

MR. EICHENGREEN: Thank you, Madame Chairman. Unlike my colleagues, I'm not going to talk about the Asian crisis, which I think is largely irrelevant to the task of this commission. I am going to talk about high tech, appropriately, for our venue this afternoon. I apologize if much of what I have to say is unoriginal. Economists are not known for their originality.

Hard thinking about the trade deficit has to start with the fact that the difference between imports and exports of goods and services is nothing more or less than the difference between domestic investment and domestic savings.

It's important for all of us to understand that this equality is not the prediction of an economic model; it's an accounting identity. It has to hold in every economy in every point in time. And if the data suggests that it doesn't, there is something wrong with the data.

Looking at the deficit this way reminds us that it exists for both good and bad reasons. It exists because investing in the United States is attractive, because the U.S. economy is dynamic. Investment here is high, consequently, the deficit is large. Foreign investment entering the United States at the moment is running at an annualized rate of about

\$300 billion, which fortunately for us is just about sufficient for the time being to finance the current account deficit. And much of that FDI is going into the high tech sector, as you heard this morning. Details are in my written presentation.

That's the good news. The bad news is that U.S. savings rates are low, which also contributes to the country's external deficit. Inadequate savings have been a problem of our country for some time now, but the problem is aggravated at the moment by the high level of the stock market, which encourages households who feel wealthier. As a result, they are consuming an even larger fraction of their current wage and salary income.

A significant share of U.S. investment, therefore, has to be financed by foreigners. That inflow of capital into the United States is simply the flip side of the trade deficit.

How long can this continue? That is, I think, the critical question for you. The optimists would say indefinitely because economic growth is robust and the United States has a formidable lead in information technology. U.S. investment rates will remain high indefinitely. Foreigners will continue investing here indefinitely. The U.S. current account deficit can be financed indefinitely. And because

growth in corporate profits will remain robust, the high level of the stock market will be sustainable indefinitely. Moreover, the country's low measured savings rates, which reflect the consumption fueled by American household's growing stock market wealth, are not really a problem. Savings properly measured, not just wage and salary income not consumed but also the increase in stock market wealth, is not really that low. And the trade deficit relative to the expected future size of the U.S. economy is really not that high. These then are simply several different ways of saying essentially the same thing.

That brings me to my central point. Everything in this rosy scenario, the rapid growth of the U.S. economy, the attractiveness of investment here, the high level of the stock market, the willingness of foreigners to pour ever more money into the United States, hinges on the solution to the productivity puzzle, which is, of course, whether the increase in productivity growth which allows the U.S. economy to continue growing robustly, despite being at or very close to full employment, is a temporary blip or a permanent shift.

If it's a permanent shift, benign neglect of the trade deficit is entirely justified. Alan Greenspan can similarly adopt a "What, me worry?"

attitude and let the monetary reigns hang loose. But if the productivity surge is only temporary, then there is reason for you and all of us to worry. Eventually, the rate of economic growth will slow. Investment in the United States eventually will become less attractive. And in this case, markets not being known for smoothly adjusting to that kind of information, could adjust with a crash, and the dollar could come down all at once.

So, the solution to the productivity puzzle, it seems to me, is the key element of your diagnosis. My own hunch -- it's only a hunch and I can elaborate on it later if you like, is that much of the acceleration in the U.S. productivity growth is permanent, or at least sufficiently long lived that investment enclosed, and their other corollaries are likely to be sustained for a good long time.

But to repeat, the only honest answer to the question, is the increase in U.S. productivity growth permanent, is we don't know. It's too early to tell. We have one revision by the U.S. Commerce Department of the productivity statistics. It's hard to discern a trend in one data point. It seems to me that prudence, therefore, dictates that we insure ourselves.

In other words, we should buy insurance against the possibility that the productivity increase is temporary, and that the whole financial house of cards could come tumbling down. Because I live on an earthquake fault I buy earthquake insurance. The same instinct leads me to believe that the United States should similarly insure itself against the possibility that the trade deficit is unsustainable.

So, what is to be done? The country should take steps to begin gradually narrowing the trade deficit now, rather than leaving itself open to the possibility that the market will do so abruptly by deciding one morning that it's not worth financing.

Because the deficit is nothing more or less than the difference between investment and savings, there are two obvious ways to go. We could encourage saving. We could discourage investment. The latter, all sensible people will agree, I think, is undesirable, but it's a direct implication of the preset policy of inaction. If you believe that the productivity miracle will not persist indefinitely, then inaction places the problems squarely in the hands of the Fed, whose only available instrument is higher interest rates. Higher interest rates make investment more expensive. They create the danger of recession,

if overdone, which should drive home the fact that this is not the optimal way of solving the problem.

Better would be to boost household, corporate, and government savings. There are two obvious avenues here. One, we can tax consumption rather than income. I'm not an expert in this area. But for me, the other fairly standard theoretical arguments for why a consumption tax is preferable to an income tax become all the more attractive given the uncertainty surrounding the trade deficit.

Two, we can save the Federal Government budget surplus, rather than spending it on new programs or returning it to the public via a mega tax cut. Prudence, it seems to me, recommends in favor of both these options.