.R. 4526 and from Business & International Education, the report of the task force of the American Council on Education.

Mr. Chairman, I hope that this presentation will be useful to the work of your committee and again, I thank you for this opportunity to appear before the Committee.

## ANNEX I

AN AMENDMENT To promote educational, training and research activities in institutions of higher education so as to contribute to the ability of American business to market its goods and services abroad and to prosper in the international economy.

### PURPOSE

Section 1. (a) The Congress finds that—

(1) the future economic welfare of the United States will depend substantially on increasing international skills in the business community and creating an awareness among the American public of the internationalization of our economy;

(2) concerted efforts are necessary to engage business schools, language and area study programs, public and private sector organizations, and United States business in a mutually productive relationship which benefits the Nation's future economic interests;

(3) few linkages presently exist between the manpower and information needs of United States business and the international education, language training and research capacities of institutions of higher education in the United States, and public and private organization; and

(4) organizations such as world trade councils, world trade clubs, chambers of commerce and State departments of commerce are not adequately used to link universities and business for joint venture exploration and program development.

(b) It is therefore, the purpose of this Amendment—

(1) to increase and promote the Nation's capacity for international understanding and economic enterprise through provision of suitable international education and training for business personnel in various stages of professional development;

(2) to promote institutional and non-institutional educational, training and research activities that will contribute to the ability of American business to succeed in the marketing of American goods and services abroad and to prosper in an international economy;

(3) to establish an International Business Education Foundation; and

(4) to provide funding for such activities through the granting of tax credits for private contributions in support of these activities.

ESTABLISHMENT OF FOUNDATION

Sec. 2. (a) There is hereby established a body corporate to be known as the International Business Education Foundation (hereinafter in this Amendment referred to as the "Foundation"). The Foundation shall have succession until dissolved. It shall maintain its principal office in the District of Columbia and shall be deemed to be a resident and citizen thereof. Offices may be established by the Foundation in such other place or places as it may deem necessary or appropriate for the conduct of its business. The Foundation, including its franchise, capital, reserves, surplus, mortgages, or other security holdings, and income shall be exempt from all taxation now or hereafter imposed by any State, territory, possession, Commonwealth, or dependency of the United States, or by the District of Columbia, or by any county, municipality, or local taxing authority, except that any real property of the Foundation shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed.

(b)(1) The Foundation shall have a Board of Directors which shall consist of twenty-five members appointed by the President, one of whom shall be designated Chairman. Of such members—

(A) five shall represent large international companies or associations of such companies;

(B) five shall represent small and medium-sized businesses or associations of such businesses;

(C) ten shall represent academic institutions or associations of academic institutions or teachers; and

(D) one shall represent each of the following agencies: the Department of Health, Education, and Welfare, the Department of Commerce, the Department of Agriculture, the State Department, and the Small Business Administration.

(2) The Board of Directors shall appoint an Executive Director who shall be responsible for the administration and supervision of the functions of the Foundation, including the employment of personnel.

(3) The Board of Directors shall meet at the call of the Chairman, but at least four times per year. The Board shall determine the general policies which shall govern the operations of the Foundation.

(c) The Foundation shall have power—

(1) to sue and be sued, complain and defend, in its corporate name;

(2) to adopt, alter, and use the corporate seal, which shall be judicially noticed;

(3) to adopt, amend, and repeal by its Board of Directors, bylaws, rules, and regulations as may be necessary for the conduct of its business;

(4) to conduct its business, carry on its operations, and have officers and exercise the power granted by this section in any State without regard to any qualification or similar statute in any State;

(5) to lease, purchase, or otherwise acquire, own, hold, improve, use, or otherwise deal in and with any property, real, personal, or mixed, or any interest therein, wherever situated;

(6) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of its property and assets;

(7) to appoint such officers, employees, and agents as may be required, to determine their qualifications, to define their duties, to fix their salaries, require bonds for them and fix the penalty thereof; and

(8) to enter into contracts, to execute instruments, to incur liabilities, and do all things as are necessary or incidental to the proper management of its affairs and the proper conduct of its business.

(d) The Accounts of the Foundation shall be audited annually. Such audits shall be conducted in accordance with generally accepted auditing standards by independent certified public accountants or by independent licensed public accountants, who are certified or licensed by a regulatory authority of a State or other political subdivision of the United States. A report of each such audit shall be furnished to the Secretary of the Treasury. The audit shall be conducted at the place or places where the accounts are normally kept. The representatives of the Secretary shall have access to all books, accounts, financial records, reports, files, and all other papers, things, or property belonging to or in use by the Foundation and necessary to facilitate the audit, and they shall be afforded full facilities for verifying transactions with the balances or securities held by depositaries, fiscal agents, and custodians.

(e) A report of each such audit for a fiscal year shall be made by the Secretary of the Treasury to the President and to the Congress not later than six months following the close of such fiscal year. The report shall set forth the scope of the audit and shall include a statement (showing intercorporate relations) of assets and liabilities, capital and surplus or deficit; a statement of surplus or deficit analysis; a statement of income and expense; a statement of sources and application of funds; and such comments and information as may be deemed necessary to keep the President and the Congress informed of the operations and financial condition of the Foundation, together with such recommendations with respect thereto as the Secretary may deem advisable, including a report of any impairment of capital or lack of sufficient capital noted in the audit. A copy of each report shall be furnished to the Foundation.

EDUCATION, TRAINING AND RESEARCH PROGRAMS

Sec. 3 (a) Each program assisted under this amendment shall both enhance the international academic programs of institutions of higher education and provide appropriate services to the business community which will expand its capacity to engage in commerce abroad. The contributions of private business enterprises may be made to public or private educational institutions and to educational and professional associations.

(b) Eligible programs to be conducted by the recipient institutions or organizations under this section shall include, but shall not be limited to—

(1) innovation and improvement international education curricula to serve the needs to the business community, including development of new programs for nontraditional, mid-career, or part-time students;

(2) development of programs to inform the public of increasing international economic interdependence and the role of American business within the international economic system; (3) internationalization of curricula at the junior and community college level, and at undergraduate and graduate schools of business;

(4) development of interdisciplinary programs between business schools on one hand and area studies, foreign language and international affairs programs on the other;

(5) establishment of export education programs through cooperative arrangements with regional and world trade centers and councils, and with bilateral and multilateral trade associations;

(6) research for and development of specialized teaching materials, including language materials, and facilities appropriate to business-oriented students;

(7) establishment of student and faculty fellowships and internships for training and education in international business activities;

(8) development of opportunities for junior business and other progressional school faculty to acquire or strengthen international skills and perspectives; and

(9) development of research programs on issues of common interest to institutions of higher education and private sector organizations and associations engaged in or promoting international economic activity.

(10) development of programs to facilitate the exchange of professors between American and foreign institutions of higher education;

(11) establishment of programs to facilitate the provision, by institutions of higher education, or low-cost market research studies and technical assistance to small- and medium-sized businesses engaged in international commerce; and

(12) creation of programs to survey, catalog and dissemminate information with respect to job and career opportunities for individuals with language, area studies and international business backgrounds.

(13) development of programs to inform the business community regarding the current availability and utility of internationally-trained college graduates.

(c) No contribution may be made to an institution of higher education or to an educational or professional association under the provisions of this amendment and receive a tax credit unless the recipient institution or association submit an application to the Foundation, at such time and in such manner as the Foundation may require, and unless the Board of Directors of the Foundation agree that the program to be funded is an "eligible program". Each such application shall be accompanied by a copy of the agreement entered into by the institution of higher education with a business enterprise, trade organization or association engaged in international economic activity, or a combination or consortium of such enterprises, organizations or associations, for the purpose of establishing, developing, improving or expanding activities eligible for assistance under subsection (b) of this section. Each such application shall contain assurances that the institution of higher education will use the assistance provided to supplement and not to supplant its current activities.

(d) Contributions may also be made directly to the Foundation and be eligible for tax credit. Such contributions may be used by the Foundation to finance its operations and to permit it to provide grants directly to institutions of higher education and to educational and professional associations, for eligible programs as defined by Sec. 3 of this amendment.

FUNDING AND TAX CREDITS

Sec. 4 (a) Funding for the establishment and operation of the Foundation and for the "eligible programs" shall be provided by contributions from private American business organizations.

(b) The contributing organization shall receive a 50 percent tax credit for the amount of such contribution. The other 50 percent shall be considered as a usual contribution to a non-profit organization.

(c) The Board of Directors of the Foundation shall determine whether each program submitted is eligible for tax credit and the Foundation shall so inform the recipient and contributing organizations concerned.

(d) The maximum total contributions which may be approved by the Board of Directors under the provisions of this amendment, for any single fiscal year, shall be $75 million.

(e) This system of tax credits for contributions to eligible programs, under the terms of this amendment, shall continue for a period of five years.

DEFINITIONS

Sec. 5. (a) As used in this amendment—

(1) the term "area studies" means a program of comprehensive study of the aspects of a society or societies, including study of its history, culture, economy, politics, international relations and languages;

(2) the term "international business" means profit-business relationships conducted across national boundaries and includes activities such as the buying and selling of goods; investments in industries; the licensing of processes, patents and trademarks; and the supply of services;

(3) the term "export education" means educating, teaching and training to provide general knowledge and specific skills pertinent to the selling of goods and services to offer countries, including knowledge of market conditions, financial arrangements, laws and procedures; and

(4) the term "internationalization of curricula" means the incorporation of international or comparative perspectives in existing courses of study or the addition of new components to the curricula to provide an international context for American business education.

(b) All references to individuals or organizations, unless the context otherwise requires, mean individuals who are citizens or permanent residents of the United States or organizations which are organized or incorporated in the United States.

Senator BRADLEY. The subcommittee will stand in adjournment until the call of the Chair.

[Whereupon, at 5:15 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

PREPARED STATEMENT OF ROGER KIRK, VICE CHAIRMAN OF THE BOARD, BROWN & WILLIAMSON TOBACCO CORP.

Mr. Chairman, Members of the Subcommittee, I am Roger Kirk, Vice Chairman of the Board of Brown & Williamson Tobacco Corporation, 2000 Citizens Plaza, Louisville, Kentucky 40202. Brown & Williamson manufactures tobacco products. It is owned by BATUS, Inc., which is owned by BAT Industries, Ltd., a United Kingdom corporation, BAT is Britain's third largest industrial and is the sixth largest foreign corporate investor in the United States. It is involved in five separate and unrelated lines of business: tobacco, paper, retailing, cosmetics and packaging and employs more than 250,000 persons on six continents.

This Committee is to be commended for its inquiries regarding United States trading relations with developing countries. We would like to point out one area that deserves special legislative attention if those relations are to be developed without adverse impacts.

At present we have in the United States a most confusing and ill advised situation in which the Federal government and several individual States have contradictory policies regarding taxation of corporations which are members of a group of corporations doing business in more than one country.

In administering the Federal tax laws, the Internal Revenue Service has adopted the arm's length standard for apportioning income between related domestic and foreign corporations. The regulations implementing IRC section 482 could not be more straightforward: (b) *Scope and Purpose.* The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer the true taxable income from the property and business of a controlled taxpayer.* * * 26 C.F.R. section 1.482-1(b)

For the purpose of the Internal Revenue Code: (6) the term "true taxable income" means, in the case of a controlled taxpayer, the taxable income which would have resulted to the controlled taxpayer, had it in the conduct of its affairs * * * dealt with the other member or members of the group at arm's length. 26 C.F.R. Section 1.482-1 (a) (6)

As has been explained many times in the record of the United States-United Kingdom Income Tax Treaty, and hearings before the Senate Committee on Finance, Subcommittee on Taxation and Debt Management Generally on S. 1688 on June 24, 1980, and before the House of Representatives Committee on Ways and Means on H.R. 5076 on March 31, 1980, most of the individual States use some apportionment formula to determine the tax liability of the unitary operations of a single multistate corporation. A substantial number of States enlarge that formula to a controlled group of corporations when the operations and management of the group are unitary in nature, i.e., integrated to engage in one business or have related business purposes. That application has become known as the "unitary method" of taxation.

A few individual States, especially California, and Alaska, Idaho, Montana, North Dakota, and Oregon, somewhat carry the unitary method a step further. They apply unitary apportionment to the worldwide operations of foreign affiliates of United States corporations, even when those corporations are involved in non-unitary and unrelated lines of business and are not conducting business in the taxing State, or even in the United States. It is this unwarranted extension of the unitary method to worldwide operations of affiliated corporations that has become known as the "worldwide combined reporting system."

In nearly forty income tax treaties which the United States has negotiated, it is the arm's length, separate accounting, separate enterprise principle which has been adopted, not the worldwide combined reporting system. This international stance of the United States has also been evidenced in approximately twenty-five treaties of friendship and commerce with which the United States has entered into with foreign nations.

The United States is a member of the Organization for Economic Cooperation and Development. Its Model Income Tax Convention and the 1974 Guidelines for Tax Treaties Between Developed and Undeveloped Countries, prepared under the auspices of the United Nations adopt the arm's length method as used by the Federal Government as the standard. Articles 7 and 9 of the 1977 Model Double Taxation Convention on Income and Capital of the OECD, as contained in the 1977 report of its Committee on Fiscal Affairs, also provides for adoption of the separate enterprise, arm's length concept.

The Council of the OECD in July 1979, recommended that the arm's length principle be used uniformly worldwide, rather than any formula apportionment method. The OECD action indicates the agreement of the governments which are members of the OECD, which includes the United States, that separate accounting employing arm's length standards is the only appropriate system for taxation of international transactions. See Transfer Pricing and Multinational Enterprises (OECD, Paris, July 1979).

Though the record as to why the individual States should not be permitted to have their own policies on taxing international commerce through the use of the worldwide combined reporting system is complete there can be no reasonable justification for a tax system which: (a) apportions income on the basis of any one or more of a number of factors not necessarily directly related to actual income and the expenses of the business; (b) taxes income outside of and not in any way related to the taxed companies' operations; (c) uses bases and factors which can be and are varied by the tax authorities from year to year; (d) calls for accounts and information on a basis totally different from any other tax system and even beyond the kind of information readily available to an international trading company, except at unacceptably huge additional costs; (e) with separate tax authorities using the same basic method, but with different factors and definitions in their calculations, can lead to multiple-taxation—even of extra-territorial income; (f) could, for example, place a U.S. company in the impossible position of being requested to disclose classified information on the details of its operations when the group or part of it is involved in the defense equipment industry; (g) is difficult to administer and is an inaccurate method of apportioning the income of multinational businesses among taxing jurisdictions; (h) may result in the State taxing income of the multinational enterprise that is not derived from or substantially related to the operation of an affiliate of the enterprise in the taxing State; (i) to produce equitable results requires equality of factors combined, when cases of truly unitary entities with equal rates of profit, property, and labor, occur seldom if ever in the context of multinational business; (j) is not only unfair, but also impedes industrial investment and decreases job opportunities as a result.

Having considered the abuses to which the use of the worldwide combined reporting system subjects corporations which have affiliates in more than one country, the International Chamber of Commerce issued the following resolution on September 26, 1979:

"The ICC views with concern the inevitability that an increase in cases in which profits taxes are levied by political sub-divisions unencumbered by treaty obligations will result in mounting double taxation of profits (which tax treaties set out to avoid). This is particularly so if the basis of assessment in any such political sub-division is not entirely consistent with that of the country itself and extends to operations carried on outside the country. This problem has manifested itself in an acute form in connection with the attempts of the State of California to impose the "global" or "unitary" form of assessment based on income or companies involved in international operations outside the U.S.

"The dangers of double taxation and the administrative problems arising from the taxation policy of California, and other political sub-divisions, have undoubtedly deterred would-be investors from making investments which would have been otherwise undertaken. This approach, if it should spread, could easily become a most important threat to international trade since international operations would inevitably be confronted with a real danger of multiple taxation of the same profits and unacceptable administrative burdens. The dangers were also recognized by the Council of the OECD in rejecting the so-called "global" method in its recent report on Transfer Pricing (Transfer Pricing and Multinational Enterprises (OECD, Paris, July 1979) pp 14–15.

"The ICC reconfirms its view that, as a general rule, tax should be based on a fair measure of income as computed by reference to the amount which could be expected to arise between independent parties dealing at arm's length. This rule has universal application. The ICC recommends that, in all cases where the taxation policies of political sub-divisions extend to non-domestic operations, all possible measures should be taken to ensure that the terms of an agreement or treaty dealing with taxation on income should bind all authorities having jurisdiction within the boundaries of each contracting State. This recommendation is in accordance with the OECD Model Taxation Convention, 1977 (Art. 2) and a considerable number of international friendship, trade and shipping treaties."

The nine governments which make up the European Economic Community have indicated their strong arguments against the worldwide combined reporting system and have in correspondence to the Department of State on March 19, 1980, urged: . . . "you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment."

The legislation to which the EEC referred was S. 1688 and H.R. 5076, identical bills introduced in this Congress which would have conformed the State rules to those of the Federal government in two very specific areas: the time at which states tax the foreign source income of foreign affiliates, and the quantity of foreign source dividends which are taxed. Hearings were held on those bills before the Senate Committee on Finance Subcommittee on Taxation and Debt Management Generally on June 24, 1980, and before the House of Representatives Committee on Ways and Means on March 31, 1980, respectively.

The Department of the Treasury supported the legislation. In his testimony before the Senate Committee on Finance, Subcommittee on Taxation and Debt Management Generally on June 24, 1980, Assistant Secretary for Tax Policy, Donald C. Lubick, said: ". . . We are in favor of a limitation on unitary apportionment as applied to foreign-based multinationals. We suggest that the same rule is probably appropriate with respect to restriction on apportionment of income to U.S.-based multinationals." State Taxation of Interstate Commerce and Worldwide Corporate Income, hearing before the Subcommittee on Taxation and Debt Management Generally, Senate Committee on Finance, Ninety-sixth Congress, 2nd Session, Statement of Donald C. Lubick, 1980, p. 41.

The International Chamber of Commerce, Chamber of Commerce of the United States, the American Chamber of Commerce in Great Britain, the Business Roundtable, the National Association of Manufacturers, the Committee of State Taxation of the Council of State Chambers of Commerce, the Confederation of British Industry, the Dutch Employers Federation, the German American Chamber of Commerce and most of the major companies in this country and Great Britain which provide employment for millions worldwide, all expressed support for that legislation.

The need to limit the use of the worldwide combined reporting system has even been recognized by the legislature and executive branches of California, the Franchise Board of which is its leading exponent. AB 525 which would limit the application of that method to foreign based corporations was passed by the Assembly and voted on favorably by two Senate committees during the most recent session of the California Assembly.

During the consideration by the House of Commons of the Income Tax Treaty between the United States and the United Kingdom in which the Federal government agreed not to use the worldwide combined reporting system, Member of the House of Commons, Roger Moate, pointed out that not only England should be concerned regarding the possible spread of that system: "It is a bad international precedent for the British Government or any other nation to have to look to perhaps 50 states in the United States for an understanding of the way in which we are to conduct our international tax affairs. That cannot be right. I am sure that the United States understands that this is a grossly unsatisfactory situation.

"It is a bad international precedent, because of the damage that it could do all world trading nations." Page 194, February 18, 1980, Hansard.

As this Subcommittee hears testimony on United States trading relations with developing countries it will be paying special attention to the influence of debt and energy positions of the Third World countries and to alternative options available to these countries for meeting financing requirements in connection with their debt and energy requirements. Developing countries, eager to participate in world trade, should not be placed in a position of being added to the list of world trading nations which can be damaged by the continuance of the paradoxical situation in which the Federal government has agreed internationally not to use the worldwide combined reporting system, but allows a few individual States to continue to use it.

Not only does this contradictory situation subject corporations to the vagaries of the system, it exposes United States corporations to possible retaliatory taxing measures by other nations and the potential spread of the worldwide system as other countries recognize the contradiction exhibited. The United States must speak with one voice on this matter.

## Prepared Statement of William K. Quarles, President, California-Arizona Citrus League

### INTRODUCTION

This statement is submitted on behalf of the California-Arizona Citrus League (the League). The League is a voluntary non-profit trade association composed of marketers of California-Arizona citrus fruits. Members are farmer cooperatives and independent shippers which represent over ninety percent of the 10,500 citrus fruit growers in Arizona and California. These growers produce oranges, lemons, grapefruit, tangerines and limes. This fruit is marketed in both fresh and processed forms.

The League speaks on behalf of the California-Arizona citrus fruit industry on matters of general concern such as legislative, foreign trade and other similar topics. Representatives of the League have devoted much time and effort to the promotion of exports and have concerned themselves with international trade problems since early in the 1920's.

### BACKGROUND

By press release of November 26, 1980, the United States Senate Finance Subcommittee on International Trade announced a hearing on United States international trade strategy. The notice indicated that the hearing was scheduled for the purpose of receiving testimony on U.S. trading relations with developing countries and in particular trading relations with the so called "newly industrializing countries" (NICs).

The League welcomes this review as international trade strategy has been a subject of great interest to the California-Arizona citrus industry. Indeed, trade strategy as specifically applied to the so called NICs has grown of increasing importance to our industry.

Trade strategy and its impact on our exports achieves this importance because of the tremendous impact exports of California-Arizona citrus have had on the industry. We have had a rich and successful history of exporting citrus. Our trading history dates back to 1892 with significant commercial volumes being first attained in the 1920's. Our experience in exporting citrus around the world and its importance to our industry, leads us to follow the development of U.S. trade strategy with keen interest.

As a preliminary matter, we note with particular concern the increasing use by our Government, as well as other governments and international organizations, of labelling the many countries of this world. Some are "developed countries" (DCs), "less developed countries" (LDCs), "least less developed countries" (LLDCs), "centrally planned economies" (CPEs) and, more recently "newly industrializing countries" (NICs). Others we do not know about yet are bound to pop up, for instance the EEC's "ACPs".

These labels seem to be designed to justify differential (or preferential) international trade arrangements. But those commercially involved in international trade "can't tell the players without a score card." They have not been apprised of the criteria used to determine which label applies to which country, nor do they know if each country has its own criteria or whether there are an internationally accepted criteria.

Our government has published "economic indicators for beneficiary developing countries" (those eligible for GSP treatment). The "1978 per capita GNP" for this list of 121 countries ranges from $10,645 to $81. For example, Brazil's per capita (#24) is shown as $1,567 and Taiwan's (#29) as $1,396 (both for 1977). Another criterion is "share of manufactures in total exports": Taiwan is fifth with 81 percent (in 1975), and Brazil is twenty-seventh with 25.1 percent (in 1977). Still another listing shows that in 1978 Taiwan was first with duty-free GSP shipments to the United States and Brazil was fourth. These two countries accounted for 36.5 percent of total GSP imports.

The U.S. balance of trade with these two countries over the past five years has been always negative with Taiwan, and declined to even with Brazil. At the end of fiscal year 1979, the United States had a positive balance with Brazil of just $46 million and a negative balance with Taiwan of $2.6 billion.

## RECIPROCITY NEEDED IN TRADE STRATEGY

The American international trader is puzzled in knowing how to deal with these two countries. They definitely bear the label "LDC's" (it says so in the TSUS), but do they also have the "NICs" label? And, whatever the official label, should not American traders expect improved reciprocity from these two countries?

In fact, if the Subcommittee's analysis of international trade strategy could only reach one conclusion we would earnestly hope that that conclusion would be that this country must seek reciprocity in all trade relations, absent the most compelling circumstances. The labelling of a country as a "newly industrializing country" or as any other general category should not by itself constitute such compelling circumstances.

Our industry has faced discriminatory and unfair trade practices from countries in the NIC category. Until these countries move to a system of fair and equitable trading relationships with a general degree of reciprocity, we would oppose any special or unique concessions or comparable treatment.

## MEXICO

Insofar as citrus is concerned, trade relations with Mexico offer a good example of why our Government must stress reciprocity. Mexico produces fresh oranges and grapefruit and very limited quantities of lemons. Oranges are grown during the entire year in Mexico, but the bulk of the crop is obtained from December to June. Thus, there is a natural market for imported oranges, particularly from July to September when the United States has ample supplies available. Nonetheless, only insignificant amounts of United States-produced citrus fruit enters Mexico. An import license is required by Mexico for imports of all fresh citrus. In fact, it is very difficult to obtain this import license and licenses are very rarely granted by the Mexican government for imports of fresh citrus. Backing up this licensing system is a high duty on citrus fruit of 35 percent ad valorem on an official price of 3 pesos per kilogram. The duty is, in effect, approximately twice as high as the U.S. customs duty on fresh citrus.

The United States is Mexico's largest export market, consuming currently over 60 percent of Mexico's exports. Over 80 percent of U.S. imports of fresh oranges originate in Mexico, and the amount of oranges is substantial. The United States, which produces its own oranges, grapefruit and lemons, is Mexico's largest market for exports of fresh citrus. As customs regulations between the two countries should be on a quid pro quo basis, the government of Mexico should remove its import restrictions to put Mexico and the United States on an equal footing.

It should also be noted that Mexico, an eligible developing country under the U.S. Generalized System of Preferences, has refused to join the General Agreement on Tariffs and Trade, and has refused, after initially indicating a willingness to enter into such agreement, to sign a tropical products agreement with the United States. Combined with the import licensing system and the high duties, this is yet another example where the United States must be mindful of the lack of meaningful reciprocity when dealing with international trade and the third world.

### TAIWAN

Another good example is the Republic of China (Taiwan). Taiwan currently assesses a duty of 25 percent ad valorem in the May to September period, and a duty of 50 percent in the October through April period on fresh citrus. The League believes these duties are the principal reason that the full potential of the Taiwan market has not been realized. Indeed, one of the largest per capita consumption markets in the world for fresh citrus is Hong Kong. The League fully expects that the same consumption levels would obtain in Taiwan were the duties lowered significantly. Combining this with the fact that Taiwan is currently the principal worldwide beneficiary of the U.S. Generalized System of Preferences, it becomes clear that reciprocity must be stressed in all future trade relations with developing countries like Taiwan.

### BRAZIL

The Finance Committee press release of November 26, 1980 specifically mentions Brazil as one of the "newly industrializing countries". To illustrate the absurdity of making Brazil eligible for special trade treatment, such as their eligibility for GSP, one has only to note Brazil's dramatic rise in prominence as the major world supplier of orange concentrate. In 1979 the Brazilian orange concentrate industry processed 190 million boxes of oranges into juice. This production resulted in 405,000 metric tons of orange concentrate. Brazil literally dominates the world's orange juice market and is by far the major producer. At the same time, Brazil is eligible for GSP treatment for its products, including citrus and citrus products. There is no better example of the need to shape trade policy on the realities of commercial considerations and without reference to arbitrary classifications such as "newly industrializing countries".

### CONCLUSIONS

Too often the United States is being unfairly discriminated against in international trading relationships through tariff and non-tariff barriers erected by our trading partners. The League feels strongly that regardless of the labeling of a country as an "LDC" or a "LLDC" or a "NIC", it is of paramount importance that our Government, to the extent practicable, stress reciprocity in all its trading relationships with both developed and developing countries. Only through such reciprocity can mutually beneficial trade thrive.

## Prepared Statement of Steven W. Easter, Vice President, California Almond Growers Exchange

### INTRODUCTION

This statement is submitted on behalf of the California Almond Growers Exchange. The Exchange is an agricultural cooperative headquartered in Sacramento, California. It has nearly 5,000 grower members which represent approximately 72 percent of the producers of almonds in California.

The Exchange receives, processes, packs and markets almonds for its members; its almond supply is obtained exclusively from its members. The Exchange sells the almonds of its members throughout the United States and in nearly every country of the world.

There are currently 365,000 bearing and non-bearing acres of almonds in California, making almonds the largest tree crop in the State. A projected 100,000 additional acres are to be planted. It is anticipated that the total Fiscal Year 1980 sales of almonds will amount to approximately $700 million.

Exports are extremely important to the U.S. almond industry as the United States is the world's largest producer of almonds. Approximately 65 percent of total U.S. almond production for fiscal year 1980 will be exported. This represents 70 percent of the total world almond supply and amounts to approximately $½ billion of exports. Almonds were California's second leading agricultural export in Calendar Year 1978, surpassed only by California cotton lint.

### BACKGROUND

By press release of November 26, 1980, the United States Senate Finance Subcommittee on International Trade announced a hearing on United States international trade strategy. The notice indicated that the hearing was scheduled for the purpose of receiving testimony on U.S. trading relations with developing countries and in particular trading relations with the so called "newly industrializing countries" (NICs).

The Exchange welcomes this review as international trade strategy has been a subject of great interest to the California almond industry. As indicated above, the Exchange exports almonds throughout the world and trade strategy as specifically applied to the so-called NICs has grown of increasing importance to our industry.

As a preliminary matter, we note with particular concern the increasing use by our Government, as well as other governments and international organizations, of labelling the many countries of this world. Some are "developed countries" (DCs), "less developed countries" (LDCs), "least less developed countries" (LLDCs), "centrally planned economies" (CPEs) and, more recently "newly industrializing countries" (NICs). Others we do not know about yet are bound to pop up, for instance the EEC's "ACPs".

These labels seem to be designed to justify differential (or preferential) international trade arrangements. But those commercially involved in international trade "can't tell the players without a score card." They have not been apprised of the criteria used to determine which label applies to which country, nor do they know if each country has its own criteria or whether there are an internationally accepted criteria.

Our government has published "economic indicators for beneficiary developing countries" (those eligible for GSP treatment). The "1978 per capita GNP" for this list of 121 countries ranges from $10,645 to $81. For example, Brazil's per capita (No. 24) is shown as $1,567 and Taiwan's (No. 29) as $1,396 (both for 1977). Another criterion is "share of manufactures in total exports": Taiwan is fifth with 81 percent (in 1975), and Brazil is twenty-seventh with 25.1 percent (in 1977). Still another listing shows that in 1978 Taiwan was first with duty-free GSP shipments to the United States and Brazil was fourth. These two countries accounted for 36.5 percent of total GSP imports.

The U.S. balance of trade with these two countries over the past five years has been always negative with Taiwan, and declined to even with Brazil. At the end of fiscal year 1979, the U.S. has a positive balance with Brazil of just $46 million and a negative balance with Taiwan of $2.6 billion.

### RECIPROCITY NEEDED IN TRADE STRATEGY

The American international trader is puzzled in knowing how to deal with these two countries. They definitely bear the label "LDC's" (it says so in the TSUS), but do they also have the "NICs" label? And, whatever the official label, should not American traders expect improved reciprocity from these two countries?

In fact, if the Subcommittee's analysis of international trade strategy could only reach one conclusion we would earnestly hope that that conclusion would be that this country must seek reciprocity in all trade relations, absent the most compelling circumstances. The labelling of a country as a "newly industrializing country" or as any other general category should not be itself constitute such compelling circumstances.

The California almond industry has faced discriminatory and unfair trade practices from countries in the NIC category. Examples from Taiwan, Mexico and Brazil are examined below. Until these countries move to a system of fair and equitable trading relationships with a general degree of reciprocity, we would oppose any special or unique concessions or comparable treatment.

### TAIWAN

For example, one of the NICs to which the Exchange exports shelled almonds is the Republic of China (Taiwan). Taiwan produces no almonds domestically and the potential market in the country, based on a per capita consumption of from one-quarter pound to one pound, is the export of from four million to 17 million pounds of product annually. The major impediment to expanding this market is that the Exchange is faced with confiscatory tariff levels on almonds imported from the United States. Despite indications earlier in 1980 that these high duties would be modified, it has recently come to our attention that the import duties have been raised to forty percent. When the standard harbor tax (4 percent) and the standard duty-paid value (115 percent of the CIF value) are added to this forty percent import duty, the actual total duty paid amounts to 50.60 percent. When it is recalled that Taiwan is currently the principal worldwide beneficiary of the U.S. Generalized System of Preferences, and that its per capita GNP stands at about $1,400, one of the highest of the world's developing countries, then our government must, in any future trade relations with this NIC, impress upon the Taiwanese that trade is a two-way street and that such confiscatory tariff barriers must be removed.

## MEXICO

Another example is Mexico. Though Mexico does not produce almonds, it uses an official pricing system and an import licensing system to restrict imports of almonds. In addition, it imposes a very high duty on shelled almonds of over 50 percent ad valorem. Were these restrictive systems removed and the duty reduced, the Exchange has estimated that its exports to Mexico will increase by 400 percent which would be an increase of about 1 percent in its total exports.

## BRAZIL

A final example is Brazil. Prior to 1974, Brazil assessed a 55 percent duty on imported almonds. In November 1974, the duty was increased to 155 percent ad valorem. Since that time, U.S. almond exports to Brazil have declined dramatically in what had been a fast-growing market. Though Brazil is a major exporter of nuts and cashews to the United States, it does not produce almonds. Here again our government must stress reciprocity in its international trade strategy before meaningful two-way trade can occur.

## CONCLUSION

The Exchange appreciates having this opportunity to present its views on U.S. international trade strategy with developing countries. As with all of our trading partners, developed or developing, the Exchange strongly believes that our Government must insist on reciprocity in all trade agreements. Trade cannot occur in a vacuum. Concessions to a trading partner, be it a developed country or a NIC, must be accompanied by reciprocal concessions from that trading partner in order to have a consistent and forthright U.S. trade policy.

O