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U.S.-Latin American Trade, and the Role Played
By U.S. Participation in NAFTA

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Thank you very much for the opportunity to appear today as a witness before the United States Trade Deficit Review Commission. The issues that you have been charged to investigate are both important and complex. I will first discuss briefly the nature of our trade balance and its implications. Then I will focus on the relevance of NAFTA and Latin American trade since that is the main subject of these hearings.

The merchandise trade and the current account balances of a country are influenced by many variables, such as macroeconomic policies. trade policies, exchange rate policy, technological change, and a host of other factors. While economists agree concerning the relationship between current account and capital account balances, significant differences of opinion exist in the profession concerning the direction of causality when the balances change, as they have done rather dramatically for this country over the past few years.

The interpretation that one gives to the recent large increases in the United States trade deficit will depend heavily on one's view of changes in the overall economy during the past ten years. Is the United States economy currently a "bubble economy" on an unsustainable course that is in danger of sudden reversal? Or is it in some sense a "new and different economy" undergoing profound transformation caused by rapid technological change?

My own assessment is that the current account deficits of the United States in recent years do reflect the fact that the United States is on the forefront of very significant technological change. Communications costs and transactions costs are plummeting, and production processes are being revolutionized. After a significant time lag, not unlike

those of previous technological revolutions, the rate of productivity in the United States economy has increased markedly during the past few years, and the prospects for a sustained higher level of productivity appear promising. Consequently, we have observed remarkable returns on equity investments and a very high rate of investment in new capital equipment. Fixed private direct investment as a percentage of Gross Domestic Product was running at a record rate of 17.3% during the first three quarters of 1999'. Investment in information processing equipment and software currently accounts for around 35% of total fixed nonresidential investment in the United States and is increasing rapidly, providing further evidence of the technological transformation occurring in this country.*

Because the United States is on the forefront of the technological change, citizens of other countries have been eager to invest here to participate in the high rates of return. At the same time members of the American public, having had their wealth increased by appreciating asset values and anticipating continued good times, have had less incentive to forgo present consumption in order to provide for the future. Therefore over the past decade the personal savings rate of the United States has fallen from around 8% of personal disposable income to 2.5% in the first three quarters of 1999.[3]

The desire of foreigners to invest in the United States has made possible very high rates of private direct investment. during a time when domestic savings were unusually low. without a significant increase in interest rates. To put it differently, we are

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[1] Rate calculated from data presented in Federal Reserve Bank of St. Louis, ***National Economic*** *Trends*, November 1999. p.24

[2] Calculated from data in U.S. Department of Commerce, ***Survey*** *of* ***Current Business.*** December 1999, Table 5.4., p. 81

[3] Ibid. Table 2. p. 17. and calculations based on figures from Table 2.1, p. 56.

borrowing from abroad to finance an investment boom as we upgrade our capital stock to embody new technology. United States investment in information processing equipment as a percentage of Gross Domestic Product is roughly twice that of Western European countries, and is 1.7 times as much as that of Japan.[4] That our borrowing has been largely for investment purposes is also evidenced by the fact that the share of capital goods imports in total imports of the United States has increased from around 25% to about 45% during the past decade.[5]

If the scenario traced out above is an accurate interpretation of events, then the recent large current account deficits are being driven primarily by the positive state of the United States economy. particularly in relation to other parts of the world that have been in recession. These deficits are an indicator of the economy's health rather than of its weakness. Since our external borrowing is making possible record levels of investment in cutting-edge technologies. the increased productivity of the economy should easily provide for repayment of the funds borrowed while at the same time increasing the standard of living of the American people.

If this scenario turns out to be mistaken, and we are instead in a "bubble economy". then our large trade deficits financed by foreign borrowing are considerably more worrisome. Should the bubble burst, and foreign lenders withdraw large amounts of funds from our capital markets, then interest rates would rise and the United States economy would fall into recession. Even in this scenario. however, the United States

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[4] Calculated from data presented in Gene Koretz, "Info Tech: Who's Spending What," *Business Week,* (May 3. 1997). p. 27.

[5] Michael R. Pakko. "The U.S. Trade Deficit and the 'New Economy'," *Federal Reserve Bank of St. Louis Review*, September/ October 1999, p. 11

economy should be flexible enough, and its institutional structure strong enough, to avoid prolonged recession.

Whatever the causes of the recent United States trade deficits, policy measures are available that could reduce them. Measures that would encourage saving, such as tax-deductibility of interest earned or greater reliance upon consumption taxes, would provide a greater pool of domestic savings and imply less dependence on foreign borrowing. Furthermore, since the trade barriers of some of our trading partners are considerably higher than our own, aggressive pursuit of multilateral trade liberalization would give us an advantage in terms of market access that should increase our exports by more than our imports.

Next let me turn to trade with our NAFTA partners. The United States is running a sizeable merchandise trade deficit with both Canada and Mexico. In the first half of 1999. these two countries accounted for 18% of the United States trade deficit (Canada 9.6% and Mexico 8.3%). This is up from 13% of the total trade deficit a year earlier.[6]

Certainly there is no reason to expect that the United States would maintain balance in its trade with individual trading partners. such as Canada and Mexico, whatever the state of its global trade balance. Yet the fact that we have sizeable trade deficits with our two largest trading partners is naturally a matter of some interest.

Our deficit with Canada is no doubt related to the depreciation of the Canadian dollar relative to the United States dollar in recent years. No one can say for sure why this has occurred. Most likely it reflects present and anticipated productivity differentials between Canada and the United States, and differences in business climate in the two

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[6] Calculations from data in United States international Trade Commission, *International Economic Review* September/October/November 1999. Table 9. p.20.

countries. In any case, the real exchange value of the Canadian dollar is significantly lower now than it was when either the U.S.-Canada free trade agreement or NAFTA went into effect, and that fact is reflected in our trade balance with Canada.

As for Mexico, I consider the United States trade deficits with Mexico to be temporary. In the four years preceding the NAFTA agreement, and in the first year of the agreement, the United States ran sizeable trade surpluses with Mexico. The peso crisis dealt a severe blow to the confidence of investors regarding Mexico. Uncertainties about Mexican regulatory processes, expected changes in the political system, and questions about the country's ability to service a large foreign debt have continued to impose a risk premium on potential investments in Mexico. If the presidential election and transition to a new administration go smoothly, and if the economic reforms are further deepened rather than compromised, capital flows to Mexico should increase rapidly. As Mexico upgrades a capital stock that has been seriously degraded by previous economic difficulties. United States firms will be prime suppliers of the capital equipment. There is a high probability that we will again soon be running trade surpluses with Mexico.

With regard to the rest of Latin America. the trade of this region with the United States has been lower than one might expect from the sizes of the economies involved. Trade of the United States with Central and South America is only about three-fourths as large as our trade with Mexico alone.

The United States has consistently run trade surpluses with the countries of Central and South America. After a decade of economic reform and significant economic progress. the region has been adversely affected in recent years by spillover effects from the Asian crisis. by a decline in commodity export prices, and by a series of natural

disasters. As a result. real Gross Domestic Product of the region probably declined slightly during 1999, but is expected to rebound this year.' Even with the economic difficulties experienced by the region, however. the United States had a slight merchandise trade surplus with Latin America during the first half of 1999. This was despite the region's sizeable trade deficit with the rest of the world.

The Latin American countries apparently have a high income elasticity of demand for goods produced in the United States. For that reason, when Latin America as a region is prospering, United States exports to the region increase rapidly. Furthermore, because the Latin American countries have higher levels of restrictions on United States goods than we have on their exports, a lowering of trade barriers in the Western Hemisphere should increase our exports to the region more than our imports from it. This is just one of several reasons why we should proceed with negotiating the proposed Free Trade Area for the Americas. The countries of Latin America have made good-faith efforts at economic reform in anticipation of Western Hemispheric free trade. We can further encourage this reform process. as well as strengthen fragile democracies in the region, by bringing them fully into a vigorous trading relationship with the United States. Economic progress in Latin America can only be good for the United States economy.

Thank you again for the opportunity to appear at these hearings today.

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[7] United Nations ***Economic Survey of Latin America and the Caribbean 1998-1999,*** Summary, p. 1, online www.eclac.cl English/Coverpage/ecosurvey.htm.