S. HRG. 107–627

RISKS OF A GROWING BALANCE OF PAYMENTS DEFICIT

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC POLICY

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

THE BURGEONING BALANCE OF PAYMENTS DEFICIT WHICH NEARLY DOUBLED IN THE LAST FEW YEARS, FROM $300 MILLION IN 1999 TO AN EXPECTED $500 BILLION IN 2001

JULY 25, 2001

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

81–374 PDF WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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C O N T E N T S

WEDNESDAY, JULY 25, 2001

WITNESSES

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RISKS OF A GROWING BALANCE OF PAYMENTS DEFICIT

WEDNESDAY, JULY 25, 2001

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON ECONOMIC POLICY,
Washington, DC.

The Subcommittee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Charles E. Schumer (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. I would like to call the Subcommittee on Economic Policy to order.

This is our first hearing, at least with me sitting in this seat as Chair, and I would like to thank my colleagues and particularly Chairman Sarbanes and Ranking Member Gramm for the confidence they have shown in me and I will try to do the best job I can. I would also like to thank our witnesses for coming today. It is a very distinguished panel and I am honored that you are willing to sacrifice your morning to be here. Your presence today indicates the weightiness of the subject—the balance of payments deficit.

In my view, this is probably the least explored and least understood economic issue in Washington and the rest of the world. In an increasingly globalized economy, no issue could be more important or ripe for study, particularly because even those who do understand it, like our witnesses today, are not sure if there is any right solution.

As we all know, the U.S. balance of payments deficit is burgeoning. Over the last 2½ years, it has risen from $320 billion in 1999 to $500 billion this year.

A number of economists have already expressed concerns about the sustainability of our dependence on foreign investment. With the national savings rate dropping to around 4 percent in the last few years and the personal savings rate in the red, the United States was forced to fund its investment boom with foreign investment, which has generated the massive imbalance we have today.

But like the Egypt of 1875, which through its profligate spending became so indebted it was forced to sell its ownership in the Suez Canal to the British, we are living beyond our means and we cannot continue to do so, at least in the opinion of many.

What holds for individuals apparently holds true for the economy at large. Living beyond one's means is not sustainable in the long run and the problem is not self-correcting.

Some economists thought that the problem would self-correct. Over-borrowing would become a drag on the economy, as more of the domestic GDP was allocated to foreign debt servicing. The slower economy would weaken the dollar and, as a result, the United States would become less attractive to foreign investors, but that has not happened, at least in the last little while, the reverse has. The dollar has never been stronger and now, more than ever, foreign investment is descending upon the United States.

Recent gains in the Euro have been marginal and, arguably, speculative. And as Mr. Roach notes, today foreign ownership of U.S. Treasuries is 37 percent, U.S. corporate bonds is 46 percent, and even in the vast equities market, 11 percent.

This is a dangerous paradox. Foreign investment should be slowing, but it is speeding up. The dollar should be getting weaker, but it is getting stronger.

I would like to point out that our witnesses today disagree about whether a weaker dollar is the right solution. This disagreement in and of itself among the most studied economists in the United States shows how complex this is. As I see it, this hearing is the first foray into trying to elucidate this paradox, and in doing so, maybe figuring out a way to overcome it. No four people could be better called upon to meet this challenge. There are a number of questions that I am hopeful we will get some light shed upon today.

First, what is the primary driver of this growing imbalance? Is it simply the result of a mismatch in the supply of national savings and the demand for investment?

Second, is the imbalance unsustainable? I am swayed by concerns that at some point, the imbalance will become unsustainable. It almost seems as if a balance of payments-induced recession is not a question of if, but when. If it is unsustainable, will it occur gradually or is there a possibility of a coordinated, massive withdrawal of foreign capital that could straightjacket the economy?

Third, what are the risks to the economy? Should international investors decide to retrench, would the United States be at significant risk for higher interest rates, more scarce investment sources, and a bear market?

And finally, what policies, if any, should be considered to rectify the imbalance or mitigate the resultant risks?

I look forward to exploring these issues today. As I mentioned, we could not have assembled a more thoughtful or impressive panel to do so. And I am hopeful that we can begin to come to some conclusions about what policies we should be pursuing in order to avoid this faultline that is running through our economy.

I want to thank our witnesses again, and I look forward to your testimony and discussion.

Let me introduce our first two witnesses, who really need no introduction. These gentlemen have spent much of their lives trying to help our country, particularly in the economic sphere.

Paul Volcker is the Former Chairman of the Board of Governors of the Federal Reserve System. He has done an outstanding job in that role and in subsequent and previous roles, in a long and distinguished career in Government. Robert Rubin, who is now the Director and Chairman of the Executive Committee of Citigroup, of course, has been one of the most successful Secretaries of the Treasury that our Nation has known, following in the tradition of great New York Secretaries of the Treasury that began with Alexander Hamilton.

And let me call on Mr. Rubin first, and then Mr. Volcker for their statements.

STATEMENT OF ROBERT E. RUBIN FORMER SECRETARY, U.S. DEPARTMENT OF THE TREASURY DIRECTOR AND CHAIRMAN OF THE EXECUTIVE COMMITTEE CITIGROUP, INC.

Mr. RUBIN. Thank you, Mr. Chairman.

Secretary Hamilton was killed in a duel.

[Laughter.]

It struck me as you said that.

[Laughter.]

In any event, I thank you and I thank you for having us, and it is an honor to be here with Chairman Volcker.

I think it is very useful and timely to develop further Congressional focus on our country's current account deficit. And thus, I think this hearing is a very good idea. I also think, Mr. Chairman, that recent events in Genoa and elsewhere suggest that there is a full range of issues with regard to globalization that would merit further focus by this body.

The current account deficit, as you know, is basically the trade deficit plus the deficit in payments, interest, dividends, and the like. But public discussion of the current account deficit, it seems to me at least, has become a symbol for concern about the whole area of trade related matters. I will briefly express my views on these matters, and related policy issues—hopefully, that will be responsive to the questions in your letter—as well as very summarily sketching out an approach to the broader issues around globalization.

To begin, the United States has had remarkably good economic conditions over the past 8 years, with far stronger growth and far greater productivity increases than Europe or Japan, and far lower unemployment than Europe. At the same time, our markets have been more open to imports than Europe or Japan, our currency has been strong, our capital markets have been open, and our trade and current account imbalances have grown substantially.

I have no doubt that our economy has benefited enormously from both sides of trade, not only exports, but, even though it is not popular to say this, also very powerfully from imports. Imports lower prices to consumers and producers, dampen inflation—and thereby lower interest rates—provide a critical role in allocating our resources to the areas where our comparative advantage is greatest, and, maybe most importantly, imports create competitive pressure for productivity improvement. All this is contributing greatly to our low levels of unemployment and to rising incomes at all levels that we have had in recent years.

The imbalance between exports and imports, which is the core of the current account deficit, has occurred because of vast net capital inflows from around the world into the United States, motivated by the relative attractiveness of the United States for investment and as a repository for capital. That vast net inflow has allowed our consumption plus our investment to exceed what we produce. The consequence of that vast capital inflow has been a lower cost of capital in our country and greater investment helping to increase productivity.

Another consequence of net capital inflow has been a strong dollar, which has lowered cost to consumers and producers for what we buy abroad, and created more favorable terms of exchange between what we sell and buy abroad. The result is lower inflation, lower interest rates, higher standards of living, and greater productivity. The strong dollar has also helped attract capital from abroad.

The next question is, even with our open markets—and that was a question that you put forth, Mr. Chairman—imports and a strong dollar being beneficial, is the imbalance itself a problem.

While a current account deficit reduces aggregate demand, until this year, we have had fully adequate demand and, where additional demand is desired, monetary and fiscal policy, such as the current tax rebate, seems to be more preferable as a means of generating demand.

The claims against future output which worry some people from the vast net capital inflows are like any other borrowing or raising of equity capital—if the funds are well used for investment, then the future contributions to growth should exceed the cost of repayment or other forms of return to foreign investors.

The remaining concern is that, in various ways, the current account deficit could contribute to future instability, as, for example, by adversely affecting confidence with respect to the dollar or making us more vulnerable to a change in perception abroad about our economic prospects or the soundness of our policy regime. And it is that soundness of the policy regime which is another reason why, at least in my judgment, maintaining fiscal discipline is so critically important for economic well-being. While we should be able to sustain this deficit for an extended period because of the size and strength of our economy, it would be desirable over time to greatly reduce this imbalance.

There are some policy measures that could promote this purpose and would be beneficial in other ways as well. And there are some policy measures often more frequently advocated, which might help reduce the current account deficit, but could have other severe adverse economic effects and, in my judgment, on balance, would be most unwise.

Doing whatever we can to promote structural reform and trade liberalization in Europe and Japan would contribute to greater growth with more attractive investment opportunities in those areas, thus increasing our exports to those areas and increasing investment flows to Europe and Japan. That is good for us in many ways, including reduction of our current account deficit, and exemplifies why it is enormously in the interest of the United States to be strongly engaged in providing leadership on international economic issues.

At home, increasing savings over the full business cycle would reduce imports and reduce the inflow of capital and, in my judgment, would be the most constructive approach to reducing the current account deficit. While our low personal savings rate seems to be a cultural phenomenon and, in my view at least, there is a real question about how much net effect some savings tax credits have, I do think carefully crafted tax credits for subsidizing saving is a useful approach to explore if Congress at some point revisits the recently enacted 10 year tax cut, which itself is a significant diminution of future national savings and, in my view, was most unsound.

Two frequently mentioned correctives for the current account deficit that might have some impact, but on balance would be highly detrimental to our economic well-being are increased trade barriers and modifying our country's strong dollar policy.

Increased trade barriers would increase prices, lessen the comparative advantage effects that we enjoy, and reduce competitive pressure for productivity. Also, history suggests that if restrictive trade measures are put in place here in the largest economy in the world, that could readily lead to retaliatory trade measures in other countries.

Modifying our strong dollar policy could adversely affect inflation, interest rates, and capital inflows and would lessen the favorability of the terms of exchange that we have with the rest of the world.

Having said all this, and this is my final point, as our Administration made clear over the past decade, trade liberalization, though highly beneficial on balance for industrial and developing countries, can create dislocations, just as technology does to a far greater degree, and there are critically important matters, in our country and around the globe, such as poverty and the environment, that will not be adequately addressed by the policy regime that I have been discussing. The demonstrators this past week in Genoa were sometimes strident, and we certainly must condemn violence, but there are underlying concerns about globalization that are serious and need to be addressed. Thus, in our country and abroad, there should be a parallel agenda to promote productivity and equip people to deal with change, including education, effective retraining, programs to help the poor join the economic mainstream, environmental protection, and much else. And in my view, the industrial nations, in their own self-interest, should greatly increase assistance to developing nations.

Mr. Chairman, let me conclude where I started. The current account deficit is a complex issue that immediately leads to the whole range of trade-related issues. I believe this Committee performs a great service by having this hearing and whatever other processes it employs to provide serious public examination of these issues.

Thank you.

Senator SCHUMER. Thank you, Mr. Rubin.

I will now call on our Former Chairman, who has been such a great leader for this country over many, many years, Paul Volcker.

STATEMENT OF PAUL A. VOLCKER FORMER CHAIRMAN OF THE BOARD OF GOVERNORS FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Well, thank you, Mr. Chairman. I congratulate you on assuming the Chairmanship of this Subcommittee.

I note of my personal knowledge that you have been working in this area for, what, 20 years or something, and now in the Senate, certainly going back into the 1980's, when I was Chairman. And I appreciate the background and leadership you bring. I agree with my colleague here, Secretary Rubin. I want to congratulate you on your initiative in having this hearing.

I could probably shorten it a bit by saying, after listening to your statement and after listening to his statement, I will say, amen, and go home.

[Laughter.]

Senator SCHUMER. We never do that in the Senate.

[Laughter.]

Mr. VOLCKER. Well, let me just take a few minutes to read what I have written here about the broad nature of the challenge before us in the face of these current account and trade deficits that have reached historically large magnitudes.

And I would mention, too, as the Secretary just mentioned, what has been going on, looking backward, where we have had a decade characterized by a strong dollar and a large and growing net inflow of capital, with its counterpart of a greatly enlarged trade and current account deficit. What has been little appreciated, I think, is the extent to which those developments have supported the relatively strong and well-sustained performance of the U.S. economy.

For most of that time, the other main economic centers—specifically, Japan and the continent of Europe—were mired in some combination of slow growth, high unemployment, and excess capacity. In sharp contrast, until recently, the U.S. economy was accelerating. There was good growth in investment and profits and a sustained high level of consumption and by the end of the decade, as a consequence of consumption, personal savings, as economists measure those anyway, practically disappeared.

In those circumstances, labor markets tightened, tightened to an extent that in the past had been associated with strong and accelerating inflationary pressures. Yet, prices, particularly of goods, have moved relatively little at either the wholesale or retail level. How could those contrasting developments be reconciled?

A key part of that explanation is that foreign capital—in effect, the savings of other less affluent countries—has moved strongly toward the United States. They have been attracted by perceptions of strong growth and productivity and the powerful attraction of the booming stock market. Along with the rising Federal surplus, it was that foreign capital that in the absence of personal savings, in effect, financed much of our investment. The capital inflow has also tended to strengthen the dollar despite the growing trade and current account deficits. And that strong dollar, combined with the ready availability of manufactured goods from countries functioning far below their economic potential, contributed importantly to containing inflationary pressures. Now it seemed, for the time being, a benign process: For the United States, a current account deficit without tears; for other countries, the American market has provided a sustaining source of demand in an otherwise economically sluggish environment.

What is in question is what you posed for us all, Mr. Chairman, the sustainability. Our trade and current account deficits are now trending toward $500 billion a year, close to 5 percent of our GNP. Those are very large amounts by any past standard for the United States. And given our weight in the world economy, we are absorbing a significant portion of other countries savings. With the low level of our personal savings, and now the prospect of diminishing Federal surpluses, this means we are dependent upon maintaining a strong inflow of foreign funds. We have also become fully accustomed to a ready supply of cheap goods from abroad. Both factors point to continuing large trade and current account deficits.

For the time being, growth in most of the rest of the world is so slow that there is no near-term prospect that the world markets will tighten, limiting the availability of imports at attractive prices. Moreover, the latest indications are that the strong flow of foreign funds into the United States is being maintained, even in the face of our economic slowdown and stock market correction. But looking further ahead, the risks are apparent.

We cannot assume that Japan and Europe will not at some point resume stronger growth, and that they will then want to employ more of their own savings at home. We would certainly like to see stronger growth in the emerging world, which in turn would attract more capital from the United States. Here at home we have become less dependent on traditional "old economy" manufacturing industries, but there are surely limits as to how far we can or should countenance further erosion in our manufacturing base.

All of this suggests that, over time, we must look toward a narrowing of the trade and current account deficit. That will require a revival of personal savings and maintenance of a strong fiscal position. It may require, too, some strengthening of the Euro and the yen relative to the dollar.

In concept, adjustments of that sort can be made over a period of years consistent with continuing expansion in the United States and stronger growth in the rest of the world. But as developments in the "high-tech" world and stock market have again demonstrated, sentiment in financial markets can change abruptly and bring in its wake strong pressures on economic activity. The timing and degree of those changes simply cannot be predicted with any confidence. It seems to me evident, however, that as our trade and financial position becomes more extended, the risk of such abrupt and potentially destabilizing pressures increases.

The United States is already a very large net debtor internationally, and for some time ahead will remain dependent on foreign capital if our economy is to resume growth. We should, and we do, export capital as our businesses and our investors seek out prospects for the highest returns. To finance both our current account deficit and our own export of capital, we must import close to $3 billion worth of capital every working day to balance our accounts. That is simply too large an amount to count on maintaining year after year, much less enlarging.

One way—an entirely unsatisfactory way—to approach the need for adjustment would be to fall into extended recession or a prolonged period of slow growth. Given that the world economy as a whole is operating well below par, the dangers of such a development would only be amplified.

Conversely, I do not think we can count on extending the experience of the 1990's. That would imply further depleting our personal savings, ever-larger external deficits, and adding even more rapidly to our international indebtedness.

For the time being, confidence in the prospects of the U.S. economy, its financial markets, and its currency has remained strong, little shaken, if at all, by the generally unexpected current slowing of growth. Our leadership in innovation, the sense of increasing productivity and efficient management, and the stability of our political institutions help underlie that confidence. Those are, indeed, very precious assets. But, in my judgment, they are no cause for complacency. The huge and growing external deficits are a real cause for concern. They are symptoms of big imbalances in the national economy and the world economy that cannot be sustained.

Senator SCHUMER. Thank you, Mr. Chairman.

I appreciate both statements. I think they were excellent. I hope all my colleagues will get hold of them and read them because they are succinct and they lay out the problem and the dilemmas that we face.

I am going to try to stick to my 5 minutes in the questioning and go to my colleagues, and then, if we have other questions, we will have a second round. Since this is my first hearing, is there someone who works the clock?

Yes, good. Okay.

The first question I have is, as you just mentioned, Chairman Volcker, this cannot go on forever. Something has to give, and I think Secretary Rubin also alluded to that fact.

Do you think there are warning signs of unsustainability that we could look at? I mean, if things are beginning to break, would any economic signs be available? Will this just happen? Is it such a new area that we could not even guess that if X happens, that would mean it is likely that Y and Z might occur and we ought to be at least aware of it in terms of policy?

Mr. VOLCKER. Well, I am increasingly sensitive these days to my increasing age, and I have observed these markets for some period of time. The idea that you can project these changes and their timing or magnitude I think is excessive. You are not going to be able to do that.

My experience suggests that there is a real danger that they come about suddenly. Sometimes when they come about suddenly, it creates more difficulty in dealing with them.

Specifically, I do not see many signs, as I say in my statement, of unsustainability at the moment, in the short run. The capital seems to be flowing in even more generously than in the past.

That is partly a function of a feeling that the rest of the world is not doing very well and that we may have slowed down, have an unforeseen slowdown—I might mention, I do not know anybody, maybe some of your other panelists were so acute as to project the slowdown a year ago, but there weren't many——

Senator SCHUMER. I think one of them was.

Mr. VOLCKER. Well, he was a rare observer, but right now, given the condition in the rest of the world, given that our stock markets have had a large adjustment, at least in the high-tech area, we seem to have achieved that without undermining basic confidence in the outlook. Things look okay. But I do not think that can last. And ironically, one of the things that could change it is much better prospects abroad. For better or worse, we do not see those at the moment. I do not see them in the near future. But it is an ironic fact that one of our dangers would be good news abroad.

Senator SCHUMER. I find this area, there is almost a ying and yang to everything. Something good might happen that would help things out and at the same time, it creates something bad that you wouldn't want to happen for other reasons.

Mr. Secretary, do you have any thoughts on that?

Mr. RUBIN. I have no greater ability to predict than the Chairman did. If I did, I wouldn't be here. I would be back taking advantage of it.

But in any event, no, I think markets are inherently unpredictable. I think the best thing you can do, Mr. Chairman, is to try to have sound policy in your own country. And to me that means sound fiscal policy and trying to work with countries abroad to encourage growth there so that they can gradually readjust.

Senator SCHUMER. The second question is for both of you.

Yesterday, when Chairman Greenspan was before our full Committee, I asked him if he thought, given this particular problem, that the United States should reconsider its strong dollar policy, which we have. And he, in a rare instance, demurred. He said that the Administration had agreed that Secretary O'Neill would be the spokesperson on that and did not want to say anything. In your testimony, you seem to have somewhat different directions in this regard. Would each of you want to comment on the idea that we—and how you keep a strong dollar policy. This is one of the things I was trying to learn last night and I called a number of people.

That too is a conundrum. Is it just verbiage? Are there other things that you do other than just talk the dollar up, talk the dollar down?

Do either of you have an opinion on how the strong dollar policy is working and whether we should continue it, modify it, change it?

Mr. VOLCKER. If you pressed me, I would have to confess that the three words—a strong dollar policy—does not encompass the full complexities of this situation.

Senator SCHUMER. Sure.

Mr. VOLCKER. I referred to my age earlier. I spent a long time in the Treasury and in the Federal Reserve. And I spent most of that time worrying about a weak dollar.

I think I am very clearly on the record of having a long period of concern about a weak dollar. So, I do not want to be associated with a weak dollar policy, whatever that means. I do think I want a strong dollar in the sense of a strong and stable American economy and a unit of currency that people can count on.

Now if you ask me whether I think that the Euro is weak, too weak to be sustainable over a period of time, and the yen is too weak to be sustainable over a period of time, I think, yes, and that will have to be corrected as part of a change in this balance of payments situation that we are talking about. I do not think that in any way detracts from the benefits of a strong and a stable dollar, but it changes exchange rates.

Senator SCHUMER. Mr. Secretary.

Mr. RUBIN. Mr. Chairman, as I said in my remarks, I think our country has been very well served by a strong dollar policy and I agree with Secretary O'Neill. I think that is exactly where we ought to stay.

Senator SCHUMER. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Senator Schumer, I congratulate you on your Chairmanship of this Subcommittee and your first hearing. Great topic to review.

I am impressed by your ability to get high-quality witnesses to come and give us insight into very difficult issues. That was, of course, the second panel as opposed to the first, Secretary Rubin.

[Laughter.]

The confidence that led to this tremendous inflow of investment resources into the United States, at least in my mind, is in part based upon the fiscal rationality that we implemented over the last decade. Some of us are very concerned about the erosion of that. I think I saw or heard that in Secretary Rubin's comments.

The unfortunate personal savings rate that we have had has been offset by these budget surpluses and we seemingly are reversing that.

Could that be one of those sparks when those abroad realize that this is coming about, that this external borrowing of capital comes home to roost? How do we make the public aware of such a risk as it accumulates? That is my first question.

I cannot help but ask, given the basis of productivity being so heavily emphasized and how our surpluses have been generated, whether you have any concerns about the sharp deterioration that now is only a quarter or so old, but is so prominent in the projections of budget surpluses and the 10 years ahead, underlying projections that led to tax cuts and change in fiscal policy.

I have given you enough room to roam in those questions and I would ask for comments from either of you.

Mr. VOLCKER. If it is directed at me, on the fiscal policy question, I very much agree with what Mr. Rubin said about the longer term outlook.

You can support, obviously, tax relief in the short run, given the performance of the economy. But if we move and are perceived to be moving in a direction over a period of time of exhausting those nice surpluses we built up, at a time when there are no personal savings, and if we remain with no or very low personal savings, it would be very dangerous, I think, to reduce the prospects of a healthy Federal surplus.

And if perceptions of that gain ground, at a time when something else may be changing, that is the kind of thing I think that can trigger a reversal of sentiment toward the United States and a sharper reversal of capital inflows than we would like to see. So, I think that is very true.

You mentioned another conundrum, I think, for anybody concerned here as to how the public can be educated. Well, these hearings were called and we welcome them as a means of educating the public. But you always run the risk of, I suppose, lighting the fire, lighting the crisis that you do not want to see if you get too extreme in citing some of the dangers that are very real, but they are not necessarily on the doorstep and they are not inevitable.

I do not know how you traipse your way through that kind of minefield, to change the metaphor a bit, and get people educated without trying to resort to extreme statements that might be counterproductive.

Senator CORZINE. And the productivity question, Chairman Volcker.

Mr. VOLCKER. I am no expert on productivity. I have a little difficulty getting my mind around the notion that the world has changed completely. I think there is every reason to believe that productivity will perform better than it did for about 20 years when it was only 1¼ percent a year, which was abnormally low.

Whether the rather fantastic figures of the very late 1990's can be sustained, I am in a show-me posture, at least on that.

Senator CORZINE. Secretary Rubin.

Mr. RUBIN. I think I would add three comments, if I may. I agree with everything that the Chairman said.

In 1993, when serious steps were taken to reestablish fiscal discipline, I think that had a symbolic significance that had very substantial impact on confidence and on our economy.

I think the 10 year tax cut cuts in exactly the opposite direction. So, I do think it is a threat to creating deficits on the nonentitlement side of the budget that could even reach into the entitlement side of the budget, and I think it is a significant adverse development with respect to confidence, or it has the potential of being that, at least.

I do not have any wisdom on productivity, but I do think that basing a 10 year tax cut on 10 year projections that nobody thinks are anything other than highly unreliable, seems to me to be quite unsound.

Senator CORZINE. Thank you.

Senator SCHUMER. Thank you.

We are honored to have our Chairman and leader here, Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Senator Schumer. I want to make just a few opening comments.

First of all, let me say how pleased I am to join with you and Senator Corzine and others in welcoming Former Treasury Secretary Rubin and the Former Federal Reserve Chairman Volcker before the Subcommittee this morning.

I have had a long-standing interest in the subject of the risks of a growing balance of payments deficit. In fact, two Congresses ago, I cosponsored legislation with Senator Byrd and Senator Dorgan to establish a trade deficit review commission. We felt there was a need for an independent, bipartisan commission made up of distinguished individuals of varied backgrounds to study the nature, causes, and consequences of the U.S. merchandise trade and current accounts deficit.

We thought that issue was poorly understood. In fact, there was even a reluctance, I think, to discuss the trade deficit as a potential problem for the U.S. economy. It was often ignored. Some even denied it was an issue.

So the commission established by Congress had Murray Weidenbaum, the Chairman of the Council of Economic Advisers under President Reagan, and Dimitri Poppadimitrio, who is the President of the Levi Economics Institute up at Bard College, as the Cochairmen.

It had six Democrats, six Republicans. They did not reach consensus on many issues, but they did agree on one point and I quote them: "Maintaining large and growing trade deficits is neither desirable, nor likely to be sustainable for the extended future. These deficits reflect fundamental imbalances in the American economy."

And this is the report which they produced, entitled, "U.S. Trade Deficit—Causes, Consequences, and Recommendations for Action."

I, frankly, think that we are ignoring this issue at our peril, the continued growth in our trade and current account deficit and, as a consequence, accumulation of large amounts of external debt.

I think we need a good, informed public discussion about the causes and consequences and consideration of actions we might take to minimize the risks. For that reason, I very strongly commend Senator Schumer for holding this hearing. We are deeply appreciative to this panel of witnesses and the panel that is to follow for coming this morning and giving us their time and effort.

I am not going to go into a lot of the data, but let me just simply note that we have gone from being the world's largest creditor Nation to now being the world's largest debtor Nation.

We have run these really extraordinary trade deficits year after year, which has significantly built up our external debt.

We were a $34 billion debtor in 1987, $200 billion in 1989, $767 billion in 1996, $1.2 trillion in 1997, and $1.5 trillion in 1998.

As a consequence, the balance of interest, dividends and profits paid on foreign investments in the United States versus a return on U.S. investments abroad has turned negative.

Throughout most of the post-war period, that was positive. We hit a high of $33 billion in 1981. In 1998, it was minus $22.5 billion. We are the world's largest debtor and servicing that debt has increased the U.S. deficit on current account.

Obviously, in a sense, that puts us—I think that in a Tennessee Williams' movie with Vivian Leigh, there is a line—dependent on the mercy of strangers, or in the hand of strangers, or some such line like that as I recall.

Mr. RUBIN. "Streetcar Named Desire," maybe.

Senator SARBANES. Yes.

Mr. RUBIN. Dependent on the generosity of strangers.

Senator SARBANES. Dependent on the generosity of strangers. And I think that is where we are. The economic fortunes of the United States are partially in the hands of foreign investors and depends on whether they are willing to increase their investment in U.S. assets enough to offset this deficit. So, I am extremely concerned about it.

I worked a year for Walter Heller when he was Chairman of the Council of Economic Advisers. And in the economic report of the President in 1962, which was Heller's first report, he stated, and I quote him: "The balance of payments objective for the United

States is to attain at high employment levels a balanced position in its international accounts." He then noted that this did not mean doing that each year. It does not mean that balance must be maintained continuously. In some years, a surplus in international payments will be appropriate. In other years, a deficit. Do you think that this ought to be an objective of U.S. economic policy?

Mr. RUBIN. I think, Senator, it is a desirable long-term situation. But as we were discussing before, I think this is a very complex issue. I think that the question, at least to me, is, what effects has the current account imbalance had? And at least in the 1990's, it seems to me that what has really happened is we have had these vast inflows of capital from abroad that have financed a lot of the investment that has created productivity.

I do agree with you that the creation of the imbalances has the risk of possible instability at some point in the future and it would be desirable to get back into a balance over time.

However, I think it is a question of what policies one is thinking of in terms of getting there. If we could increase our savings rate, that would be good. On the other hand, we just enacted a 10 year tax cut that is the antithesis of that.

If we can encourage growth in Europe and Japan, that would be good. That is on the good side. On the bad side, Senator, I think if we did anything in terms of increasing trade restrictions, that would be enormously against our self-interest. And I at least believe that our strong dollar policy has served us well.

So the answer is, yes, there is a problem, but some of the cures are I think a lot worse than the disease.

Mr. VOLCKER. Just as a kind of historical footnote, I suspect that Walter Heller was talking about the overall balance of payments, not the current account. And now the emphasis is on the current account. With the floating exchange rate, we do not worry about the overall so much because, in some sense, it always balances. But to get to the point, I do not think we have to balance the current account every year. We can probably sustain a small deficit. We sustained a small surplus for many years. But it is a question of proportions. And year after year, with not only a large deficit, but a rising deficit, I think has to be unsustainable. After a while, we can get all the international capital in the world and it is just not going to happen.

And I might say, in your concern about being in the hands of the generosity of foreigners, it is certainly true of foreign lenders. It is also true that you are in the hands of American investors. They also have feelings about confidence and prospects. And if they begin putting money outside the United States in greater volume, we also have a problem.

Those things tend to go together. The change in mood of the foreign investor will probably be matched by a change in mood of American investors.

Senator SARBANES. Well, one of the things that concerns me is that the debt has gotten so large, and the serving of it now exceeds the flows into the United States, that we are in a self-perpetuating cycle of the situation just worsening in and of itself, let alone any further additions to it. Isn't that a significant development, to sort of cross that line?

Mr. RUBIN. I think it is, Senator. But on the other hand, I think that one would find that, if one looked at least at the 1990's, as opposed to the 1980's, that the return on investment that the inflows have financed exceeds the cost of repayment or other sorts of payments abroad.

So that, in effect, it is like any other borrowing or equity investment. I think we have actually benefited from these flows, although we certainly have to either repay them or, in the case of equity investments, make payments of some sort or other.

But I think, on net, the benefits to growth have exceeded—I guess that is one way of looking at it—that which we pay out. I do fundamentally agree with you that there is a threat to stability and I think the question is how do we get back?

I personally think that part of the danger in this that causes us to do things—I was told in law school that bad facts make bad law. And I think part of the problem here is that the problems could lead us into directions that would be far worse than the thing we are trying to deal with.

Senator SARBANES. Mr. Chairman, you have been very generous with the time.

Senator SCHUMER. Please continue if you have another question.

Senator SARBANES. No, thank you very much.

Senator SCHUMER. Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

May I welcome you back, Mr. Secretary. I will still call you that even though you are now earning an honest living.

[Laughter.]

Mr. RUBIN. I tried to be honest when I was in office, Senator.

[Laughter.]

Senator BENNETT. Yes, you were. I will stipulate to that.

Mr. RUBIN. Okay.

Senator BENNETT. I will stipulate that. But it is good to see you back and it is good to have your counsel, and we appreciate that.

Mr. Volcker, I identify with anybody who is 6 foot 7, bald and with white hair.

[Laughter.]

And wears glasses.

Senator SCHUMER. In a gray suit and a blue tie.

[Laughter.]

Senator BENNETT. Yes, gray suit and blue tie.

[Laughter.]

Mr. VOLCKER. I am so old, Senator, I identify with any Senator named Bennett, including your father.

[Laughter.]

Senator BENNETT. Yes, indeed. Thank you. There are only a few of us around who remember my father. He began what has now become the Utah seat on the Banking Committee, and I am delighted to hold it now.

Mr. VOLCKER. I testified before him a number of times. So here we are.

Senator BENNETT. Here we are.

Picking up on one of your comments, Mr. Volcker, going back to Tennessee Williams for a minute, we are not, I think, dealing with the generosity of strangers, but with the self-interest of foreign investors. They are not taking care of us out of a sense of generosity, but because this is the best place for them to put their money, in their own opinion.

And we are now faced with a borderless economy, so the same is also true. American investors may be as friendly as possible, but their self-interest will cause them to go elsewhere with the speed of light on the Internet if they decide that their money is better served some place else.

So in the borderless economy, and, frankly, I would prefer that term to globalization, maybe because it has a slightly different brand flavor to it and is less likely to get rocks thrown at it when it was used in Genoa. But in the borderless economy in which we operate now, money moves very, very freely and it goes wherever the self-interest of the investor wants it to go.

If we get the effect that you talked about, Mr. Rubin, that having it here produces an increase in the overall economy that is greater than the amount we have to pay for it, it is a good thing for us, regardless of what the current account deficit happens to be.

Now, I would like your comment on a chart. And unlike Chairman Sarbanes, I have not had the time to get it blown up big enough so everybody can see it. So all you can see are the lines and you cannot see the numbers. You will have to trust me on what the numbers are.

Senator SARBANES. We are making progress just that you are using the chart. We welcome that.

Senator BENNETT. Okay. Well, I usually use them on the floor and not in Committee.

This is the U.S. current account deficit as a share of GDP. This is not the total deficit that you are talking about, Mr. Chairman, but it is the current account deficit. And it is by year and this starts in 1980 and then goes to 2000. So that is 20 years.

Now, I am not an automatic believer in cause and effect. But you lay that chart over American economic performance and the account deficit is positive or a surplus in 1980 and 1981. Again in 1991. And it is overwhelmingly in a deficit, soars up in 1984, 1985, 1986, 1987, then starts to come down.

Then when you became Secretary, Mr. Rubin, it starts going up again. And the year of 2000, which some insisted was our very best year, at least during the campaign season, it is at the highest point it is in the chart. Is this sheer coincidence? I am perfectly willing to believe that it is. Or is the best way to solve the current account deficit to throw the U.S. economy into a recession?

Mr. VOLCKER. I must point out that those years in the 1980's, I was Chairman of the Federal Reserve Board.

[Laughter.]

Senator BENNETT. Okay.

Mr. VOLCKER. Well, as I mentioned in my statement, Senator Bennett, you can solve this—solve is a strong word. It does not really solve it in a fundamental way. But if the economy goes into recession, the current account deficit will presumably improve, particularly if you can keep the rest of the world out of recession at the same time. That is not the way you want to cure this.

The question is sustainability of the big deficits and what constructive ways short of recession you can find to achieve a more sustainable outcome.

It was widely considered, and I think appropriately so, in those years in the 1980's that the deficit had gotten too large and certainly a feeling at that time that the dollar had gotten too strong. It made me very nervous that that feeling was expressed in efforts to deliberately weaken the dollar. But, nonetheless, it was corrected over a period of time.

I think we are not in the same situation as the 1980's, but some elements resemble it. This period of deficits has been longer, larger now in relation to the GNP, as your chart points out, and it can be sustained for some time given the present state of the world. But I do not think it can be sustained indefinitely and the earlier we recognize that and take the appropriate actions, the better off we are going to be.

Senator BENNETT. Mr. Rubin, did you want to add something?

Mr. RUBIN. Senator, I would agree with both you and Senator Sarbanes. I do think that the capital inflows have contributed, probably substantially, to the economic growth of the 1990's because the financed investment that our own low savings rate wouldn't have financed. On the other hand, it is not something that can go on indefinitely, and as Senator Sarbanes said, it does create at least the risk at some point of creating instability.

I do think it would be desirable to get back toward balance. So, I both agree with you, and yet I do think that it is something that we need to be concerned about.

What I would not do, though, is have that lead us into policy areas like trade restrictions that I think would be highly adverse to our self-interest.

Mr. VOLCKER. I agree with this point on trade restrictions. I just want to say that, we do not want to get so concerned about this that we do wrong policies.

But let me make one other point about the importance of foreign investment.

It has not only been helpful during this period, it has also been essential to the growth of the American economy when we haven't been saving anything. Or saving very little, anyway. If that situation remains, we are at the mercy, if that is the right word, of foreign investment. But we should not be in a position that we are dependent upon foreign investment to a degree that I believe, anyway, cannot be sustained indefinitely. So, we therefore have to do what is necessary at home to correct that imbalance.

Senator BENNETT. What is that?

Mr. VOLCKER. Well, to some degree, I hope it is self-correcting. If you think the heart of the problem, or a large part of the problem is personal savings, when I look at the consumption patterns of my own family, I am not sure it is entirely self-correcting.

[Laughter.]

But the fact is that it has been, I think, pushed in part by this extraordinary boom in the stock market. And if the boom in the stock market is dissipated or even levels off, I think, over time, there will be some tendency to do more personal savings.

So far as direct Federal action is concerned, we both express caution about the outlook of the budget. So long as personal savings is so low, it becomes extraordinarily important that the Federal Government itself be the important part of the balancing factor, instead of foreign investment in some sense, in maintaining a surplus on its own account which contributes to the savings of the country.

And that is why I think both of us express concern about the uncertainty in the current condition of the future outlook for the budget because one of the reasons we did so well in the 1990's, in my opinion, was the combination of the foreign inflow of capital from abroad, plus the rising Federal deficit——

Mr. RUBIN. Federal surplus.

Mr. VOLCKER. Federal surplus—which made up for the lack of private savings.

Senator BENNETT. Thank you, Mr. Chairman.

Senator SARBANES. I think that is sort of the $64,000 question that Senator Bennett asked.

You both have said that it is a potentially serious problem and it introduces an element of risk and potential volatility. You then have warned against certain measures that you think that people will then seize upon this in order to do, primarily focusing on trade restrictions.

And as I understood the question, it was, well, then, given that you say there is a problem, you do not dismiss the problem. You accept the proposition that there is a problem. What should be done about it?

I would like to stay with that, Mr. Chairman, and see if we can elicit something further from you on that question.

I guess there are potentially things that could be done in the trade area that would not equal out to restrictions. If it is an open door here but a closed door for us over there—for example, everyone keeps citing the trade with China. The figure they cite when they do that is they say, well, we have $115 billion worth of trade with China. This is a big item. Then they do not say that $100 billion of it is China sending things to us and $15 billion of it is us sending things to China, for a net trade deficit of $85 billion.

In percentage terms, the largest that we have of any—actually, even in dollar terms, it is now larger than Japan, just barely. But, of course, the Japanese figure is off of a larger volume of trade. Only 14 percent of the United States-China trade are our exports to China. Japan, it is 30 percent. Europe, Canada, Mexico, it runs about 45 to 50 percent, depending on the year. It fluctuates around in there. Now those are very sharp differences. So let's take the Bennett question and stay with it for a minute. What can we do about this?

Senator SCHUMER. Which is the $64,000 question that nobody in all my reading has come up with a very good answer to? What do we do?

Mr. RUBIN. I think it is a complex question and there are no easy answers. I will give you my views, for what they may be worth.

First of all, I agree with the Chairman—increasing national savings is probably the most important thing we can do. But we just go in the other direction in a very substantial way with this 10 year tax cut. I think that if Congress ever gets to the point where it is willing to reconsider that, number one, I think it should be made far more moderate. And number two, I think its content should include incentives for savings that would work, not incentives that are simply going to shelter savings that more affluent people are already making, but a structure that would actually work for middle-income and lower-income people that would increase savings.

That is one thing, or two things, I suppose, I would do.

Senator SARBANES. What would that be? Like a matching contribution or something for lower and middle income people to induce them to save?

Mr. RUBIN. In some form or other, Senator, I think that would have a realistic possibility of increasing savings, as opposed to tax credits that mostly shelter more affluent people's already existing savings that are going to occur anyway.

But I wouldn't add that to the existing tax cut. I think if the tax cut could be revisited, although that may not be possible, and it would be made far more moderate, and then, within that context, do the sort of thing that you just mentioned, yes, I think that would be a material contribution.

Senator SARBANES. I think that we are going to be compelled to revisit the tax cut.

We have this situation now where they are going to work overtime to keep their elderly wealthy parents alive until the last year of the stepdown in the estate tax. Then, you have a 1 year window to get the estate without any taxes. And then the next year, it sunsets. So that is going to create a lot of interesting dynamics in families across the country.

Mr. RUBIN. It is an unusual structure, Senator.

[Laughter.]

Mr. VOLCKER. It suggests heavy investment in respirators.

[Laughter.]

Senator SCHUMER. 2010.

Mr. RUBIN. We should try to liberalize trade abroad. I agree, our trade barriers are very low and they are higher abroad. Therefore, trade liberalization is in our interest.

I personally think that we should have trade promotion authority with appropriate terms of some sort or other. I think a new round might make sense. I also think anything we can do to encourage growth in Europe and Japan would make sense.

On the China situation that you mentioned, we benefit enormously from the imports, so I wouldn't do something to restrict those imports. But I sure as heck would try to increase access to their markets.

Senator SCHUMER. Do you have anything to add to that?

Mr. VOLCKER. Well, you describe a pattern that one would love to see and that ought to be encouraged by public policy by whatever means.

You certainly would want to see more rapid growth abroad, which would greatly assist our export position. I would like to see the opening of the markets, too. But after watching this for many, many years, I would not count on that being a major influence, although it could be helpful.

I think as we get out of this current slowdown, we certainly want to grow again. But we want to avoid very high-powered growth, the kind of boom and heavy pressure on our economy because that makes us more dependent and less sustainable.

We certainly want fiscal restraint, and so far as this low personal savings is concerned, to change that. To change the savings rate by fiscal policy, I have become a bit of a skeptic over time, seeing all of these experiments in personal savings accounts of various sorts.

If you really want to change it, I think you have to be pretty drastic and go to a much more consumption-oriented tax system than what we now have. And I doubt that there is any near-term prospect of doing that.

Also as I alluded briefly to in my statement, as part of an orderly adjustment over a period of time, I suspect you would see some currencies that look rather depressed to me—the Euro, the yen, the Canadian dollar—strengthen.

Some combination of these events, if they happened in a nice, gradual kind of way, would maintain confidence during the interim period, and over a period of time, produce a much more sustainable position.

Senator SCHUMER. How do you do that in a period of floating rates?

Mr. VOLCKER. Well, fiscal policy. Monetary policy is obviously important in gauging the right degree, more or less, of growth in the United States. There are responsibilities in other countries that we cannot directly affect of restoring their own growth patterns.

And as I say, I do not think the short-run outlook there is particularly favorable. But looking ahead, a year, 2 years, 3 years, obviously, that is an important part of the solution.

Senator SCHUMER. I know you gentlemen have tight schedules, but Senator Corzine had another question.

Senator CORZINE. There is a changing nature of the inflow of assets. During most of the 1990's, it was not entirely, but heavily direct investment. A lot of merger and acquisitions, cross-border activity, which has slowed dramatically.

In your judgment, is it safer or more risky for us as a Nation to have flows that are security-denominated, if you would, as opposed to the direct investment, which I think gets it sometimes the description that we are in debt, when we in fact have long-term direct investments that may have a different nature than one where the deficit is being funded by short-term flows of cash?

That is one question.

Then the other is another sort of technical one. What role and how much of this benign reaction to our current account deficits, comes because we are the reserve currency of the world, if we are? And are there any risks that we are not fully appreciating and taking into consideration? Are there changes ahead for us in those areas?

Mr. VOLCKER. I will make a few remarks and then turn it over to Mr. Rubin.

But I think, normally, you would think that direct investment is more stable and more advantageous over time than portfolio investment, particularly short-term portfolio investment, which has a history of being very volatile, very short-term oriented. Direct investment can also be reasonably volatile, too, but probably not quite so sensitive as portfolio investment.

Direct investment, we always argue when we are doing it abroad, brings great management, productivity, technological improvement.

It is interesting that in this period of time, the foreigners have been buying up our companies more than we have been buying up other companies. But that is a reflection I think of the feeling that the American economy has just been doing better and the prospects are better.

Senator CORZINE. If I read the numbers right, though, that has changed in the last 18 months.

Mr. VOLCKER. You are probably more familiar with the numbers than I. And it tends to come in lumps, some very big investments sometimes.

And the other part——

Senator CORZINE. Reserve currency.

Mr. VOLCKER. The reserve currency. Look, I think the feeling that the United States is a big, strong, stable country with a relatively stable economy, a relatively stable, strong, big, internationally used currency, makes for a kind of feeling of safe haven when the rest of the world has not been doing very well.

So it is both that the history of the dollar, not just the technicalities of the reserve currency, but the fact that it is such a widely used international currency, not just by foreign central banks, but—the statement I guess is true that there are more dollars circulating in Russia than there are rubles.

It may not be the only country where that relationship is true. It just makes it a natural thing to do, so long as we are growing, so long as our prices are reasonably stable. It is going to be a place that benefits from difficulties in the rest of the world. And in recent years, there have been lots of difficulties in the rest of the world. The other side of that coin is, if the economic prospects in the rest of the world are perceived to improve, the capital wouldn't come in quite so easily.

Mr. RUBIN. I agree with all of that, Senator. I think the only thing I—it is not really adding, it is just maybe repeating—is that I believe it has been useful that the dollar has been the reserve currency of the world. And I think it is just one more reason why it is so important that we maintain sound policy in this country, particularly fiscal policy, because I think that very much influences how people around the world view keeping their assets in our dollar-denominated assets of one sort or another. Obviously, foreign direct investment is more stable than portfolio capital and you are correct about the change in flows.

Senator SARBANES. But isn't this the problem? This is the real dollar exchange rate in a basket of 26 currencies. There has been a 30 percent appreciation in the dollar over the last 5 years.

Now, of course, the NAM, the Farm Bureau, the labor people are all contacting us because of the impact of this. The manufacturing sector is down 5 percent in this economic slowdown. It is a very serious problem.

We still go along with, "having a very strong dollar," and I understand some of the benefits that flow from that. But there are also disadvantages that flow from this. And this sort of marked change over a relatively short period of time, this is 1989 back here and we have moved along like this.

But look at what has happened over the last 4 years, I guess, in the appreciation of the dollar. Of course, that worsens our trade position. Now do we just accept that or should we be trying to do something about it?

Mr. RUBIN. My view, whatever it may be worth, Senator, is that the other side of the coin is that the result is that we have had lower inflation, lower interest rates, it has given the Fed more room to lower rates if it so desired.

Manufacturing actually increased by—I do not have the exact number. It is roughly 35 percent, from 1993 to 2000. Not manufacturing employment because productivity increased so much. Manufacturing increased substantially in this country, despite our stronger currency. I actually think it is been a substantial asset to it.

If we now have a shortfall, which we do have a shortfall of demand, what I think we ought to do, as I said in my remarks, is look to a fiscal and monetary policy—that is to say, tax rebates and monetary policy—to generate the demand. I do not think that we should modify our strong dollar policy.

Senator SARBANES. Mr. Volcker.

Mr. VOLCKER. Well, I guess I would rather talk about modifying the weak Euro policy or the weak yen policy or the weak Canadian dollar policy because I do think that those currencies are abnormally restrained, let me put it that way, or unsustainably restrained, and that that, over time, I would look for some change, which should make that chart look a little differently, not because the dollar is weak. The dollar strength will be maintained if we maintain the strength of our economy. But the exchange rate might change.

The Chairman, in his opening remarks, I think said something about this whole question gets into the question of globalization or borderless world and what all the implications are.

I think the volatility in these exchange rates that are partly reflected in your chart is a very serious matter for the world economy that deserves a lot more attention over a period of time, and it is something that nobody has wanted to look at for a variety of reasons. But when you have the yen or the Euro, to take those two cases, moving by 30, 40, 50 percent, over the course of a couple of years, you get economic dislocations. And you get some of that economic dislocation in Argentina because they get caught in the slipstream. It is too complicated a subject to get into today, but I think it is a very real problem.

Senator SCHUMER. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Let's go back to my own experience in business. And I find that the economy is much more like a business than a family.

We hear this rhetoric politically all the time—well, the Government is like a family sitting around the kitchen table trying to make ends meet. If you cannot get a raise down at the factory, you are going to have to cut back on the amount of meat you eat. And so, we have to make the budget balance. And this is a very graphic image that every voter can respond to and it is wholly wrong. The economy is like a business that is constantly changing every day. Pressures are changing every day.

I found as a businessman that the most important thing that I could do is grow the business, that I could solve a whole lot of my other problems if the business was constantly getting bigger in a profitable way.

There are those of the dot-commers who think that they can grow the top line and not pay any attention to the bottom line and then suddenly discover that not having a bottom line is a bit of a disadvantage.

I am biased to look at the economy through that lens and say that as long as the economy is growing in a proper way, we can handle the problem of account deficit. We can handle a whole series of other problems.

If the economy is not growing and we have difficulties, then everything starts to come undone as well. And you talk about the weak yen. The Japanese economy has been flat or deflating for 10 years. Why would you want to invest in a currency that is tied to that?

Am I over-simplistic here when I am saying that——

Mr. VOLCKER. Just a little bit.

[Laughter.]

Senator BENNETT. Okay. Help me out. Straighten me out. That is why I come to these hearings, to be helped.

Mr. VOLCKER. Let me accept your metaphor about being in business. What occurs to me when you say that is certainly the importance of growth and all problems are easier to solve in a context of growth.

Let me think about the headline of a certain business that I read about in the paper coming down here this morning called Lucent Technologies, a great growth business. People had enormous confidence in its growth and everybody wanted its stock and wanted to invest. And the investment flowed into Lucent with great abandon a year or so ago and the stock price went to, I do not know what, but some very high level.

Expectations about Lucent changed. The economy changed somewhat. Expectations about their business changed. And you had a drastic, to use the analogy, outflow of interest in the stock of one, Lucent Technology, in a way that is very hard now for it to reverse in terms of market perceptions.

In that sense, I think the dollar has some—it is not so fragile as any individual company, but it is important what perceptions are.

Senator BENNETT. Yes. Let me step in here with a clarifying comment. I have run public companies and I have run private companies. And private is a whole lot more fun because you do not run into that problem.

[Laughter.]

I am talking about the health of the company makes it easier for you to solve problems.

Mr. VOLCKER. Obviously. There is no question about that.

Senator BENNETT. But I accept your correction here, that when you are running a public company, the perception of where you are going does kind of run away from you.

And I remember once when I was invested in a stock and my stockbroker called me and said, I think you might consider selling a little. I said why? It is doing really well. He said, yes, but today it hit 100 times earnings, and that strikes me as just a little rich.

Mr. VOLCKER. Let me suggest to you the United States in that sense is a public company.

Senator BENNETT. That is right. And that is why I accept your comment. Now where is our price earnings ratio? Are we too rich or too high?

Mr. VOLCKER. I guess in some sense, that is what we are talking about.

Senator SCHUMER. I would just tack on one final point to Senator Bennett and all of the questions before we let you gentlemen leave.

I guess the issue is, we have been talking before, is there another way to deal with this problem other than recession?

That puts the cart before the horse. We are not going to create a recession to deal with this problem. The question, and it relates to Senator Bennett's question, is, can we continue to grow without dealing with this problem? Or will it in itself, with all its tentacles and ramifications, cause a recession or a stoppage of the growth in itself because of perception change? Because there just is not enough money now in other places to continue to fuel the growth and we have not dealt with the savings problem and we have not dealt with—or we have dealt negatively, as Secretary Rubin pointed out, with the governmental savings issue.

Sooner or later, I think what worries people is you hit a wall. And everything seems peachy-keen and hunky-dory and because we put ourselves in the hands of the generosity of strangers——

Senator SARBANES. Kindness.

Senator SCHUMER. Kindness. Sorry. Kindness of strangers.

Senator BENNETT. Self-interest.

Senator SCHUMER. It is self-interest that they are doing it. No question. But then perception all of a sudden changes and, boom, we find ourselves twirling downward and we have less control over how to deal with that than we have had with other problems. Isn't that what we are worried about here?

Mr. VOLCKER. I think it is what we are worried about. In dealing with the current account deficit, we deal with the imbalances that give rise to the current account deficit.

The current account deficit is kind of a symptom——

Senator SCHUMER. Right. Of course.

Mr. VOLCKER. Of the underlying imbalance, not just in our economy, but also in the world economy. And that is what makes it so difficult. The kind of thing you are talking about we saw in Thailand, we saw in Indonesia, we saw in a lot of places.

We are so much stronger, so much bigger, that that kind of crisis is much harder to provoke, in a sense, in the United States. So, we have, I think, still a margin of safety here, but we have to worry about it.

Senator SCHUMER. It will not have the magnitude that it had in Thailand, but it could still eat into the kind of growth that we have seen.

Mr. VOLCKER. Right.

Senator SCHUMER. Certainly at the margins. Maybe not.

You look skeptical, Mr. Secretary.

Mr. RUBIN. No, it is not that I am skeptical, Mr. Chairman. I guess I would just put it a touch differently.

It seems to me that what one would hope is that, for all the reasons that we have now discussed for quite sometime, that what you get is a gradual adjustment of the underlying balances which then results in a gradual adjustment of the current account deficit so that you come back into something much closer to balance. The risk is that you have instability.

Senator SCHUMER. Right.

Mr. RUBIN. And then it seems to me the question is what policies do you have to maximize the probability of this more gradual adjustment? That is what we tried to respond to Senator Bennett on.

Senator SCHUMER. Macon, who was going to come here today and could not and be on the second panel, his view is it will all just correct itself in a nice, easy way and we do not have to worry about it. Obviously, there is a different view among all of us here. There is that other view out there, that it does not matter much.

Mr. VOLCKER. It could, but we do not count on it.

Mr. RUBIN. You maximize the probability of it by doing sensible things.

Senator SCHUMER. Right. This has been a great discussion. I think I speak on behalf of all of us that it was really wonderful of both of you to donate your time, energy, experience, intelligence. We have put ourselves in the hands of the generosity of you folks—I am not going to get this right—kindness.

Mr. RUBIN. It is kindness of strangers, I think.

[Laughter.]

Senator SCHUMER. The kindness of you folks, and we really appreciate it.

Mr. VOLCKER. It is obvious that it must be in our self-interest.

[Laughter.]

Senator SCHUMER. As Senator Bennett pointed out.

Thank you very much.

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

Mr. VOLCKER. Thank you.

Senator SCHUMER. Thank you.

Let me bring the second panel up.

[Pause.]

Let me call our second panel. And again, they have not had as much Government service, but they are equally skilled in this area and extremely distinguished.

I think these are two gentlemen who the entire economic world listens to. And let me introduce them after I thank the Secretary. I will do it in alphabetical order, as we did the previous panel.

Bill Dudley, William Dudley, whatever—I am just thinking of something. You did not grow up in Brooklyn, did you?

Mr. DUDLEY. No, I did not. I have lived in Brooklyn, but I did not grow up there.

Senator SCHUMER. Because there was a fellow who lived across the street from me when I was a little boy named Billy Dudley on East 27th Street.

Mr. DUDLEY. My grandfather was a minister in Brooklyn.

Senator SCHUMER. His name wasn't Leopold?

Mr. DUDLEY. No, no.

Senator SCHUMER. Okay. Well, there you go.

Mr. DUDLEY. Small world.

Senator SCHUMER. Yes. Yes. Everyone else is, right.

Anyway, Bill Dudley is the Chief U.S. Economist, at Goldman Sachs. He served at the Federal Reserve Board as an economist in the 1980's. He has a Ph.D, has his master's from the University of California and his Ph.D there from the University of California at Berkeley.

Stephen Roach is the Chief Economist at Morgan Stanley and has also served at the Fed in the 1970's, has his BA from the University of Wisconsin, his Ph.D from NYU. So, we can say that both were at the Fed, both worked at Morgan Guaranty, and then both left and went on to other things.

With that, let me call on Mr. Dudley first. And I may have to excuse myself—how are we going to do this? I have to run to the Judiciary Committee for about 5 minutes. Senator Corzine will just take over during that time, whenever it occurs.

Mr. DUDLEY. Okay. Thank you.

STATEMENT OF WILLIAM DUDLEY
MANAGING DIRECTOR AND CHIEF U.S. ECONOMIST
GOLDMAN SACHS

Mr. DUDLEY. Thank you, Mr. Chairman. It is my pleasure to have the opportunity to testify today and follow two very, very distinguished members who I generally agreed with their remarks.

The United States has a large current account deficit, which has grown sharply in recent years. To date, it has not proved problematic for the U.S. economy or for U.S. financial markets. But this imbalance does create a risk. If foreign investors' appetite for dollar-denominated assets were to diminish, the result could be a sharp plunge in the value of the dollar and the potential for havoc in the U.S. bond and equity markets. So how to minimize this risk? I would suggest three approaches.

First, shift away from the so-called "strong dollar" policy. It is better to make that shift now when the demand for dollar-denominated assets is still strong and policy is credible, rather than under duress later. The goal here would not be to try to deliberately weaken the dollar, but to deemphasize the dollar's value as an explicit policy goal.

Second, I would implement measures that increase the pool of national savings. This would reduce the dependence of the United States on foreign capital inflows.

And third, pursue policies that ensure the United States remains an attractive market in which to invest. This would help to keep foreign capital flowing to the United States.

Before I discuss in detail what should be done in response to the large U.S. current account deficit, let me start with my assessment of the causes and likely sustainability of this imbalance.

In my opinion, the large current account deficit evident for this country mainly reflects the disparity between the low supply of domestic savings and the high demand for investment, both for business and for housing.

Up to this point, the rise in the dependence of the United States on foreign capital has not created any great difficulties. That is mainly because foreign businesses have been eager to increase their direct investment in the United States and foreign investors to increase their portfolio holdings of dollar-denominated financial assets. In fact, the desire by foreign investors to increase their holdings of dollar-denominated assets has been so great that it has caused the U.S. dollar to appreciate significantly since 1995. The strength of the dollar, in turn, has helped to sustain the economic expansion by helping to keep inflation in check.

In general, the desire by foreign investors to increase their investment in the United States should be viewed for what it has been—a mark of the U.S. economy's success. Capital is flowing here readily because the U.S. economic system has been performing well. Many factors including credible fiscal, monetary, and trade policies, deregulation, a flexible financial system, and a transparent corporate governance and accounting framework have helped to generate high productivity growth and a healthy return on capital in the United States. These favors have helped to encourage the flow of foreign funds to the United States.

However, the dependence of the United States on foreign capital inflows does create a vulnerability that needs to be acknowledged. In particular, if the performance of the U.S. economy were to falter on a sustained basis, the appetite for dollar-denominated assets could decline sharply. The result would be a sharp decline in the dollar and the risk of havoc for U.S. financial markets. The consequence could be a vicious circle in which dollar weakness contributed to poorer economic performance, which, in turn, reinforced the dollar's slide. There are three major reasons for concern.

First, as we have already heard, the U.S. current account deficit is very large, both absolutely, and as a share of GDP.

Second, the upward trajectory of the U.S. current account deficit evident in recent years must prove to be unsustainable at some point. To see this, consider that a rising current account deficit leads to greater net foreign indebtedness. Because the interest on this debt must be paid, the increase in debt will lead, over time, to a sharp deterioration in the net investment income balance. Without trade improvement, that implies an even wider current account deficit. The result is a vicious circle of climbing debt and interest expense that ultimately is untenable.

Third, the risk that foreign investors lose their appetite for dollar-denominated assets has already increased because the performance of the U.S. economy has deteriorated sharply over the past year. In particular, the growth rate of economic activity and productivity has faltered and corporate profits are contracting as the investment boom in technology has gone bust. The budget surplus is shrinking. Put simply, the notion of the new economy is being called into question. If the economic rebound anticipated for 2002 disappoints, then the demand for U.S. assets is likely to lessen.

Up to now, prospects elsewhere have also diminished. However, if the gap in economic performance between the United States and the rest of the world narrows in the future, then it will become more difficult for the United States to obtain the same huge sums of foreign capital on favorable terms, for example, at low interest rates and a high dollar exchange rate.

Danger signs for the dollar are already visible in the shift in the composition of foreign capital inflows, a point raised by Senator Corzine. The proportion of capital inflows consisting of direct investment, which is not easily reversed, has diminished sharply this year. In contrast, portfolio inflows, especially into corporate and agency bonds, have increased.

The composition of these capital inflows is important. In contrast to direct investment, exit from publicly-traded securities is easy. Liquidation can occur quickly, with potentially destabilizing consequences to the dollar and financial markets. So what should be done to forestall such an outcome?

The goal should be to pursue policies that encourage a gradual path of adjustment—a smaller current account deficit and an increase in the national saving rate. Three major policy adjustments are appropriate, in my view.

First, the time has probably come to scrap the so-called strong dollar policy. To fail to do so now, when the demand for dollars is still strong, heightens the risk of a sharper adjustment later. It would not be pleasant if U.S. policymakers were forced to jettison the strong dollar policy under duress. The loss of credibility would tend to drive up the risk premium on dollar-denominated assets, necessitating a more painful economic adjustment.

A strong dollar policy made sense during the investment boom when the main risk was that the U.S. economy might overheat. After all, during the boom, a strong dollar helped to keep inflation in check. Now that the boom is over, the rationale for a strong dollar has lessened, especially as the dollar's strength is undermining the effectiveness of U.S. monetary policy and undercutting U.S. international trade competitiveness.

However, rather than a call for a weaker dollar, which might provoke a sharp, destabilizing adjustment, I would shift the emphasis away from the dollar altogether toward the importance of having a strong and healthy economy. If the U.S. economy performs well, then foreign capital will flow here readily and the dollar will take care of itself.

Second, policies should be pursued that would act gradually to raise the pool of domestic saving. This can be accomplished in two ways. Continued discipline in terms of fiscal policy is important. The fact is that the dependence of the United States on foreign capital would be much greater currently if the U.S. budget balance had not shifted sharply from deficit to surplus over the past decade. The improvement in the budget balance has enabled the national saving rate to remain generally stable in recent years, despite a sharp fall in the personal savings rate. Not only would slippage here reduce the pool of domestic savings, but it also might worry foreign investors that have invested large amounts of capital in the United States, in part, because of the improvement in the U.S. fiscal outlook.

Although the long-term fiscal outlook for the United States remains challenging given the impending retirement of the baby-boom generation and the increase in life expectancy, it pales in comparison to the challenges faced by Japan and Europe, which have less favorable demographic trends and bigger unfunded pension obligations. It is important that the United States not squander its advantage in this area.

In addition, the tax code could be changed in ways that encouraged greater domestic private savings. This might include additional incentives to save or a more radical revamping of the tax code to a consumption-based tax system.

Policies that raise the national savings rate would gradually reduce the dependence of the United States on foreign capital. Over time, this would reduce the risks of a sharp reversal in the appetite of foreign investors for U.S. assets.

Third, policies should be pursued that ensure the United States remains an attractive market in which to invest. This includes lowering trade barriers, investing in education in order to raise the quality of the U.S. labor force, and taking steps to make the U.S. capital markets more transparent and efficient. By creating a good environment for foreign investment—either direct or in financial assets, this would help to ensure that the flow of capital from abroad persists on favorable terms to the United States.

To sum up, the large U.S. trade imbalance is worrisome. A sharp shift in perceptions among foreign investors could lead to a collapse in the dollar that could conceivably destabilize the U.S. economy and global financial markets.

The best way to deal with this risk is to keep the U.S. economy healthy through the application of prudent economic policies. If the U.S. economy remains more productive than its rivals and the U.S. capital markets remain deeper and more liquid, then the flow of foreign monies to the United States should continue relatively smoothly and easily. The current account deficit probably would ultimately shrink, but in an orderly way that would not disrupt the ability of the U.S. economy and the Nation to prosper.

Thank you.

Senator CORZINE. Thank you, Mr. Dudley.

It is very nice to see you, Steve. We are pleased you are here. We would like to hear from you.

STATEMENT OF STEPHEN S. ROACH
CHIEF ECONOMIST AND DIRECTOR OF GLOBAL ECONOMICS
MORGAN STANLEY

Mr. ROACH. Thank you very much. It is a pleasure to be here, Mr. Chairman.

I have a long statement that I would simply prefer to submit for the record and just summarize some of the highlights.

I just want to echo the comments that were made by the first panel, as well as by Mr. Dudley. I think the Subcommittee is to be congratulated for having the courage to hold a hearing on a topic that very few people understand, let alone talk about. I really believe that our external imbalance, no matter how you want to measure it, is a topic for serious and deep concern in Washington.

The global economy, I think, suffice it to say, is in trouble right now. By our estimates at Morgan Stanley, 2001 will go down in history as a year of global recession. And it will be the second global recession in 4 years. This recession-prone global economy of ours, in my opinion, reflects some serious and worrisome imbalances in many major economies around the world. And one of those economies is us in the United States.

I would argue that the U.S. economy at this point in time is far more imbalanced than some of our fond recollections of the 1990's, especially the latter half of the decade, might otherwise lead us to conclude. And I would just cite three imbalances, all of which have already been discussed in this hearing this morning.

First, our negative personal savings rate. It is the first time we have had this condition since 1933. That was not a particularly good year in the long experience of our economy.

Second, we have a massive overhang of capital spending on new capacity, especially in the technology area.

Third, very much a byproduct of the first two, is the topic of this hearing—our current account deficit.

Mr. Chairman, I urge you not to treat this imbalance in our external condition merely as a benign symptom of America's leadership role in the global economy, or as a necessary ingredient of the great boom that we were able to achieve in the latter half of the 1990's. Instead, I believe that this imbalance should really be taken as a sign of a Nation that has really gone to excess, a U.S. economy that in many important respects has lived beyond its means.

America, as both Chairman Volcker and Treasury Secretary Rubin indicated, is a savings-short Nation that has a voracious appetite to spend or consume.

And yes, I think you in the Government are truly to be commended for taking our Government budget from deficit to surplus, from transforming the role of the public sector from a spender into a saver. But I think, unfortunately, we as a Nation have really squandered this opportunity by pushing our private-sector savings rate down to historic lows in the post-World War II period.

And so, the math is pretty straightforward here. The national savings rate is still subpar and a savings-short U.S. economy has had little choice other than to turn to foreign investors to finance our investment spending.

We have had to, of course, run this record current account deficit to attract the foreign capital that has kept the economy on this track. And that, of course, has left us in this very precarious place that was so vividly described—I won't use the line again by Tennessee Williams, but it has taken to keep the magic of our virtuous circle alive.

But the cost here is that, right now, foreign ownership of a lot of assets in the United States is at record levels. Thirty-seven percent of U.S. Treasuries are owned by foreign investors. Twenty percent of all corporate bonds are owned by foreign investors. And I have to correct. There was an incorrect figure and estimate in my testimony that Senator Schumer cited. The number is 20 percent, not 46. And 11 percent of all U.S. equities are owned by foreign investors. All of these ratios are virtually double where they were in the mid-1990's.

Now yesterday, in front of the full Senate Banking Committee, Federal Reserve Chairman Alan Greenspan admitted in a response to a question from Senator Schumer that America's massive foreign imbalances are not a sustainable state of affairs for the United States. He went on further to say that, some day, something has to give.

Now as economists, our models leave us with the same conclusion. In all of recorded history, no nation has been able to sustain a prosperity built on a shaky foundation of subpar domestic saving and increased dependence on foreign capital. Yet, that is exactly the condition that we now find ourselves in. It is an unsustainable and very worrisome state of affairs for the United States.

What can be done? That is the—I guess Senator Schumer called it the $64,000 question.

First of all, I do not have anything brilliant to add other than that which has been stated. But I want to caution you in two areas.

Number one, there is no quick-fix to this problem. I think we must resist the temptation to find an easy way out of the structural problems that beset both the United States and the global economy.

I worry, for example, that if we go down the road we went down in late 1998, by reflating through overly aggressive monetary policy and create another boom in the United States, that would give us exactly the same set of conditions that put us in the place we are in today—another liquidity-induced boom in the stock market, another binge of unnecessary capital spending, a further plunge in the personal savings rate.

And it would also temper the urgent need for reforms around the world and structural change that could really create better balance in the global economy. We did that in 1998. It was not that long ago. And here we are again, back in global recession, for the second time in 4 years.

Number two, I would suggest that this is not a time to deal with trade tensions on a bilateral basis. I wish Senator Sarbanes was still here. But I am really very nervous about viewing this as a Japan problem or a China problem, or even a NAFTA problem. The problem is really in the mirror. We are a saving-short economy and if we do not import from somewhere, we will import from somewhere else. That is what is required to attract the foreign capital. I think the options that have been laid out by the gentlemen that preceded me are fairly straightforward and I would agree with them.

I would simply underscore the following sort of three premises that reflect my own philosophy in dealing with this problem.

First, just recognize that we are, in fact, a Nation that has been living beyond its means. And when that occurs, the prudent course of events is to learn to live better within our means. And that may mean that we cannot return to the booming period of economic growth that we had in the latter half of the 1990's for a long time.

Second, and related to that is the belief that I think that Chairman Volcker and Mr. Dudley expressed, and that is that market forces will take care of the value of the dollar. I happen to think that the dollar is over-valued. I certainly concur that that view is arguable. But I believe strongly that the yen and the Euro are under-valued and market forces will take those currencies up. Currencies are relative prices. So when one goes up, the other falls and that means the dollar, more likely than not, will fall, and when the dollar falls, financial markets will be, I think, taken by significant surprise.

The third principle, and it is not a sexy one, but one that is just absolutely critical to the whole equation, is that this is a global problem. Our current account imbalance is a symptom not just of our own problems, but the world itself, which has been overly dependent on the United States as a source of growth.

So key for us is to continue to push for reform and restructuring amongst our trading partners so that they too can unlock their efficiencies, grow more rapidly without hooking themselves to the coattails of the United States.

So in closing, Mr. Chairman, I really commend you for having the courage to hold this hearing. It is a tough and critical issue.

I want to stress that America, in its long history, is the leader of the global economy since the end of the World War II, has never had a more worrisome external imbalance than it has today. And I really urge you in the Congress—this is a wake-up call that something needs to be done to an imbalanced U.S. economy.

Thank you very much.

Senator SCHUMER. Well, thank you both.

Let me apologize to Mr. Dudley for not being here, but I am familiar with his testimony and have read it.

Let me ask a couple of questions here.

I take it, just drawing it out, neither of you think that this can be sustained forever. Is that fair to say?

Mr. DUDLEY. That is fair to say.

Senator SCHUMER. Okay. There are a few who do, and Secretary Rubin was not 100 percent sure that it could not be sustained, at least for a long time. Let me ask you the question that I asked each of the other gentlemen. Might there be some warning signs of unsustainability and are they upon us?

Mr. DUDLEY. I agree with Chairman Volcker who answered the question. It is very, very hard to anticipate developments in financial markets, especially in currency markets where you can go from a virtuous cycle to a vicious cycle, very rapidly.

There is one symptom already that has become visible that may be the leading edge of a warning, and that is the shift in the composition of foreign capital inflows into the United States away from foreign direct investment, which is not readily reversed, into U.S. corporate bonds and agency bonds and equities, publicly-traded securities, which is very easily reversed.

So to the extent that the capital is now flowing into assets that are more liquid, there is more risk that those inflows could reverse more quickly. I think that that is the only thing that I could really point to.

The second thing is that if growth in the rest of the world picks up, that is also going to be, ironically, a little bit problematic for the dollar in the short run because one of the reasons why the capital has come here so readily is because the U.S. economy has performed so well relative to its major trading partners. And so, if we get the recovery in the rest of the world that we actually want, one of the consequences of that probably would be a weaker dollar.

Senator SCHUMER. Mr. Roach.

Mr. ROACH. I think that there is no real clear set of early warning indicators that we are going to move from a period where the current account has been benign to where it really turns into a destabilizing force on the U.S. economy.

What will probably occur here is that there could be a set of conditions that could lead to a weaker dollar that could certainly come about from improvement overseas or a loss of confidence, for one reason or another, in foreign investors in dollar-denominated assets. And then, when the dollar goes, it will not be an orderly correction. The gentlemen that preceded me were hopeful that if the dollar were to correct, that it would be a gradual and well-managed process. Having spent an inordinate amount of my time in the markets, if there is one thing that I have been taught, and painfully, is that there is no such thing as an orderly decline in extended markets.

Markets tend to overshoot. And as the dollar has overshot to the upside, the distinct possibility is that the dollar overshoots to the downside. Why does it do that? Because foreign investors all of a sudden wake up and they say, the dollar is weak and you have this horrible current account problem.

They are paying no attention to the current account right now because it is a capital flow story. Everyone wants a piece of America because we have cornered the market on the so-called productivity new economy miracle.

Well, if that miracle gets drawn into question and the dollar goes, the current account then becomes the excuse to take it down a lot further.

So it is a set-up. And I urge you to take it in that regard. The markets always figure out ways to humble and humiliate you in ways that you have not been humiliated in the past. There is no clear set of early warning indicators that we can focus on, but that does not mean that we should not be more attentive than ever to this possibility.

Mr. DUDLEY. If I could just add one more thing, Mr. Chairman.

Senator SCHUMER. Please.

Mr. DUDLEY. I think this whole question of how much the new economy is real and how much of the new economy turns out to be a mirage is critical in the outlook in terms of whether the adjustment is gradual or precipitous.

And in that regard, things that suggest that the new economy is real, like sustained high-productivity growth, would makes you feel a little bit more comfortable about the outlook that the adjustment might take place more slowly, and things such as low productivity growth numbers, for example, what we received in the first quarter, shrinking budget surpluses, things of that nature, that suggest that some of the miracle was a mirage, those would be early warning signs that would make you a bit nervous about the outlook for the currency.

Senator SCHUMER. Let me ask you, Mr. Dudley, because you were quite explicit in saying that we should not be focused on the value of the dollar, but, rather, on other things in the economy and let the dollar—because this is a question that I am just learning this issue, really.

What do we do now? How much does just talking about, well, we want a strong dollar, cause the dollar to be strong? And what are the other policy things that we do now that explicitly bolster the dollar that we might not do? How much of this is talking it up in psychology and how much of it is real?

When I first came to Washington from New York, when I was a Congressman, I would say, oh, boy, here's Washington. It is a lot of fluff and it is a lot of hype and a lot of psychology.

But up there in the markets, they are immutable. You cannot fool them. And the more I am around, the more I see that the markets also are influenced by puff and hype and psychology, at least in the short run. Can you give us some enlightenment about this?

Mr. DUDLEY. I cannot give you very much enlightenment, I am afraid.

I think, generally, for the foreign exchange markets in particular, psychology is very important. And the reason why it is very important is that, when currencies appreciate or depreciate, the feedback effect on that appreciation or depreciation in terms of real trade flows takes place very, very slowly. There is always a very good question when you look at any currency, where does it really belong? Where should it truly be?

People do not really know. And so, changes in psychology can be very, very important in changing those beliefs of where the currency belongs in the medium- to long-run because the feedback from changes in the currency to the real economy happen so gradually and so slowly.

I think this is one of the problems right now with the strong dollar policy. I think the Administration feels that they are a little bit in a box, that if they change the strong dollar policy in any way, the dollar will fall precipitously. They are afraid that if that happens, they will be blamed for that. They do not want that to happen. And so, they are sort of sticking with the strong dollar policy. I understand that fear. However, I think that if you do that and keep the dollar supported on the thin air of just your belief that you want it to be strong, the risk is that you could have a bigger adjustment later.

So my view is, let's move away from the dollar as the focus of policy. Let's make the focus of policy the health of the economy. If we make the focus the health of the economy, the dollar should over time take care of itself. So, I would argue against propping it up on psychological factors. I do not think that is going to gain you much in the long term.

Senator SCHUMER. Thank you.

I know Senator Corzine has to leave.

Senator CORZINE. Thank you.

Senator SCHUMER. I will come back. I have a few more questions.

Mr. ROACH. I would just say, as a card-carrying economist, I continue to this day to be truly staggered by the fact that we, in a huge market, the world's largest and deepest market, which is the foreign exchange markets, really condone the setting of an asset price based on the rhetorical elements of human beings.

Supply and demand is a very powerful force and I truly believe that the currency will be determined by those forces rather than by the ability of a person, whoever that person is, to say those magic words—a strong dollar policy.

The Europeans certainly are saying the same thing about their currency. Ultimately, the Japanese will as well. It is a zero-sum game, so they cannot all be strong at once.

Senator SCHUMER. Senator Corzine.

Senator CORZINE. Thank you.

I would like to follow up a little bit on that comment and the recommendation that we should be shifting from a strong dollar policy. I am not sure I fully understand how that gets accomplished, what kind of methodology brings that about, because, ultimately, supply and demand for dollars makes that case by whatever the market price is at a given point in time.

So, I would love to hear some comments on how you go about shifting it. I mean, you can shut up, but the fact is that it really has been driven in part by, if not in the long run, by the supply and demand conditions. I think we have talked today that this is a potential for instability in financial markets and ultimately, translation into the economy.

I am always curious about what are the shocks that we think are the elements that bring about the change in the current status of the market. When do people no longer want to hold on or demand those dollars that change the context of its value?

I continue personally to believe that our foreign holders of dollars believe we have a quality fiscal policy in place and are expecting significant budget surpluses.

I would love your own anecdotal information on your conversations with foreign investors about whether that is true. And if that perception changes quickly, do we have a potential for a shock in currency markets and a reversal of some of the problems here.

Then, finally, I think both of you have talked about steps that we need to take ultimately to have a strong and healthy economy. It does not appear that we have a strong economy now. Some might argue that it is more healthy than otherwise.

I would love to hear your current quick views on where we are, and what do we need to do to restore a healthy economy?

Mr. DUDLEY. Well, Senator Corzine, how do you shift from a strong dollar—I want to make very clear, I am not advocating a weak dollar. I am advocating a shift in emphasis away from the idea that our goal or policy is a given value of the currency.

I think our goal or policy should be a healthy economy and not be so worried about where the dollar ends up. Let supply and demand take care of it. Change the game. Let the markets determine where the dollar should be and not have our rhetoric enter in as an important factor.

Right now, I think rhetoric is important in the markets because certainly people hang on Treasury Secretary O'Neill's every word in terms of the dollar. So, obviously, the markets view is that it is pretty important.

On the issue of the fiscal side, I agree with you 100 percent. The improvement in the U.S. fiscal position was important both for generating more savings to finance the investment boom that we had, but also, it was one factor that clearly supported the demand of foreign investors for dollar-denominated assets. Any backsliding on the fiscal side I think would be negative in that regard.

One thing you can already see evident this year is, as the budget surplus projections are starting to come down, we have had a steepening of the Treasury yield curve, suggesting that people are more nervous about the fiscal outlook now than they were a few months ago before the passage of the Bush Administration tax cut plan. I think staying on course on the budget, staying the course in terms of being fiscally prudent on the budget is very important.

One area where we have a tremendous advantage relative to most of our major trading partners is that while we have a Social Security problem, our Social Security problem is very, very minor compared to the problem that you have in other countries. And we should act to keep it that way because that is I think something that makes the long-term fiscal outlook in the United States quite a bit better than in, say, Europe and Japan, which have a much greater unfunded pension liability and much less favorable demographic trends.

Mr. ROACH. I would just briefly, in response to these questions, say three things.

In terms of shifting the policy, my strong recommendation is simply to take the rhetoric out of the asset price. Do not personalize the relative price of one of the most important assets in the world.

This morning, Treasury Secretary O'Neill has an extensive interview in the *Financial Times* as Treasury Secretary and dollar spokesman articulating and personalizing his own stylized interpretation as to why the dollar should be at a certain level. With all due respect to the Treasury Secretary, it is a personal view and the markets will make that judgment. I think there is just far too much emphasis placed in rhetoric in setting asset prices.

In terms of shocks that could cause a problem here, there is a lot of them that you could always sort of conjure up in your darkest moments. I have been accused of spending too much time worrying about dark moments. So, I will not belabor those. But I think the one that we need to think about most seriously is really the final question, Senator Corzine, you raise, and that is the state of the U.S. economy.

Federal Reserve Chairman Alan Greenspan reiterated yesterday in front of the Full Committee that he is hopeful that the U.S. economy may be forming a bottom.

What if it is not? What if this is a false bottom? What if there is another leg down to come? And there is a good case to, I think, worry about precisely that possibility.

The state of the global economy, as I indicated in my own statement, poor and deteriorating as we speak. The feedback from that will come back to crimp exports. That is another potential source of downward adjustment in the United States that has not even come close to fully playing out. And then, finally, there is, I would say, the $64,000 question, Chairman Schumer, and that is the state of the American consumer.

American consumers just hung in there. Slowed a little bit, but basically, continues to spend, remains pretty much in denial that anything adverse could ever happen to the Good Ship America. What if that changes? And my guess is that there is risk to come to the American consumer who had depleted his or her savings balance, is overly indebted, and has also run out of spending from the now-infamous wealth effect.

So if the consumer who is as precarious as I have ever seen him or her, since, probably the early 1970's, throws in the towel, that could be a shock that certainly could reverberate into our foreign exchange markets and then all of a sudden, the current account will matter.

Senator CORZINE. Thank you.

Senator SCHUMER. Thank you, Senator Corzine.

I thank both of you. Let me ask you this question. I do not know if you saw, but yesterday, I asked Chairman Greenspan about this conundrum of interest rates, long-term, anyway, not responding to the constant drop, I think 275 basis points, that the Federal Reserve has done in the funds rate.

He basically said, we are not seeing anything happen because Treasuries are being eaten up at a greater amount, which led me to question the wisdom of the tax cut.

He actually demurred. I do not know if you saw this. He said, please, I would ask your indulgence that I not have to answer that question. Since I respect him, I did not push the issue, uncharacteristically of me. But could it be that this is related to the flood of foreign investment? Could it be that we do have some form of inflation going on a little bit more here than people think, but it is covered up because of all this foreign money coming in, and that if it left, things would bounce up more quickly?

Is there a relationship there? That just hit me as we were going through this hearing. Maybe not.

Mr. ROACH. I would say it is quite possible. But we are not able to isolate and identify that with precision.

But the theory, Chairman Schumer, is that when we ask foreign investors to fund our domestic savings shortfall, we have to make that funding attractive to them.

Senator SCHUMER. Right.

Mr. ROACH. Nasdaq 5,000 was all the attraction they needed. So, they did not demand a premium on dollar-denominated assets.

Nasdaq has again—I do not know where it is today, but yesterday, it closed back below 2,000 again. And so, suddenly, what seemed like a sure thing to foreign investors, whether they were buying our assets or buying our companies, is not quite the sure thing that it was a year or a year and a half ago.

It is perfectly appropriate under those conditions for foreign investors to begin demanding a premium on dollar-denominated assets, and that could well be one factor that is keeping longer-term interest rates higher than might otherwise be the case in a regime of Federal Reserve monetary easing.

Mr. DUDLEY. Mr. Chairman, my assessment is that long-term rates are probably being held up by mainly two things.

One, the deterioration in the outlook for the Federal budget. And two, a very strong belief that 275 basis points of easing is going to generate a pretty healthy rebound in the economy next year.

That is something that both Mr. Roach and I would disagree with. We think that monetary policy is not particularly powerful in the current environment, partly because financial markets have not cooperated with the Fed. The stock market is down. The dollar has appreciated. And the long-term rates have not changed very much. But I think the markets—a lot of investors have the belief that the economy is going to come back very, very quickly.

Now coming back to this question of the dollar, has the dollar's strength supressed some inflation that could come back if the dollar were to depreciate?

Absolutely, that is a risk. However, in the current environment, that is probably not a very big risk because the U.S. economy has been weak enough for long enough, that you are actually freeing up quite a bit of slack in terms of the labor market and industrial capacity.

So that, yes—if the dollar were to go down, you would probably get higher import prices and a little bit more flexibility for U.S. producers to raise prices. But that would be offset by the fact that the slowdown has freed up a lot of capacity in the United States.

Senator SCHUMER. This is the subject of a different hearing, which maybe we ought to have. But it seems to me what you are saying is that this globalization, internationalization of the world capital markets, in general, makes monetary policy less effective than it used to be.

Mr. ROACH. Absolutely. I think globalization reflects an extraordinary new conductivity in the world through trade flows, through capital flows. It is characterized by global supply chains, by rapid expansion of multinational corporations. And so, a lot of the rules that we have embraced and understanding asset price movements, to say nothing of reverberations from, say, the United States to non-Japan Asia, those rules are changing before our very eyes.

So talk about a new economy, I would far prefer to have the globalization be discussed in the context of a new economy than the sort of Nasdaq-type bubble that has since popped.

And I think you are entirely right to draw attention to really probing what we know about globalization, what we do not know about globalization, and what we need to know about globalization going forward.

Senator SCHUMER. Is this a consensus among practical economists like yourselves that monetary policy is less effective than it used to be because of globalization?

Mr. DUDLEY. I think there are certainly a number of people that would agree with that statement. Both of us would agree with that statement. I do not think it is yet a consensus view.

Senator SCHUMER. Gotcha. The easiest way out of this whole conundrum we are in, of course, is to have Americans save more.

Now particularly Chairman Volcker, but even Bob Rubin, had doubts that there was much from a policy point of view we could do to induce savings, that most of the experiments that we have done in terms of tax incentives and other types of things to increase savings have not been terribly effective.

Do either of you disagree with that? Is there anything that we could do? And what about this new idea, which I think Al Gore had proposed, which is that, since we need to increase savings in lower-income people, that a Federal match might do it. Of course, you are having a dollar outflow there, too. So tell me in general.

Mr. ROACH. I would just agree with Chairman Volcker that using fiscal policy to incent private saving is something that history has really not spoken very kindly of. I think we have been frustrated over the years in being able to raise the level of savings. The best that these measures do is alter the composition of savings, shifting it from one asset to another.

And I would actually urge you to think about our savings shortfall in a similar context. It is not that Americans are not saving at all. It is that American individuals have mistakenly transferred an awful lot of their incremental savings into the stock market. They believe that the stock market has become a permanent new source of saving. And if that view is correct, why should you save out of your paycheck?

The stock market is in the process of painfully pointing out to many Americans that that premise may be flawed. And so, I think that our system is adaptable enough to enable individuals to rethinking their savings motives away from their mutual funds, which are now at greater risk than they had thought before, and back into more traditional savings vehicles.

Mr. DUDLEY. I think the challenge in designing tax changes that encourage savings is to design changes that do not allow people just to move already-existing financial assets they have into the new tax-favored class to take advantage of that tax break, and not actually increase their saving. And that is really the challenge.

I think probably what we need to think about a little bit more is whether a shift to a consumption-based tax system is appropriate. But, unfortunately, I think that is not very likely politically, especially given the fact that we have now spent most of the non-Social Security surplus.

One of the great unhappinesses to me of what has happened in recent months is that we had this big surplus that we could have used to do a major revamping of the U.S. Tax Code in ways that could have accomplished some of these goals, and we did not even try to take advantage of that opportunity. And I think that is unfortunate.

Senator SCHUMER. Okay. Well, I want to thank both of you for excellent testimony, great answers.

Unlike many hearings, there has not been much heat and there has been some light.

Thank you.

Mr. ROACH. Thank you.

Mr. DUDLEY. Thank you.

Senator SCHUMER. The hearing is now adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JIM BUNNING

Mr. Chairman, I would like to thank you for holding this very important hearing and I would like to thank all of our witnesses for agreeing to testify today. This is a very important topic you have chosen today.

I am not sure if the average American realizes how much foreign investment we have coming in right now. Our economy is becoming increasingly dependent on foreign investment. Without it, we would not be experiencing even the anemic growth we have now.

Of course, we must think about the consequences of that investment. Specifically, I am worried that the foreign money valve may get shut off. I have heard many economists say that will not happen in the near future, and I hope they are right. However, my fear is that we have a rapid market change and it becomes more attractive to invest foreign capital elsewhere.

With increased globalization, worldwide economic factors change faster and worldwide economic changes are recognized faster. It was only a year ago that the Nasdaq was hovering at 4,029, this morning it opened at 1,959. If suddenly, American investment became unfashionable and foreign capital was pulled, it would have a devastating effect on our economy.

Of course, that leads to the question, what do we do? Well, that is why our witnesses are here today. I eagerly await your testimony to find out, what if anything we should do to ensure our economy does not experience damage from the ever increasing balance of payments deficit. I believe our economy is weak enough right now, it doesn't have to go down any further.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF ROBERT E. RUBIN

FORMER SECRETARY, U.S. DEPARTMENT OF THE TREASURY

DIRECTOR AND CHAIRMAN OF THE

EXECUTIVE COMMITTEE, CITIGROUP, INC.

JULY 25, 2001

Mr. Chairman and Members of the Subcommittee, I think it is both useful and timely to develop further Congressional focus on our country's current account deficit. Thus, I think this hearing is a very good idea. Moreover, recent events in Genoa and elsewhere suggest that the full range of issues around globalization merit great focus by this body.

The current account deficit is basically the trade deficit plus the deficit in net payments, including interest, dividends, and the like, but public discussion of our deficit has, I think, become a symbol for concern about the whole area of trade related matters. I will try to very briefly express my views on these matters, and related policy issues, and hopefully that will be responsive to the four questions in the Chairman's letter outlining this hearing, as well as very summarily suggesting an approach to the broader issues around globalization.

To begin, the U.S. has had remarkably good economic conditions over the past 8 years, with far stronger growth and far greater productivity increases than Europe or Japan, and far lower unemployment than Europe. At the same time, our markets have been more open to imports than Europe or Japan, our currency has been strong, our capital markets have been open, and our trade and current account imbalances have grown substantially.

I have no doubt that our economy has benefited enormously from both sides of trade, not only exports, but, even though it is not popular to say this, also very powerfully from imports. Imports lower prices to consumers and producers, dampen inflation—and thereby lower interest rates—provide a critical role in allocating our resources to the areas where our competitive advantage is greatest, and, maybe most importantly, create competitive pressure for productivity improvement. All this has contributed greatly to the very low unemployment and rising incomes at all levels.

The imbalance between exports and imports has occurred because of vast net capital inflows from around the world into the United States, motivated by the relative attractiveness of the United States for investment and as a repository for capital. That vast net inflow has allowed our consumption plus our investment to exceed what we produce. The consequence has been a lower cost of capital in our country and greater investment, which helped increase the rate of productivity growth.

Another consequence of the net capital inflows has been a strong dollar, which has lowered costs to consumers and producers for what we buy abroad, and more favorable terms of exchange between what we sell and buy abroad. The result is lower inflation, lower interest rates, higher standards of living, and greater productivity. The strong dollar has also helped attract capital from abroad.

The next question is, even if our open markets, imports and a strong dollar are beneficial, is the imbalance itself a problem.

While a current account deficit reduces aggregate demand, in recent years we have had fully adequate demand, and, in any case, monetary and fiscal policy—such as the current tax rebate—are a far preferable means of generating demand, if this is desired.

The claims against future output from the vast net capital inflows is like any other borrowing or raising of equity capital: if the funds are well used for investment, then the future contributions to growth will exceed the cost of repayment or other forms of return to foreign investors.

The remaining concern is that, in various ways, the current account deficit could contribute to future instability, as, for example, by adversely affecting confidence in the dollar or making us more vulnerable to a change in perception abroad about our economic prospects or the soundness of our policy regime—which, parenthetically, is another reason why maintaining fiscal discipline is so critically important for our economic well-being. While we should be able to sustain this deficit for an extended period because of the relative size and strength of our economy, it would be desirable over time to greatly reduce this imbalance.

There are some policy measures that could promote this purpose and would be beneficial in other ways as well, and there are some policy measures that are more frequently advocated, which might help reduce the current account deficit but could have other severe adverse economic effects and on balance would be most unwise.

Doing whatever we can to promote structural reform and trade liberalization in Europe and Japan would contribute to greater growth with more attractive investment opportunities in those areas, thus increasing our exports and increasing investment flows to Europe and Japan. This is good for us in many ways, including reduction of our current account deficit, and exemplifies why strongly engaging in international economic issues is greatly in our interest.

At home, increasing savings over the full business cycle would reduce imports and reduce the inflow of capital and would be the most constructive approach to reducing the current account deficit. While our low personal savings rate seems to be a cultural phenomenon—and there is a real question about how much net effect some savings tax credits have—I do think carefully crafted tax credits for subsidizing saving is a useful approach to explore if Congress at some point revisits the recently enacted 10 year tax, which is itself a significant diminution of future national savings and, in my view was most unwise.

Two frequently mentioned correctives for the current account deficit that might have some impact but on balance would be highly detrimental to our economic well-being are increased trade barriers and modifying our country's strong dollar policy.

Increased trade barriers would increase prices, lessen the comparative advantage effects, and reduce competitive pressures for productivity. Also, history suggests that protectionist measures here could lead to retaliatory trade measures in other countries.

Modifying our strong dollar policy could adversely affect inflation, interest rates, and capital inflows and would lessen the favorability of our terms of exchange with the rest of the world.

Having said all this, as our Administration made clear over the past decade, trade liberalization, though highly beneficial on balance for industrial and developing countries, can create dislocations—just as technology does to a far greater degree—and there are critically important matters, in our country and around the globe, such as poverty and the environment, that won't be adequately addressed by the policy regime that I have been discussing. The demonstrators this past week were sometimes strident—and we must condemn violence—but there are underlying concerns about globalization that are serious and need to be addressed. Thus, in our country and abroad, there should be a parallel agenda to promote productivity and equip people to deal with change, including education, effective retraining, programs to equip the poor to join the economic mainstream, environmental protection, and much else. And the industrial nations, in their own self-interest, should greatly increase assistance to developing nations.

Mr. Chairman, let me conclude where I started. The current account deficit is a complex issue that immediately leads to the whole range of trade-related issues, and I think that this Committee performs a great public service by holding this hearing and whatever other processes it employs to provide serious public examination of these issues.

PREPARED STATEMENT OF PAUL A. VOLCKER

FORMER CHAIRMAN OF THE BOARD OF GOVERNORS

FEDERAL RESERVE SYSTEM

JULY 25, 2001

Mr. Chairman and Members of the Subcommittee, I welcome your timely initiative in arranging this hearing focusing on the U.S. Balance of Payments.

Others are better equipped than I to discuss the specifics of current developments and their significance for particular sectors of the economy. In this short statement, I want to emphasize the broad nature of the challenge before us as our current account deficit reaches magnitudes with little historic precedent.

The past decade has been characterized by a strong dollar and a large and growing net inflow of capital. The counterpart has been a greatly enlarged trade and current account deficit. What has been little appreciated is the extent to which those developments have supported the relatively strong and well-sustained performance of the U.S. economy.

For most of that time, the other main economic centers—Japan and the continent of Europe—were mired in some combination of slow growth, high unemployment, and excess capacity. In sharp contrast, the U.S. economy was, until recently, accelerating. There was good growth in investment and profits and a sustained high level of consumption. In fact, by the end of the decade, personal savings, as the staticians measure those savings, had practically disappeared.

In those circumstances, labor markets tightened, tightened to an extent that in the past had been associated with strong and accelerating inflationary pressures. Yet, prices, particularly of goods, have moved relatively little at either the wholesale or retail level. How could those contrasting developments be reconciled?

An important part of that explanation is that foreign capital—in effect, the savings of other less affluent countries—moved strongly toward the United States, attracted by perceptions of strong growth and productivity and the powerful attraction of the booming stock market. Along with the rising Federal surplus, it was that foreign capital that in the absence of personal savings, in effect, financed much of our investment. The capital inflow also tended to strengthen the dollar despite the growing trade and current account deficits. That strong dollar, combined with the ready availability of manufactured goods from countries functioning far below their economic potential, contributed importantly to containing inflationary pressures. It has seemed, for the time being, a benign process: for the United States, a current account deficit without tears; for other countries, the American market has provided a sustaining source of demand in an otherwise economically sluggish environment.

What is in question is sustainability. Our trade and current account deficits are now trending toward $500 billion a year, or close to 5 percent of our GDP. Those are very large amounts by any past standard for the United States. Given our weight in the world economy, we are absorbing a significant portion of other countries savings. With the low level of our personal savings, and now the prospect of diminishing Federal surpluses, this means we are dependent upon maintaining a strong inflow of foreign funds. We have also become accustomed to a ready supply of cheap goods from abroad. Both factors point to continuing large trade and current account deficits.

For the time being, growth in most of the rest of the world is so slow that there is no near-term prospect that world markets will tighten, limiting the availability of imports at attractive prices. Moreover, the latest indications are that the strong flow of foreign funds into the United States is being maintained, even in the face of our economic slowdown and stock market correction. But looking further ahead, the risks are apparent.

We cannot assume that Japan and Europe will not at some point resume stronger growth, and that they will then want to employ more of their savings at home. We would certainly like to see stronger growth in the emerging world, which in turn would attract more capital from the United States. Here at home we have become less dependent on traditional "old economy" manufacturing industry, but there are limits to how far we can or should countenance further erosion in our manufacturing base.

All this suggests that, over time, we must look toward a narrowing of the trade and current account deficit. That will require a revival of personal savings and maintenance of a strong fiscal position. It may require, too, some strengthening of the Euro and the yen relative to the dollar.

In concept, adjustments of that sort can be made over a period of years consistent with continuing expansion in the United States and stronger growth in the rest of the world. But as developments in the "high-tech" world and in the stock market have again demonstrated, sentiment in financial markets can change abruptly and bring in its wake strong pressures on economic activity. The timing and degree of those changes simply cannot be predicted with any confidence. It seems to be evident, however, that as our trade and financial position becomes more extended, the risk of such abrupt and potentially destabilizing pressures increases.

The United States is already a large net debtor internationally, and for some time ahead will remain dependent on foreign capital if our economy is to resume growth. We should and we do export capital as our businesses and our investors seek out prospects for the highest returns. To finance both our current account deficit and our own export of capital, we must import close to $3 billion of capital every working day to balance our accounts. That is simply too large an amount to count on maintaining year after year, much less enlarging.

One way—an entirely unsatisfactory way—to approach the need for adjustment would be to fall into extended recession or a prolonged period of slow growth. Given that the world economy as a whole is operating well below par, the dangers of such a development would only be amplified.

Conversely, I do not think we should count on extending the experience of the 1990's. That would imply further depleting our personal savings, ever-larger external deficits, and adding even more rapidly to our international indebtedness.

For the time being, confidence in the prospects of the U.S. economy, its financial markets, and its currency has remained strong, little shaken if at all by the generally unexpected current slowing of growth. Our leadership in innovation, the sense of increasing productivity and efficient management, and the stability of our political institutions help underlie that confidence. Those are precious assets. But, in my judgment, they are no cause for complacency. The huge and growing external deficits are a real cause for concern. They are symptoms of imbalances in the national economy and the world economy that cannot be sustained.

PREPARED STATEMENT OF WILLIAM DUDLEY

MANAGING DIRECTOR AND CHIEF U.S. ECONOMIST
GOLDMAN SACHS

JULY 25, 2001

My name is William Dudley. I am the Chief U.S. Economist for Goldman Sachs & Co. It is my pleasure to have the opportunity to testify before the Subcommittee on Economic Policy of the Senate Banking Committee. The views expressed in my statement are my own and do not necessarily reflect the positions or views of Goldman Sachs.

The United States has a large current account deficit, which has grown sharply in recent years. To date, it has not proved problematic for the U.S. economy or the U.S. financial markets. But this imbalance does create a risk. If foreign investors' appetite for dollar-denominated assets were to diminish, the result could be a sharp plunge in the value of the dollar and the potential for havoc in the U.S. bond and equity markets.

So how to minimize this risk? I would suggest three approaches:

1. Shift away from the so-called "strong dollar" policy. It is better to make that shift now when the demand for dollar-denominated assets is still strong and policy is credible, rather than under duress later.
2. Implement measures that increase the pool of national savings. This would reduce the dependence of the United States on foreign capital inflows.
3. Pursue policies that ensure the United States remains an attractive market in which to invest. This would help to keep foreign capital flowing to the United States.

Before I discuss in greater detail what should be done in response to the large U.S. current account deficit, let me just start with my assessment of the causes and likely sustainability of this imbalance.

In my opinion, the large current account deficit evident for the United States mainly reflects the disparity between the low supply of domestic saving and high demand for investment both in business plant and equipment and in housing. This imbalance has developed primarily for four reasons.

First, household saving has been depressed as a consequence of the long bull market in U.S. equities. The rise in the U.S. equity market generated a huge increase in household net worth. This caused households to save less out of their current income. The result has been a sharp fall in the personal saving rate to the lowest level since the Great Depression.

Second, investment spending on plant and equipment surged as a consequence of technological change, which lifted productivity growth, and the buoyant equity market, which reduced the cost of capital. Investment spending also probably got a boost from a bit of irrational exuberance as investors mistook profits generated from the boom for profits that were sustainable on a long-term basis.

Third, the buoyant economy stimulated household formation and the demand for housing, which also increased the demand for capital.

Fourth, the willingness of foreign investors to supply capital to the U.S. also exacerbated this imbalance. The appetite of foreign investors for U.S. assets kept the dollar strong and inflation low. This helped to foster a more robust stock market and encouraged greater investment.

Up to this point, the rise in the dependence of the United States on foreign capital has not created any great difficulties. That is mainly because foreign businesses have been eager to increase their direct investment in the United States and foreign investors to increase their portfolio holdings of dollar-denominated financial assets. In fact, the desire by foreign investors to increase their holdings of dollar-denominated assets has been so great that it has caused the U.S. dollar to appreciate significantly since 1995. The strength of the dollar, in turn, has helped to sustain the economic expansion by helping to keep inflation in check.

In general, the desire by foreign investors to increase their investment in the United States should be viewed for what it has been: A mark of the U.S. economy's success. Capital is flowing here readily because the U.S. economic system has been performing well. Many factors including credible fiscal, monetary, and trade policies, deregulation, a flexible financial system, and a transparent corporate governance and accounting framework have helped to generate high productivity growth and a healthy return on capital in the United States. These factors have helped to encourage the flow of foreign funds to the United States.

However, the dependence of the United States on foreign capital inflows does create a vulnerability that needs to be acknowledged. In particular, if the performance of the U.S. economy were to falter on a sustained basis, the appetite for dollar-denominated assets could decline sharply. The result would be a sharp decline in the dollar and the risk of havoc for U.S. financial markets. The consequence could be a vicious circle in which dollar weakness contributed to poorer economic performance, which, in turn, reinforced the dollar's slide.

There are three major reasons for concern. First, the U.S. current account deficit is already very large, expected to reach nearly $450 billion in 2001. This is big relative to both GDP—about 4 percent—and relative to the dollar value of U.S. exports—about 11 percent of GDP.

Second, the upward trajectory of the U.S. current account deficit evident in recent years must prove to be unsustainable at some point. To see this, consider that a rising current account deficit leads to greater net foreign indebtedness. Because the interest on this debt must be paid, the increase in debt will lead, over time, to a sharp deterioration in the net investment income balance. Without trade improvement, that implies an even wider current account deficit. The result is a vicious circle of climbing debt and interest expense that ultimately is untenable.

Third, the risk that foreign investors lose their appetite for dollar-denominated assets has already increased because the performance of the U.S. economy has deteriorated sharply over the past year. In particular, the growth rate of economic activity and productivity has faltered and corporate profits are contracting as the investment boom in technology has gone bust. The budget surplus is shrinking. Put simply, the notion of a "New Economy" is being called into question. If the economic rebound anticipated for 2002 disappoints, then the demand for U.S. assets is likely to lessen.

Up to now, prospects elsewhere have also diminished. However, if the gap in economic performance between the United States and the rest of the world narrows in the future, then it will become more difficult for the United States to obtain the same huge sums of foreign capital on favorable terms, for example, at low interest rates and a high dollar exchange rate.

Danger signs for the dollar are already visible in the shift in the composition of foreign capital inflows. The proportion of capital inflows consisting of direct investment, which is not easily reversed, has diminished sharply this year. In contrast, portfolio inflows, especially into corporate and agency bonds, have increased.

For example, in the first quarter of 2001, the rate of foreign direct investment into the United States fell to $41.6 billion, less than half the pace of the prior three quarters. Conversely, investment in private-sector equities and bonds increased to $147 billion, an all-time record.

The composition of these capital inflows is important. In contrast to direct investment, exit from publicly-traded securities is easy. Liquidation can occur quickly, with potentially destabilizing consequences to the dollar and financial markets. So what should be done to forestall such an outcome?

The goal should be to pursue policies that encourage a gradual path of adjustment—a smaller current account deficit and an increase in the national saving rate. Three major policy adjustments are appropriate.

First, the time has probably come to scrap the so-called "strong dollar" policy. To fail to do so now, when the demand for dollars is still strong, heightens the risk of a sharper adjustment later. It would not be pleasant if U.S. policymakers were forced to jettison the "strong dollar" policy under duress. The loss of credibility would tend to drive up the risk premium on dollar-denominated assets, necessitating a more painful economic adjustment.

A "strong dollar" policy made sense during the investment boom when the main risk was that the U.S. economy might overheat. After all, during the boom, a strong dollar helped to keep inflation in check. Now that the boom is over, the rationale for a "strong dollar" has lessened, especially as the dollar's strength is undermining the effectiveness of U.S. monetary policy and undercutting U.S. international trade competitiveness.

However, rather than call for a weaker dollar, which might provoke a sharp, destabilizing adjustment, I would shift the emphasis away from the dollar altogether toward the importance of having a strong and healthy economy. If the U.S. economy performs well, then foreign capital will flow here readily and the dollar will take care of itself

Second, policies should be pursued that would act gradually to raise the pool of domestic saving. This can be accomplished in two ways. Continued discipline in terms of fiscal policy is important. The fact is that the dependence of the United States on foreign capital would be much greater currently if the U.S. budget balance had not shifted sharply from deficit to surplus over the past decade. The improvement in the budget balance has enabled the national saving rate to remain generally stable in recent years, despite a sharp fall in the personal saving rate. Not only would slippage here reduce the pool of domestic saving, but it also might worry foreign investors that have invested large amounts of capital in the United States, in part, because of the improvement in the U.S. fiscal outlook.

Although the long-term fiscal outlook for the United States remains challenging given the impending retirement of the baby-boom generation and the increase in life expectancy, it pales in comparison to the challenges faced by Japan and Europe, which have less favorable demographic trends and bigger unfunded pension obligations. It is important that the United States not squander its advantage in this area.

In addition, the tax code could be changed in ways that encouraged greater domestic private saving. This might include additional incentives to save or a more radical revamping of the tax code to a consumption-based tax system.

Policies that raise the national saving rate would gradually reduce the dependence of the United States on foreign capital. Over time, this would reduce the risks of a sharp reversal in the appetite of foreign investors for U.S. assets.

Third, policies should be pursued that ensure the United States remains an attractive market in which to invest. This includes lowering trade barriers, investing in education in order to raise the quality of the U.S. labor force, and taking steps to make the U.S. capital markets more transparent and efficient. By creating a good environment for foreign investment—either direct or in financial assets, this would help to ensure that the flow of capital from abroad persists on favorable terms to the United States.

To sum up, the large U.S. trade imbalance is worrisome. A sharp shift in perceptions among foreign investors could lead to a collapse in the dollar that could conceivably destabilize the U.S. economy and global financial markets. The best way to deal with this risk is to keep the U.S. economy healthy through the application of prudent economic policies. If the U.S. economy remains more productive than its rivals and the U.S. capital markets remain deeper and more liquid, then the flow of foreign monies to the United States should continue relatively smoothly and easily. The current account deficit probably would ultimately shrink, but in an orderly way that would not disrupt the ability of the U.S. economy to grow and the Nation to prosper.

PREPARED STATEMENT OF STEPHEN S. ROACH

CHIEF ECONOMIST AND DIRECTOR OF GLOBAL ECONOMICS
MORGAN STANLEY

JULY 25, 2001

Mr. Chairman, I commend you in the Congress for looking at the U.S. economy's problems through a global lens. America's gaping balance-of-payments deficit is but one symptom of the stresses and strains of globalization. The angst of Genoa is another. Yes, there are unmistakable benefits of an increasingly integrated world economy, especially the opportunity to bring less-advantaged developing countries into the tent of global prosperity. But we can do a better job in managing our collective journey. The United States is hardly an innocent bystander in the momentous transformation that is now reshaping the global economy. We must take a leadership role in facing the challenges of globalization head-on. These hearings are an important step in that direction.

The world is in the midst of what could well go down in history as the first recession of this modern era of globalization. It is a recession whose seeds were sown in the depth of the financial crisis of 1997–1998. Under the leadership of Treasury Secretary Rubin, the United States played a key role in staving off what he called the world's worst financial crisis since the 1930's. It is an honor to share this platform with him this morning. But just as America moved aggressively to save the world nearly 3 years ago, it has paid a steep price for those noble efforts. That rescue mission fostered a climate that took the U.S. economy to excess—resulting in a destabilizing asset bubble, an overhang of excess capacity, and an extraordinary shortfall of consumer saving. It also left the United States with its largest balance-of-payments deficit in modern history. As you probe the implications of America's unprecedented external imbalance, I urge you to do so in this broader context.

A World In Recession

It has been a long march on the road to global recession. As recently as October 2000, the global economics team that I head up at Morgan Stanley was still calling for a 4.2 percent increase in world GDP growth in 2001. But then a series of shocks begin to take an unrelenting toll on our once-optimistic prognosis. First, came last fall's spike in energy prices. Then came the most devastating blow of all—an unwinding of the U.S. boom in information technology (IT) spending. Another downleg in world equity markets added insult to injury, especially in wealth-dependent economies such as the United States. And the rest is now history—an inventory correction, the earnings carnage, intensified corporate cost-cutting, and global reverberations of these largely American-made shocks. It was only a matter of time before the world economy crossed into recession territory.

According to IMF convention, the global economy is technically in recession when world GDP growth pierces the 2.5 percent threshold. And that is exactly the outcome we now anticipate. Over the past 9 months, we have slashed our once optimistic 2001 growth estimates repeatedly for the United States, Europe, non-Japan Asia, and Latin America. And we have pared further our long-cautious prognosis for Japan. As a result, we are now estimating a 2.4 percent increase in world GDP in 2001—0.4 percentage point slower than the crisis-induced outcome of 1998. Like it or not, 2001 is likely to go down in history as another year of global recession.

This is the fifth global recession since 1970. All of these recessions have one thing in common: They were triggered by a shock. The global recession of 1975 was a byproduct of the first oil shock. The downturn of 1982 was driven by the shock therapy of the U.S. Federal Reserve's anti-inflationary assault. The global recession of 1991 came about in the aftermath of another oil shock—this time the brief spike that led to the Gulf War. The downturn of 1998—the mildest of the lot—came about when a global currency crisis pushed most of East Asia into depression-like contractions. And the global recession of 2001 certainly stems, in large part, from America's IT shock.

The world economy is currently about midway through a three-stage downturn in the global business cycle. The first stage was dominated by the abrupt about-face in the U.S. economy in the final 6 months of 2000; as recently as the middle of last year, the economy was still surging at a 6.1 percent annual rate, whereas by year-end it had slowed to about 1 percent. Wrenching adjustments in America's IT and corporate earnings dynamics were at the crux of this transformation from boom to bust. While the forecasting community was quick to lower its sights on the U.S. economic outlook in early 2001, it was not as swift to diagnose the second stage of this cycle—surprisingly serious collateral damage to the broader global economy.

In retrospect, we should have seen that one coming. Courtesy of the new connectivity of globalization—expanded trade flows, globalized supply chains, and explosive growth of multinational corporations—the loss of U.S. economic leadership reverberated quickly around the world. The global trade dynamic has been especially important in transmitting this new contagion. By our estimates, the volume of world trade currently amounts to almost 25 percent of world GDP, essentially double the share prevailing in the 1970's. That reflects over 30 years of 6 percent annualized expansion in global trade volumes, fully 60 percent faster than the 3.7 percent average growth in world GDP over this same period.

Moreover, the world's dependence on cross-border trade became even more pronounced in the 1990's. Over the 1989 to 1997 interval, growth in global trade averaged 2.3 times the growth in world GDP. By contrast, over the preceding 17 years, the growth in global trade was only 1.4 times the growth in world GDP. With global trade accounting for a much larger portion of world GDP today than it did in the not-so-distant past, it exerts far greater leverage over the global business cycle. Out of that leverage has come a new strain of global contagion—linking the world economy more closely than ever before.

But now global trade, the glue of globalization, is screeching to a standstill. Our latest estimates point to just a 4.3 percent increase in world trade volumes in 2001, a deceleration of 8.5 percentage points from the record 12.8 percent increase in 2000. This outcome represents the steepest year-to-year decline in global trade growth on record, setting in motion a "negative accelerator" effect that is wreaking havoc on industrial activity around the world. If anything, our latest estimates may be understating the downside to global trade in 2001. Outright declines in the first half of this year—especially in the United States—suggest it will be a real stretch to hit our projected 4.3 percent increase for the year as a whole. That, in turn, underscores the downside risks to our global recession forecast.

The sharp deceleration in global trade is symptomatic of a world that had become overly dependent on the United States as the engine of global growth. Our estimates suggest that America accounted for close to 40 percent of the cumulative increase in world GDP in the 5 years ending in mid-2000. The United States-led slowdown in global trade also unmasks the world as being without an alternative growth engine. Once the U.S. economy slowed to a crawl, it quickly became apparent that there was no other candidate to fill to the void. The rest of the world has tumbled like dominoes—first non-Japan Asia, then Japan, America's NAFTA partners, and now Europe and Latin America. The result is a rare synchronous recession in the global economy.

Alas, there is a third phase to this global downturn, one that has yet to really play out. It will be defined by the feedback effects that could well take an additional toll on the U.S. economy. Two such impacts loom most prominent—the first being a likely downturn in U.S. exports brought about by the confluence of a weakening external climate and a strong dollar. Inasmuch as the U.S. export growth dynamic has only just begun its descent, there is plenty of scope on the downside; in global recessions of the past, America's real exports have declined by anywhere from 6 percent to 20 percent.

The other shoe about to fall in the third phase of the global downturn could well be the American consumer. This judgement is not without controversy. But as I see it, the case against the U.S. consumer is more compelling than at any point since the early 1970's. Saving short, overly indebted, and wealth depleted, consumers are about to get hit by the twin forces of layoffs and reduced flexible compensation—the year-end payouts granted in the form of stock options, profit sharing, and performance bonuses. Tax rebates notwithstanding, I believe that this confluence of forces will finally crack the denial that has kept the American consumer afloat. In my travels around the world, the wherewithal of the American consumer is at the top of everyone's worry list. A U.S.-dependent global economy needs the American consumer more than ever. I fear that the world is about to be in for a huge disappointment.

The Legacy of 1998

Alas, there is a more sinister interpretation of the events now unfolding: I do not believe that the current global recession should be viewed as merely the latest in a long string of isolated and unexpected shocks. Instead, I see it as more of a by-product of the previous crisis-induced downturn in 1998. If that view is correct, it would be appropriate to treat these two downturns as more a continuum of a drawn-out global business cycle—one that could well go down in history as the world's first recession of this modern-day era of globalization. Moreover, I would go further to argue that if the world does not get its act together, this type of downturn could well be indicative of what lies ahead—a more unstable and recession-prone global economy.

It all started in the fall of 1998. The global currency crisis that began in Thailand had cascaded around the world, eventually leading to Russian debt default and the related failure of Long-Term Capital Management. The result was what Federal Reserve Chairman Alan Greenspan dubbed an "unprecedented seizing up of world financial markets." United States President Bill Clinton and Treasury Secretary Robert Rubin went even further, both calling it the world's worst financial crisis since the Great Depression.

The Fed swung into action to save the world, leading the way with an "emergency" monetary easing of 75 bp in late 1998. Other G–7 central banks more or less joined in, albeit on the their own terms and with something of a lag. This led the Bank of Japan, which had just about run out of basis points, to adopt its now infamous ZIRP—zero-interest-rate policy. Europe also jumped in—belatedly, of course: First, there was a pre-ECB coordinated rate cut in December 1998 and then there was another 50 bp easing once the new central bank opened its doors in early 1999. Collectively, the authorities did what they do best—cutting official overnight lending rates in a classic reflationary ploy.

The world economy sprang back with a vengeance that few anticipated. The out-of-consensus "global healing" scenario that we embraced in late 1998 placed us very much at odds with financial markets that were positioned for global deflation and another year of ever-deepening crisis and recession. But we felt that the world had been given the functional equivalent of a massive global tax cut. It wasn't just the monetary easing, but it was also an IMF-led liquidity-injection of $181 billion in bailouts in Thailand, Indonesia, Korea, Russia, and Brazil, collectively worth about 0.5 percent of world GDP. The boost to industrial-world purchasing power brought about by cheaper Asian-made imports was icing on the cake. A seemingly resilient global economy accelerated sharply in the second half of 1999, and world GDP growth spiked by 4.8 percent in 2000—the fastest such gain since 1976. The footprints of global healing were unmistakable. So were the perils of its unintended consequences.

The Downside of "Global Healing"

In retrospect, global healing sowed the seeds of its own demise. It led to a false sense of complacency on two critical fronts: First, it created the climate that culminated in the Nasdaq bubble. The Federal Reserve was, in effect, easing aggressively at a time when the U.S. economy was already booming. In the midst of the Fed's emergency easing campaign, America's real GDP surged at a 5.6 percent annual rate in the fourth quarter of 1998. Far from faltering, the U.S. economy was on a tear. I cannot remember when such an aggressive monetary easing had occurred in the context of such an outsized gain in economic growth. Although our central bank began to take back its extraordinary monetary accommodation by mid-1999, by then it was too late—the damage had been done. Moreover, it was compounded by the Fed's now infamous Y2K liquidity injection of late 1999. America was on the brink of a runaway boom. A Fed-induced, Nasdaq-led liquidity bubble gave rise to the great IT overhang that has since wreaked such havoc on the United States and the broader global economy. Such was the legacy of global healing.

Global healing dealt another critical blow to the world economy. The tonic of vigorous growth dampened enthusiasm for reform. Asia rode the coattails of the same powerful IT-led U.S. growth dynamic. Indeed, we estimate that United States IT exports accounted for as much as 40 percent of non-Japan Asia's overall GDP growth in 2000. With growth like that, who needs reform? Everything that was wrong had seemingly been fixed—and quite quickly at that. At least, that was the implicit logic throughout Asia, as banking reform was put on hold, corporate restructuring stalled, and the old ways of crony-capitalism endured. Global healing was a powerful antidote for the region's devastating crisis—the cover that impeded long-overdue reforms.

The same was the case for any repair that was about to be made to the world financial architecture. Out of the depths of the crisis of 1997–1998 came renewed commitment by the major industrial nations to make the world a safer place for globalization. The great powers of the world insisted they had learned a most painful lesson. Commissions were formed—I had the pleasure of serving on one of them, sponsored by the Council on Foreign Relations. Recommendations on architectural reforms were put forth, only now to gather dust on bookshelves around the world. Sadly, the power of global healing tempered the urgency of these reforms, as well.

All this speaks of a world that has yet to come to grips with the full ramifications of globalization. The crisis of 1997–1998 was, in retrospect, a warning of what was to come. In increasingly connected world financial markets, systemic risks in the emerging world loom all the more potent—especially if the industrial world has been lagging on its own reform agenda. The current events unfolding in Argentina, along with the potential for a new round of contagion in Brazil and elsewhere in Latin America, are the latest painful reminders of just such a possibility. The quick fix of reflationary interest rate cuts is not the panacea for a Brave New World in need of fundamental reform. It is high time to face up to the heavy lifting that is needed to make globalization work. Until that occurs, I suspect the global economy will remain more recession-prone than ever.

A Fragile Global Recovery

As day follows night, recovery will, of course, come. It always does. But the real issue is the character, or quality, of the coming global upturn. Hope springs eternal on that score. Financial markets are lined up on the optimistic side of the 2002 outcome—yield curves have steepened, equity cyclicals have rallied, and next year's earnings expectations are brimming with optimism. The risk, in my view, is that the outcome for the United States and the broader world economy will not conform to these optimistic expectations—that the world will remain on a decidedly subpar growth trajectory.

Such are the realities of what has been dubbed a U-shaped world. By definition, a U-shaped upturn is a protracted period of subpar growth. Morgan Stanley's current baseline prognosis calls for 3 percent average growth in world GDP in 2001–2002—an outcome fitting that description to a tee. It depicts a world economy that falls short of its long-term growth trend by about 0.7 percentage point per annum over this 2 year interval. Moreover, I fear that risks could tip to the downside of the scenario, suggesting that the world's potentially chronic growth deficiency will become even more pronounced. In such a subpar growth climate, the risk of a recessionary relapse is high. The world economy will be lacking in both the leadership and the cyclical resilience that typically cushion unexpected blows. Little wonder the world has tipped so quickly back into recession in the aftermath of the crisis of 1998.

But there is a deeper and more profound meaning to this U-shaped world. On the one hand, it reflects a worrisome imbalance in the broader global economy—the world has simply become too dependent on the United States. Lacking in structural reforms, the world has been unable to unlock the efficiencies that would create new and autonomous sources of domestic demand. Instead, on the heels of a U.S.-led boom in global trade, the rest of the world took the easy way out—hitching itself to surging external demand. Only through structural reform can the global economy wean itself from excessive dependence on the American consumer and the U.S. IT cycle.

A U-shaped world also poses a major challenge to the United States: America must now begin the heavy lifting that is needed to come to grips with the painful legacy of a popped financial bubble. Rationalizing the great IT capacity overhang is at the top of that agenda, followed by a long overdue need to rebuild personal saving. The bubble took America to excess, and those excesses must now be purged. As I put the pieces of global economic recovery together, I worry most about the quality of the coming upturn. The quality factor hinges critically on the combination of reforms and structural change. Unfortunately, based on recent experience, there is little ground for encouragement.

This global recession is different. It is both the first recession of the Information Age, as well as the first recession in the modern era of globalization. As such, it should be viewed as a critical wake-up call. One can only hope it will trigger structural reforms that will rejuvenate domestic demand in the broader global economy. With any luck, it should also force America to come to grips with many of its own post-bubble excesses. If progress is made on those counts, a high-quality upturn in the global economy will ensue. If, however, the world sidesteps the challenge and squanders the opportunity for meaningful reform, a low-quality rebound will occur. That, unfortunately, would be a setup for an even more painful day of reckoning. The stakes are enormous for a world now back in recession.

America's External Imbalance

The United States has shouldered a heavy burden as the engine of global growth. Excesses have built in the structure of the domestic economy. That is the message from the Nasdaq bubble, a negative personal saving rate, and an outsize capacity overhang. At the same time, America's economic and financial relationship with the rest of the world has been stretched as never before. That is the message from a massive balance-of-payments deficit. All this poses risks on the dark side of the great American boom.

While there can be no mistaking the extraordinary performance of the U.S. economy in recent years, unfortunately, it has been built on a shaky foundation of increased foreign indebtedness. History demonstrates that such external imbalances cannot persist indefinitely. Something usually gives in response—the currency, other asset prices, or the economy. Steeped in denial, few worry of such consequences. Therein lies a key risk for the global economy and world financial markets.

America's current-account deficit hit 4.4 percent of GDP in 2000, and, by our estimates, is likely to hold near that share through 2002. That qualifies as the widest external gap of the post-World War II era—a full percentage point larger than the previous record of 3.4 percent in 1986–1987. We should avoid the slippery slope of looking to our trading partners as scapegoats. Our balance-of-payments deficit should not be viewed as an indication of a competitive assault on American markets. It is not a Japan problem, or a China problem, any more than it is a NAFTA problem involving Canada and Mexico.

If there is a scapegoat, it can be found in the mirror. America's external imbalance is, instead, more a reflection of serious flaws in the macro structure of the U.S. economy—namely, a chronic domestic saving deficiency. From an accounting point of view, national investment must always equal saving. Consequently, when there is a lack of saving, one of two things has to happen: Either investment must be reduced or an alternative source of saving must be uncovered. America has opted for the latter of these options. A shortfall in domestically generated saving has been augmented by an inflow of saving from abroad—inflows that can only be attained by running a massive external deficit.

The imbalance between domestic saving and national investment has not come out of thin air. It is very much a hallmark of America's bubble economy. Five years of excess returns in the U.S. stock market—with the broad Wilshire 5,000 surging by an average 25 percent per annum. over the 1995–1999 interval—led to serious distortions of both consumer and business sector behavior. Consumers became convinced that an ever-rising stock market had become a permanent new source of saving. As a result, they drew down their income-based saving—with the conventionally measured personal saving rate—national income accounts basis—falling from a pre-bubble 6.6 percent in late 1994 to a negative 1.2 percent in early 2001. Why should American workers save out of their paychecks if the stock market was automatically performing this function? Similarly, Corporate America became convinced that IT investment was a surefire recipe for enhanced returns in the stock market. The IT-led investment cycle soared in response, with business capital spending hitting a record 13.9 percent of nominal GDP in late 2000.

This juxtaposition between negative personal saving and record investment spending was a classic recipe for an ever-deepening current account deficit. Ironically, it occurred at precisely the moment when the Federal Government was getting its fiscal house in order—moving from being a dis-saver to a saver by transforming seemingly open-ended budgetary deficits into surpluses. Indeed, Government net saving—Federal, State, and local, combined—moved from a pre-bubble deficit of 2.8 percent of nominal GDP in the fourth quarter of 1994 to a post-bubble surplus of 3.1 percent of GDP in early 2001. Unfortunately, this 5.9 percentage point positive swing in greater public sector saving was more than offset by the 7.8 percentage point decline in the personal saving rate. As a result, the net national saving rate—a broad aggregate that includes personal, business, and public saving—stood at only 4.8 percent in the first quarter of 2001; that is little changed from the pre-bubble reading of late 1994 and less than half the 10 percent average of the 1960's and 1970's. Such a saving-short U.S. economy had little choice other than to turn to foreign investors to finance its investment boom.

In retrospect, it is not surprising that an asset bubble produced this unstable state of affairs. Just as American consumers and businesses came to believe that ever-ebullient equity markets had become a new source of saving and excess return, so did foreign investors. They became more than willing to invest in dollar-denominated assets. Portfolio inflows surged from abroad, as did foreign direct investment, especially through a surge of European-led cross-border merger and acquisition activity. Largely as a result, foreign investors currently own 37 percent of U.S. Treasuries, 46 percent of corporate bonds, and 11 percent of equities. It was the ultimate in virtuous circles. America's New Economy prowess won over converts at home and abroad. The rest of the world was dying to buy a piece of the action, and so there was little reason for foreign investors to exact a premium on dollar-denominated assets. That is exactly what should happen in a financial bubble—that is, until it pops.

A Venting Of Excesses

Yet, this is not a sustainable course for any nation. It depicts a U.S. economy that is now living well beyond its means, as those means are defined by the domestic capacity to fund its investment needs. That, in my opinion is the painful legacy of a financial asset bubble that took our real economy to excess. Consumers have overspent. Businesses have over-invested. And the United States funded these excesses by borrowing from abroad. There is no telling when the music will stop. The longer this state of affairs persists, the greater will be the temptation to ignore its consequences. But the math is straightforward: If left unchecked, an ever-widening current-account deficit raises the debt-servicing burden of international indebtedness to onerous levels. And an increasingly larger share of domestically generated income will have to be exported to offshore creditors, who, in turn, establish an ever-larger claim on the ownership of dollar-denominated assets. An ever-widening current-account deficit implies that foreign investors will ultimately end up “owning” America—unless, of course, something gives. And it usually does.

What should give, in my view, will be the high-flying U.S. dollar. In the interest of full disclosure, I have been wrong on the dollar for close to a year. I felt the dollar would finally fall as the United States veered toward recession. I also felt the current-account deficit would exacerbate the correction, once it got going. Over the past several years, however, the dollar call has not been driven by the current account—instead it has been all about capital flows. The rest of the world wanted a claim on America’s New Economy prowess and has been willing to pay up to get it. And despite the ever-widening current-account deficit, the dollar has soared. A broad index of the real trade-weighted value of the dollar is up 31 percent since late 1994 to a level that now stands just 12 percent short of its all-time high in March 1985.

Like any currency, the dollar, of course, is a relative price. If you are negative on the dollar, you have to give careful consideration to the alternatives. This has not exactly been a year to fall in love with yen- or euro-denominated assets. But I suspect their day is coming. First of all, I continue to believe that the U.S. economy will surprise on the downside. While the case for outright recession is admittedly arguable—although one that I continue to embrace—I remain convinced that any recovery is likely to be muted. That would most assuredly dampen the likelihood of an earnings resurgence that would validate the New Economy play still priced into the strong dollar.

At the same time, I believe that global investors could well begin to flirt with reform stories in both Japan and Europe. Indeed, the micro evidence of corporate reform is building in Japan. At the same time, structural change in Europe looks increasingly impressive—underscored by tax and cost harmonization, improved labor-market flexibility, enhanced shareholder value cultures brought about through cross-border merger and acquisition activity, and ongoing deregulation. Politics remain the major impediments in both cases, in my view. If Prime Minister Koizumi, the reformer, carries the day in the upcoming Japanese Upper House elections, Japan’s political risk premium could start to narrow. And if European politicians start pulling together—seemingly a stretch right now—the euro might rise as well. The dollar could then finally be in trouble, with its downside exacerbated by an outsized U.S. current-account deficit.

History shows that massive current-account deficits eventually trigger currency depreciation. The key word in this statement, of course, is “eventually.” Economics often does a good job of revealing the endgame. Timing is a different matter altogether. But the lessons of the second half of the 1980’s should not be forgotten: A then-record current-account deficit set the stage for sharp depreciation of the U.S. dollar. I see no reason to believe that the endgame will be any different this time around.

But not only could the dollar give—so, too, could America’s current-account deficit. Usually, it takes a recession to force a major current-account adjustment. That is what is required to reduce domestic demand—and the import content of such spending. That was the case in the early 1990’s when the United States last dipped into a mild recession. The current account went from a deficit of 3.4 percent of GDP in 1987 to virtual balance in 1991—an outcome assisted by the inflow of foreign payments that helped finance America’s military efforts in the Gulf War. If I am right and the U.S. economy slips into a mild recession, an import-led current-account adjustment could well be in the cards over the next year, as well.

Courtesy of the bubble-induced excesses of the 1990’s, America is still living well beyond its means. Foreign investors have been more than willing to subsidize a profligate U.S. economy. The combination of an overvalued dollar and a massive current-account deficit underscores the tensions that have arisen from this state of affairs. These distortions are not sustainable for any economy. As the U.S. economy now begins to vent its post-bubble tensions, dollar and current-account adjustments seem more likely than not. And, by the way, that is the last thing most investors currently expect.

Backlash Against Globalization?

Where might this all take us? The most worrisome possibility is that trade liberalization might give way to some form of protectionism. To the extent that slow growth prompts mounting layoffs, the political winds could well shift. The outcome might lead to the erection of new competitive barriers that would supposedly shield workers from the harsh winds of globalization. While the body politic has steadfastly resisted this temptation, there may be a change of heart as the world now slips into recession.

Public opinion polls reveal that U.S. workers oppose several aspects of globalization—especially trade liberalization, immigration, and foreign direct investment. (See Kenneth F. Schreve and Matthew J. Slaughter, *Globalization and the Perceptions of American Workers,* published by the Institute for International Economics, February 2001.) Even during goods times, according to these polls, the benefits of globalization are thought to be largely outweighed by the costs. In tougher economic times, that resistance can only intensify.

Moreover, there is a gathering sense of anti-American sentiment around the world. In my travels, I have heard firsthand more than one distinguished European leader sarcastically describe globalization as "economic integration according to American rules." The Asian crisis took this resentment to a new level. Crisis-torn countries in the region deeply resent IMF-led bailouts that sent their economies into depression-like contractions from which many have never really recovered. With the United States the IMF's largest shareholder and the major architect behind the stringent bailout packages of 1997–1998, America is blamed for much of which still ails Asia. The recent escalation of sino-U.S. tensions underscores a different strain of this same animosity.

In my visits to Japan I detect a similar sentiment; the logic goes something like this: "We followed your policy recommendations, and look where they got us." Ongoing trade skirmishes between the United States and Europe—to say nothing of the recent dispute over the GE-Honeywell merger—are part of this same script. Fair or not, the legitimacy of such claims is not the issue. Anti-American sentiment is a growing problem around the world. The widening of income disparities between rich and poor nations over the past century adds insult to injury. Globalization is not perceived as the rising tide that lifts all boats. Instead, it is increasingly thought of as the wedge of disenfranchisement. In theory, globalization is all about a shared prosperity—bringing the less-advantaged developing world into the tent of the far wealthier industrial world. But, in reality, when there is less prosperity to share, these benefits start to ring hollow. As the world economy now tips into recession, the assault on globalization can only intensify. That is the tough message from the streets of Genoa.

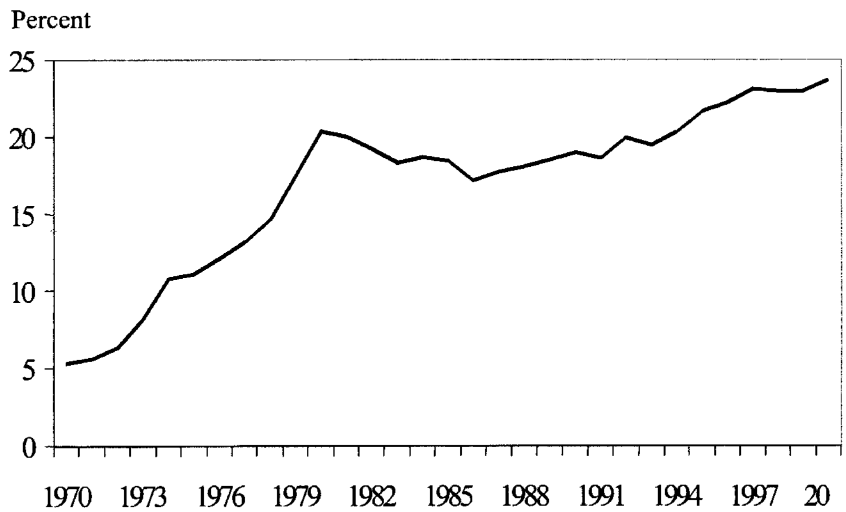
Mr. Chairman, if this hearing accomplishes one thing, it should underscore America's commitment to globalization and the principles of free trade on which it rests. Protectionism is antithetical to everything that globalization stands for. However, if a backlash arises, protectionism could be the gravest risk of all. While the voices of dissent are few, they are growing louder. Yet this is not a time to turn back the clock and single out scapegoats for a world in recession. America's gaping current-account deficit should not be viewed as a lightning rod for pointing fingers at our trading partners. It is a by-product of the profound imbalances that lie at the core of the global economy—a world that has become overly dependent on a saving-short United States as the engine of global prosperity. Yet it is also a by-product of an American appetite for excess—and our willingness to rely on foreign capital to sustain that excess. It is time to face these excesses head-on.

There is no guidebook to globalization. We are learning along the way. It is inevitable that we will stumble from time to time. Fortunately, our system is strong enough to give us valuable feedback at critical junctures. This is one of those wake-up calls. The world economy is back in recession for the second time in 4 years. That, more than anything else, is an unmistakable sign of stresses and strains in the very fabric of globalization. Don't be tempted by the quick fix as you frame policies aimed at enhancing United States and global prosperity. The heavy lifting of reform and structural change is really the only way to make globalization work. We must not squander this opportunity.

Thank you very much.

Figure 1

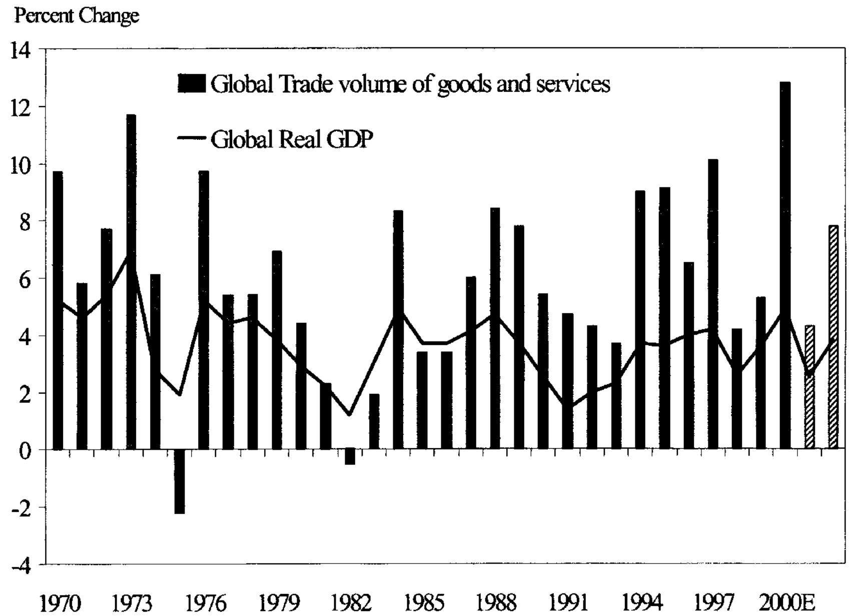
Global Trade Share of World GDP



Source: International Monetary Fund, Morgan Stanley Research

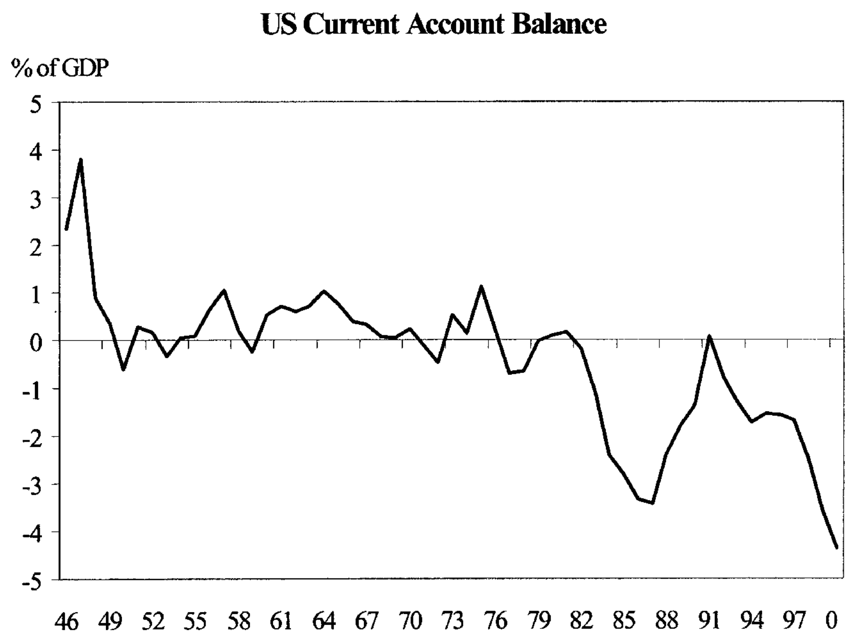
Figure 2

World Trade Growth



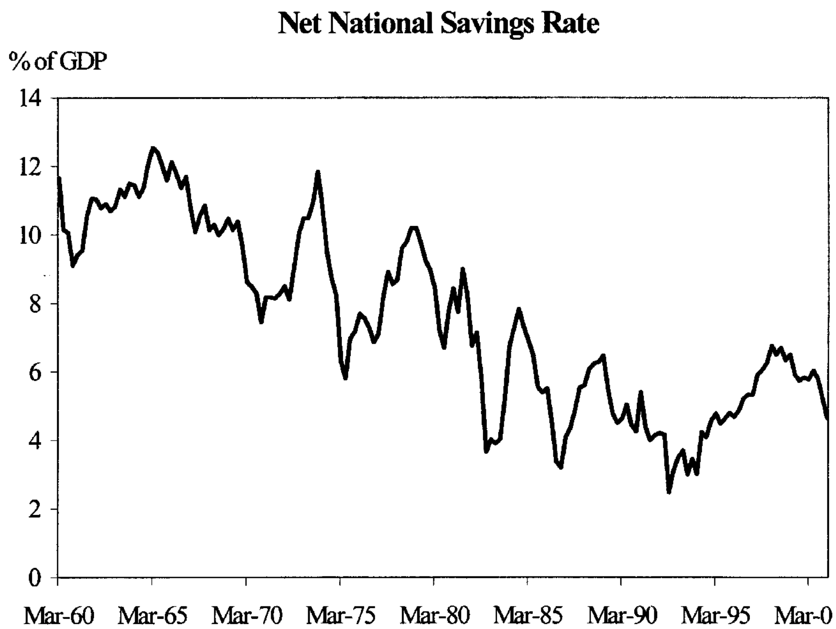
Source: International Monetary Fund, Morgan Stanley Research

Figure 3



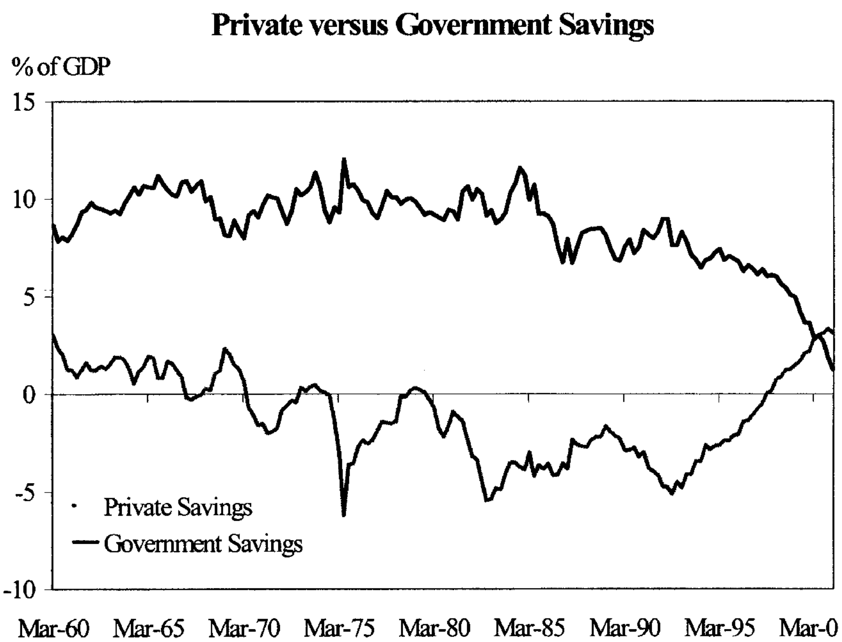
Source: Bureau of Economic Analysis

Figure 4



Source: Bureau of Economic Analysis

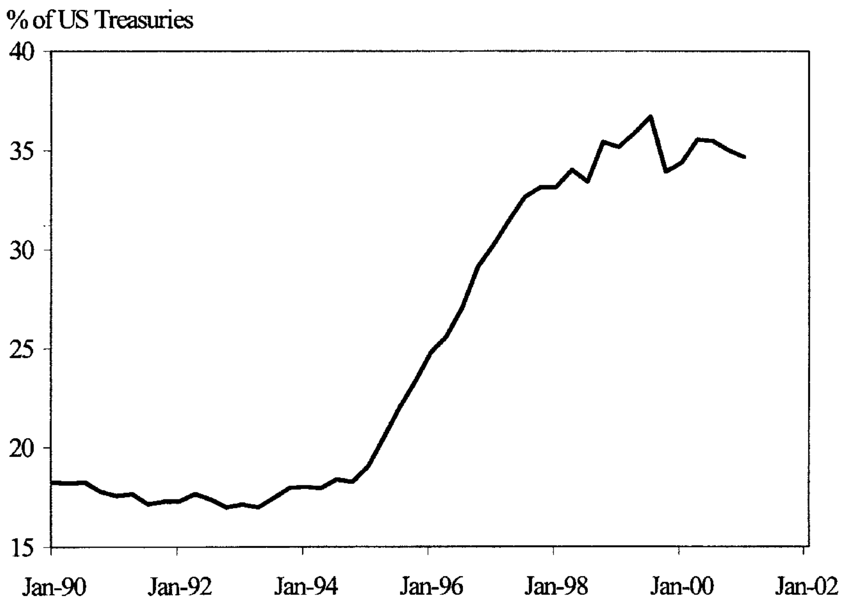
Figure 5



Source: Bureau of Economic Analysis

Figure 6

Foreign Ownership of US Treasuries



Source: Federal Reserve Board, Flow of Funds

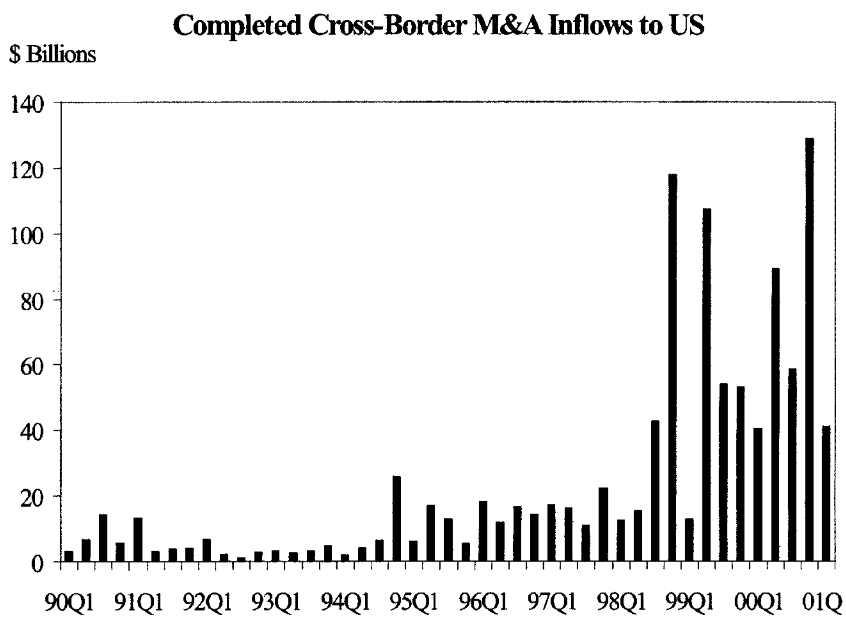
Figure 7

Source: Federal Reserve Board, Flow of Funds

Figure 8

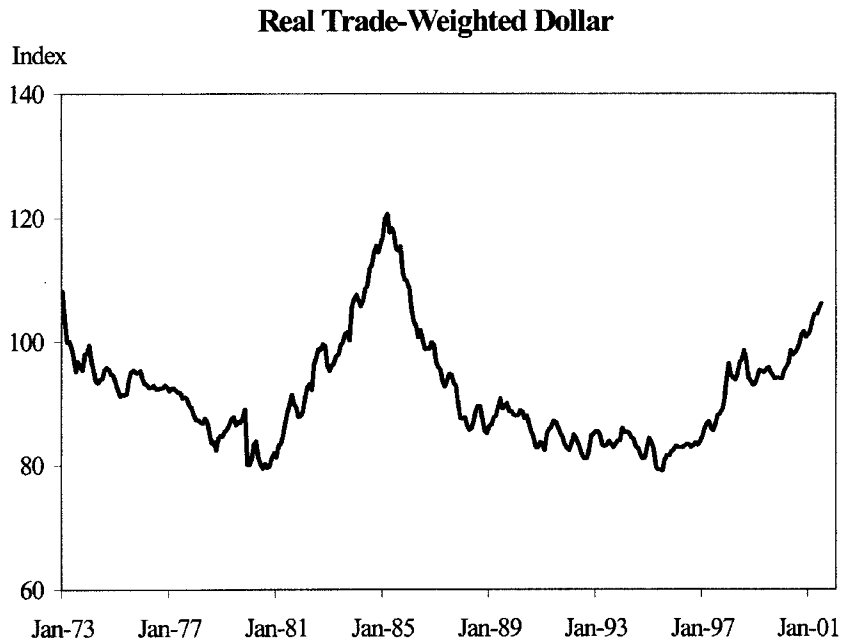
Source: Federal Reserve Board, Flow of Funds

Figure 9



Source: Thomson Financial Securities Data

Figure 10



Source: Federal Reserve Board

The U.S. Current Account Deficit As A Share of GDP