

DR. DUGGER: Yes, thank you.

It's an honor to be asked to testify here before the Trade Deficit and Review Commission. I will build on my colleague Dr. Bill Dudley's comments. I agree with virtually everything he said.

My comments will focus on just two aspects of this question, first, the adjustment process itself, sort of the mechanics of it, and some comments about the history, sort of historical foundation for why we have a current account, capital account balance that we have.

My principal findings are on the first page of my written testimony. There are nine of them, probably ten, but I just listed nine. The large U.S. current account deficit in foreign capital inflows are the result of a long economic history, the backwardness of our trade partners, and an important unstructured aspect of the U.S. economy.

America's high consumption, low savings orientation constitutes what is, quote, unquote, old about the U.S. economy and its what is unstructured.

The old U.S. economy served to support the import substitution and export led growth strategies of key Asian and European allies during the Cold War decades. The U.S. has been able to continue its consumption savings pattern because trading partner

countries have had less competitive and less restructured business investment environments.

Capital in business prefers the legal, accounting, and governance frameworks of the United States. The U.S. current account/capital account adjustment path will be determined by:

(a) The perceived amount of needed restructuring, and

(b) The aggressiveness of restructuring activity whether it is the result of government policy or not.

The trigger for the U.S. adjustment will be a financial market recognition that effective restructuring changes are underway in trading partner countries.

Capital will flow into trading partner economies where restructuring needs are great and restructuring reforms are actively underway.

The adjustment speed will be amplified by an upturn in U.S. savings rates triggered by the initial phases of that adjustment. Real interest rates will rise and, quote, unquote, old economy, high consumption, low savings paradigm will begin to shift.

The adjustment process will be most stable if the U.S. savings rates are made as high as possible before it begins.

Putting this discussion in currency terms, which is really the way I discuss it, I focus more on the capital account than the current account. As Bill on my right pointed out, the capital account and current account issues are inextricably linked. Because capital can move more quickly than trade, the adjustment process is likely to begin in the capital account, and therefore, I focus on that.

It is likely that the dollar will fall relative to other world major currencies, the Euro and the yen. And most importantly is that the dollar's decline may surprise policy makers and market participants for the same reason they were completely surprised by the speed and depth of the Asian downturns.

They did not give adequate consideration to economic history in assessing down side risk. Governments and markets are equally likely to be surprised by the speed -- they were surprised by the speed of the Asian upturns. They did not anticipate how rapidly capital will flow into countries when restructuring is clearly underway in those countries.

The future of the Euro, the dollar, and the yen and the adjustment of the U.S. current account deficit will depend on the degree to which actual restructuring deviates from baseline market

expectations. The focus of my comment this morning is that the current baseline market expectation does not give adequate weight to historical or market forces.

There will be a current capital account adjustment. That's unavoidable. Whether the adjustment is smooth or stable depends on the mechanics of the process.

On page 3 of my written testimony, I give the two key elements of this adjustment process as I see them. To understand the U.S. current account adjustment path, it is essential to keep in mind that usually the worse a country's economy conditions are, the higher its potential marginal rate of return on investment is. That is, the worse a country's conditions, the more attractive it is to investors once true restructuring reforms are initiated.

When real restructuring reforms get underway, potential becomes expected and currency markets begin to do what they're supposed to do, that is, allocate capital to its highest expected marginal rate of return.

Two rules follow from this. First, when restructuring initiatives are not underway or are very slow, capital flows to the countries with the lowest amount of needed restructuring. Generally these

countries have lower taxes, are more productive, and are growing faster.

Second, however, when restructuring efforts are actively underway, capital flows to the country whose restructuring needs are the greatest. Its expected marginal return on investment is higher.

A recent example of the first rule is the United States versus Europe. Examples of the second are Japan versus Europe and the emerging market countries, like Brazil, versus both Europe and the U.S. together.

I have provided some familiar data on capital flows between the United States and Japan and Europe and generally, as you all know, the U.S. has been a beneficiary of very substantial flows from Europe over the past several years, has been a net contributor of flows to Japan.

A month ago, President Deussenberg of the ECB told the German newspaper Morganpost that he was convinced Euro weakness against the dollar reflects disparities between U.S. and European growth rates and the unfinished job of structurally reforming European national economies.

Mr. Deussenberg is correct, but his comment is correct with respect to the first rule and the relationship between the United States and Europe. His

comment omits mention of the yen and, in so doing, he highlights the second rule.

Despite the fact that Euro area growth in 1999 was uniformly stronger than Japanese growth, global investment managers allocated capital in far greater amounts to Japan. The reason was expected structural change.

Rightly or wrongly, last year market participants believed the prospects for structural reform were greater in Japan than in Europe over the same time horizon. They were so confident in their view they allocated over 120 billion to Japanese portfolios and direct investments, about \$10 billion a month.

In Europe both the perception of the need for structural change and actual reform efforts appear to be less than in Japan, but they are clearly increasing. I would introduce yesterday's New York Times business page discussion of the German economy as an example of this rapidly changing perception of markets, U.S. versus Europe.

The Euro is bringing new competitive forces to bear on old protected economic sectors. The ECB is assuring the monetary stability that is so vital to nurturing individual initiative and entrepreneurial

spirit. Reform is beginning to happen ironically under center and left governments.

It is not reasonable to think that the net flow from Europe will continue to be 125 billion a year into U.S. investments. We need to ask ourselves what would happen to the dollar if the net allocation fell to, say, 85 billion, the amount allocated to the United States in 1998.

Those who doubt large allocated changes can occur quickly need to look again at the shifts in allocation that have taken place in just the last 18 months.

CHAIRMAN D'AMATO: Two minutes.

DR. DUGGER: The capital flows from the U.S. and Europe into Japan last year were the result of Rule 2. When restructuring efforts are actively or more or less equally underway, capital flows to the country whose restructuring needs are the greatest.

Europe is beginning to restructure. Equity shareholder rights groups are springing up everywhere, as have proxy research services. If it all goes ahead well, as I expect it will, it will unleash a major wave of restructuring. The resulting gains in capital productivity investment, some experts say, will increase GDP by one percent over the next three years.

Europe is changing, and history is going to catch up with the United States.

Thank you.

CHAIRMAN D'AMATO: Thank you very much, Dr. Dugger.

Mr. Hale.