MR. FEKETEKUTY: Thank you, Mr. Chairman. I also have four points to make. The first one is that the short-term impact of the trade deficit is undoubtedly modest and benign. It has allowed us to consume more goods and services; we’ve had less inflation; it has allowed the Fed to run a policy that has resulted in lower interest rates. And, undoubtedly, it has also contributed to the run-up in the stock market, because it gave foreigners more assets that they could invest in the U.S. stock market.

However, I do worry, like Dr. Preeg, about the long-term cumulative impact of the accumulation of liquid dollar balances held by foreigners. The increasing stock of those dollars exposes us to shocks when foreigners decide to readjust their portfolio. And that undoubtedly will increasingly constrain the freedom of U.S. macroeconomic policymakers. It exposes us to the effect of shifts in foreign dollar holdings whenever foreigners for one reason or another lose confidence in the future of the American economy.

There is a longstanding argument over tradeoff between Wall Street and Main Street. It is hard to talk about the impact of the trade deficit without thinking about the corrective policies.

There is no adequate solution on the trade policy side. An attempt to correct the trade deficit through import measures would clearly trigger an equivalent response by foreigners, which, in turn, would have a very negative impact on domestic and world growth.

We can always try to do a better job in persuading foreigners to reduce trade barriers, but, as Carla knows, we’ve tried just about everything, and I’m not sure how much room there is to squeeze more out of that process.

This brings us back to macroeconomic policy. I don’t believe we would want to throttle the economy for the sake of the trade deficit.

This brings me to the final point and that is our policies demand the use of the dollar as reserve currency. Obviously, the use of the dollar as a reserve currency tends to push up the exchange rate and tends to increase our deficits over time. And here's where the debate between Wall Street and Main Street comes in. We have tended to maintain policies that favor the use of the dollar as a reserve currency. The question is whether we could reduce the trade deficit by encouraging the use of alternative assets as reserve currencies by other countries.

I remember -- a little small historical

note -- when I was at the Council of Economic Advisors in the early '70s. We were engaged at that time in the big debate on flexible versus fixed rates and Paul Volcker was trying to maintain the fixed rate. We in the Council were arguing for flexible rates, because we believed that this would give us not only more flexibility in managing macro policy but also would reduce the tendency for the government to intervene in capital flows and trade for the sake of the trade balance, the flexibility provided by flexible rates.

We may have oversold. The use of flexibility in macroeconomic management has too frequently led to a fiscal monetary mix that used shifts in trade as the balancing mechanism, and that has its costs.

As Dr. Preeg mentioned, the costs are at the microeconomic level, because a shift in exchange rates leads to a shift from tradable into non-tradable or from non-tradable into tradables. These shifts inevitably impact on industries that are particularly sensitive in international trade. And, of course, we see the results, more recently, in the request of the steel industry for protection.

This time around, the chorus for protection has not been as loud as it was in the '80s, when many of our key export industries were suffering -- industries such as farm equipment and construction equipment. And, of course, on the import side, many of our basic industries such as the steel industry, the auto industry and the chemical people were imported.

This time around the reaction hasn’t been quite so large, partly because we’ve run a full employment economy, partly because the foreign investments have altered the degree to which foreign producers find it in their interest to take advantage of lower exchange rates to expand market share. The auto industries hardly showed any response in this most recent period, but we did see an impact in the steel industry.

I do worry that our macroeconomic policy managers too often ignore the impact of their policies at the micro level. They leave it to the trade policymakers to clean up the mess.

Thank you very much, Mr. Chairman.