MR. McKINNEY: Thank you very much for the opportunity to appear today as a witness before the Commission. I will first briefly discuss 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 interpretation that one gives to the recent large increases in the U.S. trade deficit will depend heavily on one's view of changes in the overall economy during the past ten years. Is the U.S. 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 U.S. in recent years do reflect the fact that the U.S. is on the forefront of very significant technological change. Communications cost and transactions cost 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 U.S. 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 percent during the first three quarters of 1999. Investment in information processing equipment and software currently accounts for around 35 percent of total fixed non-residential investment in the U.S. and is increasing rapidly, providing further evidence of a technological transformation occurring in this country.

Because the U.S. is on the forefront of 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 forego present consumption in order to provide for the future.

Therefore, over the past decade, the personal savings rate of the U.S. has fallen from around 8 percent of personal disposable income to 2-1/2 percent in the first three quarters of 1999.

The desire of foreigners to invest in the U.S. 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 borrowing from abroad to finance an investment boom as we upgrade our capital stock to embody new technology. U.S. 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.

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 U.S. 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.

Whatever the causes of the recent U.S. trade deficits, policy measures are available that could reduce them. Measures that would encourage savings, such as tax deductibility of interest earned or greater reliance on 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 U.S. is running sizeable merchandise trade deficits with both Canada and Mexico. In the

first half of 1999, these two countries accounted for 18 percent of the U.S. trade deficit.

Certainly there is no reason to expect that the U.S. 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 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 U.S. 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 U.S., and differences in the business climate of the two countries. In any case, the real exchange value of the Canadian dollar is significantly lower now than it was when we entered the U.S. - Canada Free Trade Agreement or when NAFTA went into effect, and that fact is reflected in our trade balance with Canada.

As for Mexico, I consider the U.S. trade deficits with Mexico to be temporary. In the four

years preceding the NAFTA agreement and in the first year of the agreement, the U.S. 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 the 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, U.S. 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 U.S. has been lower than one might expect from the sizes of the economies involved. Trade of the U.S. with Central and South

America is only about three-fourths as large as our trade with Mexico alone. The U.S. has generally 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 U.S. had a slight merchandise trade surplus with Latin America during the first half of 1999.

The Latin American countries apparently have a high-income elasticity of demand for goods produced in the U.S. For that reason, when Latin America as a region is prospering, U.S. exports to the region increase rapidly. Furthermore, because the Latin American countries have higher levels of restrictions on U.S. 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 U.S. Economic progress in Latin America can only be good for the United States economy.

Thank you again for the opportunity to appear today.

COMMISSIONER HILLS: Thank you very much, Professor McKinney, and now I'd like to call on Professor Weinstein.

Thank you for being with us.