Question and Answer Period – Afternoon Session

Commissioner Rumsfeld, would you like to start the questions?

COMMISSIONER RUMSFELD: Thank you, Mr. Vice Chairman.

I don't wish to oversimplify, but I would like to try to simplify a couple of things. I think it's safe to say that the general impression in our country -- among non-economists -- is that a trade deficit or a negative current accounts balance is a bad thing. That's kind of a general feeling when you see the headlines in the papers. People think, "Oh, that's not good for our country."

Let me ask a few questions. I don't get the impression from anything I heard this morning or anything I've heard this afternoon that simplistic approach is the opinion of any of the eight people who have presented.

So my question is, is the trade balance or the current account balance, as a concept, a useful concept, or is too aggregated to be really useful? And if it's useful, what's it useful for?

Second, if it's useful, should we really care what the overall numbers are or should we really only care about the elements that make it up? My impression is that overall aggregated numbers can't be dealt with directly. One can only deal with the subelements of it, and so it's a circular set of questions. I come back to the beginning. Is this really a useful thing, and, if so, for what?

VICE CHAIRMAN PAPADIMITRIOU: Do you wish to direct to any particular panelist --

COMMISSIONER RUMSFELD: No, I don't --

VICE CHAIRMAN PAPADIMITRIOU: -- or whoever wishes to respond?

COMMISSIONER RUMSFELD: Yes.

VICE CHAIRMAN PAPADIMITRIOU: Or maybe each one of you can respond.

COMMISSIONER RUMSFELD: Right.

MR. MAKIN: I think Mr. Rumsfeld raises the right question.

As it's currently constructed, I don't think the trade deficit is a very interesting or useful number. For example, the treatment of intracompany trade. We're saying the dollar's weakening a bit. Maybe that's going to be reducing the trade deficit. Well, if the dollar weakens, maybe we'll want to produce and sell more inside the U.S.

Computer companies are basically putting together stuff in boxes, and if the dollar weakens, they'll want to produce and sell more inside the U.S., because it's a more attractive base from which to sell. And if they do that, they'll import more stuff to put in the boxes, and imports will go up.

Somebody said, "Oh, the trade deficit's going up, and it didn't do any good to depreciate the dollar, so somebody must be cheating." No, you just have to look at it on a very disaggregated basis and see that in today's world, the location -- the locational decision for companies is very important. Where do you raise money? Where do you lend money? Where do you produce? Where do you market? All these things are critical.

And exchange rates -- if you have a sustained movement in exchange rates, you may have more production activity going on in the United States with a weaker dollar and larger imports and a larger trade deficit. What's wrong with that?

So, that's an example of -- a specific way of suggesting that it's not a good guide for policy. I think it's much more useful -- it's certainly useful to collet numbers that suggest to you, overall, are we spending more or less than income? The current account deficit will tell you that.

And why are we doing it? If we're doing it simply because we have to borrow to finance rapidly growing investment opportunities, do we want to stop that? I don't think so.

If we're doing it to consume, the markets will take care of it. If we're doing it to consume, the markets will see that you're borrowing on a unsustainable basis; you're borrowing to accumulate things that aren't going to produce the means to pay the foreign investors. You're currency will depreciate, interest rates will rise, and absorption will go down.

So, I think it's a bad guide to policy and a misleading guide to our position vis a vis the rest of the world. I wish -- when I used to talk to my students about trade deficit, I said, I don't want to hear deficit called bad or good, just deficit, because there's not easy way to characterize it.

VICE CHAIRMAN PAPADIMITRIOU: Professor Blecker.

MR. BLECKER: Thank you.

Well, I certainly agree that just looking at the deficit number and assuming that it's bad is too simplistic. And it's quite true that there are many good things that can happen in an economy that can cause a trade deficit to rise. An example would be a poor developing country that needed to borrow to finance investment in order to grow, and such a country would be expected to run a trade deficit.

But this brings me back to the analogy that Dr. Makin raised earlier -- the young household that has a net debt position but it's only about one-eighth of their income. The problem with this is that the young household analogy is better for a poor developing country than for the United States.

I view the United States more like a middle-aged couple approaching retirement, in which case, we shouldn't be doing all this borrowing every year. We should be putting away and saving for retirement, lending to those young folks out there who are setting up their families and buying houses or building their economies, as the case may be. And, so I think that depending on how you use that analogy, it may not look so good.

Now let me flag a few reasons why I think it is useful to discuss the trade balance. First of all, these conversations we're having about the causes lead us back to these underlying issues, which are so important.

Secondly, the --

COMMISSIONER RUMSFELD: But can we deal with those underlying issues directly, is my point.

MR. BLECKER: Well, perhaps we can, but this is where they all come together and where the public gets interested, perhaps.

But also the current account number tells us something. And what it tells us is what we're borrowing from abroad every year; therefore, it tells us what we're adding to our net international debt. And while those numbers at present do not look very scary, if they keep going at the way they are going, it will not be very many years before they do start to look scary, and those investors who are now so happily parking their money here may decide that it's time to pull it out and send it abroad. And it would not take a very large change in investors' sentiment to force a major adjustment here. That is not accurate.

There are now over $5 trillion of outstanding U.S. financial liabilities to foreigners. If only five or six percent of that was sold off, it would force us to balance the current account overnight, and that would require some very painful adjustments: either a major fall in the dollar's value or a significant recession.

So, there is a vulnerability that is created by the running of current account deficits year after year, and if we don't look at it, then I think we're ignoring potential problems down the road.

VICE CHAIRMAN PAPADIMITRIOU: Thank you.

Commissioner Krueger.

COMMISSIONER KRUEGER: Thank you.

Thank you all for your testimony, and I think we all are basically persuaded, based on this morning and this afternoon, that we've got the saving identity and it's relationship underneath it and all that.

But I'd like to follow up for a minute, if I can, with Professor Blecker, because you've been -- we've got the young couple --

MR. BLECKER: Could you please speak in the mic; I'm having trouble hearing?

COMMISSIONER KRUEGER: Sorry, mic was turned that way; my apologies.

We have this analogy going of the young couple and their borrowing, and you're worried about the United States being middle-aged. We are growing more rapidly than the rest of the world. There is evidence that the rate of return on investments here is higher. Does this not, to some extent, alter your judgment of the deficit on current account, as contrasted with many developing countries where indeed the reason they're not doing well is the rate of return on investment is low?

And connected with that, you talked about the debt we had here. I think the examination of the capital inflow suggests that a great deal of it is equity and not short-term borrowing. And that, it seems to me, also might be something you might want to comment on in terms of your interpretation of the deficit.

MR. BLECKER: Thank you, Dr. Krueger, you raise many good questions. Let me try to tackle a few of those.

First of all, as someone said this morning, equity ownership varies. If we're talking about direct foreign investment in a plant in the United States, that's one thing; it's not likely to be sold off in a hurry. But a portfolio of 500 shares of some stock on Wall Street is something you can sell off very quickly, so that a lot of that equity ownership is quite liquid and could be liquidated in a crisis or panic.

Regarding the rates of return, that's a complicated issue. One of the mysteries that you're probably aware of over the last decade has been: if we're such a big international debtor, why don't we see large net outflows of investment income? And in fact every time they revise the statistics, the point at which it turns negative gets pushed up -- now, it's up to 1998 I think. And what's happening is that the net inflows of direct investment income have, until recently, outweighed the net outflows of interest and dividend income on the portfolio investment and bank loans.

And some very good studies have been done at the Levy Institute, where Dr. Kregel works, and elsewhere, which show that for the direct investment the rate of return is higher abroad. We have a net, positive position for direct investment, and we also have had a huge net inflow of direct investment income relative to the net outflow of portfolio or interest income. Thus, what you said about rates of return may be true for financial investment, but is not true for direct investment.

Regarding the rates of return on financial assets -- and this, again, gets back to the relative states of the U.S. economy and the rest of the world -- it's true that rates of return on financial assets are higher here. But you can look at the glass as half empty or half full. Is it a sign of our strength or is it a sign of the rest of the world's weakness? We also should not forget that higher interest rates in the U.S. can be interpreted as signaling an expectation of future dollar depreciation.

And what concerns me is that if we don't pay attention to the other side of the coin, the weakness of the rest of the world, that if we make adjustments that push us in a downward direction without the rest of the world recovering, we have a recipe for some very serious global problems.

So, rather than just patting ourselves on the back about how well we're doing, we need to look about how to revive the rest of the world economy, and in so doing, we will lessen the amount of adjustment that we have to do.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Mr. Chairman.

This morning, we heard from folks who talked about the deficit as being unsustainable. I believe that Mr. Rubin and Mr. Greenspan both have called the deficit unsustainable. I'm having a little trouble understanding at what level unsustainability becomes some kind of crisis or recession.

According to the numbers released today, we're running a current account deficit at the annual rate of $300 billion, with half that deficit attributable to Asia. What I'm worried about is the fragility of the global system. I mean, we have a four-engine airplane with one engine, and only one-engine -- that being the American economy -- and that's driving the whole system.

And we keep hearing economists talk about the fragile nature of the system. Yesterday, in the New York Times, Jeff Gorton, who as many of you know, was Under Secretary of

Commerce, who is now at the Yale School of Management, had this to say: "I interviewed 20 top officials on Wall Street and Washington to get their views on what caused the Asian financial debacle last fall. They didn't agree on much except on one point: We are in for a series of financial crises over the next several years."

Then he says, "The most worrisome set of circumstances relates to the United States, which for the last few years has been single-handedly supporting the world economy," and he cites the soaring trade deficits, and downward pressure on the dollar as a sign that something is amiss and one of the things that could trigger some kind of a problem.

Let me see if I can focus the question -- we're trying to predict the future. There's an old Chinese adage about the future -- that the darkness lies one inch ahead. I think we have a little trouble looking through the darkness.

The Economists' Intelligence Unit predicted two weeks ago that American growth would reduce from about 3.9 percent this year, to less than half that -- 1.7 percent in two years. So, if our growth is going to be reduced by more than half over two years, what would be the implication for the deficit and the sustainability of those numbers. What if they kept going up?

Could it be triggered by an event abroad? I understand that the Chinese economy is getting more and more dependent on exports to the United States. If exports to the United States from China drop off because of a rapid decrease in American growth and that triggers a Chinese currency devaluation, what would that do for the global economy and for the sustainability of this deficit?

So, I'm really asking a question of thresholds here, which is hard to answer, but I'm hearing a lot of optimism, today. Yet I keep hearing the unsustainability argument, and I don't understand what that means.

So, in terms of a reduction in growth and the impact on our global partners and the increase in these deficits, how long can we continue under this scenario before we reach some kind of trouble? And, what would that trouble be? Who wants to try that? Mr. Blecker?

MR. MAKIN: Well, these are important questions, things I think about every day, and I'm reminded first of what my friend, Herb Stein, says, if something can't continue forever, it won't.

It's clear that the good performance, the extraordinary performance of the U.S. economy over the past year with an actual strengthening of the dollar at least until July, lower interest rates, faster growth, lower inflation, was partly due to the backwash of the Asian crisis. That is, if the rest of the world is not demanding resources, if money is seeking a safe haven in the United States, and the Fed is cutting interest rates in order to give relief to the rest of the world, that's going to give a surge to U.S. absorption. And, so the current account deficit will go up.

Flip side, probably, as the rest of the world recovers -- we hope it does -- the proximate symptoms in the U.S. will be initially negative; that is, interest rates may rise negative for the rapid growth of the economy. Interest rates may rise, the dollar may weaken as flows to the United States slow down, and the rate of growth may slow.

However, when people say, what if the rest of the world stops investing here, I always like to perform an experiment, which in 1971, then Treasury Secretary Connolly performed when everybody was grumbling about the U.S. and the strength of the dollar.

He said, "Fine, let's let the dollar depreciate by 25 percent. Let's suppose that everybody doesn't want to finance the U.S. current account, and the dollar depreciates by 25 percent. The United States then becomes the world's major exporter of deflation, while others get to import some reflation, and how would European producers and Asian producers like to compete with American companies in a global marketplace with the dollar 25 percent weaker?"

My guess is that the answer would be they would not be terribly eager to compete under those conditions, and it’s that fact and the implicit attractiveness of the U.S. as a strong, good producer that will keep the dollar from collapsing.

It may go down a bit, and it may go down for reasons that are perhaps constructive for the balance of growth in the world economy; that is, Japan’s recovering, Europe’s recovering, and so we have to have some adjustments here where the U.S. grows a little more slowly, and the rest of the world grows a little more rapidly.

But I don’t see it as a sort of we’re heading for the edge of a cliff, and the world’s going to come to an end; rather, we’ll get an adjustment, and the rate at which the U.S. can grow without inflation when the rest of the world is growing may not be four percent, which is where we are now. It may be three percent, which is what the Fed guesses it is. And that may require a transitional period of higher interest rates.

These are all, it seems to me, natural adjustments that in the process of making them will be a little bit painful but the key point to recognize is that it’s probably not good to continue, to use your analogy, to have the U.S. be the only engine of growth. And if we go through a period where other countries are also growing, we’ll have some adjustment pains for the U.S. that will include higher interest rates and perhaps a weaker dollar.

But there, again, I don’t -- I guess, ultimately, these things come down to what policy measures ought to be taken? Should we step in to strengthen the dollar? It was in the newspaper today, the dollar goes down, oh, we should all strengthen the dollar. Why would we want to do that? That’s preventing an adjustment process that’s going on.

Should the Fed not raise interest rates, if we get some pressure on inflation? I don’t think so, because when they do that, interest ultimately go up more anyway.

What we may be entering is a period where we are seeing a desirable redistribution of growth from the U.S. to elsewhere, and, ultimately, it’s a more sustainable global economy where growth rates are a little more evenly distributed, and the U.S. isn’t the only engine of growth.

So, I see these things happening. I don’t see any major policy initiatives that are needed, and I don’t see anything bad about it. I mean, this is a cyclical economy, and these are the kinds of things that happen when you’re going through an adjustment.

We had an extraordinary event in Asia and emerging markets since 1997, which was there a tremendous amount of excess capacity in those economies, and that created a very constructive situation for the U.S., because those countries weren’t bidding for raw materials; for a while they weren’t bidding for capital. So, we’ve had, kind of, the wind at our back.

As those countries begin to recover, we get a little bit of a headwind, and I think we have to be prepared for that. But if we were to respond by saying, "Oh, let’s not trade with China with anymore," I don’t think that would leave us better off; it certainly wouldn’t leave China better off.

COMMISSIONER D’AMATO: Professor Blecker?

MR. BLECKER: I think there’s actually a fair amount of agreement here that some kind of adjustment is coming, and the question is, is there going to be a hard landing, a soft landing, and so on? And certainly we cannot predict a collapse. I would not want to predict a collapse. On the other hand, I wouldn’t want to rule one out.

One of the things we should have learned from the Mexican and Asian crises and other crises in recent years is just how unpredictable these things are. You can see if you look at the statistics in advance foreshadowings of what’s to come. You see the big current account deficits; you see the overvalued currencies; you see the handwriting on the wall that an adjustment is coming.

But it may be better or may be worse. It may be benign and gradual, as has been suggested by some experts here, or it may be much more severe. We can look at statements by Mexican officials and business leaders before 1994 and by Asians before 1997 that said just what we’ve been hearing here, that their big deficits were just a sign of the strength of their economies and that the whole world wanted to pour funds into their emerging markets. Well, they did for awhile, but it didn’t last.

Now, we’re not Mexico or Thailand. We do have a much more capable Federal Reserve and regulatory system and so on, but still we have to keep on top of these things, and we have to not make those policy overreactions -- here, again, I agree with Dr. Makin -- not make those overreactions that would turn a needed correction of the dollar into a rout for the real economy. That error, I think, would lie in excessively raising interest rates to try to rescue the dollar. I think that would be just about the worst thing we could do.

COMMISSIONER D'AMATO: Mr. Griswold.

MR. GRISWOLD: If I could just add that economists are on notoriously shaky ground when they make predictions about the future. I wouldn't put a whole lot of weight in predictions of growth in the future. They have a hard enough time explaining happened in the last year, never mind predicting what's going to happen in the next year.

But I think the U.S. economy's on a fundamentally different foundation than Mexico and the East Asian economies, where I think we have a more transparent and efficient capital market. And the best we can do to avoid an East Asian type meltdown is to pursue sound domestic policies.

But let me say, I think -- about the sustainability of the U.S. current account deficit, if you look at the foreign ownership of U.S. assets as a percentage of our assets, it's still relatively low. The Council of Economic Advisors puts it at something like 11 or 12 percent, which I don't think is alarming for any reason.

And also as foreigners accumulate more assets in the United States, it increases their stake in our economic success and stability. Why in the world would foreign investors want to yank their money out when it will just compound their losses? So, I think, if anything, foreign ownership of U.S. assets gives them a higher stake in ensuring our stability, and I don't think you'll see the kind of panic that you saw in those East Asian economies that were fundamentally unsound but that was hidden from investors by their lack of transparency.

COMMISSIONER D'AMATO: Ms. Bates?

MS. BATES: I would just add one point to this. When we talk about unsustainable, I think people are generally referring to the current account deficit and/or the strength of the dollar rather than the growth rate of the U.S. economy. I'll make that distinction a little bit clear.

The other analogy that I'd like to draw to build on what we've been saying here is my experience being from Britain when the pound came out of the ERM in 1992, there was a sharp devaluation of the pound, and people were very concerned that this was going to cause a similar crisis domestically as had happened with some other countries, and it didn't, largely because of the institutions within the UK economy, the flexibility of the economy. We did not have the high rates of inflation that people were predicting, and the economy adjusted and actually had a bout of growth as a result.

So, I think we've sort of all been saying that at some point there's going to be a readjustment, and a large degree of whether that will have a negative impact on the U.S. economy depends on domestic institutions and strength of the U.S. economy.

So, I'd say it's less of a concern than it would be for some Asian economies or other countries.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Wessel.

COMMISSIONER WESSEL: Excuse me, thank you.

We're presently having a debate in Washington, as I'm sure you all know, due to our large and growing budget surpluses, which some say will continue as far as the eye can see.

And there is a raging debate as to what to do with that. First are those who argue for large tax cuts, and others argue that we should pay down the debt.

As I understand it, that debt is negative dissavings by the Federal Government, and my question would be: Which would be the better policy option for us to pursue in terms of looking at the trade balance itself and what impact it might have on that?

MR. GRISWOLD: I think if your focus is strictly on the current account deficit, the best thing you could do is for the Government to hold onto that money and buy down the outstanding debt, because that's a form of public savings, which would tend to shrink the deficit.

But I think you have to look beyond that and look at the health of the U.S. economy, and then the debate becomes, is that money better used to buy down the debt or to put back in the private sector to fuel more investment? And if it causes the U.S. economy to grow more rapidly, then that very well could expand the trade deficit, but I don't think that would be a cause for alarm for all the reasons we've tried to lay out here today.

MR. BLECKER: I'd like to add to that that under present circumstances, a tax cut, especially one heavily weighted toward individual income taxes, would be just about the worst possible thing, because it would only further fuel the consumer boom that is leading to the low saving rate and contributing to the large trade deficit.

And, as Dr. Mann said in the morning session, consumers have the highest propensity to import of any group of spenders in the economy. So, from the standpoint of the trade balance, a personal income tax cut would only worse the situation.

Of course all those forecasts of the gigantic future budget surpluses have to be taken with considerable grains of salt for the reasons I've stated about our ability to predict the future. Just a few years ago, we were predicting large budget deficits ad infinitum as far as the eye could see. So, we need to be very cautious, first of all, about whether or not the large surpluses will really come to pass.

But there's also a third deficit, which is the deficit in public investment, or the deficit in infrastructure, education, health, and the many areas that the public sector is legitimately responsible for. And I think one of the things we need to look at is a reorientation of our fiscal policy toward providing more of that. I know it's not on the agenda here on the Hill right now, but I think it needs to come back onto the agenda as a third option in terms of what to do with the budget surplus, if in fact there is one, and such public investment could only help to improve our international competitiveness.

VICE CHAIRMAN PAPADIMITRIOU: May I ask you to hold off for one minute, because I know Commissioner Rumsfeld has to leave --

COMMISSIONER RUMSFELD: One question. Newspapers or magazines and journals are filled with talk about the information revolution, the Internet and the advances in computer power and telecommunications. There are economists who opine that these things that are happening at such a rapid rate are having an effect on our economy. Does anyone want to comment on their implications for the current accounts balance or deficit?

MR. GRISWOLD: Mr. Rumsfeld, you raise a very good point, and I think that's why it is entirely mistaken to think of the United States in terms of a middle-aged couple about ready to retire. In many ways, we are on the cutting edge of technological and economic revolution in the world.

In some ways, we're the most developed economy in the world, and yet we are a developing economy, and that's why I think it's very shortsighted to think there's something wrong with us investing so much and investing it so effectively.

I think we're finally, as Chairman Greenspan's pointed out in a number of speeches recently, we're finally reaping some of the productivity gains from technology. And I think that's reflected in the returns on investment, and that's what's drawing investment from around the world.

So, I think in some ways the current account deficit is a sign that the world sees that we are on the cutting edge of a very important technological revolution. And that's why it's, I think, a big mistake to look at the current account deficit as a problem when in fact it's a sign of some very fundamentally good things going on in the economy.

COMMISSIONER RUMSFELD: Thank you very much.

Dr. Makin.

MR. MAKIN: It's too bad the commissioner's won't be able to get to hear us disagree on the panel, but I want to register a sharp disagreement with the notion that cutting taxes would be a bad idea.

One of the problems that the United States is facing is that as the economy expands and as the stock of capital has grown rapidly in an investment-led expansion -- and my numbers on the capital stock relative to GDP are taken from the income accounts, and they show it rising rapidly -- the rise in the capital stock is pushing up labor productivity, and wages are rising.

But, as Chairman Greenspan has clearly indicated, one of the constraints we're beginning to face is on the available supply of labor. It strikes me that in an economy that has tremendous investment opportunities that may be constrained by the growth of the available supply of labor, that a reduction in tax rates, to use the whatever we're talking about here, an immediate sharp reduction in tax rates, which increases the amount that households get to keep after they work, would be an excellent investment in maintaining both sustainable growth in the United States and a sustainable and rising current account deficit.

If we have a rising current account deficit because the available supply of labor rises and production opportunities increase in the United States and people are more anxious to invest here, I see absolutely nothing wrong with that.

I would add that the evidence on the rates of return to so-called public investment is mixed at best. I would much rather invest in individuals by letting them keep more of what they earn.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Zoellick.

COMMISSIONER ZOELLICK: Thank you. I'd first like to thank all four of you -- thank you -- for your testimonies, which I found very helpful.

I think I understand the economic theory, but I'd like to test it with some history. And, so my first question -- I have two -- is for Mr. Makin and Ms. Bates.

As I recall, the United States was a debtor country until about 1914, and then we became a creditor country for a number of decades, and then, again, we moved into a deficit position.

So, my question is, if the argument today is that because the United States is an appealing location for investment and therefore we are drawing capital into the country and because we don't have the appropriate savings to supply that capital and therefore we're running the current account deficit, why wasn't that true in the United States for much of the 20th century when I also would have thought the investment climate would have been attractive other than in the Great Depression?

The second question is to Mr. Griswold and Mr. Blecker, and it refers to more recent history. I recognize this is all a question of degree, but given the size and direction of current account deficits and given the fact that I think all four of you and the other four panelists all talked about the exchange rate as an adjustment mechanism, why do you think the dollar has stayed relatively strong given the increasing size of the current account deficit?

MR. MAKIN: Well, I'd rather answer the second question, but I'll try the first.

I think the question is why didn't we see a situation where investment opportunities exceeded savings opportunities in the United States --

COMMISSIONER ZOELLICK: And why didn't we therefore run a current account deficit from 1914 to 60-something?

MR. MAKIN: Well, you have the advantage on me, since I don't know what the numbers look like, but I'll take it that we ran a current account surplus during that time.

Again, the superficial explanation would be that domestic savings relative to investment was more adequate; that is, American households were more willing and anxious to finance a rapidly rising investment in the United States than they are today. And, so in that case we could have seen an investment boom that was more financed domestically. I don't know whether that's the right answer, but approximately that might be it.

The Government budgetary surplus or deficit in peacetime would have been fairly inconsequential at that time. So, I'm guessing that we would have seen a much higher level of participation by American investors in let's say the rapid growth in the '20s than we are seeing today.

And that might -- let me just add, actually, now I think I have the answer.

Well, in the '20s, remember --

COMMISSIONER ZOELLICK: The first one wasn't bad.

MR. MAKIN: In the '20s, remember the Europeans weren't in a big position to invest heavily in the United States, nor were the Japanese. The Japanese entered a serious depression in the mid-'20s and the Europeans were recovering from a serious war.

And so if investment growth was going to be financed in the United States, it would have to come -- or it would be more likely to come from domestic American investors where the United States was fortunate enough to have been unscathed at home in terms of its productive capacity by the war, leaving aside the tragic loss of life. So, I think we came out of the war awfully well, and so we were able to finance.

COMMISSIONER ZOELLICK: Ms. Bates?

MS. BATES: I'd just add a couple of points to that, looking at it from obviously the European perspective.

Obviously, in the 1920's and '30s, most countries were still on the gold standard, and that had and impact --

COMMISSIONER ZOELLICK: Could you speak up a little?

MS. BATES: I'm sorry. During the 1920's and -- or at least during the 1920's, most countries were on the gold standard, and that had an impact in terms of capital flows around the world. We were in a very different international environment at that point.

And, historically, although people have made the comparison that the early 20th century was a time of great capital liberalization, similar to the period that we have now, one of the points that's often missed is most of that capital was flowing to empire or ex-empire, and so there were very different motivations for the sort of international investments. Of course, the major source at that point was still the UK, and it was looking to other parts of the world.

So, some of the political and institutional changes that have happened, certainly since the second world war, had a major impact on the flows of capital around the world, and therefore in investment decisions.

COMMISSIONER ZOELLICK: And then my dollar value question?

MR. BLECKER: Actually, I think it's related to the first question, but the short answer, why does the dollar stay high if the trade deficit is so big, is that, today, the causality is starting with the capital account and the capital flows, and since the financial flows are coming in pursuit of the higher interest rates and the attractive financial market conditions, the booming stock market, and so on, that's keeping the dollar up, and the trade deficit is the effect and not the cause.

The reason this relates to your other question is that if we think about the period where the U.S. mostly had a current account surplus, let's say from the '30s through the '70s, it was actually a time of relatively closed capital markets.

And we've had a lot of capital market liberalization since the '70s, or starting in the '70s, and since then, here and in other countries which didn't previously allow outflows. For example, Japan liberalized capital outflows somewhere around 1980, if I recall correctly. And, of course, the pre-World War I period was a period of greater financial market liberalization.

And it's actually quite interesting, in both the period before World War I and the last few decades of financial market liberalization, both times, the U.S. has ended up being a net borrowing country.

I'm not enough of an economic historian to think on my feet about exactly what that means for us, but I would say this: That to the extent that the financial flows are in the driver's seat, they are adversely affecting other sectors of the economy, such as manufacturing, agriculture, and even services.

The big surplus in services just shrank last year with all the financial crises, and so I wonder if we have not gotten to the point of overderegulating and overliberalizing financial markets and if it’s not time to rethink some of that in order to stabilize financial markets and bring currency values back more into line with balanced trade flows and more sustainable and balanced growth.

COMMISSIONER ZOELLICK: Mr. Griswold.

MR. GRISWOLD: I think the fact that the dollar and the trade deficit have grown in tandem is evidence that the cause flows from capital flows to the current account. Basically, you have a strong dollar because in order to buy U.S. assets, of course, foreigners have to obtain dollars first.

And as to its impacting manufacturing, I think the evidence I presented earlier shows that that is simply not true. If you look at the industrial production figures, if you look at manufacturing output, they have grown very rapidly during the 1990’s, at a time when our trade deficit has also grown, for the reasons that as investment has grown so, too, has production.

So, I don’t think there’s any tradeoff between a large current account and manufacturing. At this moment, we have a very strong investment environment in this country. It is aiding our manufacturing; It is aiding the strong dollar, and leading to our large current account.

COMMISSIONER ZOELLICK: Thank you.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Becker.

COMMISSIONER BECKER: Yes, thank you, Mr. Chairman.

Most working people in the United States, their families and communities believe that we're on the wrong track with our trade policies in this country. Poll after poll has been taken that's indicated this. I think they relate the deficit to jobs, and there's some support for this when we see record deficits being run up every month.

At the same time, we see records being run that sort of seem to parallel this, the loss of manufacturing jobs in the United States. These are usually family-supported jobs. These are the kind of jobs that help you participate in the American dream; you can own a home; you can buy a car; you can educate your children; you pay your taxes; you support the social programs of the United States. These are the kind that pays the Medicare and the Social Security. You don't provide for these on minimum wage jobs. There's a lot of hurt going on in a lot of manufacturing jobs and industries in America today.

One of you said a little bit earlier that we have to suffer a little more pain, perhaps. Well, these are the people that's suffering the pain.

And I question the relationship between the trade deficit and the manufacturing job loss, and I would ask to what degree do you believe that the deficit causes job loss in the United States? Conversely, to what degree does manufacturing job loss increase the trade deficit?

MR. BLECKER: If I might begin on that, this is a complicated issue. Today, we have the lowest unemployment rate in about 30 years, 4.3 percent. It is very hard, based on that, to believe that the trade deficit is reducing the total number of jobs in the economy, and there is some truth to what's been said here today, that because we're a booming economy, we're buying a lot of imports from all the other economies that are more depressed. They're not buying our exports, and that's why we have a trade deficit.

However, where the trade deficit is having its impact, or the trade flows that underlie the deficit, are having their impact is on the composition of employment. The tradeable goods industries -- manufacturing and agriculture and the tradeable parts of services -- are the ones taking the hit. And, so the way we're maintaining the closest thing to full employment we've seen in a long time is by changing the nature of employment out of tradeable goods industries and into non-tradeable services.

And, for the most part, the comparison that you made is accurate in that the jobs that we're creating in those non-tradeable areas are not as good jobs in terms of the pay, the benefits, the security, and so on. And that's why the average family is still feeling the pain you described. If you lose your job in the steel industry and you get a job as a night watchman in a warehouse or something like that, it's not the same in terms of the income and the security and the benefits.

So, the effect is on the type of jobs, the quality of the jobs. You can see, if you look at my figure 9, the yawning gap between imports and exports over the last few years, actually a lot of it is due to drying up export markets, which is certainly hurting the manufacturing sector and agriculture, as well. And that's what's happening -- a change in the composition of jobs.

But to the person who loses their job, the job is lost. It's no comfort to them that somebody else got a job at McDonald's, but in the aggregate that's what's happening.

COMMISSIONER BECKER: Let me put one more figure in there, then. The Department of Labor estimates that for every billion dollars of exports that we generate in this country, we create 13,000 jobs. Shouldn't the same work in reverse? For every billion dollars of imports that we have coming into the

United States, we've lost 13,000 jobs? And if that's true, then the $300 billion deficit that we're roaring into, or $360 billion, or more by the end of this year, will amount to the loss of more than 2.5 million jobs, right?

MR. BLECKER: Well, it does, but those jobs are replaced by jobs elsewhere, just not as good jobs.

MR. GRISWOLD: I think it's a terrible misunderstanding to think that trade policy determines the total number of jobs. It does not. It may determine the composition of jobs and I think favorably so. Trade allows us to move into jobs that are more productive than those that are replaced.

If you look at the correlation between imports and job creation, they're actually positively correlated. The more imports we have into this country -- the more imports grow each year, the more jobs are created. And actually the causation goes that, the more jobs we have, the more imports we can afford to buy.

And if you look at manufacturing jobs, they were actually growing significantly during this decade up until the Asian crisis. If you look from 1992 until mid-1997, we had added several hundred thousand manufacturing jobs in this country at a time when the trade deficit was growing significantly.

What's happened in the last two year is not because of the trade deficit itself, but because the bottom has fallen out of export growth, and that has hit farming and manufacturing. But up until mid-1997, when we had a very large trade deficit -- it wasn't as large as it is now -- but manufacturing was growing significantly.

And one last thing on wages. Over the last two years, real wages in the United States have moved up sharply, up and the down the income scale, at a time when you all know that the trade deficit has grown even faster than before. So, I think there's no theoretical basis and there's absolutely no empirical evidence to link the trade deficit to either declining jobs or declining wages. And the last two years stand in stark evidence of that.

COMMISSIONER BECKER: Dr. Makin.

MR. MAKIN: I would be very sympathetic with Mr. Becker's comments, if I could see some numbers that showed some pain in the manufacturing sector. But, as a matter of fact, I watch it very closely, because I'm very interested in possible inflation pressures in the pipeline. But if you look at wage growth and decompose it into manufacturing, services, and other sectors, what you will find is that the wages in the manufacturing sector, wage growth has accelerated rapidly.

In 1998, wage growth in manufacturing was relatively slow at a 1.6 annual rate. But this may give you some reason to be optimistic -- in the last three months, the annualized rate of increase in hourly earnings in manufacturing is 7.5 percent. So, I see evidence that the manufacturing sector is picking up and going out and paying up for labor. So, I would think that labor would be happy.

COMMISSIONER BECKER: But this is precisely why the Chairman of the Federal Reserve, Greenspan, wants to raise interest rates because the workers might get a few bucks more for their work and consequently may be able to save some money. So, we want to jack up interest rates now, so we'll have a downturn and curtail domestic spending and get people laid off. Is this the right track to be going on?

MR. MAKIN: You can take that up with Chairman Greenspan. But my point is that the manufacturing sector is prospering here, and the real wage increases in manufacturing are rising rapidly.

Chairman Greenspan is not going to worry if one sector does well relative to another. Overall wage increases are what would concern him, if they were in excess of productivity growth. And, there, the evidence if far more mixed. Overall wage increases have accelerated to about a 4.5 percent annual rate over the past three months, and so far as I can see, the Fed has raised rates by 25 basis points after having cut them by 75 last fall. It doesn't seem too drastic to me.

I think what Chairman Greenspan would probably say is, "Look, if there is inflation pressure -- and we could argue about that -- if there is inflation pressure and we do nothing, the market will raise interest rates." So, you can pay me now or pay me later is I think the Fed's attitude.

But what I wanted to point out is that in this period of time, when we have a rapidly rising trade deficit, there are some expressions of concern. One of the things that I certainly see as a positive for the manufacturing sector is that real wage growth is accelerating, and it's clear that the available supply of labor is somewhat limited, and therefore wages are being bid higher, and that's a good thing.

COMMISSIONER BECKER: Ms. Bates?

MS. BATES: I'd like to address your question about trade and jobs by taking a slightly different tack. I think one of the points that hasn't been brought up quite so clearly is the impact of productivity change and general economic change on the economy and on the U.S., generally, over the last ten years.

Most economic theory would obviously tell us that trade has been a major contributing factor to the economic growth that's been happening in the U.S. It's been helping the recent boom. I think one of the points that's missed a lot in this debate is that the nature of trade and the movement to the higher productivity jobs involves economic change and dislocation.

And something that's been happening in the U.S. over the last decade has been an acceleration of that process of change and dislocation and churning and job loss but job recreation, and there's a been a net gain, but there's a sense of churning and economic change in the economy.

And I think that is where you hit the nail on the head with the fear in the public in terms of what this means and why it's coming out in an attitude against trade. And I think that's a slightly misplaced factor to be looking at.

It's more a nature of economic change within the economy, itself, feeding on a sense of insecurity, but it's being driven by a productivity change and economic development within the economy rather than specifically through trade.

And, so looking at the policy implications of that, it would be more important to look at some of the domestic labor market institutions and structures rather than looking at trade policy as the answer.

COMMISSIONER BECKER: Ms. Bates, I'd like to respond to that just a little bit. I read your testimony, and I think you came very close to being judgmental about the quality of the manufacturing jobs that's being lost in the United States and your reference to the leather industry about whether that should be a matter of concern.

I represented workers in the shoe industry very early on in my career. These were usually community-based industries in which community well-being thrived on that single industry. They were generally good family-supported jobs. Those are gone. And to simply dismiss the value of this kind of work, shoe workers in the United States is wrong. I really -- I find fault with that, and I think you are being very judgmental about the kind or value of the manufacturing jobs that's being lost in the United States.

There are people, economists mostly, that say that we can live without manufacturing in the United States. I guess we could, but it wouldn't be the same country that we have now.

MS. BATES: I think maybe I could just respond to that. My reference to the leather production in my testimony was simply to make -- not to make the point that you're alluding to but to make the point that if you're measuring trade balance by looking at one particular aspect of trade rather than looking at trade as a whole, you're getting a misrepresentation of statistics.

And I just was saying you could say the same thing about trade in oranges or trade in any one good. You need to look at an accurate data picture of the totality of economic activity. That was not meant to be disparaging to any particular industry.

To follow on, I'm also not suggesting that the decline in manufacturing jobs is good or bad; I'm trying to address the point about the nature of -- the public response to the nature of the economy that we're in right now. As you say, it's come out in a sort of attitude against trade.

I think it's really a broader sense of economic change. I'm not meaning to make judgment whether it's good necessarily or bad, but that the nature of this economic change is much more diverse through the economy than just being driven by trade, per se, and that that's perhaps what needs to be addressed.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Hills.

COMMISSIONER HILLS: I'd like to ask Dr. Makin, if the trade deficit is a factor of our buoyant, robust investment at home, which has given us many, many benefits and the fact that we're unable to finance that robust investment from our own domestic saving, are there any measure that you would recommend that would encourage greater savings at home? And would those measures have any downside or upside with respect to the health of the overall economy?

MR. MAKIN: I hesitate because I've spent a lot of time looking at savings behavior, and I'll first say this one specific thing I would do and then suggest that it perhaps isn't a major problem.

I think probably if we wanted to increase the saving rate, the best thing to do would be to redesign the tax system and go to a consumption-based tax that would remove what now amounts to a double taxation of savings. And of course this issue was contemplated in 1984 at the Treasury, and the Treasury decided instead to reform the income tax.

And I think had we gone to a consumption-based tax at that time, low, uniformed, consumption-based tax, probably today we would be seeing more inclination among Americans to finance the very attractive investment boom that has come along in this decade.

Having said that -- so, that's what I would do in the policy arena, a more neutral tax system, quite simply. Having said that, when you look at savings behavior across the world -- Europe, Japan, and the United States -- and I'm leaving aside the formidable measurement problems -- I would say simply that Americans will always save less, all other things equal, for a very simple reason: Americans are more optimistic about the future than are Japanese or Europeans' households, typically, and with good reason.

The history of the last 100 years would suggest that American households don't have to contemplate a possible major conflict being fought on their soil; maybe some awful day it will happen. But American households are more optimistic, because we haven't had major conflict here, because America has grown up as a country that has expanded, its manifest destiny expanding across a continent. And, so Americans essentially think something will always turn up, and what really, really annoys people elsewhere is that it always has.

Having said that, I'm not sure it's a good guide to policy. On the policy front, again, I would go back and say, probably, we should neutralize the tax system and at least not penalize saving and have a consumption tax.

COMMISSIONER HILLS: Thank you.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Lewis.

COMMISSIONER LEWIS: I'd like to ask a question about wages and the effect of wages on this whole issue of trade.

There's an article that I read a couple of years ago -- there's premises here. I read, today, that Mexico now exports more cars to America than we export to the rest of the world, and this is a recent development in Mexico. So, the question is why did their automobile industry grow the way it has? Is wages one of the factors here?

Number two, there was an article that said, no longer do countries' trade advantages depend chiefly on their natural resources -- soil, climate, or raw materials -- and to a lessening degree on the availability of capital but on the ability of individual firms and entrepreneurs to find their niche in making a specialized set of attractive, high-quality products.

Well, is wages a factor in what's happening now with the trade in the world, and are we trading and buying goods from other countries -- and take the Japanese automobile out of the equation, because technologically it is superior in a lot of ways to ours in terms of fuel consumption -- but taking that out, is wages one of the key factors in why we're in a trade imbalanced situation?

And then, thirdly, I read an article that said that in the last 20 years, until a year ago, of the five quintals of American income levels, four quintals have actually -- three quintals have actually lost ground and two have gained ground over the -- from 42, I guess, to 90.

So, if wages have lost ground here for the three quintals -- and I don't know if this is accurate or not -- but if they've lost ground here, then why are we uncompetitive with other places? Are those wages still higher than in other countries?

If the booming economy has caused an increase in wages, why has the three lower quintals lost ground?

MR. MAKIN: I'm glad you weren't setting my exams when I was trying to get a Ph.D. Those are very difficult questions.

Do you want everybody to take a shot? Well, I've talked about a lot, so --

MR. GRISWOLD: I'll be glad to take a swing at that. I think it's wrong to ascribe the trade deficit to differences in wages. I think it really comes down to the savings and investment balance, and if you look at wages, it just doesn't explain -- for example, we run a large trade deficit with Japan and their real wages in some measures are higher than ours. And the same with Europe.

COMMISSIONER LEWIS: But that's because of the automobile, essentially, in Japan.

MR. GRISWOLD: Well, all right. Then, look at Germany. Germany has higher real wages than here. We run our third largest bilateral trade deficit with Germany. Mexico has wages that are much smaller; we run a bilateral deficit with them. It just doesn't explain the differences in wages. You have to --

COMMISSIONER LEWIS: Well, you may have to look at the goods that were imported from these countries and how large a factor is wages in the price of those goods? In other words, wages might not be a large factor in the price of automobiles, but they may be a large factor in the price of apparel or sneakers. And from Germany, we may be buying manufactured goods, not -- where wages is not a significant factor.

MR. GRISWOLD: Well, I'd have to look at that.

COMMISSIONER LEWIS: Right.

MR. GRISWOLD: But let me just address the question about the trend of wages in the United States. I think in some ways the decline in real wages has been overstated, because, one, I think inflation has been systematically overstated, which would tend to depress real wages, because the denominator's bigger than it would otherwise be. And also those don't include benefits, which are an increasing share of the compensation.

And if you add in non-wage compensation and take a more realistic measure of the cost of living, you'll find that wages have not been falling; they've tracked relatively closely with productivity, which is just what an economist will tell you. Wages tend to reflect productivity. Productivity has taken a spurt upward in the mid to late '90s, and, lo and behold, you're seeing real compensation taking a spurt upwards.

And as far as trade goes, you can't just look at wages; you have to look at productivity. Mexican workers get paid a lot less than American workers, because they're a lot less productive, not because there's anything fundamentally wrong with them as people, but because they have less capital to work with, they're less educated, and their infrastructure is less developed.

COMMISSIONER LEWIS: Then why are new automobile plants being built in Mexico, if they're less productive as opposed to being built in America?

MR. GRISWOLD: Well, I think production plants are being built all over. If you look at automobile production in the United States, it's up over 50 percent since 1992. Our trade deficit has tripled since 1992, manufacturing output's up 40 percent, automobile and automobile parts manufacturing is up over 50 percent. The U.S. automobile industry is booming.

COMMISSIONER LEWIS: Then why would anybody invest in Mexico then? Why would automobile plants be built in Mexico, if we can product it better here?

MR. GRISWOLD: Well, certain parts of the manufacturing process they can do more efficiently down there.

COMMISSIONER LEWIS: I don’t know what that means, more efficiently.

MR. MAKIN: Let me take a shot at this.

Let’s suppose -- these are very specific decisions -- Ford says, "Okay, we produce automobiles. We have to assemble the automobiles. We have to finish them. We have to ship them."

When Ford decides where to produce automobiles, they’re thinking about a number of things. Where are we going to sell most of these cars, because we’re thinking about what are the transportation costs from the production facility?

What is the real unit labor cost of assembling them and if it’s lowest in Mexico, that’s where they’re going to produce the cars.

COMMISSIONER LEWIS: Why would it be lowest in Mexico?

MR. MAKIN: Well, it could be -- I mean, it may or may not. It could be a number of reasons. One of the reasons is that if you need, for example, unskilled labor and Mexico is having a sharp slowdown as they did after 1995, the economy is dead on its feet, then there are a lot of people available in Mexico at a relatively low unit labor cost --

COMMISSIONER LEWIS: So, wages becomes a major factor here.

MR. MAKIN: And who loses? The Mexicans are happy to get the job --

COMMISSIONER LEWIS: I'm not trying to say who wins or loses. I'm just saying that --

MR. MAKIN: Labor costs, as you know, in most any business, are between 60 and 70 percent of the total. The labor costs in what a big company like Ford's going to do is break down labor costs in terms of our production of the actual vehicle, then labor costs as a part of our distribution of the vehicle, et cetera, et cetera.

So, there's -- location is a key element in every decision of the production process for major multinationals. Ford is not an American company; Toyota is not a Japanese company. They are all companies that happen to be headquartered in those countries that will produce, finance, sell, market, source anywhere where it’s least expensive, and if the don’t, they’re out of business.

Nissan is a good example. They’re practically out of business, because they fell behind Toyota on sophisticated production techniques.

And, certainly, if everybody is producing cars in Mexico, initially, it’s because probably unit labor costs for that particular kind of production are lower. If everybody goes to do it in Mexico, the cost will be driven up, because the demand for labor will go up, and then they’ll try to find someplace else.

But I would assume, again, not knowing the business, that assembling cars in northern Mexico, which is close to the U.S., is an attractive proposition if you’re out of labor somewhere in the United States. Whether or not that creates jobs in the United States is an open question. Somebody’s got to move the vehicles back to the United States. If the cars are then more competitive with Japanese cars, you sell more cars in the United States, et cetera, et cetera.

COMMISSIONER LEWIS: Professor Blecker.

MR. BLECKER: I’d like to take a few stabs at that, and I want to start with the general and then come down to the specific.

In general, the importance of wages and labor costs to trade varies depending on the nature of the product and the stage of the production process. So, you're going to see the United States exporting things like airplanes where labor costs are relatively less important, and where technology and other factors are more important. So, that's pretty clear.

But there are many goods or stages in production, like labor-intensive assembly, where labor costs are the dominant factor. And what's been happening in those sectors and industries is a new phenomenon that is very well illustrated by your example of the car factory in Mexico.

And that is although average productivity in a country like Mexico or China is very low, because the average includes all the poor farmers in the rice paddies or the cornfields in Chiapas or somewhere, in the new factories that are brought in by multinational corporations or that import the technology from the U.S., Europe, or Japan, the productivity is actually close to our levels.

And this has been documented specifically in the case of the automobile industry in northern Mexico in some very good studies by Professor Harley Shaiken, who showed that the

Mexican workers in those auto plants are almost as productive as American auto workers -- 80, 90, up to 100 percent as productive -- but their wages are only 10 percent of American wages or lower.

So, when you have that kind of comparison, clearly, the unit labor cost, which is the correct measure -- wages adjusted for productivity -- is going to be significantly lower, and that's going to create a shift in production and a shift in trade flows.

COMMISSIONER LEWIS: Why shouldn't that happen then to every automobile plant in America?

MR. BLECKER: Well, the automobile deficit, as I understand it, is quite high. So, it's probably happening to a lot of them, but there are different kinds of cars, there are different parts -- for example, we may get a lot of parts and components from Mexico, but some of them still get assembled up here in our more automated assembly lines. There may be a difference between simpler cars and more complicated cars.

I'm not an expert on the auto industry, but, certainly, there are a lot of jobs that are being lost in the auto sector. It's not that there aren't any more auto workers here, but there are many auto workers who aren't auto workers anymore, and they or their spouses are doing something else at lower pay and with lower benefits. Maybe they're chauffeurs driving limos around, but many of the cars and a lot of the parts in them are imported.

That affects our income distribution and our ability to generate the middle-class standard of living that Commissioner Becker was talking about earlier.

MR. MAKIN: Or they may be working for Mercedes, which has located its production facilities from Germany to the United States or BMW. And it would be interesting -- you know, I don't know the answer -- it would be interesting to ask why doesn't Germany locate their production facilities in Mexico? Don't know. Apparently, I'm sure they looked at all the possibilities and decided that the United States was a more effective place to locate their production -- cost effective place.

Because what you have with German companies, which are constrained to hire labor at a very high cost, is many of them are simply saying, "We're not doing it here."

COMMISSIONER LEWIS: Well, unfortunately, a lot of the reasons, a lot of the location decisions are dependent on the incentives that the localities give them also today.

MR. MAKIN: Why is that unfortunate?

COMMISSIONER LEWIS: Because I read where in Tennessee it will take like 50 years for that community to recover the costs that they gave to whatever plant moved in there. They gave too much. Just like stadiums are built giving big incentives to --

MR. BLECKER: There was considerable tax competition to get those BMW and Mercedes plants located in those particular states they went to. In addition to which, they happen to be among the lower wage states in this country. So, they came here, but they were handsomely rewarded.

MR. MAKIN: Is that bad or good, I don't know?

MR. BLECKER: It's good if you've got a job in that plant. It's not good if you were a German car worker.

CHAIRMAN WEIDENBAUM: I'd like to toss in a little positive spin to this discussion, and that is when you look at our exports and imports through the filter of technology. Make a simple distinction, high-tech products and low-tech products, and you can measure that very simply -- the Census Bureau does it regularly -- viola. You look at the high-tech products, year after year we have a large and usually rising trade surplus. For low-tech products, the reverse -- we have a large trade deficit.

I think there's some lessons. Economists like to toss out such awful terms as comparative advantage and things like that, but those industries where we have highly trained, highly educated, highly paid workers, they're the industries where America's leading the world.

So, I think a discussion that focuses on the industries that are having a hard time holding their own is incomplete unless you look at the positive side and that is those many sectors of the American economy where we set the standard.

COMMISSIONER LEWIS: I totally agree with that. And that's one of the reasons I was concerned when China, I understand, said to Boeing, "If you want to sell us planes, you have to build them here in China," which takes away the whole theory of comparative advantage.

CHAIRMAN WEIDENBAUM: That's political economy.

COMMISSIONER LEWIS: Right.

CHAIRMAN WEIDENBAUM: Both sides are political.

COMMISSIONER HILLS: I was late to come in on the auto question, but my perception is that joint production of automobiles has made the industry much more efficient, and the fact is that the automobile industry, from what I've read, has done extremely well in the last two years, so that one cannot complain about their situation.

Elements of the industry have advised me that they very often locate in less mature markets in order to tap into those markets and to have geographic proximity to export markets.

But do any of you have a point of view -- perhaps, Mr. Griswold -- whether by opening up markets so that efficiencies can be maximized has been beneficial, not only to the industry worldwide and industries worldwide, but particularly to the United States?

MR. GRISWOLD: If I understand your question properly, I think it would undoubtedly be good for the United States as a whole and the automobile industry if foreign trade barriers to U.S. automobile exports came down. We'd have a more efficient industry, higher real wages.

To get back to the point of the trade deficit, it would not have an effect on the trade deficit, because what you'd have -- if foreign trade barriers come down to automobile exports or any of our exports, what you would have is foreigners would be more eager to get their hands on dollars in order to buy those exports that they now have access to, those U.S. exports. The dollar would go up. We would tend to import more, and we'd tend to export less, perhaps, in those sectors where they were not being rewarded with lower trade barriers abroad.

So, at the end of the day, the trade deficit would not be affected, because you haven't affected the savings and investment balance. But it would undoubtedly be a good thing.

COMMISSIONER HILLS: We were getting off the trade deficit and into industry-specific, and I was simply addressing the efficiency of a particular industry that no longer is solely domestic. It's very hard to categorize an automobile today as solely American, because so many parts are brought in from other places. And that also goes to the assembly feature. But, please, Mr. Chairman.

VICE CHAIRMAN PAPADIMITRIOU: Do you have response? Yes?

MR. BLECKER: Yes, because I think Mr. Griswold's last comment gets to a very fundamental issue about whether changes in trade policy can affect the trade balance, and I think it's important to address this.

The story he just told, which you can find in a lot of textbooks, is that if we sold more exports so there would be more demand for the dollar, it pushes dollar's value up, and the adjustments will work themselves out. There would be no net improvement in the trade balance.

I think that kind of old-fashioned story just doesn’t work anymore. And the reason it doesn’t work is that this kind of commodity trade, whether it’s in autos or steel or anything else, is a drop in the bucket in the financial markets that are determining the values of the dollar and other currencies. And the currencies are going to do things depending on what’s going on in the financial markets, and they’re not even going to notice whether auto exports went up or down.

If you look at the figures -- If I recall my calculations -- the amount of currency trading in today’s world I think it’s, I don’t know, it’s at 1.5 or so approximately trillion per day is more than our imports for an entire year in the United States.

So, we just can’t believe in those kind of simple stories anymore about these automatic exchange rate adjustments that would balance trade. Otherwise, we wouldn’t have had the question from Commissioner Zoellick. If that were true, we wouldn’t have a trade deficit, because the dollar would already have adjusted down.

Clearly, something else is operating, and I think that what’s operating in the currency markets is financial factors are dominating trade flows.

VICE CHAIRMAN PAPADIMITRIOU: I wonder if I can ask a question and bring us back to the relationship of the negative savings rate and the trade deficit.

It seems that throughout the day we've heard that there is a causal relationship, and yet, Professor Blecker, you indicated that it's not necessarily a causal relationship. Would you mind elaborating on that comment that you made?

MR. BLECKER: Well, when you sort of balance out the country's accounts, it has to be true. The trade surplus or deficit is going to equal savings minus investment. The only point is that the causal story doesn't have to start with a saving variable, which in turn includes several parts: the Government surplus or deficit, corporate saving, and household saving. And each time we put our finger on one part of that -- the budget deficit in the '80s or the personal saving rate -- we think aha, we have the culprit, but in fact it's only part of the story.

And not only that, the saving rate is what we call an endogenous variable. For example, one reason the Government budget balance has gone up and we have this big surplus is because we've had so much growth. The same growth causes the budget balance to improve and the trade deficit to worsen, as has been discussed earlier.

So, all these variables in this identity, this equilibrium condition are endogenous variables affected by the same forces. They're affected by growth rates in the U.S. and abroad; they're affected by exchange rates; they're affected by financial inflows and outflows, and I think they're also affected by some of the trade policies and trade barriers we've been talking about. If you have a highly competitive economy, you have a high profit rate, rising incomes of your workers, you're going to have a high saving rate as a result.

I think some of the high saving in Asia isn't just cultural. They didn't have these high saving rates 50 or 60 years ago. It's due to the success of their economies in selling a lot of exports while holding wages down, not absolutely -- their wages have actually risen quite a bit -- but relative to productivity and depressing consumer demand with -- you know, you could actually attribute a lot of what happens to the saving rate to income growth.

There was a very interesting study by Barry Bosworth at Brookings in 1993, and in a little noted part of it he tested for the reasons for the falling saving rate in the United States, and he found that one of the main explanatory factors was a slowdown in income growth of household income growth, and he also showed an across country comparison that income growth rates were a major explanatory factor of the saving rate.

So, the saving rate, itself, is a variable that is affected by other things, which can also affect other parts of the trade equation or be affected by those. So, that's why I don't think we can have simply one-way causality on the saving rate as some sort of exogenous factor, which it is not, to trade.

All of these variables are part of a larger macro model, which in turn is conditioned by structural parameters, which in turn reflect policies and institutions and practices, including trade policies here and abroad. And we have to look at that whole complex picture and also every situation is different. There may be times when a change in fiscal policy is the driving force, but there may be other times when it's not.

CHAIRMAN WEIDENBAUM: One of the charges to our Commission is to examine the statistics on the trade deficit and to make recommendations for improvement. Does anyone have any specific suggestions for improving the measures of what we're talking about?

MS. BATES: The one piece of work I've been made aware of in this area is the sort of model being approached under the International Trade Data System, which is work that's been done by some departments in the Treasury Department trying to establish -- to address some of the things I outlined in my testimony about the fact that smaller value exports are often undercounted, the fact that there are long time lags between the time at which trade occurs and the publication of trade statistics, as was obvious during the recent debates around steel. We had to wait many weeks before the figures became available. And also to try and make sure the small exporters are able to file. Sometimes their costs of filling in a lot of paperwork for all the different agencies that are involved in trade can be very burdensome.

So, what I understand they've been working on trying to do is set up on a system which would have electronic filing over the Internet coming into one centralized system that would then disseminate data to various different sources and that they have done some work on this.

I think that sort of approach where you use the new technologies, such as the Internet and information technology, to speed up the process of collection and dissemination of statistics and make them more accurate, make sure more of the different transactions that are going on are actually measured and included, would do wonders to improve the level of debate and improve our understanding of what's actually going on in the economy.

In one of the questions earlier on, we were talking about the use of the trade deficit as a measure. I think increasingly it's become more and more anachronistic because the nature of the economy is changing so much that we're going to need to make sure we're measuring the new areas that are happening too, so that we actually have an informed debate.

MR. GRISWOLD: If I could just add, I think the benefits of having more accurate information on the current account have to be weighed against the costs of the Government collecting more data. And I would be very concerned that a process that tried to count every last export and import became so heavy in paperwork that it interfered in trade.

We don't count the trade between California and Nevada for good reason that in the end it doesn't matter, and I think I would look forward to the day when we view international trade with the same general benign indifference that we look at trade between states. I think we'd all be better off.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Becker.

COMMISSIONER BECKER: I think we need to look a little bit as to the trade policies for the other countries and our ability to compete with them.

Its generally thought that trade with the emerging countries enhances the workers' standard of living, and they can afford to participate more in their own economy, etc., and everybody's better off.

But the problem, as we see it, is that the workers in most of these countries do not have the ability nor are they permitted to share in the wealth that they help create. They don't have freedom of association necessary to develop unions or bargain to improve their lot in life. Governments most often subsidize industry, and there's no enforceable environmental regulations. And, as a result, it's almost impossible for industry in the United States to compete in any real sense with those countries.

The question I would frame is to what degree do you believe that the rights of workers, human rights, the right of freedom of association and to bargain collectively, in order to share in the wealth they help create, have on our overall trade deficit? Is this something that we should even be concerned about as far as you're concerned?

MR. GRISWOLD: As far as it concerns the trade deficit, I think the effect is minimal for all the reasons we've talked about. I think if it doesn't affect the savings and investment balance in the United States, the effect on the trade deficit is going to be minimal.

If you look at trade barriers, they just don't explain the differences in our -- for example, our bilateral deficits. We have bilateral deficits with both Canada and Mexico, and yet we run a bilateral surplus with Brazil, which has relatively high barriers, while Mexico and Canada are virtually open. There we have basically the level playing field and the fair trade that everybody says we should have with countries.

If you look at Europe, we run our largest surplus with the Netherlands, and yet under the exact same external tariff, we run our third largest deficit with Germany. So, trade barriers, themselves, provide virtually no explanation as to either our bilateral or our overall trade deficit.

VICE CHAIRMAN PAPADIMITRIOU: Professor Blecker.

MR. BLECKER: Well, I'd have to disagree with that. Three-quarters of our current trade deficit is with the Asian countries, and half of it is with Japan and China alone, and those two countries, I think it is well documented, are very closed to imports, not just because of official, legal trade barriers, but because of corporate buying practices, the vertical integration of the Japanese keiretsu, and the Chinese government's ability to manipulate industries like aircraft where they won't import airplanes unless we share the technology with them and build the airplanes in China.

So, these are closed countries where we have the lion's share of our trade deficit, or at least they are much more closed than other countries. I think that's not a coincidence, and it shows that trade barriers do matter. They matter because they in turn reverberate on savings rates. The saving rates are not autonomous. You can afford to save a lot in a country where you can artificially stimulate your industries like that, and where you repress consumption in order to force people to save.

Now, with regard to labor rights, I agree it's very important, and it's important for workers in industries like steel or textiles to feel a sense of fair trade and equal competition, but I would have to say that in terms of quantitative impact on the overall trade balance, it would probably be relatively small.

Imagine, for example, that workers got more rights in China and Mexico and doubled their wages. That would be extraordinary. Imagine doubling your wages. But then the wages in Mexico wouldn't be one-tenth of ours, they would be one-fifth. The wages in China -- I don't know what exactly they are; we don't measure them -- but just to make up a number, suppose they're now one-fortieth, they would then be one-twentieth.

We'd still have low wages in those countries. Not as low, and so it would help some, definitely. It would help some in particular industries and sectors where there's this ability to create the low unit labor cost competition I described earlier. But in regard to the aggregate trade deficit, it's probably not a major factor.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner D'Amato.

COMMISSIONER D'AMATO: Yes, Mr. Chairman.

I'd like to just follow up on this point you made, Mr. Blecker, on the trade barriers in Asia. What would be your judgment as to the quantitative impact of the whole range of those barriers?

I've spent some time in China. American businessmen in China have an extremely difficult time doing business in China, and anyone who has done business in China I think will admit that. I know it's hard to quantify the actual magnitude of the barriers, because a lot of our exports are, in effect, deterred, simply because it's just too difficult to get them in there. Nevertheless, is there a way to quantify the impact of these barriers overall?

MR. BLECKER: Well, we could try to estimate it. There was a study several years ago at Catherine Mann's group, the

Institute for International Economics, by Fred Bergsten and Marcus Nolan, and they estimated the quantitative impact of Japan's import barriers on the U.S. trade balance. And if I recall correctly -- this is off the top of my head; you'd have to check -- it was somewhere around $15 to $20 billion. Now, that's not the whole trade deficit, but it's a significant chunk of it, and this study was from a very pro-free trade organization. So, I think you have to give a lot of credence to this.

With China, I don't know of any estimates. Perhaps there are some, and it's something the Commission should certainly seek research on, but one need only look at the proportional imbalance between our imports from China and our exports to them -- it's a five times ratio -- to realize that if, let's say, half of that -- we're talking $20 or $30 billion -- could be due to barriers.

If you add it all up, my guesstimate would be somewhere in the $40 to $50 billion range, but that's an area where we should seek out studies and get more evidence.

COMMISSIONER D'AMATO: Well, $40 to $50 billion, that's a pretty large chunk.

COMMISSIONER HILLS: Did you say $40 or $50 billion?

MR. BLECKER: I don't want to pin myself down to a particular number, but if you start with Japan being --

COMMISSIONER HILLS: That would be their whole deficit with us.

MR. BLECKER: I meant $40 or 50 billion for all of Asia, not just Japan. But if you start with the Bergsten-Nolan estimate for Japan, then maybe there's something of a similar order of magnitude for China, perhaps even more, and then there's other Asian countries, which also have structural trade barriers, it's not hard to get up to numbers in that range. But, again, I don't want to be pinned down to a specific number, because I haven't estimated it myself.

COMMISSIONER HILLS: Is your analysis based upon the fact that in Japan we compete rather head-to-head, because we're both industrialized countries? In China, we do not compete. We buy things from China that we don't make here, and they buy things from us that, for the most part, we don't make here.

MR. BLECKER: But the point is they buy very little from us. They buy much more from Japan than from us.

COMMISSIONER HILLS: Well, actually, in 1998 China was in the top three of our fastest growing export markets.

MR. MAKIN: They're buying a lot of computers, I understand.

VICE CHAIRMAN PAPADIMITRIOU: If I could just follow up on the comment.

MR. BLECKER: Our exports for the entire People's Republic of China last year were smaller than our exports to Singapore. That makes it hard to believe that the supposed vast consumer market in China is really buying our exports.

COMMISSIONER LEWIS: Say that again, please.

MR. BLECKER: Our exports to China last year, our merchandise exports, were $14.0 billion and to Singapore they were $15.6 billion. There's a lot more people in China, and even if you correct for the difference in income levels, this is a closed market.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Lewis.

COMMISSIONER LEWIS: I'd like to ask each of you a theoretical question. As a nation constructs a foreign trade policy, what purposes should be considered in constructing a foreign trade policy?

Obviously, one of the purposes should be to provide an environment in which competition is good for American companies, because it causes them to constantly renew their plant and equipment. One purpose for foreign trade policy has to be to provide an environment to which American companies can make money in the world.

What other purposes would you say should be considered as part of a foreign trade policy of a country?

MR. MAKIN: Well, I'll be radical and say I don't think a country should have a foreign trade policy. And by that I mean I think a country should try to set up a set of conditions under which its producers and consumers are able to produce and compete as freely as possible, consistently with an orderly society. And that under those conditions, a trade policy will take care of itself.

COMMISSIONER LEWIS: Well, then you're saying the policy should be just totally laissez faire.

MR. MAKIN: Yes.

COMMISSIONER LEWIS: Okay.

MR. MAKIN: And let me just suggest that if we look at the results of -- let's say, is the United States more laissez faire than China or Japan? Certainly, the United States is far more laissez faire than Japan, and I'd certainly rather be in this economy than that economy as a producer or a consumer, having lived in Japan as a consumer. Shopping is a very dismal prospect in Japan. Every place you go, the price is the same, and it's high.

So, I don't see any point in imitating that kind of a system, and I guess I was wondering where --

COMMISSIONER LEWIS: So, your policy would be a laissez faire policy.

MR. MAKIN: Right.

COMMISSIONER LEWIS: Okay, thank you.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Zoellick.

COMMISSIONER LEWIS: No, I'd like to ask each of them their opinion on what policy.

MR. GRISWOLD: I'll be quick. Two complimentary objectives: One should be the broadest possible prosperity and benefits, and I think that's the problem with protectionism. It defends the interest of a small group at the expense of the whole.

Second should be the liberty of citizens. Government should not interfere in the ability of the citizens to spend their hard earned dollars as they wish.

And both of those objectives I think point very strongly towards free trade.

COMMISSIONER LEWIS: Thank you.

MR. BLECKER: Very briefly, I think that with trade policy, as in any other area, we have to look at the costs and the benefits. There are well known gains from trade -- gains in efficiency, scale economies, greater variety, the whole gamut. But there are also costs of trade liberalization, including income redistribution effects, adjustment costs, and -- in some cases, at least -- loss of high wage jobs and their replacement with low wage jobs in nontradeable services.

I think we need to balance those things. I think a reasonably open but not purely laissez faire policy is best. I think we have to address sectoral issues where there are sectors that have particular problems, and that we need to deal with the fact that there are different institutions and practices and policies in different countries, which may make trade policy remedies necessary to offset those factors that are making the world market less than a level playing field.

COMMISSIONER LEWIS: Thank you.

MS. BATES: I think I would say that I would rather look at it in a broader sense than just strictly trade policy. I think you have to have a sort of approach to globalization and to trade, investment, your domestic structure, and the structure of countries overseas to broaden out a little bit from strictly trade policy. But, generally speaking, to have open markets to encourage economic growth, bearing in mind that they're a means to an end rather than an end in themselves.

And I think the counterpart to that is you need to have the right domestic institutions and infrastructure to make sure that the largest number of people within the economy benefit from the gains that you derive from having open markets.

And I think, as we go into the future with the sort of economy we're looking at in the U.S. that's going to mean things like portable pensions, portable health care for workers as they move between jobs, lifetime access to education and training.

All those sorts of things need to be there domestically to make sure that the vast majority of Americans benefit from this gain that we will get from having open markets with the rest of the world.

COMMISSIONER LEWIS: Mr. Makin, I assume -- Dr. Makin, I assume that when you were talking about laissez faire, that would not include military defense. I mean, obviously --

MR. MAKIN: Right. And I guess I was going to ask you, do we have a trade policy? Does the United States have -- I don't think the United States has a trade policy.

COMMISSIONER BECKER: Sure we do. It's set by General Electric and General Motors and other multi-national companies. They're the ones that set the trade policy in the United States.

VICE CHAIRMAN PAPADIMITRIOU: I want to exercise one of the powers of the Chair here.

MR. MAKIN: I'm sorry.

VICE CHAIRMAN PAPADIMITRIOU: Commissioner Zoellick.

COMMISSIONER ZOELLICK: Just two follow up questions for Mr. Blecker.

You mentioned some studies, and I was wondering whether you had reviewed any studies on Chinese exports to the United States and their displacement of U.S. production? Because my understanding is one of the same institutes you cited, IIE, has done work on this question, and they have concluded that Chinese exports have primarily, in fact almost totally, displaced production from third countries that would be competitors with them. And I'm curious whether you have information to the contrary? That's the first question.

The second question is if I were on the Trade Commission in the European Union and I said to you the European Union has higher levels of union participation, higher wages and compensation, at least I would argue as a European, higher social protection, is the United States being an unfair trader with Europe because of that factor? And, if not, then isn't what's good for the goose, good for the gander? How can we make the case with other countries, if Europe can't make it with us?

MR. BLECKER: Those are tough questions on a final exam. With regard to China, I have not studied U.S.-China trade. My colleague at the Economic Policy Institute, Robert Scott, has worked a lot on that, and I understand he's a witness for your next set of hearings. So, I think you might better direct that question to him.

It's certainly true that China and other newly industrializing countries are to some extent taking export markets away from each other. I think that's one of the reasons they're all getting into crises and that they have all this excess capacity. But what I was emphasizing was China's closure to imports from the U.S. rather than the exports taking away jobs. Undoubtedly there is some mix of taking away jobs here and from Mexico and Korea, and it's a question of how much from where?

Regarding Europe, actually I have heard some Europeans say -- I don't know if they use the word "unfair trade" over there -- but I have heard them look at the U.S. as a relatively laissez faire place, and depending on your perspective, what part of the European political spectrum you're on, that's either a good thing or a bad thing, but there is a sense that it does put a pressure on Europeans to lower their wages and to reduce some of their social policies.

Again, some welcome this and some very much oppose it. Why did they move production of BMWs and Mercedes to the American South? I think clearly the difference in labor costs and in labor conditions and unionization -- you notice they didn't choose Michigan where they might face the United Auto Workers. Those differences do matter, but we should remember that they are much smaller than the differences between the U.S. and developing countries.

COMMISSIONER ZOELLICK: If I could just follow up on this, because, again, it's our role more to gather information, but since people have mentioned BMW and Mercedes a number of times, having talked to people from both companies, another big investment reason -- of course there are many -- is to be close to the market in which you're going to operate, because many companies have learned over time that they will learn more about their market and have a better sense of it, in addition to lower transportation costs. So, if they produce in the market where they plan to sell, I think we have to be a little careful about stressing only the wage points for investment location decisions. Obviously, once you decide to go to a market where you locate, that's one element.

But the reason I'm focusing on this European point, not just making a debating point, is that it strikes me that as a policy question, if the United States decides that it wants to apply this logic to other countries, wouldn't there be a risk that other countries would apply it to us to our disadvantage, because we do export a lot to Europe, as I recall?

MR. BLECKER: Well, there's a risk that the logic would be to apply it to us. Where that's to our advantage or disadvantage, again, might depend on one's perspective.

COMMISSIONER ZOELLICK: Could you explain that? So, in other words we would raise wages, be more unionized, and so on and so forth.

MR. BLECKER: Yes. If we lack social policies that, say, Europe has -- I know I've heard this argument from Canadians in the NAFTA context -- it creates a pressure to reduce those social policies in those countries. So, they might indeed want us to harmonize upwards.

COMMISSIONER ZOELLICK: So, just so I could trace the logic of that, if we followed through on this policy idea, it would be a way of using trade policy to help establish our wage polices, our social welfare policies, all the things that Congress likes to do on its own.

MR. BLECKER: Any time you enter international negotiations over these things, yes, it would somewhat abridge our autonomy in those areas as it would for other countries. So, it would be a question of harmonizing standards. And I think that some of the popular opposition to trade, which we’ve heard so much about, might actually dissipate, if people had more of a sense that there was fairness and balance and equal treatment.

VICE CHAIRMAN PAPADIMITRIOU: We seem to have been carried away, and we’re in a time deficit, and therefore I think I would like to bring this to a close. And on behalf of the Commission, I would like to thank you all for coming. We appreciate very much your coming and your comments.

Thanks very much. This session is adjourned.

(Whereupon, the above-entitled matter was concluded at 4:37 p.m.)