MR. MAKIN: Thank you very much, Mr. Chairman. As always, it is a pleasure to address a distinguished panel, and I see many friends and colleagues on the panel.

I'll try to move quickly.

Basically, I'm going to say that the causes of the trade deficit may actually be good news rather than bad news.

But let me start at the beginning. I want to offer some basic definitions, and I'll go quickly here, because I think this group is pretty well informed on these matters.

The trade balance as usually measured for the United States is the difference between the dollar value of goods and services sold abroad and the dollar value of goods and services purchased abroad. We have a balance on merchandise trade and services trade, and then the other major category of external accounts is net income on foreign investments.

When we put all these things together, we find that in 1998 the U.S. economy, I should say, had a current account balance that was in deficit at about 2.6 percent of GDP, or about $220 billion.

I don't think it's too misleading to use the trade balance and the current account balance interchangeably, because, conceptually, the current account balance is a much more useful concept. So I will be, in the course of my discussion, switching between them, and in my written testimony, I'm somewhat more detailed in terms of the connection between them.

With the U.S. net foreign asset position at about a negative $1 trillion; that is, the cumulative value of past current account deficits runs about $1 trillion and U.S. GDP at about $8.5 trillion, I don't take U.S. global indebtedness to be too alarming; that is, oftentimes it's suggested that we have a trade deficit and a current account deficit, and this means we owe a lot of money to the rest of the world, and isn't it terrible.

As I've said, U.S. net indebtedness to the rest of the world is something on the order of $1 trillion whole U.S. annual income is $8.5 trillion. It's something like a young professional household with about $85,000 in annual income carrying $10,000 in net debt.

It's hardly surprising that foreign claims on the United States have grown more rapidly than U.S. claims on foreigners during the last decade when the United States has experienced a remarkably vigorous, investment-led, non-inflationary expansion.

These characteristics have led foreigners to be anxious to invest more in the United States than the U.S. invests abroad. More specifically, with the U.S. stock market rising rapidly, foreign investors want to participate just as much as American investors. When they do so, net foreign claims on the U.S. rise more rapidly than U.S. claims on foreigners rise

In sum, the rise in U.S. liabilities to foreigners is a more a sign of U.S. strength as an attractive destination for global investors than it is a sign of U.S. weakness.

A useful way to view the trade or current account balance of the United States when considering policy or other practical implications is to express it in terms of some basic accounting identities. This will take me to some discussion of the causes of the trade deficit.

The U.S. current account balance is by definition the sum of private net saving and public net saving. More concretely, if private net saving is zero and all Government budgets are in balance, the current account balance will be zero.

Alternatively, if U.S. investment exceeds U.S. savings while the Government accounts are in balance, the U.S. will have a current account deficit that measures the net capital inflows required to finance the excess of domestic investment over domestic saving.

This last condition reflects another identity that the U.S. current account balance is equal to net capital flows into our out of the country. When the U.S. current account is in deficit, it simply measures U.S. spending in excess of income that must in turn be financed by capital inflows, alternatively, net borrowing from abroad.

That definition of spending, of course, includes investment.

I'm suggesting here that when we look at the current account, it's important to look at it and say: Do we have a current account deficit that is net capital inflows, because investment opportunities are rising more rapidly in the U.S. than savings or because we're spending more than we ought to?

In the past decade, I would argue that part of the reason we've had a rising current account deficit is a rapid increase in investment opportunities in the United States relative to the increase in savings at home. The mirror image would be Japan where investment opportunities are more limited and less than Japanese saving.

Households in Japan are seeking outlets, productive outlets, for saving and sending money to the United States. Whether or not that puts Japan in an advantageous or a disadvantageous position, is perhaps almost a metaphysical question. I would rather live in the country where there is an excess of attractive investment opportunities recognizing that that would mean that I'd be running a current account deficit unless domestic savings rose as rapidly as domestic investment opportunities.

Turning to the causes of the U.S. trade deficit, fundamentally, the U.S. current account deficit largely composed of the trade deficit measures the excess of U.S. spending over U.S. income, including investment and consumption. Proximately, if U.S. income grows rapidly relative to income growth abroad, then U.S. imports will grow more rapidly than U.S. exports, which after all are just a mirror image of imports by foreigners.

One of the causes of a trade deficit could be an extraordinarily rapid period of U.S. growth. Indeed, the last time the U.S. had a current account <u>surplus</u> was during the brief 1990-91 recession when U.S. imports fell rapidly with U.S. growth.

Simultaneously, of course, the U.S. experienced a rapid and temporary inflow of funds at that time from abroad as contributions of our allies and the conduct of the Gulf War. Still, even after adjusting for the impact of the Gulf War, the U.S. current account was nearly in balance during the 1990-91 recession.

One way to get back to balance is to -- I'm not saying to have a recession, but certainly the current account and trade deficits typically fall for the U.S. in a recession, because the rate at which we absorb imports is reduced.

Since 1991, the U.S. current account deficit has risen steadily as a result of rapid U.S. growth and, simultaneously, the eagerness of foreign investors to push funds into the U.S. which in turn implies that U.S. spending rises even more rapidly since it's financed on easier terms than would be available if the U.S. economy were not able to absorb foreign capital inflows.

Sometimes I say that we don't have a current account surplus in the U.S., because foreigners won't let us. They are so eager to invest in the United States on terms that look very attractive to U.S. borrowers that they end up financing a high level of U.S. investment relative to domestic savings. That's got to show up as a current account deficit.

Therefore, if the U.S. is growing rapidly, absorbing imports, using those imports to produce goods, add to its capital stock, add to its wealth, we probably are going to see a current account deficit for the U.S. If we go rapidly into a recession, we're probably going to see the trade deficit and the current account deficit fall.

My time is getting limited, so I want to add here a little general commentary on where we might be today and then close.

Clearly, right now, the situation for the United States is becoming interesting, and the question we're trying to answer is the following: As the U.S. current account deficit rises this year -- and it is rising -- the question we have to ask are will foreign investors finance net capital flows to the United States of about $25 billion per month on terms -- that is interest rates -- that will be attractive to the stock market?

This is where we get to the problem side of this. We may have an adjustment underway here where foreign growth and recovery that we're seeing this year is a good thing, but it means that investment opportunities in the rest of the world have grown relative to investment opportunities in the United States.

And, so now when global asset managers are asking themselves, "Where should I put my money," they may be thinking, "Well, maybe I should put a little more into Japan, a little more into Europe." There's a big restructuring decade coming in both of those countries.

We've probably been through our restructuring decade, and what we may see is that the terms on which we can finance a current account deficit of $25 to $30 billion will not be as attractive as they were; that is, U.S. interest rates will rise because of an external constraint, and that may put some pressure on equity prices. Pressure on equity prices, of course, reduces U.S. absorption and spending and is a part of the process of working this out.

I guess I raise this issue because I think the best thing to do in these circumstances is not to get alarmed. If market prices, in terms of the willingness of the rest of the world to lend to the United States, suggests higher interest rates and a weaker dollar and a lower stock market, so be it.

We'll just have to -- it's better to let that happen, let a natural process of adjustment happen, than to intervene in foreign exchange markets and make believe the dollar doesn't have to go down, artificially try to support the stock market, et cetera. Here, again, I think the Japanese have shown us the way <u>not</u> to go over the past decade.

Mr. Chairman, I sense --

VICE CHAIRMAN PAPADIMITRIOU: Thank you.

MR. MAKIN: -- that my time is up.

VICE CHAIRMAN PAPADIMITRIOU: It's a good thing we don't give traffic tickets, because you, I think, have passed more than one red light.

MR. MAKIN: My apologies.

VICE CHAIRMAN PAPADIMITRIOU: Thank you, Dr. Makin.

MR. MAKIN: Thank you for your indulgence.

VICE CHAIRMAN PAPADIMITRIOU: The next panelist is Ms. Jenny Bates, who's a policy analyst from the Progressive Policy Institute.