

MR. PRICE: Thank you.

The Chairman is gone, but Vice Chairman Papadimitriou, members of the Trade Deficit Commission, thank you for your invitation to appear before you on the subject of the trade deficit.

After holding steady for several years, the U.S. trade deficit has been rising sharply since 1997, as shown in Chart 1 on the first page of my written statement. It deserves close scrutiny by this Commission.

Your report later this year on the deficit's causes, its consequences, statistical issues related to it, and other issues should help guide and hopefully sharpen the thinking of our nation's policy-makers in this complex and controversial topic.

In the realm of economic policy, which is concerned with raising the standard of living of everyone, some economic indicators deserve more attention than others. Progress in raising everyone's standard of living tends to be reflected best by variables like the real growth rate; unemployment rates; the distribution of income; investment in people, systems, equipment, and structures.

The trade deficit is not a variable like one of those. In fact, like interest rates, the ups and downs of the trade deficit may reflect positive or negative trends. Again, the chart shows the ups and downs within the business cycle. The trade deficit tends to fall when the national economy weakens and to rise when it strengthens.

The structure of our national economic accounts allows us to understand the forces underlying the trade deficit consistent with the legislative charge that your Commission has been given.

Trade flows make up the largest and most volatile portion of the current account flows with net investment income flows and net unilateral transfers, such as foreign aid or pension payments to Americans abroad, accounting for much smaller portions of the current account than the trade flows.

As also shown in Chart 1 of my written statement, the movements in the current account closely track the trade deficit. By the procedures used in constructing our national economic accounts, the current account deficit equals two other interesting measures: our net capital inflow for the difference between the amount of capital foreigners invest in the

U.S. minus the amount of capital Americans invest abroad; and also, equal, the second measure, the amount that investment in the U.S. exceeds domestic saving. That includes saving by business and government as well as households.

When these independent measures, these three measures, do not come out equal in practice, the statistical framework identifies what is known as a statistical draft discrepancy, which I'll come back to later.

After the fact, we can explain changes in the trade deficit by examining changes in the components of these three net balances: exports and imports; capital flows, inward and outward; and domestic savings and investment.

All of these aggregates are typically rising over time. So explaining changes in the trade deficit generally means explaining differences in their growth rates in a generally expanding world economy.

The trade deficit will tend to be driven up when any of these six trends occur: Americans find imports more attractive, foreigners find our exports less attractive, foreigners find investing here more attractive, Americans find investing abroad less

attractive, Americans spend a rising share of their income, or Americans find investing at home more attractive.

All of those six do not necessarily happen in the same direction, and they can often be moving in different directions as their effect on the trade deficit. If any one of those six is going in the opposite direction, it tends to move the trade deficits or trade balance in the opposite direction.

Substantial recent increases in the trade deficit over the short run tend to be driven by two large forces. One is the differential growth rates in the U.S. relative to our trading partners. The other is exchange rate.

Stronger growth in the U.S. typically means that Americans' incomes are going up enough so that people increase their spending on imports more rapidly.

As American profitability and the structure of interest rates rise, this discourages capital outflow, encourages capital inflow, and raises U.S. equity values so that we can have a wealth effect that raises spending faster than income and encourages more investment in the U.S.

Slower growth abroad typically means that foreign incomes to spend on our exports grow more slowly and that profitability and the structure of interest rates abroad decline, which discourage capital outflow from the U.S. and encourage capital flow to the U.S.

The relationship between domestic growth and a country's imports is indicated in Charts 2 and 3 of my written statement. Chart 2 shows the movements of our imports and movements of our GDP growth. They're on different scales because exports on average tend to be growing faster. You see, when you find deceleration of our GDP, you find deceleration of our imports and the opposite.

The same for foreign growth and our exports. Their acceleration and deceleration tend to be in tandem. They also have the influence of exchange rates. The *Economic Report of the President* noted recently that exchange rate movements reflecting in part the desirability of U.S. assets have also contributed to the rising trade deficit by affecting the relative price of imports and exports.

My Chart 4 shows that over the last several decades, the trade deficit has tended to rise when the

dollar is strengthened. And between 1995 and 1998, the dollar appreciated, although it was less than the appreciation we saw through the '80s.

So what has happened recently in the later 1990s? You see that all of the trends that tend to raise the deficit or depress the trade balance have been occurring. Strong domestic demand following import prices have caused imports to accelerate. Weak foreign demand has depressed our exports, although proportionately they seem to be rebounding somewhat in the last half year.

Higher profitability here than abroad has encouraged capital inflow, discouraged capital outflow. Strong domestic demand and profitability have spurred robust investment here. National savings has moved up almost entirely on the government side, but it's gone up less than the amount of investment. Therefore, the savings-investment gap has widened.

It is sometimes said that domestic saving and domestic investment move autonomously and determine a country's trade balance. If every country's trade and current account balances were essentially determined by their own internal and autonomous savings and investment decisions, there would be no mechanism

for equilibrating the world's trade and financial flows.

Only by recognizing that these trade and international capital flows are jointly determined with domestic savings and investment decisions can we properly understand the forces at work behind our trade balance.

Recent experience provides an excellent case study of how the trade deficit, net capital inflow, and savings-investment gap are jointly determined. Since mid-1997, economic crises in Asia, Russia, and very sluggish growth in other areas encouraged the net capital inflow into the United States. It has contributed to lower interest rates here for a period and a stronger dollar, therefore encouraging more U.S. business investment and more U.S. household spending on housing and consumer durables, which kept U.S. savings in check, despite a large increase in government saving.

Ex post, the three identities, the gaps we talked about, have been maintained, but no one can deny that developments abroad had a direct and substantial effect on both the size of U.S. trade deficit and our savings-investment gap. All three of them moved in

tandem, but it isn't just something within the U.S. that is determining these flows. All three move and influence each other.

I think it is worthwhile to compare what has happened in the recent run-up in the trade deficit.

If you look again at the chart on page one, the recent run-up in the trade balance in magnitude is comparable to the run-up of the 1980s, when the trade deficit was associated with notions of weakness in U.S. manufacturing and the creation of a Rust Belt in the more industrial areas of the country.

Legislation creating your Commission charged you with looking at many of the variables that were troubling during the period of large deficits during the 1980s. Although the magnitude of the recent rise in the deficit is similar, as I said, the underlying patterns of the domestic economy accompanying those two increases are very different.

Since the large swings in the trade deficit occurred in manufactured goods in both cases, we should look at indicators from the manufacturing sector alone as well as for the economy overall.

U.S. business investment weakened during the course of the 1980s but has strengthened in the

course of the 1990s. Manufacturing capacity, in particular, has been expanding rapidly in the recent period. Even with the deceleration of manufacturing investment to a more sustainable rate, it continues growing at a rate faster than at any point during the 1980s.

Growth in productivity was falling in the 1980s but has been rising in the late 1990s. Growth in manufacturing productivity has been particularly strong of late. Manufacturing output was sluggish, with the trade deficit's rise in the '80s, but has continued buoyant in the late 1990s.

National unemployment was much higher in the mid-80s. National employment in 1985 was still 7.2 percent versus 4.2 percent in 1999. Such low unemployment has increased employers' investment in training their workers.

Unemployment among manufacturing workers was higher than the national average in the mid-80s. For example, in 1985, there was still 7.7 percent unemployment among manufacturing workers. Last year the national average unemployment rate for manufacturing workers was only 3.6 percent, less than the national average.

Robust investment in training, equipment, and new systems has raised productivity and generated much stronger non-inflationary real wage growth over the last three years than during the 1980s' period of large trade deficits.

I think you need to look at these, as you take your legislative charge, to see what possible effects this experience of the deficit has had. And I think you'll see a very different picture than before.

I am also pleased that your Commission is charged with making recommendations on improving our trade and current account statistics. The people in our department, associated with us in the Economics and Statistics Administration, the Bureau of Economic Analysis, and the Economic Directorate of the Bureau of the Census provide the basic statistics we have for trade and current account and capital flows. They have been considering ways to improve them.

I have attached a joint product by them as a three-page attachment to my written statement, ideas they have for ways to think about how we can improve our trade and investment statistics.

The statistical discrepancy is something of a canary in the mine of our statistical measurement

problems. I have talked in general terms about trends in the three gaps, but, in fact, when you try to measure year by year what is going on, it is very hard to piece together because of the statistical discrepancy problems.

We have had faster growth of income than growth of product for four years running. The gap is a swing of about \$200 billion difference in the amount of growth you measure on the income side. And that means that the gap we measure in savings and investment is hard to be sure what it is.

By the same token, you expect in theory that the current account and the capital account should be the same. We measure those two independently. And in recent years, we have had \$100 billion gaps in a single year for those.

So those are serious issues. If we are going to be able to understand the underlying dynamics of international trade and investment flows, we need to get better statistics. And I urge you to read their attachment to my written statement.

Last week at the Humphrey-Hawkins testimony and again this week, Chairman Greenspan said, quote, "Growing net imports in a widening current account

deficit require ever larger portfolio and direct foreign investments in the United States, an outcome that cannot continue without limit."

Although we cannot predict with any confidence how the recent slide in the trade balance will inevitably end, we should consider some alternatives ways it might end.

Faster growth abroad offers the most benign mechanism for lowering the trade deficit. That would improve the market for our exports and gradually tilt capital inflows abroad.

There are increasingly hopeful signs that a number of economies important for our exports are strengthening. Unfortunately, this mechanism for reversing the slide in the trade deficit is also the one least under our control.

Mechanisms more under our control that could reduce the trade deficit in theory would cause more harm than good by suppressing consumption and/or investment, directly or indirectly, and disrupting the domestic economy.

Concern over the trade deficit should not lead to measures that undermine our fundamental economic success. We should keep in mind that the

remarkably strong growth of our economy in recent years is improving the conditions we care most about. Real wages and incomes, unemployment, investment, and our traded goods sector itself are all flourishing.

Thank you for this opportunity to discuss the issues raised by the recent increase in the trade deficit, and I'm happy to answer any questions.

VICE CHAIRMAN PAPADIMITRIOU: Thank you very, very much.