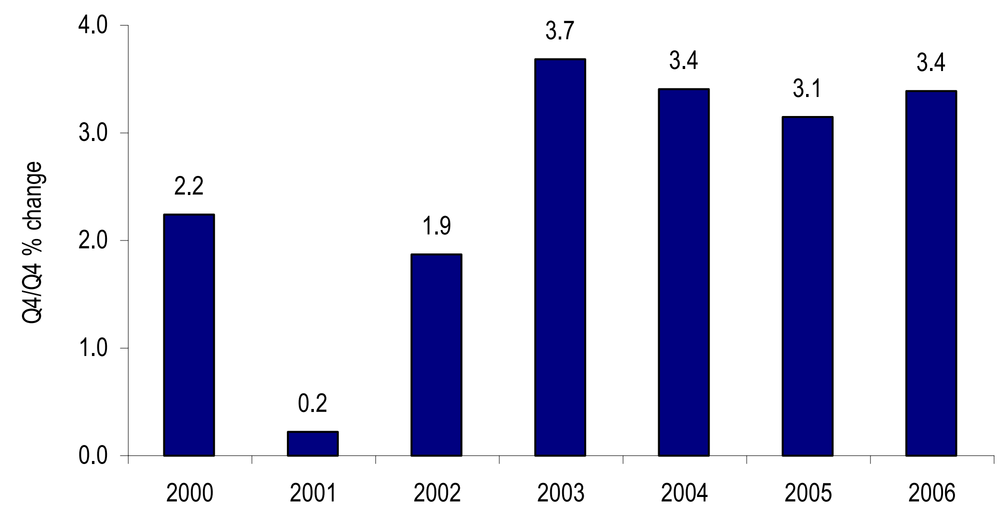
Statement of
David R. Malpass before the
Senate Budget Committee
February 1, 2007

Chairman Conrad, Senator Gregg, members of the Committee, thank you for the invitation to testify on the current account deficit and the U.S. foreign debt. I am chief economist at Bear, Stearns & Co. Inc. The views I express today are my own and are not necessarily those of my employer.

In recent years, U.S. growth has been faster and steadier than most expectations. Even so, the frequent view has been that the U.S. is on the wrong economic path, heading into a slowdown or a recession in part due to the trade deficit. Instead, the U.S. has enjoyed a strong multi-year expansion. Growth in 2006 was faster than 2005, and 2007 looks equally robust. If so, this would make five years in a row above 3% growth. Rather than causing a slowdown, job losses or higher interest rates, the extra goods and capital inflow associated with the trade deficit have coincided with strong growth, profits and job creation.

U.S. GDP Growth



Source: Haver; Bear, Stearns & Co. Inc.

As the expansion has progressed, the unemployment rate has fallen to 4.5%. With over a million net new jobs added in the fourth quarter of 2006, the household employment survey may begin to show an even lower unemployment rate in 2007.

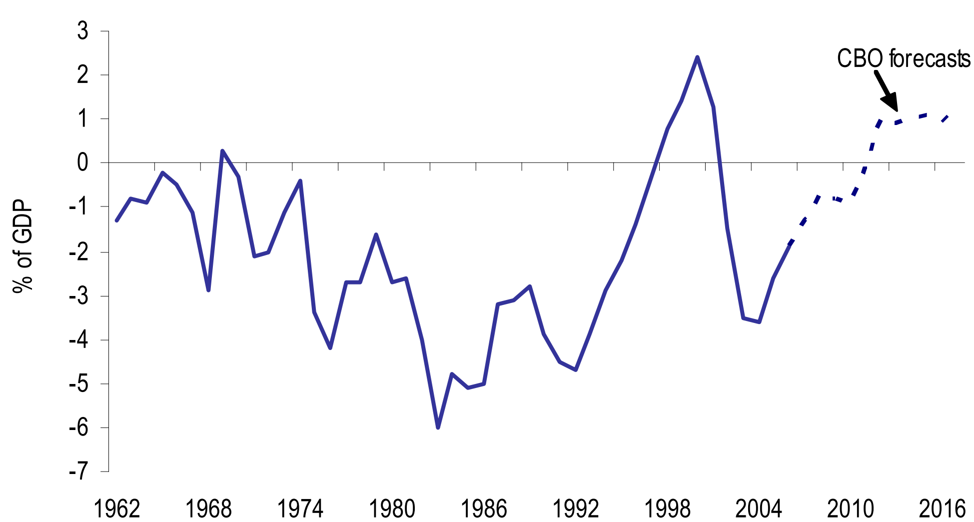
U.S. Unemployment Rate

Source: Haver; Bear, Stearns & Co. Inc.

U.S. housing weakened in 2006, but this was after two particularly strong years in 2004 and 2005. I expect somewhat elevated inflation rates in much of the world in 2007 given the weakness of most world currencies earlier in the decade. But I don't expect a major negative impact on growth or financial markets from the related interest rate hikes, unless inflation really heats up.

Meanwhile, U.S. profits and consumption have been growing along with jobs. A welcome side-effect has been a surge in government tax receipts and a sharp decline in the fiscal deficit. The national debt held by the public has fallen to 37% of GDP. By this measure, the U.S. government debt is below average for the industrialized nations and well below the average of the euro-zone nations. The fiscal deficit has fallen to an expected 1.5% of GDP in FY2007, and CBO projects a surplus in the near-term.

U.S. Federal Government Budget Position with CBO Forecasts



Source: CBO; Bear, Stearns & Co. Inc.

Trade Deficit Consistent with U.S. Growth

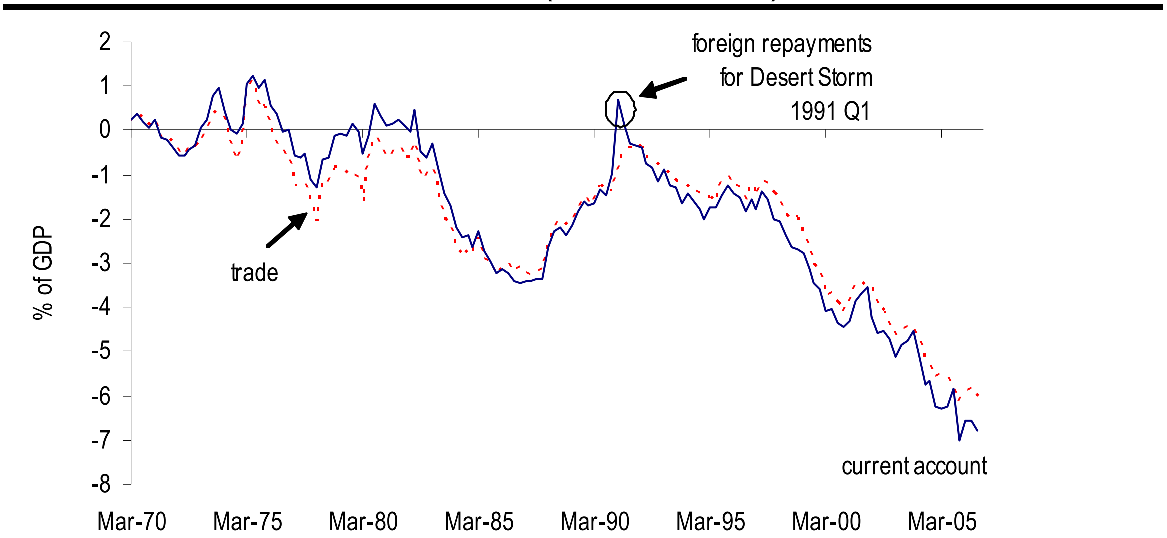
The unusual strength and steadiness of U.S. growth are hard to reconcile with the fragile-world viewpoint that the U.S. deficits are weakening the economy or creating a harmful global imbalance. I'd like to make some observations about the trade deficit, then turn to a discussion of the foreign debt.

- By definition, the current account deficit includes the merchandise trade deficit, the services surplus, investment income and transfers. For the U.S., the current account deficit is slightly bigger than the trade deficit and the gap is relatively steady, so the terms are often intermixed.

- It's normal for the U.S. to run a trade deficit. It's been around for hundreds of years of solid American growth, turning to surplus only during recessions and wars (when imports collapse) and in the brief period after World War II when the U.S. provided capital and export goods for the rebuilding efforts abroad. Normally, the U.S. brings in extra goods and capital to keep up with our growth.

- The trade deficit for the four quarters ending September 2006 was a record $779 billion (6.0% of GDP). The current account deficit for the four quarters ending September 2006 reached a record $879 billion (6.8% of GDP). Note that trade surpluses coincided with recessions. For example, the two deficits shrank in 1989 and 1990 after a shift in growth conditions favored U.S. exports over imports – the Fed funds rate rose to 9.75% in February 1989, the U.S. hiked tax rates in 1990 and fell into a recession, the Berlin Wall fell in 1989 spurring U.S. exports to Europe, Japan boomed in 1988-90, and the U.S. received foreign funds related to Desert Storm which moved the current account into surplus. **These growth factors were more instrumental in the narrowing of the deficit than the weakness of the dollar in 1985-1987.**

U.S. Trade and Current Account Balances (last obs. 2006 Q3)

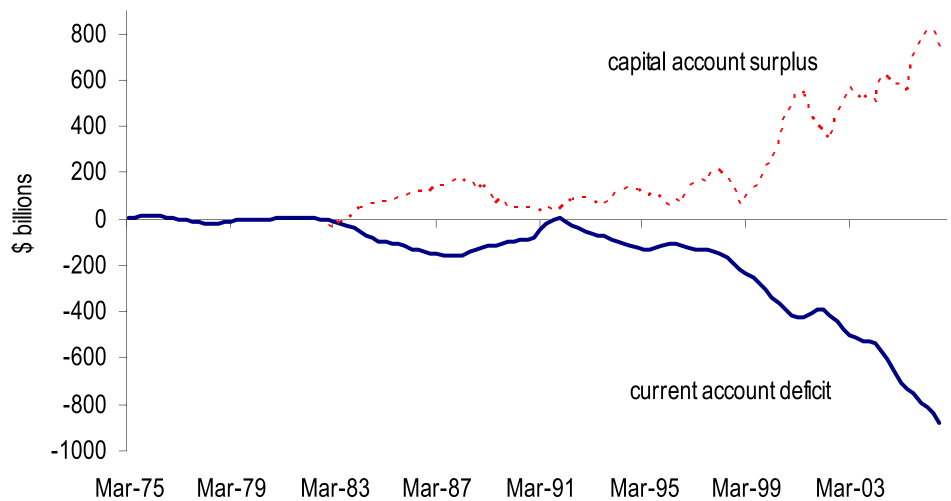


Source: Haver; Bear, Stearns & Co. Inc.

- **Countries with trade deficits often produce more growth and jobs than countries with trade surpluses.** For them, trade deficits are an indicator of an attractive, growing economy. Since the 2001 recession, the U.S. economy has created 9.7 million new jobs, compared with a 190,000 decline in Japan despite its trade surplus. Like the U.S., Spain (3.7 million new jobs) and the U.K. (1.3 million new jobs) ran trade deficits and created jobs rapidly in this five-year period. Wages are rising solidly in these three. In both theory and practice, a liberal trading environment allows more jobs with higher wages as people specialize.

- The current account deficit and the corresponding capital surplus connect foreign savings to U.S. growth, investment needs and younger demographics, creating a sustainable part of the global economic balance. **The current account deficit is large as a share of GDP because the differentials driving it are particularly large** – the U.S. has grown over 3% for four years running, drawing in imports; its investment climate is particularly attractive to foreigners; and the demographic differences are particularly favorable to a U.S. trade deficit. Absent a sharp U.S. slowdown, I expect the U.S. trade deficit to remain large until the fundamental differentials move against the U.S.

U.S. Current and Capital Account Balances (last obs. 2006 Q3)

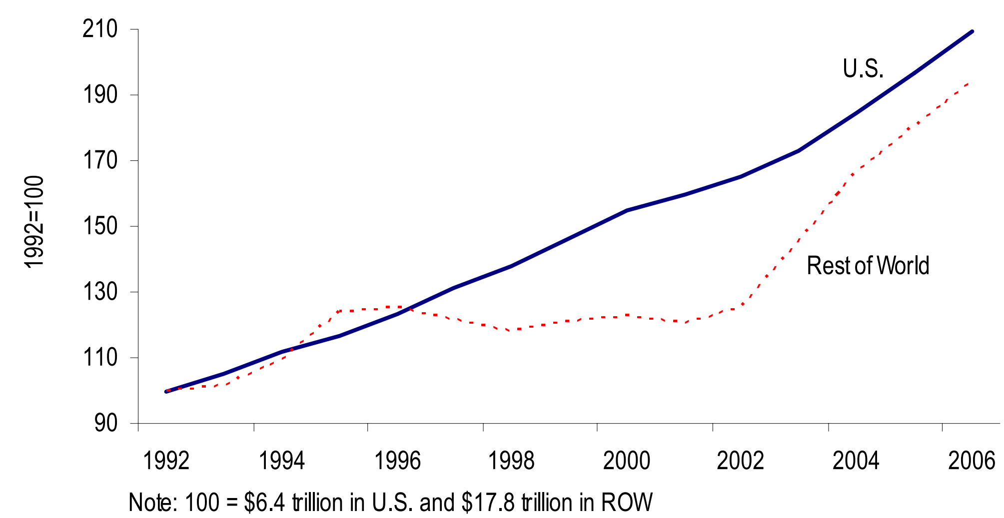


Source: Haver; Bear, Stearns & Co. Inc.

Growth Differential Contributes to the Trade Deficit

- Between 1992 and 2006, U.S. dollar GDP grew by about 110%, a strong influence on U.S. imports. That compares with dollar GDP growth for the rest of the world of around 95%, an important factor in U.S. exports. For the trade deficit to balance, U.S. imports would have to slow sharply while exports rise sharply. More likely is that the trade deficit remains wide.

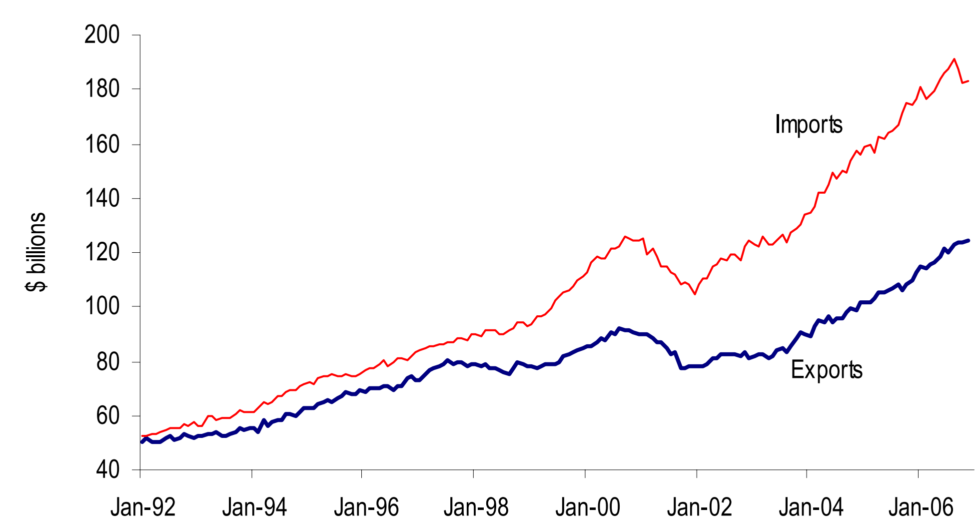
U.S. and Global GDP (last obs. 2006 est)



Source: IMF; Bear, Stearns & Co. Inc.

- U.S. imports reflect growth in the U.S. economy while U.S. exports reflect growth in foreign economies.

U.S. Exports and Imports (last obs. November 2006)



Source: Haver; Bear, Stearns & Co. Inc.

Demographic Differential Contributes to the Trade Deficit

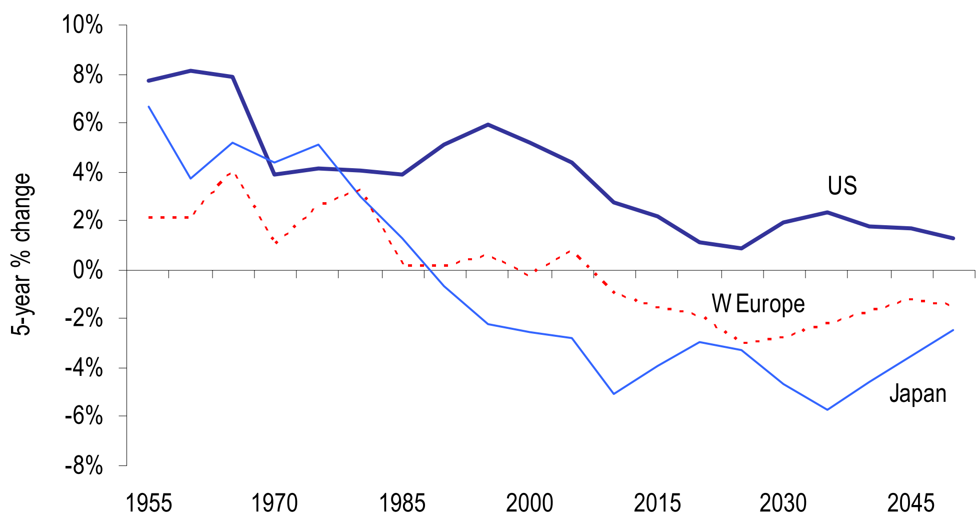
The recent surge in the U.S. trade deficit reflects, in part, the unprecedented shift in the demographics of the world's large economies.

- The under-60 U.S. population is expected to grow for at least 50 years while the under-60 populations in Japan and Europe are already declining and in China will turn down within a decade.

- Older foreigners need claims on younger people while younger Americans need capital. Foreigners want to save more than they invest in their own economies, and are eager to help us invest more heavily (through their purchase of bonds.) This makes good demographic sense. Older investors (concentrated abroad) need steady returns. Younger people (concentrated in the U.S.) need cash and debt for college degrees, houses and business startups.

- This creates a healthy synergy across generations and across borders. Japan's under-60 population is expected to decline 3%-4% every five years for a generation, creating an urgency to ship goods and funds to young people in the U.S.

Different 5-Year Growth Rates in Populations Under 60 years Old



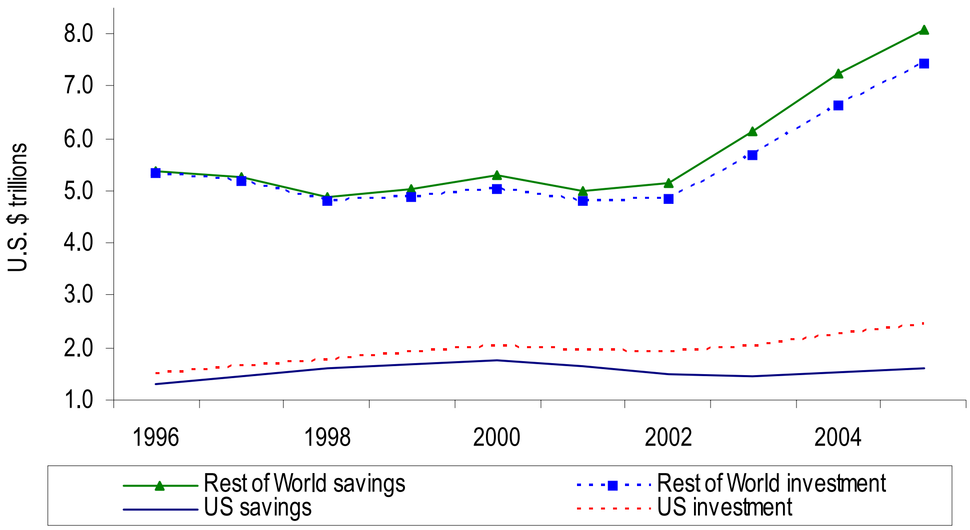
Source: Haver; Bear, Stearns & Co. Inc.

Investment Differential Contributes to the Trade Deficit

- Though widely criticized as an imbalance, the trade deficit and related capital inflow link the investment needs of the younger, faster-growing U.S. with the disinvestment process in aging, slower-growing economies abroad. Foreign savings become part of the overall pool of U.S. capital which helps fund extra U.S. investment. This adds to U.S. growth and to foreign earnings.

- In 2005, investment outside the U.S. was $670 billion less than foreign savings, while investment in the U.S. was $842 billion more than U.S. savings (roughly equal to the U.S. current account deficit). Shrinking working-age populations in the large economies of Western Europe and Japan need less investment while the expanding U.S. work force needs more.

U.S. and Foreign Investment and Savings Differential (last obs. 2005)



Source: IMF; Haver; Bear Stearns & Co., Inc.

- With all the negativism about the U.S. economy, it's easy to forget its attractiveness to foreign investment. And while there is much discussion of America's heavy use of foreign capital, there is not as much of the foreign need for investments in the U.S. America's current-account deficit is matched by a capital surplus, while the rest of the world's current account surplus is matched by a capital deficit, a voluntary net flow of capital to the U.S.

International Trade Balances in 2006 ($ billions)

United States*	-$777
United Kingdom*	-$100
Japan*	$56
China	$177
Eurozone*	$125

* includes OECD estimate for 2006 Q4

Source: OECD; Haver; Bear, Stearns & Co. Inc.

Trade Deficit Provides Leverage

It's frequently asserted that foreigners fund U.S. consumption. A more complete statement is that **foreigners fund U.S. investment and consumption** in the same way that U.S. funds do.

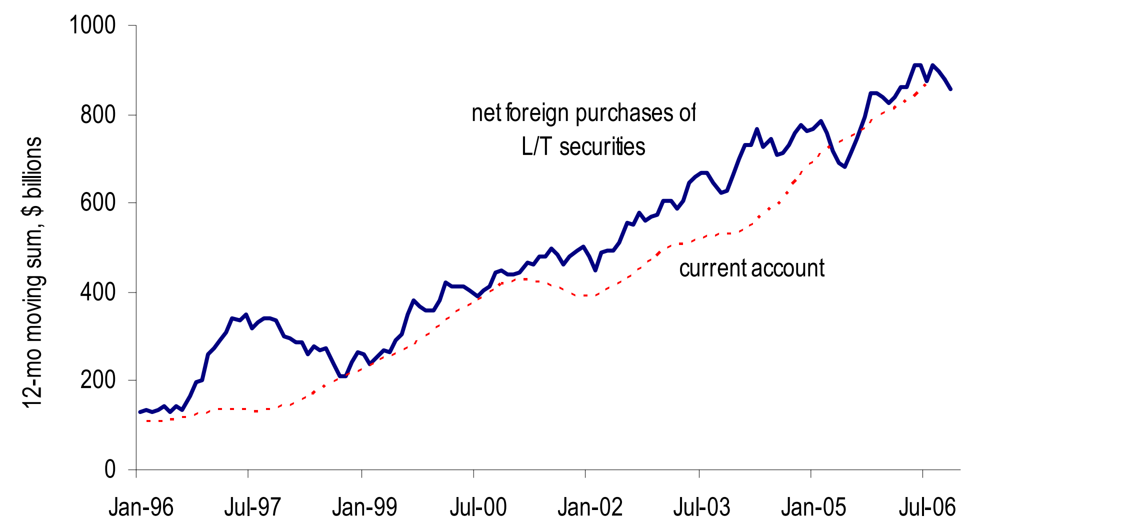
- The U.S. current-account deficit is a form of leverage in which foreigners finance the full spectrum of economic activity from consumption to home-building to R&D and capital investment. The U.S. creates gains from this incremental capital. Foreign bond purchases become part of a U.S. capital structure that produces 5%-7% annual nominal growth. The capital flow makes good sense for the elderly foreign saver who may face a low yield at home. And it makes good sense for the younger, faster-growing U.S. economy which can profit from relatively inexpensive foreign capital.

- Does the U.S. spend more than it produces? Yes. Many companies also spend more than they produce, using bonds and bank loans, some from foreigners, to make up the difference. They add employees, machines, supplies and advertising before they produce. **Growing corporations are expected to be cash hungry.** This leverage is treated as a positive for companies but a negative for countries, a key inconsistency in popular economics. Rather than paying the debt back, the growing company rolls the debt over and adds more, just as the U.S. has been doing throughout most of its prosperous economic history. Part of each additional corporate bond offering puts the company and the U.S. in the position of investing more than we save, drawing in foreign capital and contributing to the trade deficit.

The Growing Foreign Debt: Funding the Trade Deficit

Over the 12 months through November 2006, foreigners increased their net holdings of longer-term U.S. securities (equity plus debt with a maturity greater than one year) by $860 billion, providing a stable source of funding for the current account deficit.

Net Foreign Purchases of Long-term Securities (last obs. Nov 2006)



Source: Haver; Bear, Stearns & Co. Inc.

- The U.S. tends to pay higher interest than many foreigners can earn locally. For example, Japan's interest rate is 0.25% versus 5.25% in the U.S. The foreigner benefits from investing in the U.S. and the U.S. benefits from using foreign capital to expand the U.S. economy.

- The total return on U.S. investment tends to be higher than foreigners earn in the U.S., since foreigners have tended to prefer lower-yielding, safer, fixed-income assets appropriate to the older demographics of foreign savers. The U.S. owns more equity and direct investment abroad than foreigners own in the U.S.

- Just as with corporate borrowing, the U.S. needs to maintain the quality of its new investments, whether funded by U.S. or foreign capital, and make sure that the return on investment exceeds the cost. This requires a flexible, private-sector-based economy paying attention to profitability and costs.

Part of the foreign-funding concern rests on the view that the market for global capital flows is a "buyers' market," meaning the potential buyer of a U.S. Treasury sets the price and yield and has the power to disturb markets by selling, or even by reducing purchases. This argument has been made without confirmation since at least the twin deficits debate of 1984-5.

- U.S. bond yields and the value of the dollar have fluctuated over a wide range in response to many factors -- U.S. growth, inflation, tax policy, and, above all, expectations of Federal Reserve rate policy -- but foreign buying and the trade deficit have simply not had much impact. Foreigners don't have much influence on key fundamentals such as Fed policy, growth, inflation, tax rates and return on investment, and aren't often a leading indicator of them.

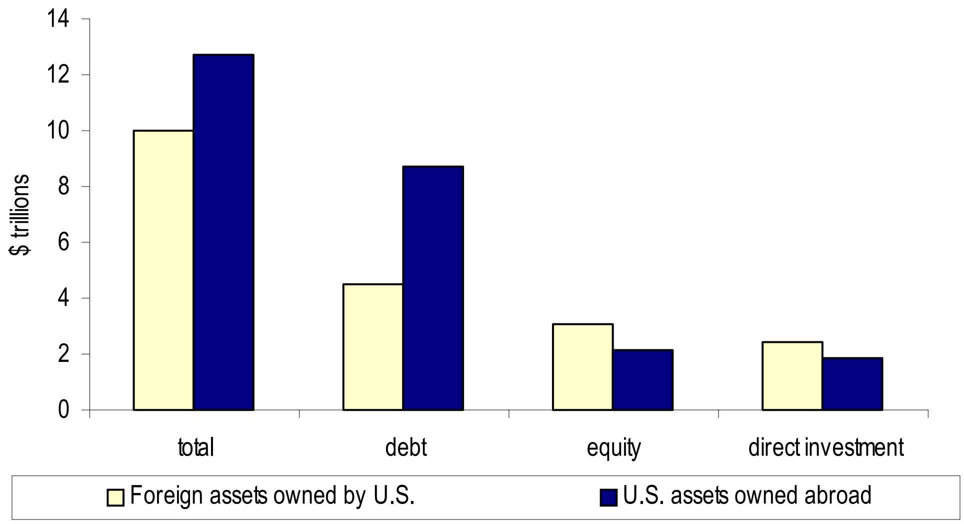
- While it's true that foreigners own a big portion of U.S. government securities, **foreigners own a smaller, declining portion of overall U.S. assets** – some $2.7 trillion (the net debtor position of the U.S.) versus $80 trillion in total U.S. assets. In essence, they have outbid Americans for Treasuries while giving up ownership share in other (faster-appreciating) assets.

- As a result, **foreign decisions account for only a small fraction of the swings in the dollar, interest rates and bond yields –** swings that are primarily caused by other factors. For example, the dollar's super-strong phase began at the end of 1996 with monetary policy's concern with irrational exuberance, and ended with the post-9/11 shift to the Fed's considerable period of monetary accommodation. The trade deficit didn't play a role.

- Likewise, U.S. bond yields fell to an extreme low in June 2003 on belated concerns about deflation, not on some newfound ease in funding the already-record current-account deficit. And the ongoing rise in bond yields reflects 2003's dollar weakness and related inflation concerns, not problems in funding the current-account deficit.

- In concept, the cumulative current account deficit creates a net foreign debt. A mark-to-market process takes account of the gains and losses in the various investments. In general, this benefits the U.S. since it tends to invest in faster appreciating assets abroad than foreigners do in the U.S. The 2005 data, the most recent available, showed that the U.S. held more equities and direct investments abroad than foreigners held in the U.S., but fewer bonds.

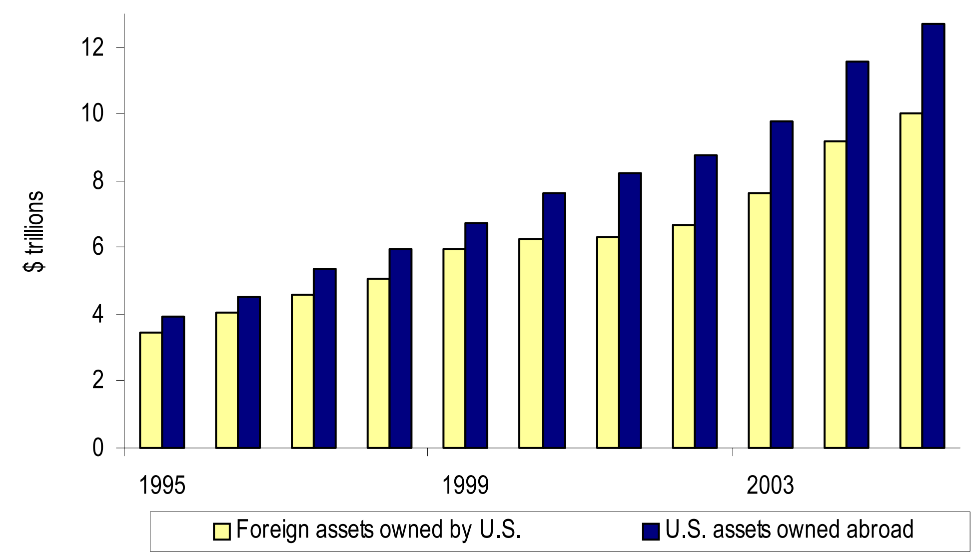
U.S. Net International Asset Position at End-2005



Source: Haver; Bear, Stearns & Co. Inc.

- While the net foreign debt of the U.S. is growing (the result of capital inflows), household net worth is growing faster, meaning **foreigners are investing in the U.S. too slowly and conservatively to keep up with our growth.** Their capital mingles with domestic savings, providing $2.7 trillion of net international capital to combine with $27 trillion in net U.S. household financial savings as of Sept. 30, 2006. While the U.S. reports a negative "personal savings rate", this measure arbitrarily excludes the economy's gains. **In some recent years, the one-year increase in U.S. household savings, per Federal Reserve data, has exceeded the entire foreign debt of the U.S.**

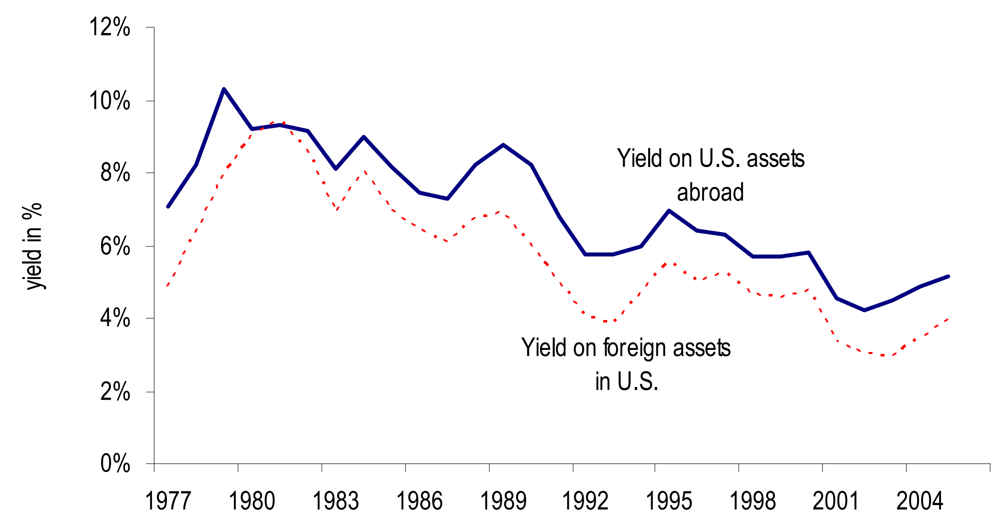
U.S. International Asset Position (last obs. 2005)



Source: Haver; Bear, Stearns & Co. Inc.

- U.S. investments abroad tend to earn more than foreign investments in the U.S. Though not an exact analogy, part of the U.S. current account deficit and capital inflow is the U.S. re-circulating foreign capital back into foreign economies, paying a low, safe interest rate and earning a higher, more risky return.

Yields on U.S. Assets Abroad and Foreign Assets in U.S. (last obs. 2005)



Source: Haver; Bear, Stearns & Co. Inc.

Problems with the Trade Deficit Data

Most of my points thus far have been aimed at explaining why the trade deficit is sustainable. Many also add arguments showing that the trade deficit isn't nearly as large as the data suggests:.

- Many U.S. imports come from U.S. factories abroad, with the profits and the high-value-added jobs staying in the U.S.

- Import and export data don't take into account the jobs, value-added, or profit associated with those transactions. The U.S. tends to import many low-value-added products while exporting high-value-added products. **Rather than the trade balance, the bottom line should probably be job, income, and profit growth, all high-scoring categories for the U.S.**

- U.S. imports are counted more carefully than exports. It's likely that U.S. export data substantially understates actual exports. A large part of the discrepancy between the sum of global imports and exports is often attributed to the undercounting of U.S. exports.

Risks of the Trade Deficit

- The real challenge to the U.S. trade deficit is the same as the challenge to U.S. leverage – profitability. Whether this is a problem depends more on small U.S. businesses, not economics. To date they have been an efficient user and deployer of global capital. As a result, U.S. growth accelerated as the trade deficit expanded in the 1990s and 2000s. With its trade deficit, the U.S. gets new, profit-oriented investments and growth, drawing in imports. Foreigners get better investments than they could at home, often buying low-yielding U.S. government securities to meet their needs for safety, long maturity and yield.

- The fixation with the trade deficit encourages protectionism in the U.S. and leads to an underestimate of the power of the American economic model. We should spend less time analyzing trade deficits and more time removing obstacles to investment and innovation both in the U.S. and abroad. The economic focus should be on sustainable growth and rising living standards, which often lead to a trade deficit.

- The second risk is that the rising trade deficit will encourage Washington to adopt a weak-dollar policy. As currencies weaken, the losses outweigh other investment considerations, forcing capital flight. Rather than produce an "improvement in competitiveness," as some claim, a weak-dollar trend would more likely slow U.S. investment and economic growth. The trade deficit might improve as imports sag, but jobs and living standards would decline.

Reducing the trade deficit

- To reduce the trade deficit requires a narrowing of the differences driving it – slower growth in U.S. GDP, population or investment, on the one hand; or faster growth in foreign GDP, industrialized country populations, or investment on the other. No one should want to take the first approach. We grow our economy and population faster than our trading partners (which draws in imports) and provide more attractive investments (which brings in foreign capital). Thus, the primary burden should be on the trade-surplus, capital-outflow countries to enhance their economic climes, not on us to diminish ours.

- The trade deficit probably wouldn't respond much to a weaker dollar unless it changed these differences (for example, by pushing us into inflation and a recession.) Yen strength hasn’t dented Japan's trade surplus, and it took a recession to create our last trade surplus in 1990-1991.

- Two ideas to reduce the trade deficit in a healthy way: a tax cut in Japan to boost investment and consumption there; explicit U.S. promotion of prosperity in developing countries. Our current policies are based on austerity abroad – weak currencies combined with trade and fiscal surpluses. This holds down their imports and pushes their capital into the U.S.

- Rather than unsustainable (it’s been called that for 25 years), I expect the trade and current account deficits to expand to the extent that the U.S. grows faster than our trading partners and contract when we don’t.