ALAN S. BLINDER

Biography

ALAN S. BLINDER is currently a Visiting Fellow at the Brookings Institution, on leave from Princeton University where he is the Gordon S. Rentschler Memorial Professor of Economics and-Co-Director of the Center for Economic Policy Studies at Princeton University, and Vice Chairman of the G7 Group.

Dr. Blinder was the Vice Chairman of the Board of Governors of the Federal Reserve System from June 1994 until January 1996. In this position, he represented the Fed at various international meetings, and was a member of the Board's committees on Bank Supervision and Regulation, Consumer and Community Affairs, and Derivative Instruments. He also chaired the Board in the Chairman's absence.

Before becoming a member of the Board, Dr. Blinder served as a Member of President Clinton's original Council of Economic Advisers from January 1993 until June 1994. There he was in charge of the Administration's macroeconomic forecasting and also worked intensively on budget, international trade, and health care issues.

Dr. Blinder was born on October 14, 1945, in Brooklyn, New York. He earned his A.B. at Princeton University in 1967, M.Sc. at London School of Economics in 1968, and Ph.D. at Massachusetts Institute of Technology in 1971 -- all in economics. At Princeton, Dr. Blinder chaired the Department of Economics from 1988 to 1990, and founded Princeton's Center for Economic Policy Studies. He has taught at Princeton since 1971.

Dr. Blinder is the author or co-author of 12 books, including the textbook Economics: Principles and Policy (with William J. Baumol) now in its 7th edition, from which well over a million college students have learned introductory economics. He has also written scores of scholarly articles on such topics as fiscal policy, monetary policy, and the distribution of income. From 1985 until joining the Clinton Administration, Dr. Blinder wrote a lively monthly column in Business Week magazine.

Dr. Blinder served briefly as Deputy Assistant Director of the Congressional Budget Office when that agency started in 1975 and has testified many times before Congress on a wide variety of public policy issues. He is a Governor of the American Stock Exchange, a Trustee of the Russell Sage Foundation, and has been elected to the American Philosophical Society and the American Academy of Arts and Sciences.

He and his wife, Madeline, live in Princeton, N.J.; they have two sons, Scott and William.

Testimony of
Alan S. Blinder
Professor of Economics, Princeton University
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to the
U. S. Trade Deficit Review Commission
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I was asked to give my views on the causes of the trade deficit, its likely consequences and impacts, and also some possible solutions--all in five minutes. So, with due apologies for superficiality, I will restrict myself to the main points. I have three.

Causes: In the 1980s, as you recall, economists fretted about the so-called twin deficits. The idea was that increases in the federal budget deficit were making the trade deficit balloon. The 1990s have been quite different, as the table at the end shows. This table displays the elements of an accounting identity that I am sure you have seen before. (The components do not actually add up because of the statistical discrepancy, which should be added to the righthand side.)

X - IM	=	(T-G)	+	(S - I)
(trade balance)		(budget balance)		(private saving - investment)

If the gap between private saving and investment does not change much, changes in the government budget will indeed "cause" approximately equal changes in the trade balance--which is what happened between 1981 and 1986, when the budget deficit increased by $162 billion and the trade deficit increased by $147 billion.

But the budget deficit, of course, disappeared between 1992 and 1998, and yet the trade deficit mushroomed from a mere $39 billion (just 0.6% of GDP) to a whopping $202 billion (2.3% of GDP). What happened? As the table shows, the swing in the private saving-investment balance overwhelmed even the sharp increase in government saving. Private investment soared, rising from 13.7% of GDP to 17.5%. That is certainly good news; indeed, boosting investment was **the** principle reason to favor smaller budget deficits. Second, private saving fell from 18.4% of GDP to just 15.7%, as personal saving plummeted. The main reason for the sharp drop in personal saving, it appears, is that the massive wealth creation in the stock market and elsewhere reduced the perceived need to save. While most of us feel vaguely uncomfortable with a private saving rate near zero, that development, too, is a measure of our success. Americans not only feel richer, they are richer.

So that is my first main point: <u>The trade deficit is largely a product of macroeconomic success, not failure</u>.

<u>Consequences:</u> My second main point is that, <u>at least so far, the consequences have also been benign.</u> **A** trade deficit constitutes a subtraction from domestic demand and, with the U.S. economy on the verge of overheating, this subtraction has been more than welcome. Without it, the Federal Reserve would have been raising interest rates more aggressively than it has.

Looked at from the point of view of the rest of the world, bouyant U.S. demand has helped support weaker economies in Europe, Asia, and elsewhere. Our trade deficit is, after all, their trade surplus. During 1998, for example, the United States alone accounted for about half of the growth in world demand.

<u>Impacts:</u> Is there a dark side to all this? Not much so far. The standard economic view is that a trade deficit used to finance a consumption boom (as in the 1980s) sows problems for the future, but a trade deficit that finances productive investment boom does not. Currently, the U.S. trade

deficit is doing a bit of each. Furthermore, with unemployment now at 4.1%, who can seriously raise the protectionists' usual cry that the trade deficit costs Americans jobs?

But there are incipient worries. One is that the yawning trade deficit will reawaken protectionist sentiment in the United States. You can see stirrings of this now, though so far they have been muted. Another concern is that we may be setting the dollar up for a big fall--which brings me to my third and final major point.

Solutions: I believe that a lower dollar--make that a much lower dollar--will ultimately plav a maior role in whittling our trade deficit down to manageable size. The differential between 1 O-year government bond rates in the U.S. and Japan, for example, is implicitly forecasting that the dollar will be worth only about 70 yen a decade from now.

What else might help trim the deficit? Look back at the accounting identity. We certainly don't want to curtail American investment. If we had any good ideas for boosting private saving, I would probably recommend them; but I am skeptical that we do. Finally, faster economic growth abroad is desirable on many grounds, and it would certainly boost our exports.

Getting the dollar down will not require what some people call "a weak dollar policy." Rather, the markets will do the job for us. The key question is whether the necessary exchange rate adjustments will come smoothly or abruptly. My guess is the former--which is the way it happened in the 1980s. But no one can be sure about such things. So, if you want something to worry about, that is it.

Thank you for your attention.

An Accounting Identity

(in billions of dollars)

	X-IM	=	(T-G)	+	S	-	I
1981	+6	=	-82	+	632	-	571
1986	-141	=	-244	+	807	-	747
change	-147	=	-162	+	+175	-	(+176)
1992	-39	=	-380	+	1165	-	867
1998	-202	=	6	+	1371	-	1531
change	-163	=	+386	+	+206	-	(+664)