COMMISSIONER KRUEGER: Thank you, very much. I'm sure the commissioners would like to start with the questions. Commissioner Wessel.

COMMISSIONER WESSEL: Recently, several members of the agricultural community raised fears about the upcoming trade negotiations, as well as what's happened to them in the past, for example. The peso devaluation after the Mexico crisis took away many of the benefits they had anticipated as part of the negotiations.

I wanted to get your views, Mr. Dooley primarily, but others if you have comments on it as well, as to their idea that as we enter into a new trade agreement that we find a mechanism that would discount those activities. Potentially one of their ideas was by reducing the tariff phase out, meaning lengthening the tariff phase out so that the benefits to the devaluation would not be as great. Sort of a speed bump, if you will, in the process of devaluation. Do you have any comments on that?

MR. DOOLEY: No, I'm hardly an authority on trade negotiations.

COMMISSIONER WESSEL: No. More the question of the devaluations and the question of whether there's a proper response to that.

MR. DOOLEY: I think that the perception that the financial markets are behaving badly, and putting an additional strain on things like trade negotiations, is well founded when you have 50 percent real devaluations throughout several emerging markets simultaneously. That changes relative prices in an important way, and as far as we can see, these changes have been reasonably persistent. There's an initial overshooting and the exchange rate comes back, but the devaluation does need to stick for a while.

There are two obvious questions. Was the exchange rate appropriate in the first place? I mean, was the level of the exchange rate before the crisis maybe a part of the problem, and the adjustment, therefore, entirely appropriate and certainly not something that you would want to condition trade negotiations on.

But I must ask you, putting on a hat which I really shouldn't wear, but it’s how much do we really know about the appropriate global exchange rates, particularly between the emerging markets and the rest of the world right now? With how much confidence can we say that the large devaluations are inappropriate? My own view, and I've done quite a lot of research on the exchange rate determination, is that we don't know enough about it to make these kinds of fine judgments.

So, I guess my reaction would be that the financial markets do have profound -- or seem to have had profound effects on all of the prices. Big changes in all of the prices make trade negotiations much more difficult, and the costs of the negotiations, as you suggest, become important.

I guess where I would come down is that these adjustments are more likely to be appropriate than inappropriate, and therefore, I would -- I guess I would weakly fall into the camp that says that these relative price changes were pretty much inevitable, they would have happened anyway, they were delayed for a long time. When they actually happen they're costly. But I wouldn't condition them. My own view would be that I would not want to condition further trade negotiations on the basis of these changes.

COMMISSIONER WESSEL: I wasn't suggesting that we condition future trade agreements on those particulars, but rather as we negotiate agreements and hopefully reach them, that if a currency is artificially held high, that if, in fact, there are massive devaluations, at that point they're almost speed bumps put in the process to alleviate some of the pressures on our economy in that process.

MR. DOOLEY: In principle that sounds fine. In practice, I wouldn't want to be in charge of the technical group that does it.

MR. EICHENGREEN: I can't resist a couple of words, if only because you started with the WTO negotiations and their relevance to this commission's brief. I wrote my dissertation on the effect of tariffs and trade liberalization on the balance of payments in an environment on floating exchange rates. The answer you get from I think almost any analysis of that problem is that the WTO negotiations are to a first approximation also irrelevant to your problem.

The trade deficit is a macroeconomic phenomenon. It depends on savings and investment rates here and abroad. The WTO negotiations will affect the relative prices of the goods produced by different U.S. and foreign firms and in different U.S. and foreign sectors, but it will only have a first-order impact on the issue of concern to you if it significantly affects savings rates or investment rates here.

The logic for that, I think, is pretty clear. If there is significant trade liberalization by our Asian trading partners or others, the exchange rate is going to move to neutralize the aggregate impact on your problem, the trade deficit, of that trade liberalization. Trade liberalization doesn't occur in a vacuum. There are lots of other things that will affect relative prices, and the exchange rate will offset whatever our negotiators achieve in Seattle if we don't deal with the fundamental macroeconomic determinants of the problem.

I'm a supporter of trade liberalization. I think its benefits in the last 30 years for the U.S. economy and the world economy have been enormous, but I don't think it's relevant to your problem.

COMMISSIONER KRUEGER: Okay. Mr. Weidenbaum.

CHAIRMAN WEIDENBAUM: Professor, at the end of your statement you come up with a couple of positive suggestions for reducing the trade deficit by increasing our savings. I must say, I tend to shake my head up and down in agreement with your two suggestions, although for reasons I'll explore in a moment, they strike me as very modest in terms of their impact.

I can identify as someone who not only favors consumption taxation but actually developed some proposals that have been introduced for that on the Hill. But I have to admit when pressed, the macro effects of shifting from income taxation to consumption taxation is not exactly overwhelming. A shift from the right direction in terms of altering the mix of saving and consumption, but not dramatically. And in terms of the federal budget surplus again, someone who is for the barricades to eliminate budget deficits, I have to again point out the obvious. Shifting from awesome deficits to a substantial surplus in the federal budget has not had a noticeable impact on our national savings rate, at least not in the desired direction.

Am I missing something or are these modest proposals just because this is the greatest we can do or the problem isn't that important that we need to think of more dramatic means?

MR. EICHENGREEN: At the end there, you gave the two answers. I would give responses to your question. These are modest proposals because I think the problem is a modest one. But, if you're not an apostle of the new economy and you believe that our rapid productivity growth is not going to be sustained, then we have a big problem.

My hunch is that we've entered a decade of more rapid productivity growth than we enjoyed in the 1970s and 1980s, the implication is that a major currency crash and a sharp correction in the U.S. current account deficit are unlikely. U.S. economic policy shouldn't be oriented around eliminating the small danger of a large negative event. We know how to solve the trade deficit problem. We could adopt a panoply of policies to discourage investment. But, that would be entirely undesirable.

The other element of your answer is mine as well. Savings behavior is simply one of those things that economists don't understand as well as we should. We observe big differences in the savings rates between the U.S. and Canada; for example, we suspect that those differences have something to do with the tax system -- differences in the tax system, among other things. But as you know better than I do, these are issues that we as a profession shouldn't give advice on with confidence.

COMMISSIONER KRUEGER: Do either of the any panelists want to add anything?

MR. DOOLEY: An important issue here is that the efficiency of the U.S. national intermediation has two effects. One, it allows us to get along with a low savings rate with a very high rate of return investment. A very high quality capital stock. The other is that it attracts foreign savings.

I'm more impressed by how bad financial intermediation is in the rest of the world and how attractive that makes U.S. financial markets and claims on the United States for residents in the rest of the world who will accept the rate of return in the U.S., on average substantially below what they will demand to invest their wealth in their own countries. As long as this is the case, the U.S. is going to have a trade deficit.

Will this lead to a sudden stop, as Barry suggests? Well, like any economic analysis, the thing driving Barry's comments is that productivity growth -- if that’s what is driving things, if that stops suddenly we could have a sudden stop and a serious problem.

If it's just the efficiency of U.S. financial intermediation, however, then the last thing in the world we want to do is direct policy toward changing anything, any behavior of financial institutions or U.S. savers. It doesn't suggest there will be a sudden stop. If financial intermediation accrues in the rest of the world, that will happen gradually. And as it does, the U.S. trade deficit will shrink and we can all go home.

So, I don't share the concern about sudden stops in the rest of the world's desire to invest in the United States, mainly because I'm impressed by how bad things are everywhere else.

CHAIRMAN WEIDENBAUM: This all sounds so reasonable, frankly, you know. We heard Barry with earlier hearings. But there's something that strikes my sense of irony. In the earlier part of the 19th century when we were a relatively poor developing country, we were importing capital.

The Europeans financed our canals and railroads and heavy industry. Now that we're a wealthy country, and others are in that poor developing area, we're still competing with them. We're still attracting the capital. It appeals to my sense of irony only.

MR. EICHENGREEN: I think it's more than irony. Given the disturbingly large gap in living standards between rich and poor countries, which is associated in part with very different levels of capital per worker in what we might call the -- what economists have long called the north and the south, there is an efficiency argument for transfers from capital abundant to capital scarce regions.

Our century is different from the 19th century because what people had in mind in the 19th century was a debt cycle, which you described in your question, where poor countries have low savings rates, and as they mature and enjoy higher incomes their savings rates rise. They move from being importers of capital to being exporters.

Now, we are in a peculiar and disturbing situation where the poor residents of many developing countries save more than their American counterparts.

And more importantly, capital flows are driven by differences in the efficiency of investment. The 19th century story was heavily differences in savings rates over time and across countries.

Professor Dooley and I have given two reasons why investment is unusually productive in the United States at the moment. It's financial system. It's constellation of institutions that give us an advantage in high tech. And in some sense that is a different situation from 100 or 150 years ago.

MR. GLICK: Can I add something also? There is a key difference between our economy now and the economy of 100 years ago which reflects the increased role of the service sector in industrialized society. In the 19th century we competed internationally only in manufacturing. Now we compete not just in manufacturing but also in service. And as Professor Dooley has mentioned, we compete well in the United States in the financial services.

Moreover, although traditionally we think of services not as traded, but as non-tradable. As the globalization of economies proceeds, we see more types of services traded across countries -- legal services, consulting services, entertainment, etc. - all in which we excel very well also.

Now, when you think of competition in services, as well as manufacturing, then you go back to the issue of how do you interpret productivity? Most of the focus of what I think that Professor Eichengreen had in mind when he referred to productivity was productivity in high tech manufacturing industries. But when you think of productivity more generally as also being able to compete well in the broad service area, our advantages in this area may go on much longer than the perceived advantages in technology we have right now.

A good example is to compare us with Japan in the 1980s. Back then, Japan was perceived as the country which was leading in the high tech productivity area. That changed quite rapidly. No one would think of Japan as being a big leader in the area of services now or in the future. So, that's one reason why I think Mike Dooley has confidence that our current deficit may be more sustainable than you might think, because we have advantages not just in manufacturing, but in other services as well.

COMMISSIONER KRUEGER: Commissioner Papadimitriou.

VICE CHAIRMAN PAPADIMITRIOU: Thank you very much to all of you for your commentary. It was extremely enlightening. I have a couple of questions, however. And I agree, actually, with the issue of productivity. But, it seems it is very difficult in some ways to measure actual productivity within the different sectors, manufacturing as well as services; I do agree with the notion that one should buy the protection that productivity provides.

But my question actually begins on the suggestions that you made for dealing with the trade deficit, which is in terms of increasing savings. First I suppose I do want to note that given the projections of the CBO, and which are not that much different from the Executive Branch, we seem to be doing and will be doing quite well into the future, and be able to save trillions of dollars. So, there will be some increase in savings if we were to think in the long run.

The other question is we know from the experience in Europe through the value added tax that even though they don't have a trade deficit, as we do, they have different problems. They are domestic problems. They have unemployment and their growth is actually quite low. Is that remedy a solution to the trade deficit that might actually cause different problems on the domestic front even though alleviating, perhaps, the foreign front?

MR. EICHENGREEN: On your second question, one of my points in my written remarks is that in a world of globalized financial markets like the one in which we increasingly live, policies to encourage saving can help to solve the trade deficit problem. They're not going to have a big impact on the rate of growth of the U.S. economy, the level of investment in the U.S. economy, the level of unemployment in the U.S. economy.

If we save some more, we will rely on imported capital less, but in a world of increasingly integrated financial markets our savings is -- our investment is less and less constrained by our savings. The difference between them creates your problem, the trade deficit, but they don't drive the rate of growth of the U.S. economy. The institutions that contribute to our rate of productivity growth drive the rate of growth of the U.S. economy.

What can we do with the rate of savings? I should be up front with the Commission and say I quite agree with Professor Weidenbaum's reaction that my recommendations are weak soup. But this is precisely because we know so little about how to promote saving. Economists even dispute whether more government saving will produce more aggregate saving or simply be offset (through Ricardian equivalence) by the reaction of households.

I'm not a believer in strong Ricardian equivalence. What the government does with its budget does matter for our national savings rate. Government savings, however, are not the problem at the moment. The government is, for the time being, living within its means, and it’s the household that's not. Alas and alack, how to encourage household savings is something that we don't know well. But we give households better incentives through the tax system to save, we can't worsen that situation and maybe we'll improve things.

COMMISSIONER KRUEGER: Commissioner Rumsfeld.

COMMISSIONER RUMSFELD: Yes. Dr. Eichengreen, you talked about the saving rate being somewhat disturbing in your comments. Is it conceivable that the data's not good? That either it's not any good or it's imperfect or it needs to be assembled and aggregated differently or pieces are missing or we're looking at the wrong thing?

One of the things this Commission could do if there is data that is collectible or measurable that it ought to be available to us and isn't, is to recommend that something be done about that. It seems not to have been part of the discussion, except in the sense of saying there are things we don't know, and that is certainly true.

Another thing I don't know what is that thing at the end of your background sheet where it says the Bellagio Group, and then there's a symbol written I've never seen before?

MR. EICHENGREEN: I'm sorry. I didn't get that.

COMMISSIONER RUMSFELD: You have a background sheet you submitted in your written testimony. Well, there's a symbol after the word. Seventh line down.

MR. EICHENGREEN: Oh, I see. I think this is a problem with staff's printer.

COMMISSIONER RUMSFELD: Oh. I see. I thought you being a professor it might be a test.

MR. EICHENGREEN: No, those are supposed to be quotation marks.

I do think that savings data are flawed. But go back to the accounting identity that you have to hold in your mind, that if the current account deficit numbers are not flawed or they are at least reasonably accurate, then we know as a matter of accounting -- that the savings is $300 billion a year lower than investment. So, even if we have trouble measuring savings somehow, we also have trouble measuring investment. But the difference between them still has to be the current account deficit, as a matter of definition.

So, better savings numbers are desirable. Better investment numbers are desirable. But, unless the current account numbers are deeply flawed, such refinements are not going to make the problem go away.

COMMISSIONER RUMSFELD: And you're comfortable the way they take into account appreciation and real estate and look at the totality of the situation with respect to saving?

MR. EICHENGREEN: No. I'm uncomfortable about not knowing how to best account for capital gains. Not even government statisticians agree about how to do that. But if we followed a somewhat different convention there we would have to revise other things in the national accounts as well, and those revisions as a group would not make the current account deficit numbers go away, if we have independent sources of information on the latter.

COMMISSIONER RUMSFELD: But if the current accounts aggregated number is not something you can address, you can only address it in its sub-pieces, and if the pieces are considerably different than they appear, that becomes quite important, wouldn't you think?

MR. EICHENGREEN: Others will know better than I do the extent to which we rely on those same savings and investment numbers to construct our estimates of the current account.

COMMISSIONER KRUEGER: The errors -- the errors and omission is very small relative to the current account deficit which is -- I mean, the errors and omissions in the balance of payment statistics is a reconciling item. So, I -- they're just different orders. The problem is if you redid the national income accounts to do the savings figures the way you suggested, you'd also do some other parts, and these show up on both sides of the balance sheet.

CHAIRMAN WEIDENBAUM: I was weaned by Morgenstern while he was writing on the accuracy of economic observations. Your experience as a grad student is always a traumatic one you recall vividly. And Morgenstern would show, for example, that country A’s exports to B never equal B's imports from A, and all sort of similar and more sophisticated problems.

But it gets back to Commissioner Rumsfeld's point that how much confidence do we have -- not just in the savings statistic, you know, that's residual and they're the most treacherous things anyway, but in -- a current account deficit he focused on, $300 billion plus minus how much, and does that make much difference in terms of a trend, in any event, which gets back to the issue of sustainability. Gentlemen, address the data aspect.

MR. GLICK: All economic variables are measured with some error. Some variables, such as components of GNP or the current account are measured with more error than others. In particular savings is measured with more error than other components of GNP, in part because it's a residual.

We don't go out and normally ask people how much they save. Rather we measure how much output is produced, subtract from that what people consume, and what they pay in taxes. What's left over is the residual that is called savings.

There are probably some reasons why the amount of savings that's recorded is less than it should be. I can give you an example of that. Recently Social Security contributions by federal government employees were added to the measured savings rates. That had the affect of raising our measured savings rate by a few tenths of a percent. That's not large, but it's a measurable amount.

Going back to what Mr. Weidenbaum recalls learning from Morgenstern, there's a reason why in current account and trade balances, exports tend to be measured with less precision than imports, and the reason is that countries have an incentive to keep track of their imports because they levy tariffs on imports, and they care about the revenue they collect. So, there are economic incentives for why some statistics are measured better than others.

Having said all that, I still agree with what Professor Eichengreen said, you take extreme cases of what the bias might be in savings or whatever. It's still not enough to wipe out a $300 billion trade deficit. It may effect the level of the trade deficit somewhat, but not reduce it by $300 billion.

So, are there biased statistics? Yes. In savings in particular? Yes. I might mention that there are other potential biases relating to how to incorporate the role of stock market gains and real estate value gains.

I'm not sure whether those gains should be called savings, but one interpretation is that they affect people's incentives to save to the extent that unrealized stock value gains increase their wealth that they can rely upon to finance future consumption. But savings are measured imprecisely. If you measured it more precisely, it's not going to make the trade deficit go away.

COMMISSIONER KRUEGER: Michael Dooley.

MR. DOOLEY: Yes, I'm really uncomfortable with the idea of relating cross-country care -- cross-country calculations of savings rates to the trade deficit. And one way to interpret the Commissioner's question is suppose we use a different accounting framework that included things like investment and education and savings, household savings, which clearly it should, and included -- I never knew about this one, Social Security payments. I think you would get different cross-country sets of comparisons.

Certainly the numbers wouldn't be the same. Would either of those calculations be very useful in explaining the distribution of savings across capital stocks, that is, the trade deficit?

The fundamental issue of the deficit is that foreign savings are being used to support capital formation in the United States. Is that a welfare-improving phenomenon for the world? I think my own view is that that is largely independent of the U.S. level -- the measured level of the U.S. savings rate.

COMMISSIONER KRUEGER: But since I'm the next one anyway to ask a question, let me follow up on that, and then I want to ask Professor Eichengreen if they're related.

Insofar as there is a capital inflow, and I'm going to agree there is, the first thing to be said is if we recalculated savings for education we'd also recalculate educational expenditures as investment, so it wouldn't affect the difference?

MR. DOOLEY: That's right. It would not affect the difference.

COMMISSIONER KRUEGER: So, you still have a capital inflow either way.

MR. DOOLEY: Right.

COMMISSIONER KRUEGER: But quite clearly that capital inflow is responsive to the real rate of return on investment, right?

MR. DOOLEY: Absolutely.

COMMISSIONER KRUEGER: So, then, that leads to my question to both of you. If we buy that the productivity increase now is associated with an above average or even more perhaps, long-term sustainable rate of return on investment, then we have to link the capital in flow in some sense to this higher rate of return, which is my first question to you.

What evidence is there that that's the case? And then a second question for Professor Eichengreen would be insofar as we are worried that maybe the productivity increase isn't sustainable, if and when the productivity thing runs its course or whatever, would that not then be self-correcting as it's also a smaller capital inflow? I'll let you go first.

MR. DOOLEY: Actually, there are two. The rate of return on U.S. capital to U.S. residents is not necessarily as it is for non-residents. The rate of return on foreign capital. But the actual physical productivity, the productivity of the capital stock, because you have to go through a financial system to acquire points on that stock.

We saw a tremendous run up in equity prices in emerging markets recently, and substantial inflows in those markets. But because the financial systems themselves are poorly organized, we also saw tremendous collapses. The U.S. can pay a lower rate of return to the rest of the world because people have confidence in U.S. financial markets.

And that's, in my view, why we are cursed to get a capital inflow. I don't think we could do anything to stop residents of emerging markets in developing countries from wanting to invest a substantial part of their wealth in the United States.

Do we want to, in turn, invest in those countries, which you would think because their capital is poor, they have lower wage rates. Well, we would, except that the financial market for those countries has the disturbing property of breaking down every four or five years. And that is substantial -- and so, I think instead of worrying about levels of savings rates, what we should focus on is that the U.S. is an attractive place to invest both because of the real return on capital and because of secure financial intermediation? The answer is yes.

Is the rest of the world an attractive place for U.S. residents to invest? Yes, if you only look at the real rate of return, real capital; no, if you look at the financial institutions that you have to deal with, in actually holding those claims on those capital funds.

And so I really don't think the measured savings rates has much to do with the distribution of savings across countries. The U.S. will attract foreign savings. U.S. residents, however, are also testing the foreign markets, but not to --

COMMISSIONER KRUEGER: Regardless of the differential and the real rate of return on capital?

MR. DOOLEY: I think non-residents will accept a much lower rate of return on claims in the United States.

CHAIRMAN WEIDENBAUM: Can I try rephrasing what you said? Maybe that provides the answer. You're making a distinction between nominal rates of return and risk-adjusted rates of return. And risk-adjusted rates of return here are so much higher than in Southeast Asia these days. And it's hard to conjure up any policy that we can embark on that would eliminate that gap.

MR. DOOLEY: Perhaps, but what it indicates to me is the United States and all the creditor countries, industrial countries, have a tremendous stake in stabilizing financial markets in the rest of the world. We need -- I mean, it's our citizens -- well, it's in our citizens' interest to have access to those higher rate of return assets. What's happening is the financial markets are getting in the way. The financial markets are supposed to facilitate that, not be a blockage.

COMMISSIONER KRUEGER: One last follow-up question before Barry. And that is what I know hear you saying is it's a risk adjusted part. Before, I thought you were talking simply about the lower cost of financial intermediation here. Is it both? Is it predominantly one, predominantly the other? Are there any estimates?

MR. DOOLEY: No, there are no estimates that I know of. My own experience leads me to believe that it's the very substantial difference in the efficiency of financial intermediation which makes the big difference.

COMMISSIONER KRUEGER: That -- then it's a cost differential, it's not a risk?

MR. DOOLEY: Well, no, no. I'm sorry. It's the risk the institutions, the financial markets break down, and so it's the risk of that which increases the cost of investing.

COMMISSIONER KRUEGER: Barry Eichengreen and then -- Barry, you can go ahead.

MR. EICHENGREEN: I'm not inclined to agree entirely on this one with Professor Dooley, because I think there is a substantial part of the world out there whose contracts are as secure and whose financing systems to a first approximation work more or less as well as ours do. Europe, for example, and, The 1990s to the contrary, notwithstanding, Japan. Japan may be able to clean up its act in the future as well. Europe is as large or larger an economy than the United States. There are plenty of places other than the developing third world countries where Americans will invest through European mutual funds and similar vehicles for Europeans to invest here.

On Professor Krueger's question, which is if the large capital inflow is being fueled by the productivity miracle, so that the productivity miracle goes away slowly but surely, so will the capital inflow and the trade deficit, which is simply the flip side of the same coin, it is true that productivity growth tends to be a slowly moving variable. It is the outgrowth of a large constellation of interacting institutions. It doesn't jump up all at once by several percentage points a year and then suddenly reverse course without warning.

Professor Krueger's conjecture as I understand it, is the productivity miracle plays itself out, productivity growth will slow gradually over time, the capital account surplus will wind down gradually over time, the trade deficit will disappear smoothly over time. But even if all of that is true of productivity, it need not be true of the financial markets.

Even if the productivity miracle is disappearing gradually over time, the financial markets will still presumably wake up one Monday morning to this realization. Some influential pundit will acknowledge the fact. Other market participants will conclude that someone knows better than they do and they will adjust their portfolios accordingly. So, I think even if the underlying real phenomena are very slowly moving and gradually adjusting, the financial markets are not, and that can very well adjust with a crash or a hard landing.

COMMISSIONER KRUEGER: Mr. Glick.

MR. GLICK: I just wanted to paraphrase my understanding of Mr. Dooley's argument, at least for my benefit, if not for the benefit of the commissioners, which is that we normally think of, you know, capital moves in responds to interest rate differentials adjusted for exchange rate changes. And depending on your model because of the volatility of the exchange rates you want to take into account sort of the variance factor of the exchange rates as well.

But in addition, you've got this country risk factor. Something specific to the country which one way to interpret it as something related to the quality of the infrastructure. The financial system. The possibility of default in a country. And clearly that's much higher now in developing countries than it was before.

I think someone asked can you measure it, are they estimates. I mean, one measure is just looking at the differential in the rate on corporate bond issues in these countries. A bond issues in your market and what you can get on the U.S. Treasury. And clearly that's a very volatile -- that spread is a very volatile measure, but after the Russia crisis it went as high as 15 percent. It was that magnitude during the Mexican peso crisis. Fifteen percent.

Now, that may, in fact, understate sort of like the country premium that investors have to receive if you're an American resident and you're deciding whether to invest abroad to compensate you for the possibility of a disaster happening every five or 10 years.

So, I think our perception of the country risks abroad are much higher now that they were, you know, two or three years ago.

COMMISSIONER KRUEGER: Commissioner Lewis.

COMMISSIONER LEWIS: Professor Dooley, you make the statement, "Quite a few governments should require concessions about private lenders as a condition for their loans to debtor countries." Could you define who those parties are?

MR. DOOLEY: It depends on the debtor country, but it could be --

COMMISSIONER LEWIS: What are we? Are we a creditor country?

MR. DOOLEY: Yes. We're the creditor. We are the player in the game that goes in after the trouble starts.

COMMISSIONER LEWIS: Well, why are we a creditor government if we're running a deficit?

MR. DOOLEY: You're a creditor to the other government in this case. The government of Korea, right, or Mexico is probably a better example. We made substantial loans to the government of Mexico.

COMMISSIONER LEWIS: We being the --

MR. DOOLEY: The IMF and the U.S. government. Okay. So, when the financial crisis strikes, private investors in Mexico want to sell their planes to someone and exit. Okay.

With the international rescue packages essentially what happens is creditor governments, both directly and to the IMF, make loans to the debtor government, the government of Mexico. The government of the United States makes loans to the government of Mexico. The government of Mexico then uses the proceeds of those loans to stabilize markets, to buy assets, to bail out the banking system.

Therefore, the money that the U.S. government loans to the Mexican government is paid out to private investors.

COMMISSIONER LEWIS: The trouble I'm having is it sounds like a circle.

MR. DOOLEY: It is.

COMMISSIONER LEWIS: The Mexican people are saving more than they're investing, vis-à-vis the United States.

MR. DOOLEY: That's right.

COMMISSIONER LEWIS: So, they're lending money to us?

MR. DOOLEY: I'm not sure if that's true bilaterally, but yeah, most -- that's certainly true.

COMMISSIONER LEWIS: And then we need to lend money back to their government because they don't have enough money for investments?

MR. DOOLEY: No. No. That -- I'm sorry. There are two-way trades in the financial assets, right? We U.S. residents lend -- U.S. banks lend money to Mexican firms.

COMMISSIONER LEWIS: Yes.

MR. DOOLEY: Okay. Mexican residents also buy U.S. broker bonds. On balance, if you take the U.S. and the rest of the world, the float is net towards the United States. But the net floe is very slow relative to the two-way trade in the financial assets. So, even though we are a debtor country, we have a very large stock of claims on residents to the rest of the world, in particular, emerging markets.

So -- so, if I lend -- if everybody on this table lends $1,000 to everybody at your table and you lend $900 back, okay, there's a net, but there's also a large outstanding stock. All right. What happens in the financial crisis is that the U.S. residents, private investors, want their money out of Mexico because they're afraid -- they're afraid they're going to lose their shirts.

That leads to a collapse of asset prices in Mexico and of economic activity, which is what we're really concerned about.

So, the U.S. government then lends money to the government of Mexico to try to stabilize that situation.

COMMISSIONER LEWIS: The problem I have is that China is running about a $60 billion surplus with us. That means that the Chinese are essentially investing $60 billion in the United States.

MR. DOOLEY: Well, China is certainly investing -- the bilateral trade flows, the structure of bilateral trade flows does not match necessarily the structure of the flows and financial assets. It's certainly conceivable that Chinese residents have that many claims on the U.S., but it's not. If it was a two-country world, that would necessarily be true. Okay.

So, for this argument, we and China are the only two countries. It's certainly true that they're running trade surplus that they are investing in the United States. But there -- but, so that's fine. But we also invest in China. So --

COMMISSIONER LEWIS: China seeks investments from the United States in China.

MR. DOOLEY: Yes, indeed. Indeed. So, quite independently is a net capital flow. There can be and there are very large what we call two-way trades in financial assets. The easiest thing is to suppose there was no trade deficit between the United States and China at all.

There could still be a very large flow of U.S. investment into China and a large flow of Chinese investment into the United States. And in fact, more and more that's where we think the real welfare consequences of open capital markets come from.

Suppose that Chinese financial markets are not very good, but we get a big inflow of U.S. capital into China through direct investment or other forces, and it's very efficient. Chinese residents, on the other hand, are actually trying to avoid their rather inefficient banking system. They hold claims to deposits in U.S. banks. Okay. That can help both sides.

And the welfare -- and the well being of residents of both countries can be improved very substantially by that. The problem, of course, is stability.

If Chinese residents have a very large stock of claims in the United States, the residents of the United States have a very large stock of claims on Chinese residents. As long as things go smoothly, that's great, and it's easy to show, quantitatively, that the wealth implications of that can be very positive. If it breaks down on one side or the other, then we have problems. Then perhaps there's a recession in China, and it has implications for the whole region.

So, we're really talking about two very different animals here. One is the net trade between the two countries. All right.

COMMISSIONER LEWIS: Which causes an investment by whoever has a surplus?

MR. DOOLEY: Right. Right. The other is the composition of trade and financial assets between the two countries, which can also be very important. And it can lead to substantial problems. And my work tends to focus on the second of the two questions.

What is the nature of the financial relationships between the two countries? Is that operating smoothly? And does that have an effect -- does that finally, in the end, have an implication for the net trade? I think it does, but it's -- it's not straightforward.