REMARKS OF SENATOR DOLE

FORUM FOR ECONOMIC AND POLITICAL RELATIONSHIPS
BETWEEN THE NETHERLANDS AND THE UNITED STATES

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Why worry about the deficit--What does it mean to the average American?

- If nothing is done to reduce deficit spending over the next five years, the total Federal debt will nearly double to over $10,000 for every man, woman and child in America.
- At this level, by 1989 it will take one-half of all Americans' personal income tax payments just to pay the Federal Government's interest bill.
- By 1989 the annual Federal interest cost will amount to $250 billion--about $1,100 for every American.
- That $1,100 per person interest cost is equal to 40% of each person's annual expenditure for food.
- Virtually all economists agree that the sustained enormous deficits that we are facing will be economically harmful.
- Many Americans will find home-buying more difficult with higher deficits. Consider a family purchasing a home at today's current interest rate, averaging about 12-1/2%, with a $55,000 mortgage. If the deficits push interest rates up, total interest costs over the 30 year term will be $15,500 more for each one percentage point increase.
- All Americans will directly feel the results of high deficits if they lose jobs as a result of a business slowdown resulting from a crowding out of private investment, or if they lose jobs to imported products made more competitive because of an abnormally strong dollar or if they end up paying higher prices because inflation is rekindled.

What is the Federal deficit likely to be?

- The estimates of future Federal deficits are quite sensitive to one's economic assumptions. Yet even under the most optimistic of economic assumptions, the deficit will remain at historically high $200 billion levels over the foreseeable future, unless drastic action is taken.
- Assuming an extremely strong recovery (4% real growth of GNP) is sustained over the next few years and all of the Administration's

proposed spending cuts and revenue proposals are enacted, the deficits are still projected to be:

FY 1985	FY 1986	FY 1987	FY 1988
$180 billion	$177 billion	$180 billion	$152 billion

- o If economic growth is not so strong (3% real GNP growth) and interest rates are slightly higher (9% T-bill rate), and Administration's spending cuts are not enacted, the projected deficits would be:

FY 1985	FY 1986	FY 1987	FY 1988
$202.6 billion	$236.7 billion	$270 billion	$290.1 billion

- o If we have an economic downturn during this period, we may be facing $300 plus billion deficits.

What about defense spending

- o Over the period FY 1985-1987, the Administration's defense recommendation is about $65 billion higher than the 5% real growth path that Congress last year set as adequate for a strong defense.
- o The Adminstration's defense recommendation is a first offer that sets its opening bargaining position. I believe that the final defense number for FY 1985 will be close to the $289 billion figure contained in last year's budget resolution.
- o Even at a $289 billion level, defense spending will have increased 91% since 1981, the first year of the Reagan Presidency.

Why should we act this year on the deficit

- o If we fail to deal with the deficit now, the problem will become worse. Current projections showing deficits holding in the range of $200 billion probably are optimistic, as they are based upon assumption of steady economic growth through 1989. However, postwar experience suggests that the average recovery lasts only 3 years, making a recession in 1985 or 1986 likely.
- o If we postpone action until 1985 and we do suffer another recession, the deficits would then hit the $300-$400 billion range. At that point, it may be difficult to cut the deficit

without further weakening the economy. Our choices would become very difficult indeed.

- Of course, failure to reduce the deficit in 1984 makes a recession likely to come sooner, as interest rates are forced up by private credit demands clashing with Treasury borrowing needs.

- By postponing action of the deficit, we increase the risk of recession. The average increase in the unemployment rate during a postwar recession is about three points, or three million jobs. By acting to reduce the deficit, we can significantly lower the risk that three million workers will lose their jobs in 1985 and 1986.

- The rise in interest rates will depress auto sales, housing starts, and capital goods orders. It is widely recognized that sustained economic recovery will be impossible unless these key sectors are healthy.

- Alternatively, the Fed could offset the deficits' impact on interest rates by "monetizing" the debt, leading to a resurgence of inflation in 1985. If we do nothing, we will force the Fed to choose between high interest rates and recession, or inflation.

- Failure to reduce the deficits in 1984 may also depress the stock market. A key factor in determining equity and bond prices is investors' confidence that Congress and the Administration can produce a sound fiscal policy. If we send the signal that the deficit problem is secondary to politics, equity and bond prices may fall.

- The exploding cost of servicing the Federal debt will make controlling spending more difficult each year, unless the deficits are reduced soon. Each year that we add $200 billion in new Federal debt adds about $15 billion to the next year's interest costs.

- The economy is now on a path where more and more of its resources go just to pay off the debt. According to economist Lawrence Summers, "It's a case where the miracle of compounding (interest) works against you."

- In 1976 net interest accounted for just 7% of total outlays But if we do nothing, by 1988 the total Federal debt will be more than half of total GNP, and the net interest cost of servicing this debt will reach 14% of all spending. Each year that we do nothing, the share of Federal spending that we can control gets smaller.

- Recent studies indicate that current and prospective budget deficits may have helped to overvalue the American dollar. If the deficits are not reduced, the problem of overvaluation could become worse, weakening the competitive position of American exports and costing the U.S. jobs in such industries as steel, electronics, and agriculture.

Deficit downpayment in 1984

- The President has taken the lead to begin a deficit-reduction effort in 1984 by calling for bipartisan negotiations on a package to reduce the deficit by $100 billion over 3 years. As the President suggests, we can work with a variety of modest spending reductions, and tax reforms that raise revenue, to enact a significant deficit "downpayment" in 1984.

- Even though election-year politics makes it difficult to launch the kind of major assault on the deficit that we really need, that is no reason to do nothing. If we set reasonable expectations, we should be able to make a noticeable dent in the deficit that will make our job easier in the years ahead. Even more importantly, it can demonstrate to our citizens and to economic decision-makers in the private sector that we can face up to the deficit problem even in an election year.

- The Finance Committee is considering spending and revenue options just within its jurisdiction that can achieve the $100 billion "downpayment" goal. To do that we are drawing on a number of proposals that have been on the table for some time, including some already in the legislative "pipeline":

  -Items included in the FY 1984 reconciliation bill, S. 2062, which awaits Senate action

  -Treasury-endorsed proposals on tax shelters and other abuses

  -Administration -proposed spending cuts that were not followed through on last year

  -Administrative savings and other proposals made by the Grace Commission

  -Additional proposals considered in the Finance Committee last fall

- Target. We can aim at $100 billion in savings--$21.2 bilion in revenue changes pending in S. 2062, $21.1 billion in spending reduction from Finance Committee programs in S. 2062, $7 billion or so from Grace Commission recommendations, $9.5 billion in debt service savings, and the remainder from additional spending and tax changes aimed at desirable policy reforms. The goal is a roughly one-for-one balance between spending and revenue changes.

- Feasibility. The key is to follow the President's suggestion and concentrate on relatively non-contentious items, avoiding things like the third-year tax cut and indexing, mean-tested entitlements, social security, and the like. Our effort must be bipartisan and balanced to do the job: Democrats and Republicans alike will benefit by cooperating to take swift action on the deficit. Time is of the essence if we are to make a beginning this year.

- Initial Finance Action. On February 23, the Finance Committee began action to reduce the deficit. The Committee agreed to changes in health care programs that save $8.7 billion between now and 1987, over and above the provisions in S. 2062. In addition, the Committee agreed to the goal of raising $50 billion in revenue between now and 1987, provided at least that amount of spending reduction can be achieved. The House Ways and Means Committee has also scheduled a markup on the deficit and the bipartisan working group is showing some signs of progress. So we may be on our way.

Recovery--What progress have we made

Strength of recovery

- A strong recovery is on track and appears to be moderating to a pace that can be sustained in the years ahead. As an indication, look at the expansion of real gross national product. It grew by 9.7% in the second quarter of 1983, 7.9% in the third quarter, and an estimated 4.5% in the fourth quarter. By this measure, the recovery is the strongest since 1961.

- Housing starts are running at a rate of about 1.7 million units a year, and new home sales are up by 91% over the recession low.

- Industrial output in 1983 rose 6.5%, and factory utilization is up to 79.4%--the highest level in two years, and close to the normal capacity of 82%.

- The Commerce Department's survey of business plans for 1984 show that business plans to increase capital investment by 9.4%--this is a rate about 2% higher than that seen at comparable points in previous postwar recoveries.

Inflation

- The best news about this recovery is that it is noninflationary. In 1983 the producer price index rose just 0.6%--the lowest increase since 1964. The CPI for 1983 was 3.8%, the lowest since

1972. Continued moderation in producer prices indicates low inflation will continue.

Creating Jobs

- People are going back to work, and the pace of job creation has been unusually high for a postwar recovery. On January 6 the Labor Department announced the civilian unemployment rate dropped from 8.4% to 8.2% in December. Overall, this means unemployment has dropped 2.5 percentage points over the past year.

- The continued strength of the recovery shows that recent growth in employment has not just been a statistical fluke, but shows a real turnaround in the labor market. Unemployment fell 230,000 in December, and there have been 4 million jobs created in the last year.

- What is more, the growth in jobs is broad-based. While manufacturing industries showed the most dramatic gains, all industries other than government and agriculture showed dramatic drops in unemployment.

MONEY, DEFICITS, AND INTERNATIONAL FINANCE

- It is clear that high interest rates and a stable dollar attract investment from abroad into the U.S. This is no doubt a result of many factors, including Federal Reserve policy, expansive U.S. budget deficits, and concerns on the international scene that make the U.S. seem to be a safe haven.

- The attraction of capital into our country has a number of consequences. One is that it helps finance our national debt, so that high budget deficits have not yet resulted in the kind of "crowding out" or higher interest rates that many analysts fear. But it is not clear how long that day of reckoning can be postponed if our fiscal imbalance is not corrected. Financing our debt abroad, plus the effects of tax cuts and a stock market boom that reduce credit needs in the private sector, have helped so far. But as other countries experience economic recovery the situation could change significantly.

- The attractiveness of the United States for investment also tends to alter the balance of trade. A strong dollar makes it more difficult for U.S. producers to sell their goods overseas, and easier for foreign producers to market goods here. This means, at least in the short run, slower growth and fewer jobs in U.S. companies that depend heavily on export markets. But it also means lower costs to U.S. consumers because of competition from imported goods, and increased incentives for U.S. producers to keep costs down and be more efficient. So there is both an impediment to growth and an anti-inflationary effect.

- In the long run the present situation--large U.S. budget deficits, restrictive or moderate monetary policy, and a large U.S. trade deficit--probably cannot be sustained. But while there will have to be a correction, it need not be a drastic or sudden change. We should not forget our recent history, when double-digit inflation and other problems caused the decline of the dollar and undermined our ability to generate the capital needed for stable growth. Lower deficits, low inflation, and higher rates of capital formation and investment remain the key to a stable, growing economy. That is why we need to tackle the deficit problem <u>now</u>, encourage the Federal Reserve to run a steady course without throttling recovery, and choose tax and spending policies that foster savings and investment.

- It is difficult for the U.S. to argue that third-world nations should use the free market as the key to their development strategy, and seek markets overseas, if we fail to foster stability in international economic relations. High U.S. deficits and a high dollar are destablizing because they cannot be sustained in the long run--and they run the risk of fanning the fires of protectionism in that country. That is counter to our goals for promoting growth in Latin America and throughout the developing world.

1984 OUTLOOK FOR INTERNATIONAL TRADE IN THE SENATE

Talking Points

Export Administration Act

- The Senate has been considering legislation to reauthorize the Export Administration Act.
- The Senate bill is likely to contain provisions protecting the sanctity of export contracts and encouraging exports while tightening national security exports controls.
- The Finance Committee has voted to delete the import control authority now contained in the bill based on a general reluctance to us trade as a political weapon. Some difficult issues on national security controls will have to be resolved in conference with the House.

Generalized System of Preferences (GSP)

- The current GSP program, which permits duty-free entry to goods exported from developing countries, will expire in January 1985. S. 1718 is the Administration's proposal to renew it.
- The Administration supports the program as a way of helping poor countries to develop.
- Organized labor will seek substantial reductions in GSP benefits, including total exclusion of the advanced developing countries from the program.
- The current exemption for most textiles and apparel products will doubtless be retained.
- The Subcommittee on International Trade held its second, and last, hearing on S. 1718 on January 27. No markup is scheduled at this time.

Reciprocity-H.R. 3398 (the miscellaneous tariff bill)

- The Danforth-Bentsen bill has gone to the Senate for the third time as part of the miscellaneous tariff bill package, but the Senate failed to act on that package before the recess.
- We expect the Senate will act on the bill containing reciprocity early in 1984 and have some hope of prompt House action on reciprocity.
- Senator Baker has asked Senator Byrd to clear H.R. 3398 for Senate consideration.

Israeli Free-Trade Area

- The Administration has proposed that a reciprocal duty-free arrangement be established with Israel. I will sponsor this for the President.

- A hearing was held on this on February 6.

- Because our overwhelming trade advantage with Israel is threatened by a free-trade agreement between Israel and the E.C., this proposal is very important to U.S. trade interests.

DISC

- I have introduced a bill, S. 1804, which reflects the Administration's proposal to replace DISC with an entity which will be compatible with GATT rules.

- The new entity, called the Foreign Sales Corporation, will exempt a portion of the income generated by significant sales functions performed outside the U.S.

- We are reviewing the revenue effect of this proposal before proceeding to markup.

Trade Reorganization

- A trade reorganization bill, S. 121, has been reported out of the Government Affairs Committee, and the Finance Committee will have hearings on this issue in February.

- In view of House opposition to trade reorganization, the Administration's proposal does not appear to be going anywhere.

- "Industrial Policy" amendments contained in the Senate trade reorganization bill will complicate Senate action on the bill.

Trade Law Reform-S. 2139

- There are a variety of proposals to reform our trade laws, streamlining the antidumping and countervailing duty procedures and responding to industrial targeting and so-called "upstream" subsidies.

- We are likely to consider these issues in the Finance Committee once the House has had an opportunity to review and refine them.

- While important, trade law reform is very controversial in its specific aspects. It is too early to predict its prospects.

Domestic Content Bill

- I would anticipate an effort to pass domestic content legislation in the Senate in 1984.
- Although the bill passed the House, I anticipate substantial opposition to the bill in the Senate.
- I regard the bill as a dangerous and counterproductive idea which could inflict considerable damage on American exporters while providing transitory benefits to the auto industry and its workers.

Trade Deficit

- The U.S. merchandise trade deficit exceeded $60 billion last year and will be larger next year.
- This deficit is caused in major part by the over-valued dollar which in turn is a reaction to the high interest rates caused by the federal budget deficit.
- We are looking at ways of reducing the federal deficit, but we are considering calling hearings in the Finance Committee to see what else might be done to reduce this growing trade deficit.

LDC Debt

- The huge debts accumulated by less developed countries, particularly Mexico, Brazil and Argentina, is a major cloud hanging over the international trading system.
- These debtor countries have promoted exports and slashed imports in an effort to earn the foreign exchange needed to pay their debts.
- While most of the attention has been focused on the dangers of default, I believe we must also be concerned about the effects of LDC debts on our balance of trade.