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**US Trade and Current Account Deficits and the Market Adjustment Path:
America's Consumption Orientation is What is "Old" about the US Economy**

Statement of

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Introduction

The subject of this morning's hearing: the role of financial markets in adjusting the US trade and current account deficits is timely. My central conclusions are these:

- (1) The large US current account deficit and foreign capital inflows are the result of a long economic history; the backwardness of our trade-partners; and an important unrestructured aspect of the US economy.
- (2) America's "high-consumption, low-savings" orientation constitutes what is "old" and unrestructured in the US economy.
- (3) The "old" US economy served to support the import-substitution and export-led growth strategies of key Asian and European allies during the Cold War decades.
- (4) The US has been able to continue its consumption/savings pattern because trading-partner countries have had less competitive (less restructured) business investment environments – capital prefers US legal, accounting, and governance frameworks.
- (5) The US current/capital account adjustment path will be determined by (a) the perceived amount of needed restructuring, and (b) the aggressiveness of restructuring activity, whether the result of government policy or not.
- (6) The trigger for the US adjustment will be financial market recognition that effective restructuring changes are underway in trading-partner economies.
- (7) Capital will flow into trading-partner economies where restructuring needs are great and restructuring reforms are actively underway.
- (8) The adjustment speed will be amplified by an upturn in US savings rates triggered by the initial phases of the adjustment – real interest rates will rise and the "old economy" high-consumption, low-savings paradigm will begin to shift.
- (9) The adjustment process will be most stable if US savings rates are made as high as possible before it begins.

¹ Member, Board of Directors, Generations United, and Managing Director, Tudor Investment Corporation. I am deeply indebted to Tudor colleagues, Robert C. McNally and Dong Zhang for their assistance in preparing these remarks. The views presented are solely my own.

Putting the discussion in currency terms, the US current account deficit adjustment will ultimately involve a fall in the dollar relative to other major world currencies – the euro and the yen. The dollar's decline may surprise policy-makers and market participants for the same reason they were surprised by the speed and depth of the Asian downturns -- they did not give adequate consideration to economic history in assessing downside market risk. Governments and markets were equally surprised by the speed of the Asian upturns. They did not anticipate how rapidly capital flows to countries when restructuring is clearly underway.

The future of the euro, the dollar and the yen, and the adjustment of the US current account deficit will depend on the degree to which actual restructuring deviates from baseline market expectations. A focus of my comments this morning is that current baseline market expectations do not give adequate weight to either historical or market forces.²

The strength of the US situation and its vulnerability are evident in the data below.

Table 1. US Projected Change in Net Savings (\$Billions)³

Savings	1999	2000	2001	2002
Household	158	87	16	-56
Gross Business Savings	1205	1259	1316	1376
Government Savings	120	161	193	246
Gross National Savings	1483	1507	1525	1566
Gross Private Domestic Investment	1622	1755	1900	2057
Shortfall (Inflows from Abroad)	-139	-248	-375	-491

A major reason so much capital flows into US markets is the simple fact that the United States is the best place in the world to do business. This is America's principle strength. The US has a culture the legal and accounting resources needed to support business activity. It takes about two weeks to start a limited partnership LLC business in the United States. It takes about two months in Japan, and about 20 months in Europe. In the US there are 250 million people and 350 thousand CPAs. In Japan there are 120 million people and 12 thousand CPAs.

America's principle vulnerability is its increasing dependence on inflows of foreign capital. In and of itself, dependence is not a problem. Global growth occurs on a foundation of increasing interdependence.

The question is whether the US dependence is stable. The fact that capital's continued attraction to US markets depends on our trading-partners remaining competitively backward suggests that it is not or, at least, that there is a significant risk that it is not. Our trading partners are doing everything possible to restructure and catch up to the US. Will they do it quickly, that is, in the next year or so? Certainly not. But with the US example at hand and the opportunity to avoid US mistakes, in time, they can and almost certainly will.

At the same time US household spending continues to outstrip income, with the difference made up by either borrowing or spending capital gains. Households are liquidating or selling more financial assets than they are buying. Spending growth has accelerated in the past

² Because the Cold War origins of the US high-consumption, low savings economy is so important, I have attached as an appendix a complete recounting of capital flows between the US and its principle Cold War allies.

³ Bureau of Economic Analysis and Congressional Budget Office.

two years while income growth remained stable. The rise in spending that has been fueled by capital gains in stocks and home ownership has hidden a gradually increasing interest burden. While consumers rate their present situation as very good, their interest burden as a percentage of their total spending is now at an all time high.

A US current/capital account adjustment is unavoidable. Whether the adjustment is smooth, or stable, depends on the mechanics of the process.

Adjustment Mechanics

To understand the US current account adjustment path it is essential to keep in mind that usually the worse a country's conditions are, the higher its potential marginal 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 are supposed to do – allocate capital to its highest expected marginal rate of return.

Two rules flow from this:

(1) When restructuring initiatives are not underway or are very slow, capital flows to the country with the lowest amount of needed restructuring – it generally has lower taxes, is more productive and is growing faster.

(2) When restructuring efforts are actively underway, capital flows to the country whose restructuring needs are the greatest – its expected marginal rate of return is higher.

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

Table 2. Private Capital Flows into the US in \$US billions
(Direct Investments and Non-Treasury Securities)⁴

	1999						1998
	Total	4Q98	1Q99	2Q99	3Q99	Avg	Total
EU (not incl UK)	123.2	24.3	20.5	68.9	9.5	30.8	85.1
Japan	0.1	10.2	-15.5	2.2	3.2	0.0	7.9

A month ago ECB President Duisenberg told the German newspaper, *Morgenpost*, that he is convinced euro weakness against the dollar reflects disparities between European and US growth rates and the unfinished job of structurally reforming European national economies.

Mr. Duisenberg is correct. But 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 relative 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

⁴ Survey of Current Business, Department of Commerce, January 2000, Table 10

over the same time horizon. They were so confident in their view, they allocated over \$120 billion to Japanese portfolio and direct investments – about \$10 billion a month.

At the beginning of 1999, most global investment funds were “underweight” Japan. That is, they did not own Japanese stocks in amounts that reflected Japan’s share of world GDP or equity market capitalization. These are the so-called benchmarks. When they saw Japan in late 1998 taking aggressive action to deal with its banking problems, they thought the time was right to re-establish “benchmark” positions in Japanese stocks. The Bank of Japan’s resistance to monetary expansion proposals that might buoy the economy but weaken the yen, assured foreign investors that the central bank would not pursue a policy that would devalue their investments.

Now all the major funds are at benchmark levels. From here forward, the rate of portfolio flows into Japan should decline, and as we have seen upward pressure on the yen has diminished.

Mr. Duisenberg’s *Morgenpost* comment affirms the first rule that capital is allocated to the country with the lowest apparent restructuring burden when both countries are slowly moving to implement reform. Europe faces large restructuring challenges and is moving very cautiously. Europe’s needed reforms are in more familiar areas of state enterprise divestiture, labor market liberalization, capital market deregulation, and fiscal imbalances involving unfunded pension and medical care liabilities. The US also faces a large restructuring challenge – a less widely perceived over-commitment to consumption relative to saving. I will attempt to convince you toward the conclusion of my talk that this consumption/saving imbalance is an artifact of the Cold War when the US successfully served as the importer/consumer of last resort.

In brief, the dollar’s fall this year will be swifter than expected because relative economic growth, the factor that occupies the thinking of most economic analysts, is not the only determining factor. Relative expected structural change will be the driving factor. Capital inflows into the US will decline, not just because expected relative growth will decline, but because in terms of relative expected structural reform, it will soon be apparent that the US lags behind Japan and Europe.

In Europe, both the perception of a need for structural change and actual reform efforts are less than in Japan, but they are increasing. 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-left governments.

It is not reasonable to think that the net flow from Europe will continue to be \$125 billion a year into US 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 US in 1998? Those who doubt large allocative changes can occur quickly need to look again at the shifts in allocations that have taken place in just the past 18 months.

Generational Competitiveness

How serious a country’s financial sector restructuring problems will be depends on how much real sector restructuring has to take place. Measuring this is very difficult. However, it seems that the clearest sign of the need for economic restructuring emerges when a country’s government is no longer able to meet its public commitments without raising taxes significantly. Thus the degree to which a country’s fiscal situation is “unsustainable” may serve as an effective

indicator of the amount of needed real sector restructuring. Generational accounting, a new approach to measuring fiscal health, can provide valuable insights.

When we speak of real sector restructuring we usually have in mind divesting state-owned companies, liberalizing labor markets, and deregulating business practices and eliminating special market protections. Resistance to these changes generally comes from people whose retirement, healthcare, and employment security would be jeopardized. Generally, the greater the amount of needed restructuring, the greater is the amount of resistance which in turn reflects the scale of the government retirement, healthcare, and employment benefit commitments. The larger the government's welfare commitments are, the more people are going to object to restructuring them.

The size of a country's pension, healthcare, unemployment, and other benefits and the degree to which they are "unfunded" (that is, the degree to which the taxes of younger generations are going to have to increased to meet commitments to older generations) is the crucial litmus test.

Generational accounting addresses precisely this question. It assesses the sustainability of a country's fiscal policy defined in terms of benefit commitments less required taxes and measures the net burdens facing current and future generations. The method involves calculating the present value of each generation's government benefits and tax payments and subtracting one from the other to yield the net implicit lifetime tax payment. A country's policy is said to be "sustainable" if the present value of each generation's already legislated tax payments covers the present value of the benefits the government has committed to. Despite the criticisms that have been leveled at it, generational accounting provides the most comprehensive methodology available to assess a nation's long-term fiscal health.

Alan Auerbach, Jagheesh Gokhale, and Laurence Kotlikoff developed the basic methodology and presented the early findings in 1991. Their most recent analysis and that of numerous other researchers is presented in a recently published book, *Generational Accounting Around the World*. I highly recommend it to you. I am not exaggerating when I say that in terms of economic policy, it may be the most important recent book in the English language."

Private corporate and individual decision-makers take a country's long-term tax outlook into consideration when allocating capital. Countries whose benefit commitments do not exceed the capacities of current tax policies are at a competitive advantage in attracting capital. My colleague Bob McNally and I, in papers for the Council on Foreign Relations and the Center for Strategic and International Studies, have argued that national unfunded pension and medical care commitments and tax levels are powerfully affecting current international capital flows.⁶ Other things equal, countries with low lifecycle net tax costs are more attractive.

We call the long-term benefit/tax advantages some countries have achieved, "generational competitiveness". It is actually heartwarming and maybe not surprising that capital favors countries that do not overburden their children.

In thinking about generational competitiveness, it is important to remember the two rules I spoke of earlier. When the speed of restructuring appears to markets to be about the same,

⁵*Generational Accounting Around the World*, Alan J. Auerbach, Laurence J. Kotlikoff, and Willi Liebfritz, NBER, University of Chicago Press, 1999

⁶*The American Stock Market as a Financial Risk*, Robert Dugger, Robert McNally, and Richard Medley, For the Working Group on Development, Trade and International Finance, Council on Foreign Relations, October 21, 1999, and *Toward a Stress Test of US Economic and Stock Market Dependence on Household Consumption: Historic and Demographic Risks*, Robert Dugger and Robert McNally, For the Global Financial Stability Task Force, Center For Strategic and International Studies, November 15, 1999.

capital flows to the “generationally competitive” country. When the speed of restructuring appears to be significantly different, capital flows to the “generationally uncompetitive” country.

The table below from *Generational Accounting Around the World* is a ranking of the amount of needed real sector restructuring. Germany’s imbalance or net long-term tax burden is nearly twice that of France and the average of France, Germany, and Italy (about \$160 thousand and a reasonable proxy for Europe generally) is three to four times that of the United States. Japan is the low man on the totem pole. The fact that the yen is strengthening despite its huge generational competitive disadvantage says almost everything that needs to be said about market expectations regarding relative structural change.

**Table 3. Generational Imbalance Per Capita
Scaled to 1995 US GDP and in 1995 US dollars⁷**

Canada	\$ 3.4 thousand
United States	\$ 45.3 thousand
France	\$10 1.7 thousand
Italy	\$197.1 thousand
Germany	\$203.9 thousand
Japan	\$300.9 thousand

Germany and France

Bernd Raffelhüschen and Jan Walliser, two German economists, determined that future generations of Germans faced 156 percent higher lifetime taxes than current newborns, or an equivalent net lifetime tax rate of 54.5 percent. These economists concluded that Germany could restore balance by (1) raising income taxes 29.5 percent; (2) increasing all taxes 9.5 percent; (3) cutting transfer payments by 14.1 percent; or (4) reducing government purchases by one-fourth.*

Investors who are indifferent between allocating capital into German or French investments for other reasons, will choose to invest in France once they incorporate France’s superior generational competitiveness.

The same is true of talented people. They may be indifferent between living in, say, Paris or Berlin, but once they think through France’s superior balance of benefits and taxes, they will choose to live in France.

Businessmen also understand that to induce talented people to stay in high imbalance countries, businesses will have to increase employee compensation enough to neutralize the higher net tax burden. Thus, even if business executives can negotiate favorable tax arrangements for their companies, they will still have to offset excessive net long-term tax burdens through higher employee compensation costs.

France’s overall burden however appears to be significantly smaller than Germany’s. It is not possible to put the matter in precise terms; however, France’s generational competitive

⁷ *Generational Accounting Around the World*. Table 4.4, p. 82-83.

⁸ *Generational Accounting Around the World*, Bernd Raffelhüschen and Jan Walliser, “Unification and Aging in Germany: Who Pays and When?“, p. 289.

advantage probably explains the strength of France's stock market and why France's growth in the past several years surged ahead of Germany's.⁹

Germany's recently announced tax and pension reforms, however, have had a positive and galvanizing effect on market appraisals of Germany as an investment locale. On December 21, the Schroeder government surprised and delighted investors by announcing business-friendly, supply-side oriented tax reform proposals. Bipartisan pension reform talks have begun, with both Green and center right CDU/CSU agreed that Germany's pension benefit formula take explicit account of aging. By inserting a "demographic factor" in the pension benefit formula, benefit increases would slow as the worker-retiree ration sank. Markets appear to be very impressed with how the German pension reform discussion reflects uncommon frankness about the challenge posed by demography; strong bipartisan consensus on the need to avoid saddling young workers with higher payroll taxes; and a commitment to private equity investment that bodes well for Germany's shift to a more equity-financed economy. The leitmotiv of Germany's press and political discussion is sustaining "generational equity" as Germany's population ages.

While success in these bipartisan pension reform talks is not guaranteed, that they are taking place at all within a consensus about the nature of the demographic challenge and need for generationally fair reform sets Germany ahead of its G7 partners. If Germany succeeds in implanting the principle that pension benefits must be scaled back to avoid increasing the tax burden on the young, Germany's attractiveness as a destination for capital investment will rise markedly.

In general, we find that when rates of reform are equal, the country with the lowest generational tax burden is favored by capital. But when a country accelerates meaningful reforms, it can overtake a country whose reform efforts lag, even if the quickly-reforming country has a larger overall burden to begin with. This is why investors are likely to increasingly reward Germany with capital flows if its pension reform negotiation, along with tax reform, advance this year.

Europe and Japan

Among countries with different restructuring speeds, according to rule 2, capital flows to the country whose expected marginal return on investment is the highest.

The US present-value real imbalance is \$45,000 per capita. Japan's is \$309,000. Averaging France, Italy, and Germany, and using the result as an estimate for Europe generally, puts Europe's imbalance at about \$160,000.

⁹ Germany's fiscal challenges relative to France are also clear from more traditional economic data and projections from the OECD: Germany's net financial liabilities are set to triple by 2030 to 216 percent of GDP, whereas France's rise to 165 percent of GDP. Left unchanged, France's pension expenditures would increase from 9.8 percent in 2000 to 13.5 percent in 2030, whereas Germany's would rise from 11.5 percent to 16.5 percent. Germany and France's elderly dependency ratio, roughly the same in 1990, will diverge. In 2010 Germany's will be 30, while France's will be 25. In 2030 Germany's will be 50 while France's will be 40. To keep net debt constant, Germany would have to raise taxes by 2.8 percent of GDP in 2005, versus only 0.8 percent in France. In 2015 the tax hikes would be roughly equally, but in 2030 Germany's tax hike would be higher than France's, 9.7 percent versus 7.1 percent respectively. Roseveare, Deborah, **Liebfritz, Willi**, Fore, Douglas, and Wurzel, Eckhard, *Ageing Populations, Pension Systems and Government Budgets: Simulations for 20 OECD Countries*, OECD Working Paper Number 168, 1996.

Dollar-yen

The decline in the dollar against the yen despite the US's superior generational competitiveness can be explained by a variety of factors. The most important is this: though Japan's GDP growth rate is much lower than the US's, its turnaround potential is much, much greater.

Clearly, the bilateral current account deficit between the US and Japan remains in the yen's favor, and the distress of many Japanese companies and households is forcing them to sell dollar assets acquired in past years and bring the capital home to meet pressing current obligations. Nevertheless, the main factor is expectations.

Market participants rightly or wrongly believe they understand Japan's problems. They believe that even if the fiscal situation blows up and the yen weakens suddenly, they will be able to hedge their yen asset holdings. They see evidence that Japan's banking system problems are known and are being ruthlessly dealt with. They also know (many of them from personal experience) that the "big bang" reforms of 1998 initiated a rigorous deregulation and opening-up of Tokyo capital markets in all dimensions.

Investment managers are also aware that Japan's unfunded elderly pension and medical care commitments are the largest in the world, and even if they are not yet familiar with the details of a generational accounting assessment of Japan's fiscal dilemma, they know that Japan's government finances are unsustainable. But they believe they see evidence that Japan's voters and leaders know there is no alternative to structural reform."

In Japan's banking restructuring, capital market deregulation, and shift in political sentiment, US and European asset-managers see a kind of fiscal and economic revolution. These market participants believe the share of Japanese GDP represented by private business profits will trend from its current very low levels upward year after year for the next decade or so. As a consequence, they are confident that investments in "new Japan" companies will do very, very well. Last year US fund managers were so certain of their views that they allocated \$83 billion dollars worth of capital into Japanese equities.

Euro-yen

Relative to the floating supply of each currency, the quantity of yen demanded for all purposes was greater than the quantity of euro demanded in 1999. The reason is simple – investors perceive more upside potential in Japan than in Europe.

As noted earlier, Europe differs from Japan in several important respects. The banking and capital market reforms needed to assure strong and rapid growth are just getting started in Europe. Japan's are arguably already actively and aggressively underway.

Second, over the next 12 to 18 months, the amount of economic restructuring that will likely take place is less in Europe than in Japan. Though Japanese budget conditions are perceived to be far worse than Europe's, a rectifying fiscal and political crisis seems much nearer.

Thus, by rule 2, more money goes into Japan and its currency strengthens.

¹⁰ A recent *Asahi Shimbun* poll finds that over 80% of Japanese voters want a change in current political conditions. The number of people supporting no party rose 60% since the 1998 Upper House election. Support for the ruling LDP and its "go slow" policies has collapsed and is now evenly split 40-40.

Euro-dollar

The capital flows from the US and Europe into Japan last year were the result of rule 2 -- when restructuring efforts are actively and more or less equally underway, capital flows to the country whose restructuring needs are the greatest.

The flows from Europe into the US, I argue, were the result of rule 1 -- when restructuring initiatives are not underway or are equally very slow, capital flows to the country with the lowest amount of needed restructuring. I do not however believe this situation is going to continue much longer.

Europe is beginning to restructure. Equity shareholder rights groups are springing up everywhere, as have proxy research services. European mutual funds and individual investors are increasingly speaking their minds at annual meetings.¹¹ Germany's recent tax reform proposal on scrapping capital gains taxes on corporation sales of shares next year is revolutionary. If it goes ahead -- as I am certain it will -- it will unleash a major wave of restructuring. Some EUR 150bn in assets will likely change hands. The resulting gains in capital productivity and investment some experts say will increase GDP by 1% over the next three years. Europe is changing, and history is going to catch up with the US.¹²

Economic History

The historical foundations of the Asian crises are now widely recognized. In one of the two best books on these events, Barry Eichengreen concluded, "... Asia's crisis can only be understood in terms of a conjuncture of long-standing historical forces and short-term financial policies." He observed:

Ultimately, the explanation for the crisis lies in the region's history and economic development trajectory, which relied on bank-centered financial systems, the use of the banks as instruments of industrial policy, and close connections between banks and politicians, all of which were designed to sustain high rates of investment and rapid economic growth.¹³

¹¹ "Hark! The Shareholders are Restless in Europe, In Asserting Rights, American-Style Tactics", Hilary Rosenberg, *The New York Times*, December 12, 1999.

¹² Another way of saying this is. exchange rates reflect the relative attractiveness of two countries' capital markets. Relative GDP growth captures the cyclical component of this comparison, but it can be overwhelmed by a secular component related to restructuring. A country in need of restructuring but doing little about it, can be expected to have a low expected return. A country like the US that has already restructured can have a high actual return; and a country needing to restructure and actually moving on that agenda would have a high expected return. The fiscal side factors in a couple of ways. The need to raise taxes could depress expected returns or drive a wedge between before and after-tax returns. The case for a strengthening of the euro against the dollar is pretty straightforward in this analysis: The perception of restructuring efforts in Europe is on the rise, pushing up the expected return on European assets. US restructuring is already largely priced into US asset markets, making expected returns fairly average, and more Fed tightening will dent expected returns even more. Europe has a high expected structural return, but also bigger fiscal restructuring needs, but the former is going to overwhelm the latter for now. The US has nearly exhausted exploiting its private sector structural opportunities but has not addressed its fiscal restructuring needs.

¹³ Eichengreen, Barry. *Toward a New International Financial Architecture, A Practical Post-Asia Agenda*. Institute for International Economics, 1999, p. 162. The other must-read book on the Asian crises is, *Safe Guarding Prosperity in Global Financial System, the Future International Architecture, Report of an Independent Task Force Sponsored by the Council on Foreign Relations*, Carla A Hills and Peter G. Peterson, Co-Chairs, Morris Goldstein, Project Director, Published by the Institute for International Economics, 1999.

A concern I want to convey this morning is that Eichengreen's observation may also be true in important ways about the US. In the US case, however, the central relationship would not be between banks and businesses via bank credit, but between the US stock market and undersaved households.

The Asian Downturns – A Short History

There is general agreement that import-substitution and later export-led growth strategies were key ingredients of the economic recovery plans of WWII-scarred Japan and Germany and other western-ally countries surrounding the former-USSR and China. This is particularly clear in Asia from the 1950s into the early 1990s. Japan first, followed by the Asian Tigers and the NICs in the “flying geese formation” successively pursued national plans to substitute domestic production of basic goods for imports and then moved up the production chain to maximize growth through exports to the developed world.¹⁴

There is also general agreement that the United States served initially as a capital provider and then as the linchpin importer/consumer-of-last-resort to support these recovery and development strategies. The US through grants, development loans, and defense arrangements met the early capital needs of its Cold War allies in the 1950s.

Table 4. Capital and Trade Flows from the US to “Iron Curtain” Allies”
(US\$ millions)

Allies	Time period											
	<u>46-49</u>	<u>50-54</u>	<u>55-59</u>	<u>60-64</u>	<u>65-69</u>	<u>70-74</u>	<u>75-79</u>	75-79	80-84	85-89	90-94	95-98
Capital Flows												
European*	1118	960	439	506	142	-431	-25440	-26955	-36096	-66063	-70845	
Asian**	613	757	955	1430	951	814	1968	64374	-16271	62745	-299873	
Trade Flows												
European		654	611	856	-427	-1706	-2349	-5263	-19500	-15741	-30024	
Asian		598	899	638	-921	-4073	-13063	-32833	-83898	-69298	-70426	

* Germany, Austria, Italy

** South Korea, Japan, Taiwan, Hong Kong

At the same time, the US de-emphasized savings and encouraged consumption, even to the point of providing tax deductions for consumer credit interest expenses. This policy supported the evolving export-led growth strategies of US allies. The high-production, high

¹⁴ See, for example, Walter Russell Mead. “The Third Way to Economic Development -- How to Reach Beyond Export-Led Growth”. *The Milken Institute Review*, Fourth Quarter, 1999, pages 30 – 40.

¹⁵ The underlying data and sources for this table are extensive and available as an excel spreadsheet upon request.

savings strategies of the recovering and developing countries were matched by a US high-consumption, low-savings economy.¹⁶

There is also agreement that this system of export-to-the-US and US-buy-from-its-allies started to break down in the 1990s. Diminishing marginal returns to export-led growth set in, and a zeroing-out of the strategy occurred the mid-1 990s.” The explanations offered by the US and other G7 governments that the Asian downturns of the mid-1 990s were mainly the result of “crony capitalism” and inadequate financial supervision and a lack of transparency are incomplete. The downturns were, of course, in part due to these factors, but the important question is how did “Asian miracle workers” became “crony capitalists” in a matter of three or four years. Something is missing.

What is missing is recognition that national security is the highest domestic political priority. In contrast to the high-production, high-savings strategy the US pursued to win World War II, a strategy in which the US essentially out-produced its enemies, the US’s Cold War high-consumption, low-savings economy won because it essentially out-consumed the USSR and China. The US was able to support its allies in a recovery, development, and growth process that exhausted the USSR and forced China to change its policies on inward investment.

The matching consumption-led and export-led economics pursued by the US and its Cold War allies were optimal for addressing the priority of winning the Cold War, but not for a non-war environment. The magnitude of the Asian adjustments following the end of the Cold War shows that Asian economic, financial and political frameworks were not optimal for a post-war environment. As soon as the Western capital markets and democracies were not required to prop up those frameworks, they ceased doing so and “Asian miracles” became “crony capitalism”.

During the Cold War years, the United States would not have let the yen strengthen as it did in the mid-1 990s, to the point that it nearly wrecked the Japanese economy. Nor would it have been as unconcerned in the Cold War years as it was in the mid-1990s that economic conditions were destroying political leadership of the LDP, Japan’s long-time dominant party. The overriding characteristic of policy in the 1990s that distinguishes it from the 1980s and earlier, was the willingness of the leading Western democracies to allow the “invisible hand” of markets to take over from the “guiding hand” of allied-government Cold War strategy. After the fall of the Berlin Wall, it became acceptable for markets to determine the fate of Asian and European export-led economies, not national security concerns.

Implications for the United States

Now, what does all this mean for the US and Europe, the dollar and the euro? A key to the answer is the distinction between “old” and “new” economies.

There is no real disagreement that the problems in the east-Asian economies were most serious in the heavy industry, small manufacturing, agriculture, construction, and retailing sectors. These were the sectors that, during the Cold War decades, were the foundations of import-substitution and export-led growth strategies. and they comprised two thirds or more of GDP. They were heavily subsidized, trade protected, and regulated. They are what we meant

¹⁶ Following World War II the US entered into a recession severe enough to trigger fears of a renewal of the Great Depression. Washington responded with a Keynesian spending program that included the GI Bill and boosted US consumption and restored the economy to positive growth.

¹⁷ Blecker, Robert. “The Diminishing Returns to Export-Led Growth.” Paper presented to the Working Group on Development, Trade and International Finance, Council of Foreign Relations, October 7, 1999.

when a decade ago we referred to “Japan Inc”. These sectors are what we mean now when we refer to “old Japan”. In all the Asian countries the shrinkage (even collapse in some instances) of the “old” sectors threatened the private and public institutions that financed them and the political systems that organized them.

There is also no disagreement that “new” sectors such as communications, information technology, professional services of all kinds, bio-medical research, and high-end design and manufacturing are growing strongly in all the Asian countries. Because these sectors represent only about a third of GDP, however? their rapid growth is not enough to offset the negative GDP effect of the “old” contracting sectors.

Is there an “old” versus “new” issue in the US economy? On this point there would be very heated disagreement. Most economists and analysts believe the US economy is very “new” in every respect. The prevailing view is the banking system has been reformed. Old industries have been restructured. And, the bulk of GDP is represented by “new” information and service oriented businesses.

The risk to the dollar (and the US stock market) is that this view is not correct, and that what is “old” about the US economy is its consumption orientation. If this historical view is at all accurate, we need to think of the priority the US places on consumption as being a mirror of the Asian import-substitution and export-led growth strategies. Just as they were restructured by market forces, the US consumption orientation will be similarly restructured. The usual way of talking about this possibility is in terms of the unsustainability of the US current account deficit.

European Restructuring

Because the bulk of US dependence is on capital inflows from Europe, the rate of restructuring there is a crucial factor. As noted earlier, a pickup in the perceived rate of restructuring whether the result of government policy or not, would according to our second rule, result in a reduced flow of European savings to the US.

Enormous change taking place in the thinking of Europe’s political leaders. Oswald Metzger, for example, a German parliamentarian, and a young leader of the Green party and its budget spokesperson, speaks with passion and conviction about unleashing the productive potential of German labor and entrepreneurs by aggressively cutting taxes and deregulating. Here was a leading member of the supposedly Big Government, far-left Green party speaking about the power of tax cuts and deregulation in ways that would make a Jack Kemp Republican envious.

Last year France’s Socialist government cut taxes in response to public pressure from its own parliamentarians after tax revenues proved higher than expected. Just recently, the French government announced new income tax cuts. And in the first week of February, the Socialist head of the national assembly called for even further cuts in income, payroll, and housing taxes. Even the lower workweek legislation is being implemented in ways to allow companies to recover flexibility. In fact some unions are resisting a shorter workweek for their members precisely because of the concessions on working hours and management they must give to companies in return. It is not an exaggeration to say France is talking left but governing right.

France’s senior representative on the ECB. Christian Noyer, constantly stresses the need for structural reform. In an October speech, Mr. Noyer stressed --

..only comprehensive structural reform **can remove the underlying impediments to higher** employment. In particular, further reforms of the tax and welfare systems are required in many

EU countries in order to increase the incentives to create new jobs and to accept them. Wage moderation can also have a significant beneficial impact.. these reforms may imply difficult political decisions, especially since necessary changes are felt directly, whereas the benefits only become apparent over time. The success, however, of past structural reforms is already visible in those countries where appropriate measures have been implemented and wage growth has been moderate.

Finally, we can ask, what about the “new economy”? Thomas Mayer of Goldman Sachs in Frankfurt has compared new economy indicators – value-added of knowledge-based industries, physical versus knowledge investments, and information and communication technology spending – and concluded that the New Economy in Europe is about half to two thirds of the size of that in the US.¹⁸ He says prospects are good that the gap will be closed. I believe closing the gap is a certainty.

While it may be premature to proclaim attainment of a European New Economy, Europe is beginning to dismantle its structural rigidities and release its physical and intellectual capital and labor endowments to be used more productively. At some point the thinking and policies advocated by leaders like Oswald Metzger and Christian Noyer will trigger market recognition of change and a decline in the net savings flow from Europe to the US. At that point, the adjustment of the US current account deficit will get underway.

Conclusion

In the discussion above, we have looked mainly at the relationships between the United States, Japan, and Europe, and suggested an adjustment path that involves a redirection of net capital flows back to Europe. This is not the only option. The restructuring returns from post-Cold War reforms and economic development in the developing world could also initiate the adjustment. From one perspective, this latter option is almost crucial.

Emerging market economies now depend heavily on trade flows to the US to obtain the dollar liquidity to finance further development. Reducing the US current account deficit would reduce emerging market liquidity. Replacing this liquidity requires developing efficient capital markets in those countries that will enable capital to be transmitted to those countries via a mix of capital market and trade channels rather than almost exclusively through trade channels.

¹⁸ *The New Economy Has Arrived in Euroland*, Goldman Sachs European Weekly Analyst, November 19, 1999.