

MR. HALE: Yes. Thank you very much for the opportunity to address this Commission.

I begin by stressing the point that I think you should be focusing on two issues, not just the trade deficit itself. The trade deficit is obviously quite awesome. It's \$400 billion, and because of the big rise in oil prices now occurring in global markets, it could be in 12 months' time moving towards \$500 billion.

But the more systemic concern, I think, of this Commission should be the growth of America's overall net external deficit on investments.

When this whole process of America running current account deficits began in 1981, this country had external assets equal to about eight percent of GDP. By the end of this year, it will have net external deficit of almost 20 percent of GDP, which is quite an awesome number by historical standards.

Some medium size and small countries, such as Australia or Canada, have external investment deficits of 30 or 40 percent of GDP and have sustained that for quite some time, but with the arithmetic of the American current account today, we could be there in just three or four years and, in fact, keep growing exponentially unless there's some major change in the configuration of global growth to permit the U.S. again

to run perhaps in seven or eight years' time a trade surplus.

So the focal point, I think, of your Commission as we go forward should not just be the trade deficit, but the sustainability of America as a large, external borrower indefinitely, with perhaps in three or four years' time an external deficit on investments of 30 or 40 percent of GDP.

I'd now like to focus first on the cause of the trade deficit; secondly, it's financing; and, finally, to review some of the issues we've just heard discussed in terms of the policy implications.

The first point I would stress is the major cause of the deficit is the global business cycle. The U.S. has been in recent years a high growth economy. Other regions have been quite depressed because of a combination of both cyclical and structural problems.

I would also add the configuration of this deficit in our domestic savings and investment account is quite different from ten years ago. In the 1980s, the major cause of our current account deficit was the budget deficit. We had a higher private savings rate in those days.

Today it's the reverse. Our private savings rate is very low. Private investment is very

high, and the counterpart is the need for external capital.

Ironically, the Asia crisis of two and three years ago greatly magnified the deficit in two ways: first, by depressing exports, but also, more importantly, by boosting American domestic consumption.

The Asia crisis was very stimulative to the U.S. economy in three years.

First, it occurred at a time when America was approaching full employment and there was great pressure on the Federal Reserve Board to raise interest rates. As a result of the Asia crisis we went to a neutral, and then to a stimulative monetary policy, generating tremendous growth demand for homes and durable goods.

Secondly, the Asia crisis also lowered our inflation rate quite significantly, boosting consumer income and also magnifying the optimism in the financial markets.

And finally, it also gave America a further claim in 1997 and '98 to the world's surplus liquidity, and the major outlet for this surplus liquidity was the financial markets of New York and Western Europe, again, magnifying our stock market boom, boosting household wealth, and also reinforcing the other

factors encouraging tremendous growth in domestic consumption.

In the absence of the Asia crisis, we would have had, I think, a much more subdued domestic consumption environment one and two years ago because without the Asia crisis, we would have had higher interest rates, a somewhat higher inflation rate, and therefore, a less buoyant stock market, as well.

If we decompose the trade deficit, we'll see that there are no real indications of major competitiveness problems. The growth of imports in recent years has been concentrated in non-technology goods.

If we look at the non-technology goods component of our GDP, we'll see that the import share has gone from 25 percent to about 34 percent since 1995. If we then look at the high technology component, the import share has been very static in the 13 and 14 percent range.

I would also add that we have a tremendous amount of income in our corporate sector generated from the offshore operations of U.S. companies. Their aggregate sales outside this country are \$1.3 trillion compared to exports a year ago of \$612 billion.

So the bottom line is we have a cyclical problem in the world economy which has greatly

magnified this trade deficit, and ironically, because of the interaction of the Asian crisis with our monetary policy and our financial markets, it magnified it in two ways, not just depressing exports, but also boosting domestic consumption.

The second important issue we should focus on is the financing of the current account deficit. The previous speakers have already commented on this, but I'll just highlight a few things further.

First, we have tremendous access to the world's capital at the current time because of the great enthusiasm and optimism there is in financial markets everywhere about the U.S. economy and, in particular, the U.S. technology sector.

There has been in recent years a dramatic change in the configuration of our stock market. Today the technology component of our market is worth \$4.4 trillion, compared to \$300 billion ten years ago.

Today technology is one third of our stock market. Telecoms are further 12 percent, entertainment three percent. So almost half of the stock market capitalization of the United States today is in the areas thought to be most attractive and most exciting among global fund managers.

This has produced a tremendous flood of capital into our markets both through portfolio

investment, as well as through M&A activity. Because of the openness of our asset markets, because of the lack of barriers here to both FDI and takeover activity, these money flows are quite awesome.

A few numbers put it in perspective: FDI is now running at a rate in recent quarters of \$200 billion dollars per annum, and a large share of this is merger and acquisition activity.

In the U.S. last year, there were \$1.7 trillion of merger activity compared to 550 billion in the whole of Europe, and half of Europe's M&A activity was in one country, the United Kingdom, a country which has asset markets analogous to our own. There are far more barriers, as Rob Dugger indicated, to such activity in continental Europe.

And in Japan, M&A activity is still in the tens of billions of dollars. That's a big increase from five years ago, but still very modest compared to this country.

So because of this technology boom, because of this enthusiasm for our equity market, the financing of our current account deficit has posed far fewer challenges than the financing did ten years ago. In that period, the late 1980s, we often depended heavily on central bank intervention by Japan and other countries as they recycled their official reserves into

dollars to compensate for occasional interruptions in private capital flows.

In the last year, foreign central banks have actually been net sellers of dollars on a modest scale because the foreign demand has been so great. An important question for us to focus on over the next 12 to 18 months is whether there will be any event that might puncture these large, private capital flows and set the stage for a funding problem that would lead to a weaker dollar and higher interest rates.

I think there are three issues we should focus on to get a sense as to whether we'll have a funding problem in 2000 or 2001. The first and most important, of course, is whether confidence in the U.S. economy will remain at a high level. Will people continue to believe in the monetary policies of Alan Greenspan and in the broad support for the technology boom that's going on in the country generally.

My current conclusion is that the policy from the standpoint of foreign investors will stay positive here in the year 2000. Alan Greenspan is now trying to address the risk of inflation, an overly exuberant domestic demand, by raising interest rates gradually, I believe, we can continue this process for the time being without puncturing Wall Street on a scale that would jeopardize capital flows.

Obviously if at some point he has to raise interest rates quite dramatically, that could then set the stage for a stock market correction and perhaps also a big dollar correction, but I don't see that in the near term. I see a continued process of monetary gradualism to slow the economy at an incremental rate, not a dramatic rate.

The second possible risk, as already mentioned by Rob Dugger, is that there's a major change in the global economy. It would redirect capital flows from the United States, and here again I see tremendous changes underway which will, over time, encourage more growth in the global economy and create alternative investment opportunities.

But the rate of change will, I think, also be gradual. Let's just consider the issue of stock market capitalization. As I have mentioned, we have \$4.4 trillion in information technology companies. If we look at Western Europe, the share there is still very modest.

There's a brand new stock market in Germany called the Neurmarkt. It's three years old. Its market cap is now 200 billion, 200 companies.

There's a company in Finland called Nokia, whose market cap is now 240 billion.

There are also a number of smaller companies in Britain and France in the Internet sector, but we can't even find in the whole of Western Europe a trillion dollars of stock market capitalization in the IT sector. It simply isn't that big a phenomenon there.

If we go to Japan, we'll see there's been a major change over the last year in the configuration of that stock market. There's now two or three IT companies with a cap equal to ten percent of the Japanese stock market, but again, we're talking here about three or \$400 billion.

There are a number of new IT companies as well in Hong Kong, in China, Australia, but again, if we add it all up, we're talking a couple hundred billion dollars.

So long as markets remain excited about technology as an investment concept, as well as the spin offs in telecom and entertainment, I think the American stock market will be quite competitive.

But there's no doubt if we go out two or three years there will be a change in the global business cycle, bringing stronger growth elsewhere, and as a consequence of monetary policy, more subdued growth here, and that could over two or three years set the stage for a dollar correction. But if it happens

incrementally, that could be a benign event because it would also facilitate a change in the trade deficit.

I would like to think if we go out two or three years the trade deficit here will be ready to fall quite significantly as a consequence of more modest growth here in domestic consumption and faster growth overseas.

The challenge is to have this process occur gradually and without financial market disruption. As Rob indicated, capital markets can easily overshoot once you change the trend.

The final risk, of course, is that we're about to go through a presidential transition. This Administration has in recent years supported a strong dollar policy. That's been good for confidence in the markets.

If there is a change of government in the new year, we will have to watch and see. Will the new cabinet ministers, will the new heads of government agencies also support a strong dollar policy?

No one can predict that right now. All we can do is stay tuned.

To summarize, therefore, the policy consequences, I think, are as follows. First, as we've been doing in the G-7 meetings and other summits, we must keep promoting stronger growth rates overseas. We

need more cyclical convergence in the global economy if we're going to bring this trade deficit down in a gradual and positive way.

Secondly, we also have to keep encouraging a higher savings rate here. I would say as a consequence of the current account deficit, we should go slowly in giving away the federal budget surplus. That has become a useful offset to the size of this current account deficit.

And finally, and most importantly, we must recognize the need to keep the investment environment in America positive and constructive, because the key to financing this current account deficit, the key to sustaining our growth is, in fact, to maintain the policies that have made this country a high growth economy with a booming stock market all through the late 1990s.

Thank you very much.

CHAIRMAN D'AMATO: And thank you, Mr. Hale.

Dr. Lipsky.