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Roger M. Kubarych joined the Council on Foreign Relations as the new Henry Kaufman Senior Fellow for International Economics and Finance in July 1999. Mr. Kubarych has been the managing member and chief investment officer of Kaufman & Kubarych Advisors, LLC. The firm continues international money management activities on behalf of institutional investors formerly conducted by Henry Kaufman & Company, Inc. Mr. Kubarych was general manager of Kaufman & Company, Inc. from its inception in 1988 until the new firm was established in January 1997.

Prior to joining Henry Kaufman & Company, Inc., Mr. Kubarych was Senior Vice President and Chief Economist of the New York Stock Exchange where he directed the Economic Research Department from April 1986 to May 1988. From February 1985 to March 1986, he had been Vice President and Chief Economist of the Conference Board, Inc., a business research organization.

Previously, Mr. Kubarych had served 13 years at the Federal Reserve Bank of New York in a variety of positions in the Research and Statistics Function and the Foreign Department. As Senior Vice President and Deputy Director of Research, he supervised research covering a wide range of economic and financial questions concerning the US and foreign countries. During 1978 and 1979, he serves as special assistant to the US Treasury Undersecretary for Monetary Affairs.

He has published a number of papers and articles on economic and financial topics and is the author of *Foreign Exchange Markets in the United States*, now in its second edition and translated into Japanese. He frequently comments on financial markets and economic policy on CNN, Bloomberg, and Fuji TV, among others, and writes a monthly column for the German newspaper *Die Zeit.*

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He is a graduate of Williams College, Oxford University, and Harvard University.

Statement to the
U.S. Trade Deficit Review Commission

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The United States has an enormous trade deficit by any standard. At almost 4% of our GDP, the current-account deficit (the most comprehensive measure of the external imbalance) has swelled beyond the previous records reached in the mid-1980s. Yet, this large deficit, unlike many instances in the past, has not been a source of high anxiety either among academic economists or in the financial markets. That is because economists agree about why we have one – much faster economic growth here than in the rest of the world, arguably a transitory phenomenon. And so far the financing of the deficit has proceeded smoothly. Private investors from around the world have been willing, and not infrequently eager, to accumulate American financial assets, over and above the prodigious volume of dollar assets they had previously amassed. In the past five years, the market value of foreign investments in US stocks, bonds, and other financial instruments has more than doubled. It has gone up by over $2 trillion – or a little less than 20% of the total increase in the value of US financial assets owned by Americans.

This pleasant state of affairs will not go on indefinitely. Eventually, economic and financial conditions abroad will improve relative to ours. As a result, either the voluntary private financing will become harder to attract, and foreign official institutions will have to step in to substitute. Or American investors will have to repatriate investments in other countries. Or the United States will have to export more and import less. Or some combination of each will be necessary. But these adjustments do not need to happen imminently nor do we have to redirect economic policies to commence the adjustment right

away. We have the time, at least for now, to proceed gradually, a luxury not enjoyed by most countries that get into the kind of payments imbalance we have built up. The structure and performance of our financial markets makes this possible.

You have asked for comment on what makes US financial markets so attractive to foreign investors. The best answer is to recognize that our markets are attractive to them for much the same reasons why they are attractive to *Americans*. Conversely, when citizens of a country lose faith in their currency and the prospective value of local financial assets it is hard, if not impossible, to retain the confidence of foreign investors. We know this from our own financial travails in the 1970s and lately from the wrenching experiences of many debt-troubled countries.

For the last several years, confidence in US financial markets has been sustained by a number of favorable factors. Foremost is that American economic data have been terrific. Our economy has delivered strong growth, low inflation, plenty of new jobs, and good profits for many of our corporations. The overall bullish sentiment in the equity market has been reinforced by the astonishing successes in the high tech sector. That has produced a certain halo effect that is so distracting that many market participants have tended to disregard inconvenient facts about some of the vulnerabilities lurking behind the scenes. In particular, the dispersion of results in the stock market has rarely been wider, as vividly demonstrated by the disparate behavior of the Dow-Jones Industrials versus the NASDAQ. Reasonably well-performing companies have been punished even as high tech start ups who have never made a nickel of earnings have been selling at stock market valuations that presuppose future profitability that is unattainable for all but a few. But

nowadays, old-fashioned investors who worry about such things as earnings and dividends have lagged badly in their relative performance, have lost clients, and have been subject to not inconsiderable ridicule.

Beyond the good economic news and the possibly ephemeral buoyant market psychology, there is a broader factor at work here. Foreign investors marvel at what they see as the core American achievement. They feel we in the United States have achieved a broad national consensus on a general framework for economic policy that eludes their own nations. That framework includes a number of critical and mutually reinforcing elements.

One is a more or less bipartisan commitment to a disciplined fiscal policy. We have moved from deep deficit to a healthy surplus and this means that the US Government is no longer competing with private industry and households for scarce capital. Fiscal prudence pays another dividend that investors admire: it means that we have regained the flexibility to respond to any unexpected slowdown in the economy with both fiscal and monetary policy measures. To investors, this lessens the danger of a steep or prolonged recession, which reinforces confidence.

Two is that there is sturdy support for an independent central bank that has achieved and retained a great measure of credibility over the past two decades. Investors, whether American or foreign, are universally allergic to inflation and are convinced that monetary policy will give top priority to holding it down, whether or not a formal inflation target is in place.

Three is a basic philosophical attachment to an enterprise-based economy, one that champions entrepreneurship and risk-taking. It is small

and medium-sized businesses that challenge the old order and generate-the technology and job opportunities for the next set of successful industries.

But the American free-enterprise model is not doctrinaire in practice. Instead, it is one that is buttressed by a powerful infrastructure of law, official regulation, and self-policing by market participants. This is particularly important in financial markets. Investors are sometimes sheepish to admit it, but they are utterly dependent on a strong, well-functioning regulatory system to counterbalance the unavoidable defects in human character and behavior. Simply ask any investor who got caught with investments in a country that does not have these protections. To ensure disclosure of information by corporations is accurate and timely; to keep brokers honest; to make sure that trades are completed reliably; to validate the financial health of those banks and other institutions that have a role in making or receiving payments – for these and other public benefits, modern financial markets need well-informed, sophisticated, and self-confident regulation and supervision. To be sure our regulatory system is complicated, and more than a little bit behind changes in the structure of the financial markets that have been taking place in recent years. But it is competently staffed, and it is trusted. Foreign investors are even tolerant of our Byzantine tax regime, because despite its complexity it is viewed as reasonably well administered and mostly fair.

Let me turn now to a discussion of what foreign investors have been doing lately. To begin with, foreign investors have not been aggressively at the forefront of the US stock market advance nor have they been especially prominent in high tech investing. But they have done well. Five years ago, foreign ownership of US equities, not counting their direct investment in US affiliates and subsidiaries, was $400 billion, or just 6.3% of a total market

capitalization of $6.3 trillion. By late last year, foreign investors owned $1.2 trillion out of $16 trillion, or 7.5%.

By contrast, private foreign investors continue to be heavily attracted by the comparatively high yields on American fixed-interest securities. They have accumulated an additional $1 trillion in US Government obligations, mortgage related securities, corporate bonds, and the like during the past five years. Together, official and private foreign ownership of US Treasury obligations now account for over a third of the total, twice the proportion they held just five years ago.

How much does the structure of our financial markets matter in preserving foreign investor confidence? Foreign investors would readily agree that the depth, breadth, and diversity of our fixed-income markets are unsurpassed anywhere else. US financial institutions are highly innovative. They have global scope. They offer a dazzling array of products across the whole spectrum of risk and reward tradeoffs. And they are at the leading edge of complex risk management strategies, notwithstanding the fact not all of those strategies work the way they are supposed to in unusual circumstances.

None of this means, however, that bond investors, foreign or domestic, are guaranteed an easy life investing in the US fixed-income markets. Last year, for instance, the total rate of return on almost all of the commonly cited bond market indexes was negative. But somehow foreign investors have taker this volatility in stride, perhaps because other bond markets are similarly afflicted.

I would like to finish up by addressing the crucial question of what might change the favorable perception of private foreign investors toward our markets. I see at least five potential danger spots that deserve to be watched carefully.

1. If for some reason or another the high tech stock market bubble bursts, foreign investors will be deeply concerned. They would anticipate a broader stock market decline that could presage a recession. Foreign investors accept the fact that the explosion of financial net worth has been a major force lifting both consumption and business fixed investment in the United States. They worry about the low American savings rate and the high debt load for consumers, now running at a record proportion of disposable personal income. They fear that many corporations are similarly overextended and may not be able to service their debts if business conditions sour. That in turn could strain US financial institutions. All in all, it would raise doubts about latent financial vulnerabilities, doubts that have been dormant for some years.

2. A slowdown in the US economy might incite demands for a more protectionist stance on trade policy. Serious investors, both domestic and foreign, view restraints on trade -- especially for a country such as the United States operating in the neighborhood of full employment of resources -- as producing higher inflation, then higher interest rates, then lower asset prices. They would sell long before the sequence was complete.

3. An overt attempt to weaken the value of the dollar in the foreign exchange markets could have a chilling effect on foreign investor sentiment. Admittedly some fall in the dollar is expected, as evidenced by the alignment of currency rates in the forward foreign exchange markets. But an outright policy shift away from the long-standing US Treasury mantra that "a strong dollar is in the interests of the United States" could trigger sizable outflows of private capital, enough to threaten US stock and bond markets too.

4. Mishandling foreign relations may also diminish foreign investor confidence. The United States now has at least seven rifts with our European allies on matters ranging from IMF governance, to bananas and beef, to aircraft noise, to the adverse WTO ruling against foreign sales corporations. Latent trade problems with Japan could break out into the open. There is the problem of ratifying WTO membership for China and for steering a skillful course through fractious Chinese-Taiwan relations. There is the matter of how to deal with an erratic Russia. And there is the broad question of how to deal intelligently with a reinvigorated OPEC. Foreign investors expect the United States to behave as a superpower, not with a narrowly nationalist economic policy agenda.

5. A lack of a firm monetary response to an upcreep in the rate of inflation would also fray the confidence of foreign investors. Trust in the judgment and operational skills of the Federal Reserve has rarely been higher. But foreign investors will want to see a strong policy response to any meaningful rise in the US rate of inflation.