BIOGRAPHY

WILLIAM C. DUDLEY

Director of the U.S. Economic Research Group at Goldman, Sachs & Co. since October 1995, Bill was named Managing Director in 1996. He is responsible for the economic and interest rate forecasts for the United States and also oversees the Canadian economic research effort. Bill has briefed the Federal Reserve Board on several occasions and is a member of the technical consultants board to the Congressional Budget Office. He also is a member of the Brookings Council of The Brookings Institution and is co-chair of the economic advisory committee of the Bond Market Association. Bill has frequently appears on television programs such as CNN and the Nightly Business Report and is often quoted in business periodicals such as the Economist, New York Times, Wall Street Journal, Washington Post, and the Financial Times. Past research papers include articles on monetary and fiscal policy, social security reform, equity market valuation. Treasury inflation-protected securities, the determinants of foreign exchange rates, health care reform, bank regulation, and the LDC debt and thrift crises.

Past duties at Goldman Sachs include responsibility for the foreign exchange outlook (1994-1995). Prior to that Bill worked for eight years analyzing U.S. financial market developments, with primary responsibility for economic policy, issues. During that period, Bill was Bob Rubin's senior economic adviser.

Prior to joining Goldman Sachs in 1986, Bill was Vice President in charge of regulatory analysis at J.P. Morgan. In that capacity, he co-authored and was the editor of the Morgan treatise, *Rethinking Glass-Steagall.* which helped lead to Section 20 securities affiliates for commercial banks. Bill began his career as an economist in the Financial Studies Section at the Federal Reserve Board in Washington. D.C.. where he occasionally briefed the Board of Governors on payments and bank regulatory issues.

Bill received his Ph. D. from the University of California at Berkeley in 1982

Testimony to the U.S. Trade Deficit Review Commission
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It is a pleasure to have the opportunity to testify before the Commission. I have three goals today. First, I will try to convince you that the U.S. trade deficit is caused mainly by a shortfall of domestic saving relative to investment rather than unfair trade practices that limit our access to foreign markets. There is a prevalent misconception about the source of trade deficits, which I will attempt to address. Second, I discuss what policymakers can do to reduce the dependence of the United States on foreign capital. The problem is not the reliance of the U.S. on foreign imports but instead the fact that the current account deficit creates a financial claim on the United States that could, under certain circumstances, destabilize the U.S. dollar. Third, I will present arguments that the U.S. trade gap may be overstated. Thus, our dependence on foreign capital may not be as large as officially reported.

Where Do Trade Deficits Come From?

As I see it, chronic trade deficits are generally caused by an imbalance between domestic saving and investment, rather than due to trade barriers and unfair competition. Consider that when investment spending exceeds the level of domestic saving, the consequence is upward pressure on interest rates. That pressure raises the return on a country's fixed income assets (i.e., real interest rates rise). The currency appreciates as the expected return on the country's assets rises. This raises the price of exports in foreign currency terms and thus reduces export competitiveness. As a result, imports grow faster than exports, the trade balance deteriorates, and the current account imbalance widens. The widening current account deficit is accompanied (by definition) with a growing inflow of foreign capital. This capital inflow plugs the shortfall between domestic saving and investment.

This is a much more convincing story to me than the alternative: Foreign countries discriminate against U.S. goods and services exports. The result is a chronic U.S. trade deficit.

If foreign countries were to discriminate against U.S. goods and services, the result should not be a larger trade deficit, but instead a weaker dollar. The dollar would weaken because the negative impact on exports would hurt economic growth, this would lead to lower interest rates. and the dollar would tend to weaken as a consequence. This would improve U.S. trade competitiveness. raising exports and shrinking imports. . The U.S. dollar would adjust in order to generate the required capital inflow (or outflow) needed to equilibrate saving and investment. The level of foreign trade barriers would influence where the dollar's value settled, but the trade balance would not be greatly affected.

To see the distinction between these two stories, consider what would happen if a country unilaterally lowered its trade barriers to the United States. The first round effect would be an increase in U.S. exports. This, however, would cause the U.S. economy to strengthen. U.S. interest rates would be higher as a consequence. The dollar would appreciate as U.S. financial assets became more attractive to foreign investors. Exports to other countries would decline as the strength of the dollar made exports elsewhere less competitive. In the end, the trade imbalance would not be affected much. Instead the proportion of exports to different countries would change, shifting toward those countries that did not raise their trade barriers.

So how does this fit in with recent U.S. history in which the U.S. trade deficit has soared? The dramatic widening in the U.S. trade deficit in recent years mainly reflects the fact that investment spending in the U.S. has risen much faster than national saving. This has necessitated large capital inflows to fill this gap. The required capital inflows has been generated in two ways. First, the dollar appreciated sharply during the 1996-98 period, especially against troubled emerging market economies. as U.S. economic performance improved sharply compared to our major trading partners. Second, the U.S. grew much faster than its major trading partners. The result was that U.S. imports grew much faster than exports. This also widened the trade gap sharply. The outcome for the trade deficit would have been even worse except for the sharp shift in fiscal policy begun around 1990. with passage of the Budget Enforcement Act. This caused the federal budget balance to move sharply into surplus from deficit. This kept interest rates from rising sharply, freed up domestic private saving for investment. and prevented the economy from growing even faster..

The important point to note here is that the dollar appreciated on a trade-weighted basis even as the current account deficit widened sharply. This suggests that it was the ex ante imbalance between the foreign demand for and the supply of dollar assets (demand outstripped supply leading to a stronger dollar) that helped to widen the current account deficit rather than trade barriers implemented abroad.

What Can Be Done?

Having argued that the U.S. trade gap is due mainly to macroeconomic imbalances of domestic saving relative to investment. I now would like to consider what U.S. policymakers can do to address it. First. measures that raise U.S. saving will tend to reduce the trade deficit and the dependence upon foreign capital over time. This could include running even larger fiscal surpluses or implementing government-sponsored saving plans that encourage greater household saving.

Second. prudent economic policies that maintain the attractiveness of U.S. financial assets to foreign investors are important. The danger of a large current account deficit is that the foreign appetite for the country's assets suddenly lessens. When this happens, the change in appetite registers first in the exchange rate. Only over time does the trade and current account balance adjust. Thus, policymakers should want to avoid spooking foreign investors. A sudden attempt at flight would lead to a collapse in the dollar, higher

U.S. inflation, a deterioration in the terms of trade, and potentially a tighter monetary policy.

Finally, it is important to recognize that a trade deficit by the United States may not be inappropriate. In general, a modest dependence on foreign capital is probably appropriate for a country whose currency serves as the major reserve currency of global economy. There is a steady demand for dollars outside the United States. The United States probably should run a modest current account deficit to accommodate that demand for dollars. In addition, in the context of the global economic environment of recent years, a wider U.S.trade deficit was also appropriate. The United States was the locomotive of global growth. The U.S. trade deficit was a small price to pay for a continued global expansion. If the focus had been on restraining the size of the U.S. trade deficit, both the global economy and the U.S. economy would have performed significantly worse.

Although progress in getting foreign countries to reduce their barriers to U.S. trade will undoubtedly not have much impact on the aggregate trade balance, it still is a worthwhile goal for other reasons. First, lower trade barriers abroad, would tend to stimulate the demand for U.S. exports and lead to a stronger dollar, all else equal. A stronger dollar improves the terms of trade and raises the U.S. standard of living. Clearly, this is a desirable outcome.

Second, lower trade barriers presumably increase the interdependence of the global economy. This has two benefits. It may reduce the prospects for armed conflict. It also tends to dampen the degree of volatility in economic activity. As the U.S. economy has become much more open over the past few decades, the economy has become less cyclical. One can show, empirically. that real GDP and the net export balance are negatively correlated. In other words, the trade sector helps absorb shocks to the U.S. economy and, therefore, makes the economy more stable.

Is the Trade Deficit Really as Large as Reported?

The third topic I would like to consider today is whether the U.S. trade deficit is actually considerably smaller than reported.

There are three facts that support the notion that the reported U.S. trade deficit may overstate the degree of the U.S. trade imbalance.

First, when one sums up all the current account balances around the world, one is left with a worldwide current account deficit of about $150 billion. This indicates that there are significant reporting errors somewhere in the world as the current account balances worldwide should, by definition. sum to zero. Even more importantly, this gap has grown rapidly in recent years. This suggests a growing problem in measuring global exports. In this regard, it is noteworthy that a recent study by the Bureau of the Census study finds that the exports of U.S. companies may be understated.

Second, there has been a growing statistical discrepancy in recent years between the growth rates of real GDP measured by product (which includes import and export volumes) and the growth rate of real GDP measured by income, which has considerably higher. This suggests that the Department of Commerce statisticians are not counting all the production or that income growth has been chronically overstated. If production is the problem, that may point to an understatement of exports.

Third, the National Purchasing Managers' report has shown a dramatic swing in trade performance, with the export component now much higher than the import component (this means that a greater proportion of companies are seeing an increase in their exports compared to their imports). Despite this, the U.S. trade balance continues to deteriorate. This is odd given that in the past the NAPM readings on exports and imports usually did a good job foreshadowing trade trends. Only recently has this relationship broken down.

Why might trade flows be misstated? We can think of two potential explanations. First, shifts in how goods and services are sold may mean that exports are not properly recorded. Internet transactions and the sale of software and other services may avoid the normal export counting mechanisms leading to understatement of U.S. exports. Second, U.S. multinationals may have understated the value of their exports to wholly-owned foreign subsidiaries. This would be attractive as a means of reducing U.S. profits and avoiding U.S. corporate income taxes especially when the companies were losing money in their overseas operations and did not have to pay corporate income taxes there. This asymmetry between profitability in the U.S. and elsewhere is a situation that has prevailed in recent years as growth in the U.S. has been strong and many other regions of the world have encountered difficulties.