MR. McTEER: Well, thank you. Since there are no time constraints, I'll just acknowledge that statement and say Ft. Worth is where the West begins, which means that Dallas is where the East peters out.

Let me welcome you to the Dallas Fed. We're very honored to have you here, and I'm very honored to be asked to speak to you. Of course, I'll be speaking only for myself and not the Federal Reserve. Chairman Greenspan asked me to make that perfectly clear.

My first thought after receiving your invitation was my vacation in Scotland last year. I told my wife I would go on two conditions: that I not have to drive on the wrong side of the road and that we find and visit Adam Smith's grave. We found it and I saluted and even pulled up a few weeds. Perhaps I should just say that I agree with Adam Smith on trade and let it go at that.

As you know, his Wealth of Nations was an argument for free trade, both internally and externally, and an argument against the fallacies of mercantilism. His absolute advantage arguments were later refined by others into the doctrine of

comparative advantage which has stood the test of time. But the case for free trade, accepted almost universally by economists, has always been a hard sell with the public.

One reason is the misleading terminology left over from mercantilism. Imports are a minus or a negative in balance of payments accounting while exports are a positive. An excess of imports over exports is pejoratively called a deficit, even though imports are what we get in trade and exports are what we give up.

Another problem is a common failure to consider secondary effects as well as primary effects. For example, on the crucial issue of jobs it's commonly believed that exports create domestic jobs and imports destroy them. That's largely but not entirely true as far as it goes, but that's only half the story.

The other half is that exports and imports generally move up and down together on a cause and effect basis. More imports lead to more exports, and vice versa. As both grow, it changes the job mix but not the total number of jobs in any predictable way.

If imports grow faster than exports for a while, they'll be financed by a capital inflow which will also tend to stimulate job growth indirectly through lower interest rates. Any residual negative impact on jobs would be offset by a monetary policy dedicated to maximum sustainable growth. In short, trade affects the mix of jobs but not their total number.

This conclusion is, of course, counter-intuitive and is viewed by many with suspicion. One reason is that jobs lost because of imports or plant relocations are easily identified and highly visible. Understandably, people adversely affected make a lot of noise. Jobs gained through exports or capital inflows are not as easily identified.

More generally, the gains from international trade are widespread and diffused. A lot of people are helped a little. The losses from trade are lower but more visible and concentrated. A few people are hurt a lot. That makes trade protection tempting to politicians. The beneficiaries of protectionist measures know who they are and they know what they

have at stake. Those harmed aren't as aware and individually have less at stake.

Comparative advantage, however, ensures that the net result is positive in each trading country. Therefore, if society chooses to compensate the losers in trade, it should be in some way other than trade restrictions.

Now, I understand that the topic today is our trade deficit rather than the benefits of trade in general, and I appreciate your indulgence. The problem is that the evils of a trade deficit are frequently exaggerated and used as an excuse for protectionism. Please don't let that happen this time.

Turning to my take on our present situation, I need to provide just a little bit more background, at the risk of some repetition. As you know, trade is carried out by people and companies, not by countries. There is no reason to expect millions of separate transactions with people of foreign countries to result in equal values of imports and exports on the one hand, and equal capital inflows and outflows on the other hand.

Each would approximate balance separately if capital transactions were limited to those that financed trade. But with massive independently motivated capital flows in the mix, our exchange rate will tend to clear the market for total transactions, not trade and capital transactions separately. Consequently, trade surpluses will be matched by capital outflows and trade deficits will be matched by capital inflows.

We've had a current account deficit matched by capital inflows for several years now, and it increased during the Asian crisis. But this pattern of international payments is, in my opinion, a result of our economic strength rather than weakness. We've grown faster than our trading partners in recent years, stimulating our demand for imports relative to foreign demand for our exports. At the same time, our technology driven economy with its accelerating productivity also attracts capital from the rest of the world.

The United States has been the best place to sell goods and the best place to invest capital, resulting in our current pattern of international

payments. Our strong dollar in recent years is additional evidence that the capital inflow and not the trade deficit is the main driver.

Viewed in this light, our international payments position reflects our relative prosperity, a sign of economic strength and vitality.

Another way of looking at our international position is, however, somewhat less sanguine. We are not saving enough domestically to finance our domestic investment. We depend more and more on foreign savings, which adds to our international debt, although not all international investment here is debt that needs servicing. That debt need not create a burden if the investment is productive and generates the growth necessary to service it.

Nevertheless, our reliance on foreign debt, foreign savings, has probably contributed to the decline in our saving rate domestically. The decline in our personal saving rate has been partially offset by our fiscal budget's reversal from deficit to surplus, but our domestic saving does need to be boosted. Measures to stimulate domestic saving that are justified on their own merits would also reduce

our current account deficit and our reliance on foreign saving.

NAFTA has clearly succeeded in stimulating two-way trade with Mexico. U.S. job growth has been the envy of the world since the beginning of NAFTA, and our unemployment rate has fallen to 30-year lows. Trade with Mexico is roughly four times more important for Texas than it is for the United States as a whole. Texas employment growth has exceeded U.S. employment growth every year since NAFTA's inception.

Unemployment on the Texas side of the border has declined significantly. U.S.-Mexican trade has benefited our border towns, although the border infrastructure does need improvement. Laredo has become a virtual boomtown but the impact on El Paso has been mixed. My colleague from El Paso will say more about the border in a later session, particularly about the Maquiladoras.

NAFTA's precise impact on trade is difficult to sort out because of the peso crisis and the sharp Mexican recession in late '94 and early '95. Econometric work done at the Dallas Fed, however, concludes that the effect has been positive. We can

make an updated version of that study available to you if you wish.

Let me close with my major conclusions. Our trade deficit, large as it is, is not currently a major problem. The trade deficit and the offsetting capital inflows are both separately and combined, signs of economic strength rather than weakness. They have not slowed job growth nor increased our unemployment rate. The period since NAFTA has seen acceleration in U.S. productivity and output growth. Inflation and unemployment have declined substantially.

I'm not saying that NAFTA is the sole factor in our recent prosperity, but it has been a major factor.

Free trade is more important than balanced trade. Measures to reduce the trade deficit should not include restrictions on trade. Focus should remain on opening foreign markets to U.S. exports, not limiting imports.

The financing of continued large current account deficits may be a potential future problem if markets come to view it as unsustainable. The best

way to deal with that is to promote domestic policies that encourage saving. Increases in national saving would tend to substitute for foreign saving and would probably lead to a better balance in our international payments.

I might add here that the Asian recovery and the renewed strength in Europe are very likely to reduce our imbalances during the year 2000 without any action on anyone's part.

I think I'll stop there.

COMMISSIONER HILLS: Thank you very much, Mr. McTeer. We appreciate your comments and we would like to offer our Commissioners the opportunity to question you.

Does anyone have a question? Yes, Dr. Thurow?

COMMISSIONER THUROW: I guess my question is at what point would you get worried? When I was coming down here, I was reading the Data Resources forecast for the year 2000 and they actually think the trade deficit in the year 2000 will be bigger than it was in 1999. They have it up to about 425.

And if you look at this problem, of course, it isn't the last four years; it began in 1981. And in 1981 if you took American assets abroad and foreign assets in the United States and subtracted the two, we had a net creditor position of $1,000 billion and today it's about minus 2,000.

If either of those numbers got substantially bigger, the 425 or the minus 2,000, at some point would you say that is something to worry about? If it was minus 8,000 would you worry, or if the trade deficit was $1,000 billion would you worry? At what point is it a problem?

MR. McTEER: Yes. I understand that those lines cross that converted us from a net creditor to a net debtor country around 1985, and it's been getting larger ever since. I think we have to receive guidance from the markets rather than try to come up with an arbitrary number.

I think the problem would be that the markets would suddenly decide that our position is unsustainable; not necessarily bad for us, but it can't be sustained. And if that should happen, they would reverse the capital inflows that we've been

enjoying and convert them to capital outflows, and of course, the dollar would weaken substantially.

But I don't really see that that's likely as long as the cost of servicing our net foreign debt is not growing substantially faster than the domestic GDP. So I'd be willing just to wait and watch the dollar and watch capital inflows and possibly be willing to react to weaknesses in the dollar if and when that happened. But I don't think that -- as long as the economy is booming like it is -- I don't see our international trade position precipitating a crisis any time soon.

COMMISSIONER THUROW: Can I have a follow-up question?

COMMISSIONER HILLS: Of course.

COMMISSIONER THUROW: If you look in recent years, we really haven't financed a lot of this deficit by borrowing from abroad where we have to service it in terms of paying interest. We've basically sold equity positions, like we sell Chrysler to Daimler-Benz.

If it was financed completely by basically selling equity in the American economy, would you say there's never a worry?

MR. McTEER: Well, there would be the matter of dividends and so forth like that, but I do think that direct foreign investment in the United States is a much more stable type investment than the portfolio investment or bonds. So there could still be a problem, I assume, but I don't think it would be as severe in financial markets.

And don't forget that as we're incurring these debts, we're also growing our exports and growing our direct investment abroad, so the trends won't always be one-sided. It will -- they tend to balance out because our exchange rates will equilibrate the total demand for foreign currencies and the foreign demand for the U.S. dollar.

COMMISSIONER THUROW: Let me ask one final question. The problem you see in the rest of the world -- if you look at the '97 crisis in East Asia, capital was flowing into Thailand. All of a sudden it stops. Now, it doesn't stop gradually.

MR. McTEER: Right.

COMMISSIONER THUROW: What happens is you -- in some sense it not only stops, you get an overshoot. I guess one of the questions -- and I'm not asking you to reveal secrets. I hope somebody at the Federal Reserve Board has a contingency plan for that kind of an emergency, because what it does in everywhere else in the world, it creates enormous problem in domestic capital and monetary markets.

It isn't just a trade problem if suddenly the rest of the world pulls the plug, as they have on other countries, because I don't think you can find any example where these things have slowly eased away. What happens is suddenly the markets reverse, as I said, and if anything, they overshoot and you have a phenomenon like Thailand. One month money is pouring in and the next month money's pouring out.

MR. McTEER: Yes. I think that took everybody by surprise. I guess it could happen here but I think the status of the dollar being an international currency and a reserve currency and increasingly transactions currency abroad gives us a little bit more assurance that it wouldn't happen to us quite as abruptly as it might have to Thailand.

COMMISSIONER HILLS: Commissioner Zoellick?

COMMISSIONER ZOELLICK: Thank you very much for being with us today and letting us use your facility, and I also want to compliment you on your research staff. I found that a number of their publications are some of the ones that I found best in the Federal Reserve System.

MR. McTEER: Well, thank you.

COMMISSIONER ZOELLICK: Please relay that to your staff.

I'd like to connect three ideas: the current account deficit, the dollar, and domestic economic growth. In some ways this follows up on Les's question.

As I understand your view of the current account deficit, the primary adjustment should occur through the exchange rate and definitely not through any trade protectionist measures. Some economists believe that one risk to the soft landing that I presume the Fed would like to achieve with our economy would be a sharp change in the dollar, particularly a sharp decline in the dollar.

I'd just like your assessment of why the dollar is as strong as it is, given the large current account deficit, particularly vis-à-vis the Euro? And then the related question is, what's the likelihood that we can expect a sharp shift in that valuation and what would its effects be on the management of the domestic economic policy?

MR. McTEER: Of course, the exchange rate equilibrates the total supply and demand for dollars -- if capital flows were merely those necessary to finance the current account deficit, then presumably the deficit would cause the dollar to depreciate. The fact that --

COMMISSIONER LEWIS: Depreciate or appreciate? Did you --

MR. McTEER: Depreciate. The fact that it hasn't suggests to me that on these two sides of the balance of payments that the capital inflow is the dominant side. In other words, we have the current account deficit, in my opinion, as a means of financing the capital inflow rather than the other way around.

And I think the reason for that is similar to the reason that our economy has been growing much more vigorously lately than most others. It's a technology-driven, investment-driven, profit-driven boom that's made the United States the most productive and the safest place to invest worldwide. We've sort of become like we were in the early days as a developing country, where the normal pattern is for foreigners to invest here and allow us to run current account or goods and services deficits in the meantime.

We have become a developing country again in the sense that our technology-driven economy is leading edge. Everybody else is following.

COMMISSIONER ZOELLICK: But just to press on the point, at some point with large current account deficits, one would expect that the dollar valuation will change, and --

MR. McTEER: That would happen if the capital inflow that's sustaining the dollar were to reverse, and that would happen should people suddenly decide that all this is unsustainable. But it's been

going on for years and years and years now, and I think it could go on for quite a long time.

COMMISSIONER ZOELLICK: And so from the last point that I was trying to connect to, from the point of domestic economic growth, you do not see the likelihood of a sharp change in dollar valuation as one that would threaten the economic growth?

MR. McTEER: Well, if you did have a sharp change in dollar valuation, it might do so, although we would be reacting to that with monetary policy. I think the current pattern of our international finance has caused our domestic economic growth to be greater than it would otherwise have been because we're not limited to our domestic saving as a means of financing our domestic investment.

We're able to have greater domestic investment because we're supplementing our saving with that of foreign saving.

COMMISSIONER ZOELLICK: Thank you.

COMMISSIONER HILLS: Let me ask you a question. You raised in your remarks the desirability of increasing domestic savings. We talked to many economists about that and were we able to finance at

home the investment that has spurred our growth, we would not be talking about the deficit today.

Have you any ideas about how -- what kind of policies our government might adopt that would increase domestic savings?

MR. McTEER: I don't know how politically feasible they would be, but I would like to see policies that would stop taxing interest income and dividend income; get rid of that double taxation. I would like to see capital gains taxes severely reduced or eliminated altogether.

I think basically tax reform is the main area you could make some changes and possibly increase the incentive to save rather than consume.

COMMISSIONER HILLS: Commissioner Angell?

COMMISSIONER ANGELL: Let's suppose that you are correct, that the main driver in our balance of trade has been capital influence. Let's suppose that the United States were to do something that many of us would not like to see happen, and let's suppose we move to a protectionist position that would reverse last year's 17 percent rise in the value of the imports and we ended up with a 17 percent decline in

the value of our imports. Let's assume that the U.S. technology remains in place, driving the capital in place.

What would happen in your view to the exchange rate if we had that kind of protectionism on the one side and a continued dominant capital inflow on the other?

MR. McTEER: I suppose initially it would sustain the dollar. The inflow would hold it up and the reduced imports, at least very temporarily, might work in the same position. But as I tried to indicate in my testimony, fundamentally imports and exports move together, so if we start having dramatic reductions in our imports, I think reductions in our exports would follow very soon.

COMMISSIONER HILLS: Are there any more questions?

COMMISSIONER LEWIS: I have some.

COMMISSIONER HILLS: Yes, Commissioner Lewis?

COMMISSIONER LEWIS: Thank you.

I'd like to clarify a couple of the things that you put in your paper. I really appreciate it,

but a couple of things I didn't understand. You said jobs gained through exports or capital inflows are not easily identified. Are you equating exports with capital inflows or are you saying exports and capital inflows is another word for imports? I'm not quite sure what you meant by that sentence.

MR. McTEER: If imports are growing rapidly, exports will tend to grow but probably with a lag. In the meantime, that increased excess of imports over exports will be financed by capital inflow, which is the other side of the coin of the trade deficit. And other things equal, I'm saying that the imports may cost us jobs but the exports will create jobs, but they're not matched. The net foreign capital inflow that's financing them will have the indirect effect also of stimulating jobs because other things equal, it will push interest rates down.

COMMISSIONER LEWIS: So when you say jobs gained through exports or capital inflows --

MR. McTEER: Right.

COMMISSIONER LEWIS: Are you equating the capital inflows with exports or is it a synonym for imports?

MR. McTEER: The capital inflows will represent the difference between exports and imports. You see, if you take balance of payments accounting, you use double entry accounting, so everywhere there's a credit there's a debit; everywhere there's a debit there's a credit. At the bottom, debits and credits equal, so you can draw a line anywhere in that horizontally and the net balance above will be exactly matched by the opposite net balance below.

Typically when people talk about the things we're talking about, they draw that line at the current account and when you do that, you're basically saying that your trade position is just matched by your capital position.

But my point is that the number of jobs in the economy doesn't really depend very much on the size of the trade deficit or surplus. It changes the mix of jobs but it doesn't change the total number of jobs. And the reason is if you change either imports or exports, the other one will start changing in the same direction and the financing that takes place temporarily when that gap persists also works to even

out the impact on jobs. So it tends over time to neutralize the effect on jobs.

And then you've got monetary policies standing by if there are frictions and so forth that keep that from working very smoothly.

COMMISSIONER LEWIS: I'd like to come back to that issue in a minute about bananas, but I just want to ask two other clarifications.

MR. McTEER: Sure.

COMMISSIONER LEWIS: You said those harmed aren't as aware and they originally have less at stake about beneficiaries of protectionist measures. Who are harmed by protectionist measures?

MR. McTEER: Well, if we put up tariffs and so forth to protect some industries, it means that we will reduce our imports. If we reduce our imports, we're making less money available to foreigners to buy our exports. So the protectionist act, to the extent it works to reduce imports, will somewhere in the economy mean that export jobs that would have been created will not get created.

But you won't know what to attribute that to. It won't be very visible.

COMMISSIONER LEWIS: What you're saying then is that even though we're running say a $250 billion deficit, if we reduce that to $200 billion, then obviously foreigners have $50 billion less to buy our goods with so it would hurt our exports?

MR. McTEER: I'm saying it would be basically neutral -- its impact on jobs and impact on domestic economic activity. You can be a rich country with a big deficit. You can be a poor country with a big surplus.

COMMISSIONER LEWIS: The other thing was you say the problems and the evils of a trade deficit are frequently exaggerated and used for protectionism. What would you say are the evils of a trade deficit?

MR. McTEER: I knew when I wrote that that was going to get me in trouble.

(Laughter.)

MR. McTEER: I should have said the perceived evils rather than evils. That was a misstatement on my part.

To many people the word deficit implies that there's something wrong and it suggests to people that policy has not been good, and if you've got a deficit,

why not do something to get rid of it? And so that leads people to make all sorts of recommendations that are not sound.

Let me illustrate the point this way. Texas citizens and Oklahoma citizens trade with each other and they invest with each other and all that. Which one has the trade surplus, Texas or Oklahoma? We don't know because we don't keep the statistics. I'll bet you if we kept the statistics and found out, we'd do something foolish as a result.

(Laughter.)

COMMISSIONER LEWIS: Let me ask you a question about the banana wars that are going on now.

As I understand it, the Europeans want bananas to come from countries that used to be their colonies. They have violated rules about allowing bananas controlled by American companies to go into Europe, and their concern -- that if they stop buying bananas from the countries that they've been traditionally buying from, the people there will be out of work -- will also increase those countries' deficits because they won't be exporting bananas.

Wouldn't that be a case where a loss of export jobs does create unemployment in that country because they don't have full employment in those countries?

MR. McTEER: Other things equal, a reduction in exports would cost jobs, until there was time for the exchange rate mechanism or other mechanisms to correct that.

I don't really know the details of the banana wars. I'm a little embarrassed by it. I think it's a little bit silly for us to be retaliating --

COMMISSIONER LEWIS: Well, the question I'm getting at, isn't it true that when you have full employment, as we do essentially, that the deficit doesn't cause unemployment if there are people moving to other jobs, even though the wages may be less? But in a country that does not have full employment, then the loss of export jobs actually does cost -- export does cost jobs?

MR. McTEER: Well, I'm assuming, I guess, that all countries have the policy tools with which to pursue full employment, so if you start getting unemployment due to any reason, if your economy is

weaker, you can have more stimulative monetary and fiscal policies to reabsorb the unemployed. The fact that they may not be at full employment already doesn't mean that they couldn't have policies to pursue that.

Again, full employment is fairly easy to achieve everywhere, and it has nothing much to do with how rich or how poor countries are.

COMMISSIONER LEWIS: Thank you.

COMMISSIONER HILLS: We thank you very much. We really appreciate your time and we believe that your testimony has been extremely helpful. We see sitting in the audience Mr. Carty, and we want to welcome him.

Welcome.

MR. CARTY: Thank you.

COMMISSIONER HILLS: Mr. Carty is Chairman and Chief Executive Officer of AMR Corporation. We're delighted that you could take the time to be here. We have about 25 or 30 minutes to hear your remarks, and we hope that you will answer our questions, so we await your wisdom.