[House Hearing, 110 Congress]
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FOREIGN HOLDINGS OF U.S. DEBT: IS OUR ECONOMY VULNERABLE?

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HEARING

before the

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

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HEARING HELD IN WASHINGTON, DC, JUNE 26, 2007

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Serial No. 110-13

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Printed for the use of the Committee on the Budget

Available on the Internet:
http://www.gpoaccess.gov/congress/house/budget/index.html

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U.S. GOVERNMENT PRINTING OFFICE
38-251 WASHINGTON : 2008

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C O N T E N T S

FOREIGN HOLDINGS OF U.S. DEBT: IS OUR ECONOMY VULNERABLE?

TUESDAY, JUNE 26, 2007

House of Representatives,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to call, at 2:04 p.m., in room 210, Cannon House Office Building, Hon. John M. Spratt, Jr. [Chairman of the committee] presiding.

Present: Representatives Spratt, Edwards, Cooper, Kaptur, Becerra, Doggett, Blumenauer, Berry, Sutton, Scott, Etheridge, Hooley, Ryan, Lungren, Simpson, Tiberi, Porter, Alexander, and

Smith.

Chairman Spratt. I would like to open the hearing and thank everyone for their coming and attendance. And I have a brief opening statement. Then we will turn to Mr. Ryan and then to Mr. Orszag to begin our hearing today.

We are here to talk for a change about the elephant in the room. Our subject is foreign holdings of U.S. debt and the question is our economy vulnerable? We touched on this issue last January when we held a hearing on why deficits matter. Today we explore the subject further.

At our January hearing, we heard from Ed Gramlick and Ted Truman that budget deficits are part of a broader problem, low national savings, which diminishes the prospect of long-term growth and, in particular, the well-being of our children and grandchildren.

We heard that our entire economy, both public and private sectors, are relying to an unprecedented extent on foreign debt, foreign capital to fund current investment and consumption because other countries are much more diligent than we are at saving.

We were reminded that national saving is the sum of public and private saving and that recent budget deficits are negative public saving and are driving down overall national savings which is already woefully inadequate.

Our reliance on foreign capital to fund our budget deficits has grown tremendously since 2001. Foreign holdings of Treasury securities have more than doubled to a level of $2.2 trillion, accounting for nearly half of marketable Treasury debt.

For every dollar of additional funds the federal government has borrowed since 2001, an estimated 80 cents is owed to foreign investors.

Most economists now believe that perennially growing deficits are unsustainable, certainly that endless growing foreign debt is unsustainable, and that our worsening and deepening current account deficit is unsustainable.

No one can predict exactly when our economy hits the wall or whether there will be a soft landing or a hard landing. We have asked today's witnesses to testify on this topic so that we can better understand the gravity of this problem, what the federal debt and deficit spending have to do with it, and what deficits policy role should be to mitigate the adverse economic effects.

We are fortunate to have an impressive panel of witnesses today. First we will hear from Dr. Peter Orszag, the Director of the CBO. And then we will hear from a panel of very distinguished economists and foreign policy experts, Dr. Robert Hormats, Dr. Mickey Levy, Dr. Kenneth Rogoff, and Dr. Brad Setser.

We thank each one of you for coming, for agreeing to testify, and for the time you are taking. We look forward to your testimony and the answers to our questions that follow.

Before turning to Dr. Orszag, however, let me turn to Mr. Ryan for any opening statement he would like to make.

Mr. Ryan.

Mr. Ryan. Thank you, Mr. Chairman. And first of all, I want to thank you for getting the hearings up and running here. I think we have a number of interesting hearings and I am looking forward to participating in those.

Clearly members on both sides of the aisle share a concern about the effects of chronic deficit spending and the resulting accumulation of debt that we are discussing here today. So it is fitting we have this hearing.

It is not simply enough to rail against deficits, to rail against debt, and then rail against the fact that foreigners are buying it up. Yes, we have a debt and, yes, we have chronic deficits and a considerable share of that debt is held by foreign investors. These are the facts that are before us today.

The question is, and I imagine the purpose of this hearing is, what are we going to do about it? First, we have got to understand why we have the deficits and why we have the debt today.

Clearly there are some political points that are going to be had by some who want to play the blame game, claiming the U.S. government would be rolling in money had, say, Republicans not squandered through our reckless tax cuts and spending the often quoted 2001 projected $5.6 trillion surplus.

But, once again, if you go back and look at the facts, we never actually had that money. It was a projection of what our number crunchers thought we have if everything went according to their assumptions. Clearly it did not.

Their assumptions did not foresee the bursting of the dot com bubble, the eruption of corporate scandals, or the economic slowdown and the recession that had already begun, and, of course, the forecasters did not foresee the attacks of 9/11 and ensuing War on Terror.

Tax relief was not the problem. Well-timed tax relief not only helped buoy the economy out of recession, it also fostered investment leading the way to significant job creation and sustained economic growth that we continue to enjoy today.

That growth has fueled double digit revenue growth and has been the key factor in not only dramatically driving down the deficit but also to getting within striking distance of balancing the budget.

The cause of the deficit and debt is that Congress has and continues to spend too much money. I will be the first one here today to acknowledge that Republicans spent too much money when we were in the majority.

After 9/11, we said largely in a bipartisan way whatever it takes and we deliberately spent enormous amounts and took on debt. But we also allowed pork barrel spending to explode and get out of control and we took far too long to get our act together to do anything about it.

But we did not just throw up our hands and raise taxes to make up for all that spending. We finally slowed down the rate of nonsecurity appropriations spending and, more important, we took a critical first step to address our largest and least sustainable spending growth about reforming entitlements, albeit to a small degree.

We set a plan to keep our economy growing strong and slow down our unsustainable spending growth and we made significant progress in the right direction. But we did not do nearly enough and we have still got major spending problems that we have to deal with.

Mr. Ryan. And I would like to bring up chart one if I could at this time. We have been told time and time again that the unrestricted growth of our nation's largest entitlements is the chief threat to our nation's long-term fiscal health. With the coming retirement of 78 million baby boomers, this problem is going to get exponentially worse.

Let us take a look at where we are heading. If we do nothing as the current budget resolution proposes, look at chart two.

Mr. Ryan. This is the debt projection we have in front of us by doing nothing to restrain our entitlement programs. We see the levels of debt required to meet our spending obligations in the decades ahead will absolutely cripple this economy.

And so this is where our conversation needs to go. We need to be constructive to look for solutions to this issue rather than just score political points or simply rail against the past. We need to start with addressing the problem and the problem is spending, and it is a problem which both Republicans and Democrats share in the blame and a problem that we must work together to fix.

I also think it is important for today's conversation that we focus on another issue critical to this Committee and that is how our choices impact our nation's global economic standing and our ability to compete in the global marketplace.

Traditionally we have been able to attract foreign capital and we are the world's top destination for foreign capital as evidenced by all this debt that is being bought by foreigners. Because we have a strong innovative economy with deep liquid capital markets, that is the case.

But remaining attractive to investors is not simply a given. We have got to make choices that support the fundamental features of a successful economy, low tax burdens, strong growth potential, and favorable legal and regulatory environment, and prudent fiscal policies that deal with long-term challenges.

Actually choosing to put our nation on the path of ever-higher spending chased by ever-higher taxes will not only severely threaten our economy at home, it sends a pretty dire message to the world about our likely economic future.

And it is just not rhetoric. International economic data confirm the fact that economies and countries with bigger governments tend to have slower rates of real GDP growth. Let us just take a look at France. Total government receipts in France represent more than half of their economy, one of the highest shares in the OECD. Not surprisingly, France has just averaged 1.5 percent real GDP growth over the last five years.

By comparison, U.S. combined federal and state local government receipts account for about one-third of the overall economy and we have averaged close to three percent GDP growth over the last five years, double the growth rate of France. That is not a coincidence. It is the direct result of choices we have made. It is the result of the choice that we have made to be a country of limited government, a country that rewards the entrepreneur and provides freedom for the individual.

And as we move forward, it is vitally important that we continue to make these types of choices so we do not leave our children with an economy that is weighed down by enormous government debt, because right now with inaction, that is a very real possibility.

This chart is not only a possibility, it is the projection and trajectory we are on right now. Entitlement programs continue to grow at unsustainable rates and are projected to double in size in the next 30 years. If we do nothing now to reform them and instead put off these tough choices as the current budget resolution does, our debt condition will be far worse than what we are talking about today and our tax burden will be twice as high.

So I am glad we are having this hearing today. We need to have this conversation and we need to ensure that we are making the right choices now both for the next year and for the next generation so that our children can enjoy an America that continues to thrive, that continues to produce jobs, and continues to be the same attractive place in which to invest in as it is today.

And with that, I yield, and I appreciate the Chairman for his indulgence.

Chairman Spratt. Thank you, Mr. Ryan.

At this point, let me say that all members without objection shall be allowed to submit for the record an opening statement at this point in the record.

Let me say also to Dr. Orszag and to all of our witnesses that you may submit your statements for the record as well and summarize to the extent that you find necessary.

Dr. Orszag, you are the lead witness. We are glad to have you. We look forward to your testimony.

STATEMENT OF PETER ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Orszag. Thank you very much.

Chairman Spratt, Mr. Ryan, members of the Committee, thank you for having me back today to testify. My testimony makes four main points.

The first is that as has already been noted foreign holdings of U.S. Treasury debt have been rising rapidly. Between 2003 and 2006, for example, such holdings rose by about 50 percent and their increase accounted for almost three-quarters of total federal borrowing over that period.

Such holdings now exceed $2 trillion and account for more than 40 percent of Treasury debt held by the public. Although the estimates are imperfect, evidence suggests that East Asian countries are associated with a significant share of recent increases and at the end of last year, such countries accounted for almost two-thirds of foreign holdings of Treasury securities.

In addition, the increases have been disproportionately tied to foreign official activity rather than private investor activity. At the end of 2006, foreign central banks owned 66 percent of all federal debt held by foreign residents which is up several percentage points from 2003. And such foreign official purchases account for roughly or a little bit more than half of federal borrowing since 2003.

My second point is that these increasing foreign holdings of U.S. government debt are related to a more fundamental issue which is the nation's substantial current account deficit. This current account deficit must be financed by increasing liabilities to and assets held by foreign investors.

In particular, the current account deficit expanded from under two percent of GDP in 1997 as shown in my first chart to more than six percent last year.

As a result of these ongoing current account deficits, the net international indebtedness of the United States, that is how much U.S. investors own abroad minus how much foreigners own here, deteriorated from about ten percent of GDP, which is shown in figure two, to about twenty percent in 2005. You see that decline that was occurring in the late 1990s and early 2000s.

So why has the current account deficit increased? There are a variety of perspectives that can be brought to bear on that question, but one is to examine the difference between domestic investment and national saving.

As figure three shows, net domestic investment climbed steadily throughout the 1990s and then declined on balance in the early 2000s. On average, it has been about seven percent of national income since 1990 and in the past four years. This net domestic investment must be financed either by net national saving or by increasing net foreign claims on U.S. assets.

Since the late 1990s, it has been financed increasingly by foreign claims as the rate of net national saving also shown on this chart has declined from an average of more than four percent in the 1990s to an average of about one percent in the past four years.

In other words, from this perspective, the increase in the current account deficit that has occurred reflects the decline in net national saving that you can see on that chart.

So the question then becomes why has net national saving declined and one can in the next chart break the decline in the rate of national saving into its components, in particular federal and private net saving rates.

As you may be able to see from the chart, the decline in the federal net saving rate from 2000 to 2003 accounts for much of the decline in net national saving over that period. After 2003, however, the rate of net federal saving rose primarily tied to increases in corporate income tax revenue which I could discuss more during the question and answer period. But the net national saving rate was little changed because the net private saving rate fell.

The bottom line is that the nation's rate of domestic investment of roughly seven percent of income or so is possible given our low level of domestic saving only because the nation is running a significant current account deficit and that in turn is possible only because foreign entities have been willing to invest significant sums in U.S. assets and securities, including U.S. Treasury securities.

That observation leads me to my third point, which is that economists generally agree that the current account deficit is unsustainable because the nation's indebtedness to the rest of the world will grow faster than its income and foreign investors will not continue to be willing to purchase U.S. claims indefinitely as their portfolios become more and more concentrated in such assets.

Views differ on whether the adjustment will occur gradually or suddenly, but there is little disagreement that some sort of adjustment is inevitable. As the CBO has pointed out in a recent issue brief, the more likely scenario appears to be a gradual adjustment without severe short-term economic consequences, but a sudden adjustment remains a risk and possibly a growing one as the nation's net indebtedness rises.

And that leads me to my final point, which is that policy makers can help facilitate the necessary reduction in the current account deficit and reduce the risk of a severe economic disruption in foreign financing by taking actions to raise the rate of national saving.

Focusing on government saving may be particularly important in light of the economic and budgetary outlook in the United States over the next few decades as Mr. Ryan highlighted.

Figure five shows that most of the discussion that has surrounded our long-term fiscal challenge has been somewhat off. It is often described as being caused by aging and healthcare. It is primarily tied to the rate of growth in healthcare costs.

In particular, if over the next four decades healthcare costs per beneficiary grow at the same rate relative to income per capita as they did over the past four decades, Medicare and Medicaid will rise from four and a half percent of the economy today to twenty percent of the economy by 2050 as the top line of that chart shows.

The bottom line shows the pure effect of aging on those two programs and I think you can see that there is some impact there, but that that rise, the difference on the bottom dotted line between 2050 and today is much smaller than the difference in 2050 between the bottom dotted line and the top solid line.

In any case, reducing government dis-saving, that is reducing the budget deficit both today and in the future, is perhaps one of the most reliable ways through which policy makers could boost national saving. Such national saving could also be increased through higher private saving, and my written testimony discusses some of the possible policy interventions that could produce that effect.

However it is accomplished, higher national saving is fundamental to reducing the current account deficit which in turn will reduce the rate at which the nation is increasing liabilities to and assets held by foreign investors, including Treasury Securities.

Thank you.

[The prepared statement of Peter Orszag follows:]

Prepared Statement of Peter R. Orszag, Director,
Congressional Budget Office (CBO)

Chairman Spratt, Ranking Member Ryan, and Members of the Committee, thank you for inviting me to testify today. Foreign holdings of U.S. Treasury debt have grown rapidly in recent years and now are a significant percentage of such debt held by the public. A broader issue is the substantial deficit in the U.S. current account--which summarizes the country's current transactions with the rest of the world, including trade in goods and services, net income from international investments and the compensation of employees, and net unilateral transfers (such as gifts, pension payments, and foreign aid). The mirror image of the nation's large current-account deficit is foreign investors' increased holdings of a variety of claims on the United States, including U.S. government debt as well as private-sector securities and assets.

My testimony today makes four main points:

Foreign holdings of U.S. Treasury debt have risen rapidly. Between 2003 and 2006, for example, such holdings rose almost 50 percent. They now exceed $2 trillion and account for more than 40 percent of Treasury debt held by the public.

Those increasing foreign holdings of U.S. government debt are part of a more fundamental issue: The nation is running a substantial current-account deficit, which is financed by increasing liabilities to and assets held by foreign investors. The current-account deficit measures the excess of the country's spending over its income or, equivalently, of its domestic investment over its national saving. After the depreciation of physical capital is taken into account, the nation saved only 2 percent of its income last year, an unusually low level for the world's leading economy. At the same time, the nation's net domestic investment was 8 percent of its income. The difference, 6 percent of income, was financed by increases in net foreign claims on the United States and manifested itself in the current-account deficit.

Economists generally agree that the nation's current-account deficit cannot be sustained indefinitely at its current level relative to gross domestic product (GDP) because the nation's indebtedness to the rest of the world will grow faster than its income. Moreover, foreign investors will not continue to be willing to purchase U.S. claims at current rates of return indefinitely as their portfolios become more and more concentrated in such assets. To be sure, views differ on whether a future adjustment in the current-account deficit will occur gradually or suddenly--but there is little disagreement that some sort of adjustment is inevitable.

The necessary adjustment of the current-account deficit, which requires slower growth of consumption in the future, could take place slowly or rapidly. The more likely scenario appears to be a gradual adjustment without severe short-term economic consequences, but a sudden adjustment remains a risk--and possibly a growing risk as foreign net holdings of claims on the United States rise as a percentage of GDP. Policymakers can help facilitate the necessary reduction in the current-account deficit and reduce the risk of a severe economic disruption in foreign financing by taking actions to raise the rate of national saving.

estimated holdings of u.s. government securities by foreign investors

Foreign holdings of U.S. Treasury securities have grown rapidly in recent years. In 2003, for example, U.S. Treasury securities held by foreign investors amounted to $1.45 trillion, and by 2006, those holdings rose to $2.13 trillion--an increase of 47 percent.\1\ As a percentage of total Treasury debt held by the public, foreign holdings rose from 37 percent to 44 percent over that span.\2\ The increase in foreign holdings accounted for about 86 percent of total federal borrowing last year and about 72 percent from 2003 to 2006.

According to survey estimates, East Asian countries held a large share of foreign holdings of Treasury securities last year--about 63 percent.\3\ The two East Asian countries with the largest holdings were Japan, which held an estimated 31 percent of all foreign-held Treasury securities, and mainland China, with 19 percent. In comparison, the European Union held an estimated 15 percent, and oil-exporting countries in the Middle East, about 5 percent.

Foreign official institutions have played a significant role in the increase in foreign ownership of federal debt. Indeed, at the end of 2006, foreign central banks owned 66 percent of all federal debt held by foreign residents, up from 63 percent at the end of 2005.

The data on ownership by country and by type of foreign entity (official versus private) are imperfect.\4\ The surveys used to collect the data do not always capture the ultimate owner of the securities. If an owner entrusts securities with a custodian in a different country, for example, the ownership of the securities is attributed to the country of the custodian, not the owner. That ``custodial bias'' contributes to the large recorded foreign holdings of U.S. securities in major financial centers such as Belgium, the Caribbean banking centers, Luxembourg,

Switzerland, and the United Kingdom.\5\ Similarly, some foreign official purchases may be misclassified as foreign private ones because they are conducted through private-sector traders.

Foreign investors also hold a growing share of securities of U.S. agencies and government-sponsored enterprises (GSEs), evidently reflecting a drive to increase the returns on their investments. At the end of 2006, those investors owned about $1.2 trillion of such securities, more than twice as much as in 2001. The countries with the largest holdings were China, with about 23 percent of all such foreign holdings, and Japan, with about 17 percent.

Examining only the securities of the Treasury Department and of agencies and the GSEs that are held by foreign investors, however, obscures the broader and more fundamental issue: the rising net foreign claims on the United States that result from the nation's current-account deficit. The specific distribution of those foreign claims among different types of assets (U.S. government debt, equities, real estate, and so forth) may be important for considering some questions (for example, the potential for short-term disruptions in specific financial markets), but the overall level of those claims is more important in weighing other issues (for example, the vulnerability of the U.S. economy to adverse economic shocks). It is therefore important to emphasize that Treasury and other agency debt held by foreign investors represents only a portion of the total claims on the United States owned by the rest of the world.

According to the Bureau of Economic Analysis, the total amount of claims on the United States held by foreign investors in 2005 amounted to $13.6 trillion--9 percent more than in 2004 and 52 percent more than in 2000. A little more than 17 percent in 2005 was U.S. government securities, up from about 13 percent in 2000 (see Table 1 below). As noted, much of the rise in the share of U.S. government securities was associated with increased holdings by foreign governments, rather than by foreign private investors. The key point, though, is that however the claims are allocated among different asset types and foreign owners, the broader issue is the overall rise in net foreign claims on the United States assets; that rise is necessary to finance the nation's current-account deficit.

the fall in the u.s. current-account balance

The current-account balance fell from -1.7 percent of GDP in 1997 to a record 6.1 percent last year (see Figure 1 below). At the same time, the outstanding amount of net international assets (holdings of claims on foreign entities by U.S. investors minus holdings of claims on the United States by foreign investors) fell from about -10 percent of GDP to about -20 percent in 2005 (see Figure 2 below).

To examine why the deficit in the current-account balance has increased in recent years, it is useful to examine trends in both net domestic investment and net national saving.\6\ Net domestic investment climbed steadily throughout the 1990s and then declined, on balance, in the early 2000s. On average, it has been 7 percent of national income since 1990 and in the past four years (see Figure 3 below).

Net domestic investment can be financed either by net national saving or net foreign claims on U.S. assets. Since the late 1990s, it has been financed more and more by foreign claims, as the rate of net national saving has declined from an average of 4\1/2\ percent in the 1990s to an average of 1 percent in the past four years. From that perspective, the low level of national saving has been responsible for the elevated level of the current-account deficit.

The decline in the rate of national saving in the 2000s largely reflects movements in both federal and private net saving rates (see Figure 4 below). The decline in the federal net saving rate from 2000 to 2003 accounts for much of the decline in the net national saving rate over that period. After 2003, however, the rate of net federal saving rose, but the net national saving rate was little changed because the net private saving rate fell. Although federal saving and national saving do not move in lockstep, there is generally a close relationship between changes in federal saving and changes in national saving. Put simply, the more the federal government saves, the more the nation tends to save as a whole.

From another perspective, the elevated level of the nation's current-account deficit has been driven by the willingness of foreign investors to provide capital to the United States. In other words, the nation's rate of domestic investment is possible, given the rate of domestic saving, only because foreign entities have been willing to invest significant sums in U.S. assets and securities. From this perspective, inflows of capital from abroad affect the current account by raising the exchange value of the dollar and asset prices in the United States. The strong dollar encourages purchases of imports by U.S. residents and discourages purchases of U.S. exports by the rest of the world. Higher asset prices and correspondingly lower interest rates encourage consumption and investment.

The willingness of foreign investors to buy U.S. debts and assets reflects the attractiveness of the United States as a destination for international investment because of its stable political environment, developed legal institutions, deep and liquid capital market, and strong banking and financial system, among other advantages. Moreover, because the U.S. dollar is the major medium of international transactions, it is less susceptible to extreme and sudden depreciation.\7\ Indeed, the longevity of the large U.S. current-account deficit can be viewed as reflecting a sequence of events that caused demand for U.S. assets to grow even faster than the supply. Between 1997 and 2000, a host of developments--financial globalization, a succession of financial crises (the 1997-1998 Asian crisis, Russia's default of 1998, and the Brazilian real crisis of 1999), and weaker economic growth in other industrial countries than in the United States--all added to the demand for U.S. assets.\8\ By propelling the dollar and U.S. asset prices higher, those developments contributed to widening the current-account deficit.

A significant share of the nation's overall external financing has been from foreign governments in recent years, as suggested by the trends in foreign ownership of U.S. government debt (see Table 2 below). In 2006, for example, net official inflows (purchases of claims on the United States by foreign governments net of purchases of claims on foreign entities by the U.S. government) were $448 billion, more than half of the $811 billion current-account deficit. Net official inflows also have grown rapidly in the past few years; in 2000, for example, net official inflows were only $42 billion. Almost all official purchases of U.S. assets were made by a handful of Asian governments, particularly China, which did so in order to keep its currency from appreciating outside of the band specified by its managed exchange rate policy. The Japanese government was also actively making purchases to keep the yen from rising before the spring of 2004.

the unsustainability of the current-account deficit

Regardless of whether its financing is provided by foreign governments or foreign private investors, the large U.S. current-account deficit, analysts generally agree, cannot be sustained indefinitely at its present high level relative to GDP. The United States--like any other country--cannot continue accumulating debt at a rate faster than its ability to repay it. If policy actions or other economic developments do not reduce the current-account deficit, at some point foreign investors will become less willing to keep adding to their holdings of U.S. assets.

To be sure, net U.S. international assets have changed little relative to GDP in recent years despite the large current-account deficit, but that situation is unlikely to continue over the long run. Movements in asset prices and in the exchange rate have raised the dollar value of U.S.-owned foreign securities and direct investments overseas by more than that of U.S. securities and investments held by foreign investors, offsetting the consequence of the current-account deficit. However, such favorable effects of valuation cannot be relied on in the long term, and sooner or later net U.S. international assets will begin to fall rapidly relative to GDP if the large U.S. current-account deficit persists.

A persistently large current-account deficit will, over time, make foreign investors less willing to provide low-cost financing for it. To date, foreign demand for dollar assets has not yet weakened significantly, in part because the dollar is still the major international reserve currency. However, once investors accumulate enough dollar assets to facilitate international transactions and to meet their other needs for holding reserves, they are likely to slow down their purchases of dollar assets for those purposes and increasingly will buy or sell dollar assets on the basis of the expected returns. For example, the Chinese government announced in March this year that it would establish an investment agency to more ``profitably'' and ``efficiently'' manage a portion of its foreign reserves, which exceeded $1.2 trillion in the first quarter of this year.\9\ Thus, to the extent that investors and governments believe that the U.S. current-account deficit will cause the dollar to depreciate, which reduces the expected return on dollar assets, the demand for dollar assets will fall.

Once foreign demand for U.S. assets begins to grow more slowly than the supply, there will be growing downward pressure on the dollar and U.S. asset prices. A lower dollar raises the prices of imports and reduces U.S. residents' purchasing power at home and abroad, and lower asset prices make U.S. residents poorer. As a result, U.S. residents will be less able and willing to borrow and spend, thereby lowering the current-account deficit; the exchange rate and asset price adjustments, in other words, will facilitate the reduction in the current-account deficit. As long as foreign demand for dollar assets does not drop too suddenly, the adjustment in the current account will be a gradual one. In that case, growth of the U.S. economy is likely to remain on track. The gradual rise in exports and decline in imports will entail more production and employment in sectors that export and sectors that compete with imports, helping to offset the negative effects of the gradual adjustment in asset prices, interest rates, and the prices of imports.

How bumpy the adjustment of the U.S. current account will be thus depends on what happens to foreign demand for U.S. assets. If short-term factors boost the growth in the demand for U.S. assets above the growth in supply, the U.S. current-account deficit may temporarily widen further. However, it seems implausible that foreign demand for U.S. assets will be boosted repeatedly by short-term factors. Once long-term downward pressures on demand begin to outweigh temporary supports for dollar assets, they will push down the dollar and those asset prices, facilitating the decline of the current-account deficit.\10\

Various factors may mitigate the risk of the type of sudden collapse in foreign financing that would be associated with a relatively rapid adjustment of the current account. For example, the unique role of the U.S. dollar as the world's main reserve currency should help to reduce the probability of a sudden stop of foreign financing, at least in the near future (although some analysts have warned that the dollar's role as a primary reserve currency cannot be taken for granted over the long run). Furthermore, nearly all U.S. international liabilities are denominated in dollars, and about twothirds of U.S. holdings of assets abroad are equity assets, denominated in host countries' currencies. Therefore, a large depreciation of the dollar would lower net U.S. liabilities to foreign investors not only by lowering net imports but also by boosting the dollar value of U.S. assets abroad. Consequently, the depreciation would not necessarily feed on itself and become a fullblown dollar crisis, unlike the effects of a sharp drop in the currency of a country with a large amount of debt denominated in foreign currencies.\11\

Thus, the more likely scenario appears to be a gradual adjustment, in which the current account falls gradually over time.\12\ Nonetheless, given the likelihood of a continued decline in the United States' net international assets as a percentage of GDP, a risk remains that adjustments in the foreign exchange rate and the current account will occur more rapidly than anticipated and that the effects of a rapid adjustment on the economy will be much more severe than with a gradual adjustment. That risk probably increases as the nation's net international assets fall as a percentage of GDP.

POLICY OPTIONS

Because the current account is equal to the difference between national saving and investment in the United States, policies that influence saving or investment will affect it. Although the current-account deficit could be improved by reducing investment, that outcome would be undesirable. With less investment, the U.S. capital stock would grow more slowly, which would reduce the growth of productivity and real wages over time. Therefore, the more desirable options for reducing the current-account deficit are those that would raise national saving.

Focusing on national saving may be particularly important in light of the economic and budgetary outlook in the United States over the next several decades. Rising federal health care costs, in particular, will place mounting pressure on federal spending, and if revenues remain at their current shares of GDP, the federal budget deficit is projected to grow rapidly, which could substantially reduce national saving.\13\ Over the past four decades, Medicare's and Medicaid's costs per beneficiary have increased about 2.5 percentage points faster per year than has per capita GDP. If those costs continued growing at the same rate over the next four decades, federal spending on those two programs alone would rise from 4.5 percent of GDP today to about 20 percent by 2050 (see Figure 5 below). Indeed, the rate at which health care costs grow relative to income is the most important determinant of the long-term fiscal balance; it exerts a significantly larger influence on the budget over the long term than other commonly cited factors, such as the aging of the population.\14\

National saving can be increased in a number of ways that could involve higher government saving and/or higher private saving. Raising government saving through deficit reduction is one of the most reliable ways through which policymakers could boost national saving. That goal could be achieved through higher taxes, lower spending, or both.\15\ Given the nature of the nation's long-term fiscal challenge, controlling the growth of federal health care costs seems a key component of deficit reduction over the next several decades. A variety of evidence suggests that opportunities exist to constrain health care costs both in the public programs and in the overall health care system without adverse health consequences, although capturing those opportunities to reduce costs without harming health outcomes involves many challenges.

National saving could also be increased through higher private saving. In evaluating policies to raise private saving, it is important to include their effects on government saving. For example, general tax incentives for private saving financed through higher budget deficits might not generate enough additional private saving to offset the higher budget deficits. Consequently, even if such policies increased private saving, they might not raise national saving. By contrast, deficit-neutral policies that encouraged private saving would work to raise national saving (because the increase in private saving would not be offset by a reduction in government saving).

Various options for raising private saving in such a manner have been proposed--for example, establishing automatic aspects for 401(k) and similar savings plans. Currently, many such plans leave it up to the employee to choose whether to participate, how much to contribute, which investment vehicle offered by the employer to select, and when to pull the funds out of the plan and in what form. Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise. Many workers shy away from those decisions and simply do not make them, and the result is often a lack of participation. Research has suggested that participation and contribution levels can be substantially affected by changing the defaults at each of those points of decision. Indeed, one of the strongest empirical findings from behavioral economics is that automatic enrollment--that is, enrolling workers in a plan unless they opt out, as opposed to requiring them to sign up in order to participate--boosts the rate of participation substantially.\16\ Legislation enacted last year makes it easier for corporations to offer 401(k)-type plans with automatic enrollment and other automatic features, and researchers have proposed ways of expanding the same logic to individual retirement accounts.\17\ If such proposals were financed in a deficit-neutral manner, so that any gains to private saving were not offset by decreases in government saving, they could increase national saving. However, even if they were implemented in that manner, they would probably generate only a fraction of the saving needed to close the current-account deficit.

However it is accomplished, achieving a higher level of national saving also entails drawbacks. In the end, policies that raise national saving have one thing in common: They reduce consumption of goods and services and/or leisure. What makes the policies different is how they affect specific households and how they affect the economy at large. Therefore, choosing the appropriate saving policy inevitably involves balancing the economic effects of alternative policies with their distributional consequences.

Despite those various trade-offs and however it is accomplished, encouraging higher national saving probably represents the most effective step that policy-makers can take to facilitate the necessary reduction in the current-account deficit and reduce the risk of a severe economic disruption in foreign financing.

ENDNOTES

\1\ Budget of the United States Government, Fiscal Year 2008: Analytical Perspectives, p. 235.

\2\ Although not strictly comparable, the percentage of federal debt held by foreign investors was estimated to be 32 percent in 1997 and 15 percent in 1985.

\3\ Department of the Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System, Report on Foreign Portfolio Holdings of U.S. Securities, as of June 30, 2006 (May 2007).

\4\ See Department of the Treasury, Frequently Asked Questions Regarding the TIC System and TIC Data, available at www.ustreas.gov/tic/faq1.shtml.

\5\ Ibid.

\6\ Those net measures account for depreciation of the existing capital stock.

\7\ The dollar's status as the major reserve currency has meant that foreign demand for dollar assets has increased as other economies and international transactions have grown.

\8\ Financial globalization has allowed private foreign investors to participate in the U.S. capital market more fully. See Congressional Budget Office, The Decline in the U.S. Current-Account Balance Since 1991 (August 6, 2004).

\9\ The announcement did not specify how much of the reserves would be managed initially by the new agency, but Chinese officials and the press have suggested an amount of up to $300 billion.

\10\ The trade-weighted dollar exchange rate relative to currencies in major industrial countries, computed by the Federal Reserve Board, declined about 9 percent between November 2005 and May 2007.

\11\ For such an indebted country, its currency's depreciation necessarily raises the domesticcurrency values of its international debt and interest payments on that debt but may not have a significant effect on the value of its trade surplus (especially if its exports rely significantly on imported materials). Thus, its net debt could become higher even as its currency depreciates, putting greater downward pressure on its currency.

\12\ See Congressional Budget Office, Will the U.S. Current Account Have a Hard or Soft Landing? (June 11, 2007).

\13\ See Congressional Budget Office, The Long-Term Budget Outlook (December 2005).

\14\ See Statement of Peter R. Orszag, Director, Congressional Budget Office, Health Care and the Budget: Issues and Challenges for Reform, before the Senate Committee on the Budget (June 21, 2007).

\15\ In evaluating alternative ways to reduce the budget deficit, it is important to be mindful of the potential effects of those policies on private saving. Some policies could reduce private saving. However, although the impact would depend on the nature of the policy change, reductions in private saving, if they occurred, would probably not be large enough to completely offset the gains to national saving from lower budget deficits.

\16\ See, for example, Brigitte Madrian and Dennis Shea, ``The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior,'' Quarterly Journal of Economics, vol. 116, no. 4 (November 2001), p. 1160.

\17\ See J. Mark Iwry and David John, Pursuing Universal Retirement Security Through Automatic IRAs (Washington, D.C.: Retirement Security Project, February 2006).

Chairman Spratt. One of the questions we pose to all of the witnesses is what is the risk of a hard landing as opposed to a soft landing? Is there any way you can predict, number one, when will it approach the limits, when we will be in danger of really hitting the wall and suffering the consequences, the dire consequences that all of our witnesses paint out here, and what is the risk that the landing will be hard, abrupt, and difficult to adjust to as opposed to a smooth glide-path landing?

Mr. Orszag. As I noted in both my oral testimony and my written testimony and as the recent CBO issue brief argues, again, the more likely scenario for a variety of reasons is a gradual adjustment in which things operate smoothly, but there is some risk, and I would not want to quantify it, that cannot be ruled out of a more disruptive and sudden adjustment that could occur.

And I think the key point is that the policy response to either kind of scenario is basically the same, which is that ultimately something has to change and you may as well start now to be raising national saving, getting the budget deficit further under control.

So regardless of whether you put that risk of a severe disruption at, you know, this level or at that level, the policy response is quite similar.

Chairman Spratt. There was a commission, I cannot recall when it was appointed, but fairly recently, five or six years ago, on the balance of payments. And its members divided about four to three or five to two on the issue of hard landing versus soft landing versus hard landing.

Those who came out fearful of a hard landing said their biggest concern is the problem of asset holders dropping assets that are declining in value, that once an asset holder sees that his assets are declining rapidly in value, he does not want to be the last person holding that particular asset.

Is that a risk and is there some way we can protect against that?

Mr. Orszag. Again, I would come back to first in terms of protecting against risk. Taking action sooner rather than later is the best possible step. I think the problem becomes that in these kind of scenarios that you are discussing, which, again, I would put lower probability on but not zero relative to a gradual adjustment, things can go wrong in an amazing array of ways. And you just do not want to find yourself in that position.

And I have written academic papers or other papers delineating some of the ways in which things can go wrong, but I think the point is they can go wrong in multiple ways and temporary phenomenon can feed on itself and become particularly severe.

Chairman Spratt. What about exogenous inflation, if you had factors in the world economy beyond our control and run-up in resource prices, oil and other resources, maybe different kind of different things that created inflation and caused foreign holders of our debt to fear that the dollar may be inflating away its value?

Mr. Orszag. I think the people who are concerned about a sudden adjustment are particularly worried about some dramatic decline in demand for U.S. assets which could be prompted by a whole variety of different potential contingencies, including potentially the view that, however it arose, that inflation in the United States would take off and that the Fed would not be able to contain it.

Chairman Spratt. What I am getting at----

Mr. Orszag. That would just be one of many possible scenarios that could engender the type of concern that some analysts have identified.

Chairman Spratt. What I am getting at is that foreign capital thus far has been a cushion. It has helped us absorb what otherwise could be adverse economic effects of a big run-up in national debt by buying and funding a lot of that debt. But it is also it seems to me a precarious way to finance our national debt.

Would you agree? We were all, not all of us, there were some brought up on Friedman, others of us were brought up on Samuelson, to believe that the national debt was not so bad because we owed it to ourselves. Now we have a debt that increasingly is owed to others.

Would you agree that a debt owed to ourselves is less problematic than a debt that we owe to foreigners?

Mr. Orszag. I think I would come back to the fundamental driver here, which is that the reason that we are accumulating those claims to foreigners is that we are saving such a low level of national income.

It is highly unusual for the world's leading economic power to be saving only one or two percent of its national income and that is the fundamental driver of a lot of----

Chairman Spratt. The fact that it aggravates the savings rate, the domestic savings rate?

Mr. Orszag. Well, necessarily it will mean that you are either only investing one or two percent of your income domestically, which then robs workers in the future of productive equipment and other things that will improve their standard of living, or it means that you are investing more than that and financing it by increasing claims on your assets from foreigners.

Chairman Spratt. I have got lots of other questions, but there are lots of other members who want to put a question to you, so let me turn next to Mr. Ryan.

Mr. Ryan. Thank you. I have a lot of questions, too, but I will try and keep it limited as well. You could go down so many paths.

I wanted to get into the twin deficit theory with you, but I think I will not belabor that.

Dr. Orszag, our capital markets are very attractive, correct, to foreign investors?

Mr. Orszag. Yes. If you look at observed behavior, that would appear to be the case, yeah.

Mr. Ryan. Right. So the hard landing theory, obviously we do not want a hard landing here. We could precipitate a hard landing if we do things in our economic policy that makes the U.S. capital markets less attractive to investment, correct?

Mr. Orszag. That would be a risk associated with making our capital market significantly less attractive, yes.

Mr. Ryan. Right. So if we want to have a soft landing as we use this vernacular, it is important that our economic policy, the things we do, whether it is how we regulate capital flows, how we tax capital, those all speak to our attractiveness of our capital markets to foreign capital and whether or not we are going to have a soft or hard landing if and when we have a landing, correct?

Mr. Orszag. The key determinate of the speed of adjustment is foreign demand for U.S. assets and there are lots of things that affect that, including the attractiveness of our capital markets.

Mr. Ryan. So one of the more important things for us to do in our own interest is to make our capital markets as attractive as possible. You would agree with that, correct?

Mr. Orszag. There are obviously tradeoffs involved. Again, one of the factors that affect continued foreign demand for U.S. assets is the relative attractiveness of U.S. financial markets.

Mr. Ryan. Right. Right. So the one thing we can reach consensus on is we are spending too much money. I think you would agree with that.

Mr. Orszag. Well, we are not saving enough money, yes.

Mr. Ryan. And saving rate, as we calculate our savings rate, when we overspend, meaning we have chronic deficits and chronic debt, that negatively affects our savings rate. I wanted to ask you a question about your last chart.

Jose, if you could bring up his last chart, the healthcare spending chart.

Can you walk me through this one more time because I find this of all your observations the most fascinating. The dotted line on the bottom is if healthcare inflation tracked with regular inflation. What is that exactly?

Mr. Orszag. In particular what it is is that if the so-called excess cost differential, that is healthcare costs per beneficiary minus income per capita, were zero in the future, it isolates the pure effect of demographics. The only reason that that line is rising is that there are more beneficiaries on Medicare and Medicaid and they are growing older.

Mr. Ryan. Right. But it is not rising at a precipitously high pace if the costs are increasing with the rest of income in society, right?

Mr. Orszag. And, therefore, the pure effect of aging on the budget is much smaller than it is often portrayed as.

Mr. Ryan. Right. So what you are trying to say here is the root cause of our future budget dilemma is healthcare inflation?

Mr. Orszag. The long-term fiscal challenge basically collapses to the rate at which healthcare costs grow relative to income per capita, yes.

Mr. Ryan. So healthcare inflation is----

Mr. Orszag. Healthcare cost growth, I would----

Mr. Ryan. Okay. Okay. And if we can do things that bring healthcare cost growth in line with other cost growth, this you are saying can generally take care of a vast majority of our budget and fiscal problems with respect to our healthcare entitlements?

Mr. Orszag. If you could bend that curve, the more you bend that curve, the degree to which you bend that curve is basically the degree to which you are getting the long-term fiscal challenge under control. There would be further steps that are required, but that is the key determinate.

Mr. Ryan. Okay. So where we ought to be focusing our efforts in your opinion, would it be on tackling these healthcare entitlements which represent the largest portion of our present value unfunded liability? Should we be focusing our efforts on attacking the cost increases of healthcare in America and our healthcare entitlements if we want to get the biggest bang for our buck in order to reduce future indebtedness?

Mr. Orszag. If your concern is the long-term fiscal imbalance facing the nation, trying to bend this curve is perhaps the most auspicious step that you could take.

Mr. Ryan. Do you think we can bend the curve by going after just changes to Medicare and Medicaid law without addressing underlying healthcare reforms or is the better path to take in order to get better results for Medicare and Medicaid cost growth and, therefore, indebtedness to go after the healthcare marketplace and the way it works right now and the inflation rate that it produces?

Mr. Orszag. I do not think it is going to be plausible to bend this curve for Medicare and Medicaid while healthcare cost per beneficiary and the rest of the health system continues at the same rate without creating massive access problems.

Mr. Ryan. Have you taken a look at cost differentials between different kinds of products that are offered in the marketplace vis-a-vis insurance, whether it be, you know, traditional low co-pays, low deductibles, first dollar type coverage plans versus higher deductible, more consumer-based plans? Have you looked at that and have you done any modeling on that?

Mr. Orszag. Yes, we have. We put out a report last December that goes into some detail about the effects of different kinds of plans along the lines that you are discussing.

Mr. Ryan. Do you believe that to the extent that an individual with a policy who has a fiscal incentive, a shopping incentive to save more of their own money while they go out and purchase health insurance has more of a likelihood to be more cost conscious and, therefore, contribute to lowering the cost increases in healthcare?

Mr. Orszag. There are steps that can be taken on both the provider side and the consumer side to try to bend this curve.

On the provider side currently, Medicare in particular is paying largely on a fee-for-service basis and the evidence suggests that when we pay more, we do not necessarily get better quality.

On the consumer side, one of the things that has happened over the past three or four decades is the share of healthcare costs that come out of pocket has actually declined markedly and the evidence does suggest that that has played a role in increasing healthcare costs.

Mr. Ryan. So axiomatically on the reverse, if the more share comes out of pocket, you will lower the cost increases?

Mr. Orszag. You would at least lower cost to some degree, yes.

Mr. Ryan. Okay. All right. I do not want to chew up too much more time. I have a lot more questions, but maybe if we do more.

Thank you.

Chairman Spratt. Mr. Edwards.

Mr. Edwards. Thank you, Mr. Chairman.

I find it interesting that we are holding this hearing today on the impact of foreign-held U.S. national debt on the same day on the front page of the Washington Post, there is a third part of a four-part series talking about Vice President Cheney, who is the architect of the Bush economic policies that led to the largest deficits in American history.

One of my hopes is that today's hearing will debunk Mr. Cheney's flat out wrong statement or declaration that deficits do not matter. I think while we disagree on the origin of the deficits, I would hope there would be bipartisan agreement that deficits do matter, that Vice President Cheney, the architect of the Bush economic policy, was dead wrong in his declaration.

Mr. Ryan talked a little bit, Dr. Orszag, about the basis of the deficits. He made a statement, and I wrote it down, tax relief is not the reason for deficit.

Let me ask you a question. Based on your analysis for fiscal year 2007, what percent of this year's deficit is the result of tax cuts passed since 2001 approximately?

Mr. Orszag. I would have to give you the exact number later and it depends how you do the accounting. But the revenue effect of the 2001 and 2003 tax legislation is roughly one and a half percent of GDP, which is about the size of the federal deficit today.

Mr. Edwards. So put that in lay terms. Had we not had the tax cuts passed since 2001, according to CBO analysis, the deficit would be how much smaller?

Mr. Orszag. If you just do a simple accounting exercise that takes that estimated revenue effect from the Joint Committee on Taxation and compare it to today's deficit, it would roughly eliminate the deficit, but I would have to get back to you to give you that exact figure.

Mr. Edwards. Okay. So----

Mr. Ryan. Would the gentleman yield?

Mr. Edwards. The gentleman has had a lot of time. In round two, I think it would be healthy to have a discussion on this, but the gentleman has had quite a bit of time. I would like to take mine.

Mr. Ryan also said entitlements are the biggest problem and I agree with him on that. I would like to point out the fact for the record, and let me put this in terms of a question.

Since Medicare was created in 1965, has there been any single increase in expenditures for the Medicare program larger than that passed in the Republican Congress on Medicare Part D? Has any other increase in the history of Medicare been larger in its increase and expenditures than that passed in wee hours of the morning with a lot of arm twisting by the Republican Majority in the House and the Congress, or is that the largest increase in Medicare entitlement spending in the history of that program?

Mr. Orszag. I would have to check with regard to ESRD, but I believe that the Part D expansion in terms of the long-term fiscal impact was the largest since 1965.

Mr. Edwards. And I think that is a fact. I think Mr. Cooper, my colleague, says the total liability of that long term is $8 trillion. So those who decry entitlement spending were actually the authors as a party, as the Majority in the Congress, the largest increase in Medicare entitlement program in the history of that program, even as we talk about how it is healthcare expenditures that are going to be a threat to future deficits.

Let me ask also in terms of the foreign-held debt, in light of our difference with Mr. Cheney that deficits do not matter, I know the debt has increased, foreign-held debt has increased dramatically since the Bush Administration has taken over. I think over $1.4 trillion or so.

China holds 23 percent of that foreign-held debt. Japan holds 17 percent. What are some of the other three or four other countries that hold significant U.S. debt?

Mr. Orszag. There are European countries, the UK in particular. I would note that some of the allocations by country can be----

Mr. Edwards. I understand.

Mr. Orszag [continuing]. Difficult to allocate.

Mr. Edwards. Does Venezuela hold any U.S. debt?

Mr. Orszag. I am sure it holds some, yes.

Mr. Edwards. Okay. Let me ask you, what would be the--we have about 50 seconds remaining--what would be the economic impact on our economy if China announced today that it was going to cash in a substantial amount or let us go the full way, if China announced today they were going to cash in all of their U.S. debt holdings, what would be the economic impact on the American economy?

Mr. Orszag. Well, again, without commenting on the probability of that happening, the result would depend in part on the response of other financial participants, but that is the kind of thing that those worried about the risk of a sudden adjustment with severe economic dislocations that would concern them.

Mr. Edwards. Okay. Severe economic dislocations. Is that similar to devastating to the American economy under most likely scenarios?

Mr. Orszag. Again, I think it is difficult to play out all of the ways that things could go wrong should they do so.

Mr. Edwards. Thank you.

Chairman Spratt. Mr. Lungren.

Mr. Lungren. Thank you very much, Mr. Chairman.

It has been kind of fun sitting here. I do not know how Mr. Orszag feels there, but you are kind of reminding me of a tennis ball and we just keep hitting lobs to you and we are lobbing you back and forth seeing if we can make some points here.

When I was here before, I remember Nancy Reagan was blamed for everything and now it is Dick Cheney. I served ten years with Dick Cheney and, frankly, if most members would vote the way Dick Cheney did on spending, we would not have this deficit.

Oftentimes he and I were out there being one of twenty-two or thirty against spending, but we were told by the other side that deficits did not matter. I do not know what has happened to Dick. I think he must have had just a bad moment. He was probably quoting one of his friends from across the aisle.

I would like to ask a question about the chart we were talking about, the medical inflation, and try and understand that a little better. And the reason is this. I recently had a conversation with a friend of mine and he talked about open heart surgery that he had. I remember my dad had open heart surgery when he was 57 which allowed him to go back to work as a practicing physician until he was 70. He then had a redo when he was 70 some years of age that allowed him to live until he was 83.

This fellow mentioned that his dad had an open heart surgery done when he was 80 years old and he lived until he was 94. In both those cases, I know for a fact my dad would not have lived as long as he did and this gentleman's father would not either.

So I am trying to figure out what the medical inflation means on this. Those are two people who would not have been alive had they not had the procedures. The procedures cost money, that they were procedures that were not done, well, probably five years before my dad has his. And while I want to see us do what we can to bend that curve, what does that medical inflation mean with respect to those kinds of things, that is procedures which are additional procedures than what we used to do that are not really a trade-out for something that was already there, but actually extends the lifetime of these individuals and presumably causes them to continue to receive Social Security benefits and causes them to be subject to other medical procedures in the future? How do you distinguish from that and bending the curve from inflationary aspects of the healthcare system?

Mr. Orszag. Well, as the designated tennis ball, let me take a crack at that.

Mr. Lungren. Yes, sir.

Mr. Orszag. I think there is a wide variety of evidence suggesting that technological advances in medicine have on average produced significant improvements in life expectancy and standards of living.

But there is also a significant amount of evidence that technologies are often applied in very low return settings or negative return settings and that if you look, for example, across different regions of the United States, cost per beneficiary in Medicare with the same technologies vary substantially by a factor of two or three in ways that do not reflect underlying riskiness to the patients and do not generate better health outcomes in the higher spending regions.

And I think, therefore, there is a significant opportunity for looking, it is going to be hard to capture, but looking for better value rather than just higher cost healthcare. That is the real challenge.

Mr. Lungren. The reason why I bring that up is it is awfully difficult for us to attack the issue if the public and we believe it is the first type of thing that I talked about versus what you have suggested. And I do not care, Democrat, Republican, who you are, it is easy to demagogue from the first part and interfere with us to try and get to that second part that you referred to. And that is probably the largest challenge I see on the fiscal side for us for the next ten years.

On the charts that you had with respect to savings, does that savings that you have of private savings, does that include value of homes because many Americans, whether it is a good thing or bad, see a much higher percentage of their savings reflected in what they have in their houses today versus what they had ten, twenty, thirty years ago?

Mr. Orszag. No, it does not. This is the national income and product account definition of saving and it is the relevant definition for the funds available to finance domestic investment. So that is for this purpose why----

Mr. Lungren. It is for that purpose, but I was just thinking. We have higher home ownership percentages today across the board than we had, I think, at least in my lifetime and perhaps a large amount of that is as the result of tax policy which drives people to have homes because of the tax benefits they get in addition to the fact of proud home ownership.

And, yet, we do not count that. And I understand why we do not count that in terms of what you are talking about, but I just wonder if we would want to necessarily alter individuals' decision making in that regard.

Mr. Orszag. Well, there are various different parts of the question. In terms of the measured saving rate in the national income and product accounts, the housing price appreciation that has occurred likely did have some downward effect on that measured rate of private saving.

Another question is what the mortgage interest deduction in particular does to home ownership and there I think there is a range of views among economists about the degree to which it actually does succeed in significantly boosting home ownership or not. And we could have a longer discussion about that.

So there are a couple of different components to your question.

Chairman Spratt. Mr. Lungren, we have got to move on.

Mr. Lungren. Thank you very much, Mr. Chairman.

Chairman Spratt. Yes, sir.

Mr. Blumenauer.

Mr. Blumenauer. Thank you, Mr. Chairman.

I would like to take up just on part of the previous discussion you have been having. While we are not taking home values per se, there has been a lot of capital flow that has been resulting from the securitization of home finance instruments.

It looks like there might be a lot of air in some of these funds, domestic and international, that may be the result of a housing bubble that may be about to burst or is bursting or a huge shift in the subprime market.

And I am trying to get a sense of the extent to which you have any thoughts about the softness in these transactions and these hedge-fund investments may have in the overall availability of capital in this country.

Mr. Orszag. CBO is very closely monitoring developments in, for example, the subprime market and when we come out with our updated economic projections as part of our August update, I will have more to say at that time on our view of developments.

Mr. Blumenauer. Okay. Good.

Mr. Orszag. You would like more now.

Mr. Blumenauer. No, no, because I am not interested in your torturing the data and I am not interested in more of the ping-pong game. I think certain obligatory charts and lines have been put on the table and I am, frankly, eager to hear the next four witnesses as well.

But I would just give you one more chance to help us sketch what might be the implications if there is a lot of air in, A-I-R, in these portfolios, what that might mean in terms of the impact of our net savings rate, capital expansion, what has fueled a run-up in corporate profits and activity or at least shielded people from other economic realities if, in fact, this is squishy. I am not asking you to put parameters around it now, but if you can just talk about the implications.

Mr. Orszag. Sure. First with regard to implications, one of the factors that is likely to increase private saving over the next several years is sluggishness or softness in the housing market. That is just the reverse of what I was delineating before.

I think a big question with regard to the subprime market in particular is how much it spreads to other financial products and the rest of the housing sector. And that was the part where I was being a little bit cautious about what CBO would or would not be saying.

Mr. Blumenauer. Mr. Chairman, this is an area of particular interest to me. And I appreciate this hearing and I will be quiet and we can move on. But at some point, our circling back and having a hearing on the implication of what has been happening in the housing market which has been a critical part of our economic growth over the last ten years, I think all of us can agree to that, whether we think it is healthy or not, whether we are from areas where there has been a run-up, whether we feel squeamish about some of the industry practices and people that have been shoved into the subprime market maybe who did not need to be there.

But I think this has very profound implications on really the underlying health of our economy and might give us some early indicators of where things might go. And if you and our certified smart people on the staff would consider it, I think it might be useful to be able to have some discussion about where we are and where we are going with that.

Chairman Spratt. Okay. We will take that up later.

Now Mr. Simpson.

Mr. Simpson. Thank you, Mr. Chairman. I am glad to be here and listen to this and the China doomsday scenario and all that sort of stuff that Mr. Edwards proposes.

I would like to ask if we are going to call this the Bush-Cheney deficit, if we could call it the Bush-Cheney economy seeing as how it happens to be one of the strongest economies we have had in quite some time. So if you do that, I would appreciate both that.

The other thing I would like to know is, you know, we always ask these questions, these doomsday scenarios and stuff, and then we like to go down on the floor and we say we have had testimony that it would be devastating to our economy, that it would destroy it, that we would all essentially might have a nuclear bomb would be better off than that, even though the scenario that they propose does not make sense.

Would it make sense for China to call in all the debt and what would it do to China's economy?

Mr. Orszag. China has a significant disincentive to do that, which is that it would, to the extent that some of these processes that we are describing actually happen, it would impose costs on China also.

Mr. Simpson. Is this like economic mutually assured destruction?

Mr. Orszag. I would not use that kind of wording, but----

Mr. Simpson. We tried that with the nuclear era. But I mean, it would make no financial sense or economic sense for China to do that; is that right?

Mr. Orszag. There would be a disincentive to China doing that. But what I would say is that because so much of this is associated with foreign official activity, the motivations of an official body may differ from those of a private investor.

Mr. Simpson. Let me ask you another question. On your chart where you list net private savings, net federal savings----

Mr. Orszag. Yes.

Mr. Simpson [continuing]. How do you determine net private savings? Congressman Lungren was asking whether housing was included. What exactly is included in that?

Mr. Orszag. That is a measure of your current income excluding capital gains minus how much you spend. That is the measure of savings that the Bureau of Economic Analysis uses for this purpose.

Mr. Simpson. We have always assumed, and I agree, there is legitimate disagreement about whether tax cuts pay for themselves, whether they make sense or not and in the long run whether they pay for themselves or not, and the argument on our side of the aisle has always been that it increases economic activity which increases the tax revenue which comes back to the federal government.

Do we know, even though it is probably none of our business, do we know what the American people did with their tax cuts over the last few years, the reduced federal taxes that they had to pay?

Mr. Orszag. There have been a few empirical studies done, not very many. What I would say is that the overwhelming bulk of the evidence suggests that while there is some offsetting impact on economic activity, tax cuts do not come close to paying for themselves.

Mr. Simpson. Do we know, though, what the consumers did with their savings? I noticed in your chart on private savings that after 2001, there was an uptick in savings.

Mr. Orszag. There have been, again, just a few studies done. There was one, for example, done on what households did with the rebates that were associated with the original legislation. We could respond in writing. I do not want to try to characterize it.

One of the difficulties is that it is hard to parse out, money is fungible, it is hard to parse out, you know, that this money went to that purpose basically.

Mr. Simpson. It would be interesting to know and would help us when we try to determine federal policy, but I have a hard time coming up with your net private savings, how you come up with that when there are investments that make sense that would be considered savings. Ask any farmer where their savings is. Their savings are in their land.

Mr. Orszag. This is the definition that has been embodied in the national income and product accounts, it is not a CBO definition, basically since the national income and product accounts were created, and it reflects a notion of saving that is appropriate for evaluating how much is available to finance domestic investment by corporations, for example, and things like computers and buildings.

Mr. Simpson. And every commercial I see on TV that investment in higher education returns a net increase to the economy.

Mr. Orszag. And if you wanted to----

Mr. Simpson. My wife invests in clothes.

Mr. Orszag. The semantics here can get difficult. If you wanted to classify, for example, expenditures on higher education as investment, that would change both the saving rate and investment rate, but it would not change the difference between the two.

Mr. Simpson. I thank you and I look forward to the panel.

Thank you, Mr. Chairman.

Chairman Spratt. Thank you, Mr. Simpson.

Mrs. Sutton.

Ms. Sutton. Thank you, Mr. Chairman. Thank you so much for being here to talk about this extremely important issue.

You know, massive holdings, foreign holdings of U.S. debt has had a palpable effect. It is not theoretical. It has had a palpable effect on workers. Where I come from, it has had a palpable effect on our economy.

The Economic Policy Institute recently estimated that while exports to China supported 189,000 jobs here in the U.S., imports displaced production that would have supported six times as many.

The jobs displaced by the increasing trade imbalance have largely been in the manufacturing sector. And, in fact, in my home State of Ohio, we have lost over 200,000 jobs since 2001 in the manufacturing sector under the Bush-Cheney economy.

So, Dr. Orszag, could you discuss the link between China's investment in treasuries and the trade deficit that is causing us to lose American jobs and just talk about how currency manipulation plays into that?

Mr. Orszag. Let me try to again break that down in a couple different parts.

Ms. Sutton. Sure.

Mr. Orszag. First, I want to say CBO is doing a significant amount of work on various forces that are affecting a broad array of American families, including relatively sluggish real income growth in significant parts of the income distribution, including high levels of economic volatility, that is, for example, earnings volatility, a lot of which gets sort of associated with international trends perhaps incorrectly, but kind of gets wrapped up together. So I just wanted to note that CBO does a lot of work in this area.

The second thing I would say is I would be again more focused on overall levels of net national saving and what is happening there because that is tied to the nation's overall current account deficit than a particular bilateral trade or current account and trade imbalance in particular.

And then finally, it is the consensus view among economists that at least over the long term, international trade may affect the types of jobs that we have but not the number.

So this is coming back to my first point. I think the fundamental issue for most American families is what is happening to their income. Is it becoming more or less volatile? Is it too volatile? Is it growing at a sluggish rate and what can we do practically to improve their standards of living?

Ms. Sutton. Okay. Would you more specifically address the issue of currency manipulation?

Mr. Orszag. What I would say about that is that there are a variety of estimates suggesting that the Chinese currency is undervalued relative to the dollar, that the estimates vary depending on the model, that perhaps evidence--well, that there is a variety of estimates out there again, and that I would not necessarily use terms like the one that you used in conjunction with currency that is potentially misaligned relative to its underlying level.

Ms. Sutton. Okay. And, Dr. Orszag, you sort of alluded to this a little bit earlier in one of your responses about motivating factors that might be at play when foreign governments make investments in our debt.

And you, I believe, if I understand you correctly, you were talking--the question was raised about China's best economic interest. Is it in their best economic interest to continue to invest so heavily in our treasuries? And I guess the question that is begged is what are the other factors that might explain why its government or entities like that would have made such massive investments in U.S. treasuries or may continue to do so even though it is not in their best economic interest?

Mr. Orszag. Well, there are a variety of factors driving this investment by foreign official institutions. One is the overall current account deficit that we have which necessitates as a mirror image capital in-flows.

The second is with regard to China in particular its effort to manage its exchange rate which requires purchasing dollars and selling domestic currency in order to achieve that objective. And the result is a significant accumulation of dollar assets.

And then the question is, what are those dollar assets invested in. And for a foreign official entity that is concerned about safety and liquidity, U.S. government debt becomes a particularly attractive investment vehicle.

So the question then becomes, is that always going to continue. And I think, again, the view is that at some point, the portfolio even of an official entity becomes saturated in dollar assets and there may be some diversification out of that.

Chairman Spratt. Let us see. Mr. Alexander, is he here?

Mr. Porter.

Mr. Porter. You go.

Chairman Spratt. Mr. Tiberi.

Mr. Tiberi. Thank you, Mr. Chairman. Your comments there are fascinating. If I could follow-up on that.

I had a conversation recently with an economist over this same issue and was challenging him on this concept of China investing in U.S. treasuries. And the challenge that he had back, and you just kind of mentioned it, if you could expand upon it, is part of the reason why others invest in us is that there is not a safer investment in terms of if you look around the world in terms of a government, in terms of an economy, in terms of our laws in the world.

Can you further comment on that in terms of if you were in another country looking at investing in foreign debt? If you are looking at Europe and Asia and the Middle East and Africa and South America and Central America and the Far East and the United States, what would you look for in terms of investing in bonds and treasuries?

Mr. Orszag. Well, again, I mentioned security yields associated with the risk return, tradeoffs, and liquidity. And consistent with your comment is the fact that roughly two-thirds of official reserves globally are still invested in dollar assets suggests that we continue to be a preferred vehicle for such investments.

But I would note that that is a privilege or a benefit that is not guaranteed to continue forever and ever. It depends in part on what we do and what happens abroad.

Mr. Tiberi. The benefit of U.S. treasuries you are saying?

Mr. Orszag. The benefit of the fact that foreign official entities have chosen and continue to choose to invest such a large share of their reserves in dollar assets.

Mr. Ryan. Mr. Tiberi.

Mr. Tiberi. Yes.

Mr. Ryan. Could I ask just a follow-up?

Mr. Tiberi. I will yield to the gentleman.

Mr. Ryan. What proportion of our foreign-held debt in China in particular is callable versus noncallable debt?

Mr. Orszag. By callable, again, U.S. Treasury debt is not like private debt.

Mr. Ryan. Yeah. But there are callable instruments we have and then the vast majority of them have fixed mature rates, right?

Mr. Orszag. The vast majority have fixed maturities.

Mr. Ryan. Right. So the vast majority of the debt could not be called tomorrow by the Chinese? Most of it, it would just expire when it matures, correct?

Mr. Orszag. Yes. But one can obviously----

Mr. Ryan. They buy in fixed ten, twenty, thirty-year notes, not----

Mr. Orszag. One can move your portfolio out of a bond by steps other than just redeeming the bond. You can sell the bond.

Chairman Spratt. They do not call on the Treasury. They sell it in the open market.

Mr. Orszag. You have to have a buyer.

Mr. Tiberi. That is why I was confused by that.

Mr. Ryan. But the idea that tomorrow they could cash in all of the debt and crash the system would require that they would be able to do that and it does not sound like they could; is that correct?

Mr. Orszag. No. Again, we are going down a hypothetical, but it is not necessary to literally redeem a bond in order to have an effect on the market. You can sell the bond and that affects the pricing and the yield on the bond.

Mr. Ryan. Thank you, Mr. Tiberi.

Mr. Tiberi. Thank you.

Can we have chart one up, Minority chart one?

Yeah, that is it. Back to the entitlement issue, Dr. Orszag. This chart speaks for itself. When you do your scoring with respect to taxes and spending on entitlement, let me give you a question that was asked to me and see how you would answer it. I had difficulty answering it.

This is from a physician, a heart physician in Columbus, Ohio. And this was during the debate on Medicare, the Medicare drug benefit. And he said to me, you guys have it all wrong in the sense that the Medicare system then did not allow him to regulate a patient's heart, did not pay for it, but, yet, paid for him cracking open the chest to repair the heart, which cost tens of thousands of dollars, and said that if you allow me to regulate this person's health through tests, through a drug, there will be less of a cost and a better patient outcome than if you would keep the system currently in place where you pay for me to repair the heart.

But, yet, the scoring does not indicate that. And I explained that to him. And he said, well, that is what is wrong with the federal government. You do not take into real-life situation where me as the doctor on the ground is actually seeing these patients and can actually save the federal government money and keep the quality of life of the patient better.

How would you respond to that, to that physician, that heart surgeon who asked that question to me?

Mr. Orszag. That CBO continues to monitor the evidence on what works and what does not, that this is one of the various different approaches that are being discussed.

But, for example, there is a pilot project in the Medicare Program, the so-called Coordinated Care Demonstration Project, which tries to provide a sort of centralized process for the various different medical interventions that are warranted for someone with a severe chronic condition. The evidence suggests that those programs are not paying for themselves, let alone actually reducing cost.

Mr. Tiberi. Well, your assumption is, though, according to this doctor, just if I could just finish this question, but your assumption is that you assume that every single patient is going to still have the open heart surgery despite the prevention because you do not take into account the savings according to this doctor of not having the heart fixed.

Mr. Orszag. Where there is evidence of offsets like that, so you do X and then you reduce cost over here, we take that into account. So conceptually we try to take it into account, but it is often the case that the evidence in favor of many propositions, including on preventative medicine and including on disease management, it is not as strong as some practitioners make it seem.

And, again, we are always looking for additional hard evidence on what works and what does not and then that would be reflected in the scoring process.

Chairman Spratt. Mr. Doggett.

Mr. Doggett. Thank you, Mr. Chairman.

And thank you for your excellent testimony. I thought that Mr. Edwards made some important observations earlier in his questions about the devastating impact of these Bush-Cheney economic policies supported by Republican Congresses on our families. I think that has to be put, of course, into historical context of folks that talk like deficit hawks, but live deficits.

Under President Reagan, we hit almost a trillion and a half dollars in deficits. Under President Bush the first, we only got a little over a trillion dollars in deficits. Under President Clinton, of course, we achieved about $62 billion, $63 billion in surplus. That was the result of true fiscal responsibility.

And now, of course, under President Bush, the biggest talker and preacher against deficits and excessive spending and in favor of fiscal responsibility, but the all-time top hitter in achieving almost unlimited deficits, we are hitting on $2 trillion. He has not quite gotten there yet, but the kind of irresponsible policies he has had take us in that direction.

And I want to yield back to Mr. Edwards to make further observations about what the impact of these irresponsible policies are on the typical American family.

Mr. Edwards. Mr. Chairman, I want to respond. Mr. Simpson had asked if we are going to call this the Bush-Cheney deficit and the Bush-Cheney debt, which it is, largest in American history, we should also call it the Bush-Cheney economy.

I want to agree with him on that and I would like to submit, if I can send to the Committee, a report done by the Center on Budget and Policy with data from Commerce and Labor and Federal Reserve.

Compared to a response to coming out of previous recessions over the last 30 years, the Bush-Cheney economic impact was less in GDP growth, less in consumption growth, less in investment growth, net worth, less in wages and salary growth, less in employment growth.

There is one area the Bush-Cheney economic policy has worked. That is it has had huge increases in corporate profits. But in every other way, it has been worse than our response to recessions in the last 30 years.

And median household income of the nonelderly population has gone down by nearly four percent under the Bush-Cheney economic program while aggregate national income and corporate growth have gone up.

Mr. Doggett. Dr. Orszag, let me then inquire of you about one aspect of these perhaps consequences of some of these policies that has not yet been explored and that is the direct impact on the private sector of the acquisition of private assets by foreign owners.

As you know, within the last year, there has been concern expressed about the Chinese purchasing a major oil company here. There is concern that was expressed about one of the Gulf states taking over our ports.

I noticed within this last week, perhaps a little less strategic, the acquisition of Barney's in New York by Dubai. And I believe the Russians are getting plenty of petro dollars also and may be looking at the United States. I guess they will not be buying any media outlets since they are basically in the business of shutting down media outlets at home.

But what is likely to be the consequence as far as foreign acquisition of private assets of continuing the same policies that you are talking about today?

Mr. Orszag. Well, again, if you look at the net impact, there are lots of shifts in portfolios that are always occurring, but the net impact of running a current account deficit is that foreign claims on U.S. assets increase. In recent years actually, those have been disproportionately in government securities and disproportionately from foreign official entities.

And if you look at some of the subcategories, for example, direct investment, that is foreign purchasers buying more than ten percent of a domestic firm, we are actually now experiencing net capital outflows in that subcategory of the capital account rather than net capital inflows.

Mr. Doggett. Is Chinese acquisition a part of Blackstone an indication of any potential future shift of Chinese investment and purchasing of U.S. investments?

Mr. Orszag. Again, what I would say is that over the past several years, the net impact of capital inflows have been disproportionately in government securities as opposed to some of these other higher-profile, if you will, portfolio decisions and, again, disproportionately coming from official entities.

Beyond that, there are lots of shifts of portfolios in particular investments that go on all the time. And I am not reading too much into that particular one.

Mr. Doggett. Thank you.

Chairman Spratt. Thank you, Mr. Doggett.

Mr. Smith from Nebraska.

Mr. Smith. Thank you. I appreciate this discussion here today and it is quite enlightening as a new member. And I have been trying to follow the issues over the past few years.

But in light of the discussion about Medicare Part D, were there competing measures that would have cost more than the Republican adopted Medicare Part D plan?

Mr. Orszag. There were a variety of proposals floating around at the time and I have not gone back and checked, but I am sure that some of them were more expensive than the enacted legislation.

Mr. Smith. Okay. Thank you. And I realize CBO, I guess the rules, if you will, stipulate that the scoring is done not in a dynamic fashion, but perhaps a static fashion.

But would you agree that an increase in the capital gains tax would create a disincentive to make a relevant sale or economic transaction and would that be good for the economy?

Mr. Orszag. An increase in the capital gains tax would temporarily reduce the incentive for realizations. The longer-term effects are more complicated and the bulk of the evidence suggests that changes in capital gains taxes do not have a substantial effect on either the sort of net realization rates or the broader economy.

Mr. Smith. Okay. We are going to see, I guess I would predict, the expiration of several tax relief measures. Do you have any concern about consumer behavior in those last six months, those last twelve months, what the relevant case might be and the long-term impact of those changes in behavior?

Mr. Orszag. Again, if you are running up against a significant change, especially in something like a capital gains tax rate, you often get a significant amount of shifting.

So, for example, if the capital tax gains rate is about to go way up, shifting realizations into the period in which the capital gains rate is lower and we would anticipate that that would occur.

Mr. Smith. And do you have a concern about that creating somewhat of a false economy or false revenue outlooks?

Mr. Orszag. That kind of phenomenon has happened in the past and I am not sure that I would associate a significant concern with it as opposed to just recognizing that it does occur.

Mr. Smith. Okay. But as we look to the future and try to predict as your office often does, are you looking at adjustments there? Is it sort of all formula driven?

Mr. Orszag. No, no. Maybe I can answer the question what is the CBO's analysis of what would happen if the tax legislation expired as scheduled. And there are a variety of effects. Over time, one of the effects is that the budget deficit is smaller than it would otherwise be. That boosts long-term economic performance.

On the other hand, marginal tax rates are higher than they would otherwise be and on net, that impairs long-term economic performance. And CBO's analysis suggests that the net impact is relatively modest from those two forces.

Mr. Smith. Okay. And another question that I have is we have talked about government spending here today as well as personal savings or lack thereof. Which do you think is a bigger concern, government spending or lack of personal savings?

Mr. Orszag. I do not know that I would want to parse it that way. What I would say is I think the evidence suggests that the biggest, from a policy perspective, the biggest impact that you all can have is through public saving.

Efforts at boosting private savings through policy interventions have often not succeeded that well, although I would note my written testimony delineates that encouraging automatic saving, that is that you are in a 401k or you are in an IRA unless you opt out, appears to have a significant effect on contributions and participation rates.

Mr. Smith. Okay. Thank you, Mr. Chairman.

Chairman Spratt. Mr. Becerra.

Mr. Becerra. Dr. Orszag, thanks for being with us. Thank you for your testimony.

Let me make sure I have this correct. We see the share of our debt being more and more held by those who are foreigners, China, Japan. Oil exporting countries are buying up our treasuries.

As we try to figure out how to finance our government's operations, we are putting our bonds, our treasuries out for market and more and more the people who are buying or the entities that are buying are foreign partners or in some cases foreign competitors, correct?

Mr. Orszag. That is correct. A rising share of our publicly-held debt is held by foreigners.

Mr. Becerra. And more and more, it is not United Kingdom that is buying our debt or even Japan, which has become a friendly nation towards us over the last 50 years, but China, some of the same oil exporting countries that we continue to claim, as the President said, we want to remove ourselves from this addiction to oil.

They are the ones that are buying more and more of our debt that we put out there, correct?

Mr. Orszag. In terms of trends, that is correct.

Mr. Becerra. Now, right now we have experienced fairly low interest rates, historically low interest rates for quite some time. But if all of those foreign buyers of our debt were to, for whatever reason, decide not to buy and we could no longer sell it so easily, that would cause us to have to raise the interest we offer on those treasuries that we are trying to sell which would cause the rest of the markets around the nation to have to offer interest rates that are higher as well. Would that not be the consequence?

Mr. Orszag. That is indeed the case.

Mr. Becerra. Okay. So if I keep following this logical train of thought, in the housing market, we continue to hear about people having to give up their home because of foreclosures. They can no longer afford to pay the payment on their mortgage because the interest rates have gone up on these adjustable rate mortgages and now they are having to give up their homes. They are losing them on foreclosure.

If for whatever reason, China or one of these oil exporting countries decided to play politics with us, say China decided to take over Taiwan finally and we said, no, you cannot do that, we are going to defend Taiwan and they said you are going to do what, maybe we are not going to buy any more of your Treasury certificates.

What could happen to something like our home ownership rates, our housing market in America if interest rates were to become volatile and increase dramatically?

Mr. Orszag. Upward pressure on interest rates would discourage home ownership and also discourage various other types of consumption, both of which would tend to--well, the net effect of which, by the way, would also be to increase the private saving rate.

Mr. Becerra. You say it in such a neutral tone.

Mr. Orszag. Yeah. I am trying.

Mr. Becerra. The sky would fall on those who try to own a home.

My other concern is this as I continue to hear this play out. We are right now still in the midst of a War in Iraq where 160,000 American troops are still based in a country where we were told we would fight a three to six-year battle, war, with the cost at no more than about 50 billion.

Now we are well beyond a half a trillion dollars in cost, unclear when the President would even consider having us come out even though this Congress has tried to push to have an end date. We are financing this principally through debt. We are deficit spending to pay for the war because we are in a deficit to begin with.

So the question is this. In our 230-year history, can you think of a time where at the same time that we are spending hundreds of billions of dollars on a war when we are in deficit, have we ever faced a similar circumstance while we have been in war while we have also at the same time cut the taxes on the wealthiest Americans in this country?

Mr. Orszag. I do not believe that is the case. I actually think we may have had a previous exchange on a similar topic. I had asked CBO staff to look into whether there had ever been a revenue reduction during a time of war. And if my memory serves me correctly, there was an engagement with Mexico in the late 19th century in which we also reduced a tariff rate at approximately the same time. And that was the only time in history that the CBO staff could uncover.

Mr. Becerra. So a tariff rate versus what we have seen to the tune of several trillion dollars in tax cuts that have gone principally to those at very highest income levels and we have a deficit that has grown to historic levels. And at the same time, we are finding our foreign competitors are buying up our Treasury certificates.

And it just seems like this vicious cycle does not end, but at the same time, it does not seem like at the White House there is any control over how we spend our money.

So whether it is because we want to maintain home ownership rates at high levels or whether it is because we want to try to do right by the men and women who are serving us in the military who are in Iraq abroad, I would think that what we would try to do is heed what you are saying and try to have more fiscal responsibility and that is perhaps why Congress has decided to go with the PAYGO system in operation so that we will no longer continue to increase the size of the deficit.

So no question there other than to say thank you for your testimony and for your comments that you have always provided to this Committee.

Chairman Spratt. Mr. Etheridge.

Mr. Etheridge. Thank you, Mr. Chairman. Let me thank you for holding this meeting and let me thank you for leading this Committee through the PAYGO system to get us back on track because I think it is important.

Dr. Orszag, thank you for being here. Your testimony today is important.

You know, we are seeing record deficits and the policies that have been put in place in the last few years got us here. And it has made it very difficult for us, I think, this year for us to meet some of the pressing needs and I will talk about that in a minute.

But too often in this town, the debate dissolves into soundbites and some talking points that are repeated over and over and over again and we get charts that try to make our points. And the truth is I want to get to something that I think is important that hopefully gets to where the American people are.

I do not understand all this stuff sometimes, but most folks understand that have a bill to pay what the interest is on it. And I want to follow-up what my colleague was just talking about. I happen to disagree with the Vice President. Deficits do matter.

And with that, let me ask you this question. Do you remember what the amount of interest we were paying in 2000, the actual interest on the national debt and how much interest we will pay this year on the national debt given that we are keeping the interest rate down to the point we are? I will not go into what will happen when it would balloon, but what those numbers actually are in the millions of dollars.

Mr. Orszag. Luckily I do not have to rely on my memory since I brought the CBO budget and economic outlook. In fiscal year 2000, net interest payments were $223 billion.

Mr. Etheridge. All right.

Mr. Orszag. And in 2006, they were $227 billion.

Mr. Etheridge. Say it again now.

Mr. Orszag. In fiscal year 2006, net interest payments were $227 billion.

Mr. Etheridge. Two hundred and twenty-seven billion. And it was how much in 2000?

Mr. Orszag. Two hundred and twenty-three.

Mr. Etheridge. It only went up $4 billion?

Mr. Orszag. One of the things that has happened in the meanwhile is that there has been an evolution of interest rates. We have exceptionally low interest rates now in the United States.

Mr. Etheridge. Okay. Now, my question, the question is that as we have seen this tremendous growth in deficits being bought by and large overseas, it means that the dollars that historically in World War II and all those times we were running deficits was paid through the America citizens which in effect meant that money was turning over in the American economy.

Those dollars now are being bought overseas. What portion of our debt, our total debt is bought overseas? The reason I ask this question, of the $227 billion, it could grow very rapidly. It is no longer enriching our country. The interest is going somewhere else, to China. As you have said, about a 500 percent increase, which means not only are they buying debt, they also are part of the balance of payment deficit we have.

And what was that balance of payment with China in 2000 versus the balance of payment in 2006? Do you happen to have that number?

Mr. Orszag. Yeah. Let me answer this in two parts. So with regard to the publicly-held debt, again somewhat above 40 percent of the nation's publicly-held debt is now owned by foreigners.

Chairman Spratt. How much?

Mr. Orszag. Slightly above 40. It is 42 or 43. With regard to the nation's current account deficit with China according to our data, and the numbers are a little different in their data, that was a little bit above $200 billion last year. And, actually, I will have to get you the number from 2000. I do not want to misquote it.

Mr. Etheridge. Okay. That being said then, roughly of the

$227 billion in debt, we can figure 42 to 43 percent of that interest is going outside the United States that is no longer available within our economy that would turn over to generate economic activity. And that would no longer be savings in the American economy which could be turned into education, to healthcare, to a host of other issues, more savings for the American people.

Mr. Orszag. Again, I do not have the data on the maturity structures, et cetera, but roughly speaking about 40 percent of net interest payments----

Mr. Etheridge. Whatever that number may be.

Mr. Orszag [continuing]. Would be flowing to foreigners.

Mr. Etheridge. Okay. Thank you.

I think, Mr. Chairman, the point is, and I thank you for holding this hearing and I thank you, Dr. Orszag, because, you know, these things are important.

I remember asking the question to the Treasury Secretary Paulsen about whether or not deficits bothered him and whether it kept him up at night. And he said it did not.

Well, I think these numbers ought to bother all of us and I am glad we have started on a track now to start getting back to a balanced budget because I think these debts being held by the people who are not necessarily going to be working in our best interest are important for us to get on better ground.

Thank you, Mr. Chairman. I yield back.

Chairman Spratt. Thank you, Mr. Etheridge.

Mr. Cooper of Tennessee.

Mr. Cooper. Thank you, Mr. Chairman.

Dr. Orszag, as you know, Standard & Poors of New York has projected that by 2012, the U.S. Treasury bond will lose its triple A credit rating. Furthermore, they have projected that by 2015, the United States of America will have the same credit rating as Greece or Estonia.

By 2020, they say that our credit rating, if things do not change, will be that of Poland or Mexico. And by 2025, they say that the U.S. Treasury bond will be below investment grade, junk debt, on par with the bonds of Brazil or Panama.

What in your professional opinion would be the impact if in 2012 we take the first of S&P projections, it is the closest at hand, and the U.S. Treasury bond loses its triple A credit rating?

Mr. Orszag. I guess the way I would answer that is that we are on a fiscal path in which the problems grow gradually worse over time and they are going to continue getting worse if we do not tackle some of the things that we were talking about before.

It is hard to parse out exactly where trigger points would be so that there would be sort of discrete adjustments. What you were describing may be one among many things that would put that gradual deterioration on a more sudden path.

Mr. Cooper. I think it is a problem that clearly the next President will have to confront if S&P is even in the ballpark of being correct.

Mr. Orszag. Every budget analyst that I know suggests that the United States is on an unsustainable fiscal path and that the problem needs to be addressed. It would be better to address it sooner rather than later.

Mr. Cooper. Exactly. I was just about to mention the precious word unsustainable. Everyone agrees on that, but who is doing anything about it? The reason the S&P projection is not a prediction is they think some policy makers are going to intervene. Well, things are keeping on pretty much business as usual.

You mentioned in your testimony that the best way out of the dilemma is to boost the savings rate and then you offer an addition to the automatic 401ks that we passed last year, perhaps some automatic IRA proposal, and then you say that would hardly dent the problem that we face.

What can we do that would dramatically boost the national savings rate?

Mr. Orszag. I think the single best thing under your control or single-most effective thing largely under your control is to move the federal fiscal balance from its current level of one and a half percent GDP deficit and much larger projected deficits perhaps even into surplus and to get it on a more sustainable path.

Mr. Cooper. But although we hope to have a budget improvement, I think most policy makers would tell you at least privately we do not see a way out of these deficits for the foreseeable future.

And no one is trying to reform the entitlement spending that was discussed earlier that must be addressed if we are going to curb growth in healthcare spending.

Mr. Orszag. And one of the reasons that I am putting so much emphasis on CBO increasingly becoming the Congressional Health Office is to provide options to you on what might help bend that curve. So we are doing a lot of things, at least for our part, to provide you with more options that you could evaluate.

Mr. Cooper. Your CBO budget options book is excellent. You could emphasize healthcare a little bit more and we would appreciate that. We would also welcome more ideas on ways to boost private savings because if you were to poll members of Congress, you would find that our own personal savings behavior is very regrettable. Just we mirror the public at large.

So I think suggestions along those lines would be very helpful because here we all agree it is unsustainable, but no one is doing much about it, either as policy makers or as individuals. We say the words, but we must not mean them because we are letting the day of reckoning come closer and closer.

Is there an opportunity for CBO staff to work on ways to boost, suggestions for us to boost private savings rates in this country, something bolder than automatic IRAs?

Mr. Orszag. Sure, although I would note, and, again, this is not a recommendation that I am making, but I would note that the evidence in favor of the proposition that a lot of saving behavior is driven by inertia and that that is a significant factor in savings rates for many American families. I would not downplay that too much.

Mr. Cooper. But today after 20 or 30 years of IRAs, what, only ten percent of Americans have one with any substantial savings inside?

Mr. Orszag. And that is in no small part in my opinion because you have to take active steps to go and sign up, go to a bank to get it. Even small impediments to taking action to contributing have large effects.

The evidence from 401ks suggest that even, you know, having to read through a document at work and sign up has a significant deterrent effect. If you are in a plan unless you opt out, your participation and contribution rates are a lot higher.

The same logic could be applied to the IRA setting, but it would require a variety of changes and I do not think it would be a small matter in terms of the required statutory changes either.

Mr. Cooper. Thank you, Mr. Chairman. I see my time has expired.

Chairman Spratt. Thank you, Mr. Cooper.

Ms. Kaptur.

Ms. Kaptur. Thank you, Mr. Chairman.

Dr. Orszag, welcome. Do you have any recent number on what we are projected to pay in interest to these foreign holders of our debt this fiscal year? It is over 200 billion, is it not, somewhere between 100 and 200 billion?

Mr. Orszag. That seems high in terms of interest on the U.S. Treasury debt paid to foreigners, again going through the math that we were walking through before.

Ms. Kaptur. I did not find it in your testimony.

Mr. Orszag. I do not believe I provided it in my testimony. But total net interest payments will be a little bit above $200 billion. Foreign entities own about 40 percent of the debt. So doing the math, that would be roughly $80 billion or so.

Ms. Kaptur. Okay. So we are approaching $100 billion. That is not insignificant. That is larger than many of our governmental departments. NASA's budget is $16 billion, for example. So you are talking about big money here.

You are talking about substitutional effects in the government of the United States where we could be spending those dollars on, for instance, veterans. I think the veterans budget is what, 60 to 70 billion a year now. I mean, you think about what that displaces in terms of our economy and that has been on an upward path.

I can tell you when I got to Congress, the amount of foreign investment in U.S. securities was about eight percent and I used to rail against it over in what was then called the Banking Committee. Now we are over half and America has lost their independence in my opinion.

And all of the actions that have occurred over the last 20 years, whether it is the destruction of our thrift institutions, changing the name of the Banking Committee to the Financial Services, charging people and giving them no interest in their checking accounts, all the fees we are placing on people, the lack of emphasis on savings, no postal saving stamp program like Franklin Roosevelt.

As a grandmother, if you want to buy a--try to buy a savings bond. You are too young to buy one. And your grandmom wants to give it to the grandchild. Good luck. They want to mail it in the mail. When ordinary people wanted help, the government of the United States fights them every step of the way. So it is really interesting to me we are part and parcel of the problem, but we cannot see our way out of it.

Let me ask you about the Saudis. I see your chart here on oil exporting countries and who owns what of this debt. Okay? Does that include the special arrangements the Saudis have with our government for the reinvestment of over a trillion dollars, but it is done in dollar denominated assets? It does not appear to me that that is in your chart. What can you tell us about when that agreement was struck at Treasury and how that works compared to the purchases by other countries of our bonds?

Mr. Orszag. I think I will have to reply in writing to you. I do not have anything to say about that at this point.

Ms. Kaptur. Yeah. Treasury never wants to say anything about that and it is pretty significant and it is different. And I think your charts underestimate the impact of that inside this economy and the close linkage between the reinvestment of those assets inside this economy. I think the numbers are worse than you presented in your charts.

I wanted to ask you about does the Treasury or anyone else identify the top specific foreign purchasers of U.S. debt for each fiscal year and, if not, why not?

Mr. Orszag. There is an identification by country of holdings of different types of assets including public debt. And we could provide those to you.

Ms. Kaptur. So we could track them back to----

Mr. Orszag. Yes. Now, there are various flaws in the data. For example, those are typically based on surveys often of custodians of assets. There can be banks in the UK holding the asset on behalf of someone else. And so the country breakdowns can often be a bit off relative to an underlying reality.

Ms. Kaptur. All right. I am going to ask some questions for the record for you to get back to us on that.

Mr. Orszag. Okay.

Ms. Kaptur. What is the linkage you have seen between our trade deficit and the increased foreign holdings of our debt?

Mr. Orszag. The trade and current account deficits necessitate the mirror image of them is a net capital inflow from abroad and part of that net capital inflow, actually in recent years a very large share, has occurred in the form of purchasing Treasury securities. So there is a direct connection between our current account deficits and net capital inflows from abroad. They are the mirror image of each other.

Ms. Kaptur. I know we have got other witnesses today, but I am pretty concerned about these hedge funds and the investors in those not being disclosed.

Would you support a federal law that would require disclosure of anything over five percent in any of those hedge funds that would be of a foreign nature, foreign purchases of assets held by those hedge funds? Do you see any disadvantage to doing that?

Mr. Orszag. Again, my role as CBO Director is not to support or not any particular legislation. We would be happy to provide an analysis of the pros and cons to you which I would rather do again in writing since I know that our time is expired.

Ms. Kaptur. Okay. Thank you very much for being here today and I look forward to replies to the questions I have asked.

Chairman Spratt. Thank you, Ms. Kaptur.

Ms. Kaptur. Thank you, Mr. Chairman.

Chairman Spratt. Mr. Berry.

Mr. Berry. Thank you, Mr. Chairman.

Dr. Orszag, we appreciate your effort. You keep referring to net interest. What is gross interest?

Mr. Orszag. It is significantly higher. It includes payments to various different, for example, the Social Security Trust Fund, which is part of the federal government.

Mr. Berry. How much is it?

Mr. Orszag. From memory, it is certainly north of $100 billion a year. It will take me a second to get.

Mr. Berry. That is fine.

Mr. Orszag. Okay. While you are asking your next question, I will look it up.

Mr. Berry. Okay. When you present the net interest that we paid in 2000 and then what we paid in 2006, there appears to be very little impact on the interest that we are paying as it relates to the amount of money we owe because we have borrowed a couple or $3 trillion more than we owed at that time. Am I correct about that?

Mr. Orszag. That is correct. And one of the reasons for that is that the--well, there have been a variety of changes. But, for example, looking at the interest rate on U.S. government debt is one factor that is affecting because you have the stock of debt and then the interest rate that is paid on the debt and you are focusing on the fact that the stock of debt has gone up as we have run these deficits, but the other factor is the interest rate.

Mr. Berry. So does the amount of debt that we owe have any impact on the interest rate?

Mr. Orszag. Yes, it does, but there are other factors that affect interest rates also. And those other factors have resulted--one of the phenomenon that has occurred over the past several years is we have a very flat and actually for a period of time we had an inverted yield curve which is unusual.

So a longer-term Treasury security like a ten-year bond typically yields more than, you know, a three-month Treasury bill. That yield curve has been very, very flat over the past several years, unusually flat.

Mr. Berry. You have testified, and I have heard many others say the same thing, that tax cuts do not pay for themselves. Do farm bills pay for themselves? Do the American people get their money's worth out of a farm bill?

Mr. Orszag. I think the question of the sort of costs and benefits of agricultural programs is that is a different question than the economic return to a tax cut. Basically I am not going to touch that.

Mr. Berry. Thank you, sir.

Chairman Spratt. Mr. Scott.

I see our patient forebearing second panel next. You are on deck. We are sorry to have kept you so long.

Mr. Scott, proceed.

Mr. Scott. Thank you.

Dr. Orszag, the gentleman from California had a situation where we had to go to defend Taiwan and China could use the fact that we are borrowing money from them as a negotiating point.

What would happen if China decided as part of the deal they would not lend us money to defend Taiwan against them? What would happen? Could we manage without borrowing money from China?

Mr. Orszag. The impact on our economy would depend in part on the reaction of other investors, whether they would step in rapidly or not. But a very sort of sudden and significant withdrawal of flows of Chinese investment into U.S. Treasury securities would likely have some at least short-term disruptive effect. And how big that would be would depend in part on what happened in the rest of the market and whether other investors stepped in.

Mr. Scott. Interest rates are international.

Mr. Orszag. They are influenced by international capital flows.

Mr. Scott. How much fluctuation, annual fluctuation is there in international interest rates? I mean, are they pretty stable from month to month, year to year, or can they go up a point, two, three points a year?

Mr. Orszag. Fluctuations of two or three basis points in a year are unusual, but not unprecedented.

Mr. Scott. We have a chart here that shows that in 2001, we had about a trillion dollars in international debt; 2007, 2.2 trillion. How much did the overall debt, national debt increase from 2001 to 2007?

Mr. Orszag. Roughly a trillion and a half dollars or so, I believe.

Mr. Scott. Well, this is 1.2 trillion.

Mr. Orszag. I do not know what chart you are looking at, but----

Mr. Scott. This one.

Mr. Orszag. Oh, I am sorry. That is foreign-held debt. So I was giving you the numbers for all publicly-held debt. Foreign-held debt has increased by about three-quarters as much as the increase in----

Mr. Scott. Okay. Well, foreign-held debt went from one to 2.2. How much did the overall national debt go up?

Mr. Orszag. By a little bit above 1.5 trillion.

Mr. Scott. One point five. So out of the net 1.5 trillion increase foreign-held net went up 1.2 which is 70 percent?

Mr. Orszag. That is roughly correct.

Mr. Scott. Of the net debt was financed from overseas sources?

Mr. Orszag. That is correct.

Mr. Scott. You had an exchange where the bond rating might be adversely affected. Can you say how close we are to a tipping point where foreign countries might stop buying and, in fact, might start selling debt and what that might do to our interest rates?

Mr. Orszag. There is a risk of a sudden and severe adjustment. That risk, I think, is small, but perhaps growing. And I cannot identify a particular trigger point for you.

One of the inherent elements of a situation like this one is that there are steps that one would presumably want to take to avoid the risk of something happening even if you cannot identify exactly when it could happen or even the exact probability of it occurring.

Mr. Scott. What order of magnitude of interest rate shock would we be looking at?

Mr. Orszag. Again, it depends on exactly what happened. And someone once said that this kind of situation, things can go wrong in such a wide variety of ways that it is just difficult to parse out all of the various different scenarios. But there have been estimates suggesting a hundred basis points or more type of adjustment.

Mr. Scott. Now, if we had not messed up the budget starting in 2001, we had projected that we would be able to pay off the debt held by the public by approximately 2008. Is that true? The projections in early 2001 would pay off the national debt?

Mr. Orszag. As you will remember at that time, there was significant discussion about what would happen in the situation in which all the publicly-held debt had been paid off.

Mr. Scott. And so all of this risk that we are discussing now would not have been there if we were in the process of paying off the debt held by the public?

Mr. Orszag. Or another way of putting it is in the kind of scenario where you were running significant budget surpluses, net national saving would be significantly higher.

Chairman Spratt. Dr. Orszag, as always, thank you for your excellent presentation, your responsive answers. We look forward to hearing you shortly, I think tomorrow or the next day, on----

Mr. Orszag. Thursday, yes.

Chairman Spratt [continuing]. Thursday. Thank you again for your participation and for CBO's input.

Now our second panel, Dr. Robert D. Hormats, Dr. Mickey Levy, Dr. Kenneth Rogoff, and Dr. Brad Setser.

If you have no objection as a panel, we will proceed in the order I just mentioned unless you want to change the order, Dr. Hormats, Mickey Levy, Kenneth Rogoff, and Brad Setser. Is that agreeable with the panel?

Mr. Hormats, thank you for participating.

And thank you for your patience, all of you. Your prepared statements will be made part of the record and to the extent you wish, you can summarize them.

The floor is yours.

STATEMENTS OF ROBERT D. HORMATS, VICE CHAIRMAN, GOLDMAN SACHS (INTERNATIONAL); MICKEY LEVY, CHIEF ECONOMIST, BANK OF AMERICA; KENNETH ROGOFF; PROFESSOR OF ECONOMICS AND THOMAS DR. CABOT PROFESSOR OF PUBLIC POLICY, HARVARD UNIVERSITY; BRAD SETSER, SENIOR ECONOMIST, ROUBINI GLOBAL ECONOMICS

STATEMENT OF ROBERT D. HORMATS

Mr. Hormats. Thank you very much, Mr. Chairman and members of the Committee. It is a pleasure to be here and I will just try to make a few key points relative to the broader issues that I have described in my written testimony.

One, you have discussed in previous prior testimony the domestic savings versus investment imbalance. The domestic issues are one part of the equation. The other is the question of where the capital to fill the domestic saving shortage comes from and the point has been made frequently that the biggest increases have come from China and the oil producers.

There tends to be a lot of focus on the reserve accumulations of central banks, but I just want to emphasize that the critical issue for these countries is the enormous amount of net savings as reflected in their current surpluses so that we can be very reliant on foreign capital supplies from countries that have very low reserves.

The reserve accumulation occurs when the central bank buys up dollars or other currencies, but the reliance of the United States on foreign capital would be there whether the reserves have been accumulated or not because it really relates to the net savings of these countries or, put another way, the net exportable savings.

In my testimony, I was asked particularly to look at some of the scenarios for the unwinding of this huge dependence. What could occur that would cause a major disruption or interruption in the inflows of this capital? So I have briefly laid out three separate scenarios.

One is what I call the benign scenario. Essentially the benign scenario occurs and is occurring already with respect to the oil producers. The oil producers now are as a result of what was up until recently a decline in oil prices and as a result of an increased amount of domestic demand and domestic investment using a growing share of their surpluses so that their trade surpluses which were over 500 billion in 2006 are likely to be under 400 billion this year and under 300 billion in 2008 which means they will have less investable savings, less net export of savings to provide our markets.

And the same thing could occur in other countries. If you see in China or any other major supplier of capital increase in domestic demand and more of their money is used at home, there would be less exportable savings. That is a relatively benign scenario because it is demand led. It is based on the fact that they have more demand for their capital. They invest more at home. They grow more rapidly. They buy more American goods and they use more of their goods at home.

That is a good scenario, but it does suggest to us that the exportable savings of these countries does have limits and one limit is that they may want to use more of their savings at home, means there is less available to export to us and other countries.

The next scenario is what I call the disruptive scenario. If you look at the countries China, Saudi Arabia, Russia, big owners of large amounts of reserves and large amounts of excess capital, if they were to consciously and abruptly shift a large portion away from the dollar market as a result of some political conflict or for some other reason, a trade dispute, that would have a very adverse impact on our economy because others watching them would probably also sell dollar assets because they do not want to be the last one through the door.

And that would push interest rates up rather significantly in this country, maybe very significantly, in fact. The dollar would decline. The net effect would be a marked slowdown in U.S. growth, possibility a recession.

Now, at some point, other countries and other people might come in to buy the cheaper dollar and the cheaper assets, but it could take a long time for that to occur. It is like catching a falling knife and it would be a very disruptive scenario.

The third scenario is what I call the highly disruptive scenario and that is consider, for instance, a major terrorist attack on the United States which struck America's infrastructure, for instance, the Port of New York, the Port of Long Beach, or a major dirty bomb that goes off in the center of a major American city that rendered the city or part of it uninhabitable for decades or a disruption in a major airport or railway station or subway system through Anthrax which would take it out of commission for a long time.

In such circumstances, foreign investors, particularly private sector investors, initially would perceive a significant risk of their U.S. investments and might pull money out or simply not put any more money in. And the budget implications of that would be enormous. The economy would weaken, therefore revenues would decline. The government would have to spend a lot more money on reconstruction, rebuilding, retaliation, recovery.

And foreign central banks seeing this big increase in the budget deficit would either perhaps decide they want to be more cautious about concentrating large amounts of additional assets into dollars or in some cases decide to withdraw some dollar assets which, again, would push interest rates up dramatically and have an adverse effect.

And even if the central banks did not panic and decided not to do this, there would be perhaps so much cutting of private sector money in the United States or withdrawals that it would present a major issue to the central banks to have to work together to stem that tide of a collapse of the dollar and an increase in U.S. interest rates.

How much damage would be done would depend in part on the fiscal situation of the United States. If we had a very large budget deficit at the time and were heavily dependent on foreign capital, we would be more vulnerable to this than if we were in a strong fiscal situation and we were not as dependent on foreign capital and we did not have as much debt.

So the underlying fiscal situation would have some effect on how the markets perceived the impact of such a terrorist attack on the American fiscal situation. And I think this is worth looking at. The underlying fiscal strength of this country would have some impact on how foreigners perceived the degree of risk that would occur as a result of such an attack.

Let me conclude because I know there will be time for questions. The book that you have in front of you and that I have given a number of members and is on the table in back makes one fundamental point that I think is well worth keeping in mind. The title of the book is ``The Price of Liberty.'' It comes from Hamilton.

And Hamilton made the point very clearly that there is a very close link between the fiscal strength of the United States and its national security. He was very much of the view that if you want to have the opportunity to borrow at reasonable rates during a crisis, a war or some other emergency, the country has to be credit worthy so that investors see it as a good place to invest their money.

If the underlying fiscal circumstances are weak as a result of bloated budget deficits, for instance, that makes it harder for the government to borrow in emergency situations. And if it does borrow, it would presumably have to pay a lot more, particularly if, as Mr. Cooper indicates, there is a risk that there be a downgrading of American assets. That would make it even more difficult for the United States to borrow in those circumstances.

So the underlying circumstances of our country, I think, would have a major impact on this. And his judgment is if you want to have a resilient economy, an economy that can marshall resources during a crisis, you cannot wait until the crisis occurs to put the economic house in order. It has to be put in order beforehand and that gives this country the resilience to muster the resources it needs in an emergency and to borrow at reasonable rates if such an emergency were to occur.

Thank you very much, Mr. Chairman.

[The prepared statement of Robert D. Hormats follows:]

Prepared Statement of Robert D. Hormats, Vice Chairman, Goldman Sachs (International)

Mr. Chairman and Members of the House Budget Committee, it is a great pleasure for me to appear before this committee to discuss an issue of great economic, financial and national security importance to our country--the growing dependence of the United States on foreign capital.

I have been asked to discuss several aspects of this issue, with a focus on the types of events that could lead to a sharp decline or reversal of the large amounts of funds that have been flowing into this country in recent years.

A few words of background might help to put this in context. First, it is worth noting that the U.S. is, and will remain, heavily dependent on foreign capital as long as out country's level of savings remains substantially below its level of investment--as it has been for many years. That imbalance is possible only if foreign investors--individuals, institutions and governments--are willing to finance it through the acquisition of U.S. assets (including stocks, bonds, real estate) or provide direct loans to U.S. entities. The current account balance reflects this savings/investment imbalance and thus tracks the net inflow of investment funds from abroad into the U.S. In 2006 the current account deficit was over $800 billion--roughly 6.5% of the nation's GDP.

The US will continue to be heavily dependent on foreign capital if this large domestic savings/investment imbalance continues. For example, even if the much focused on increase in the U.S. trade and current accounts imbalance with China were to be eliminated tomorrow, the U.S. would still experience the same sized imbalance with the world as a whole if our internal savings shortage remained the same--only it would be shifted to different nations. The nation's aggregate current account imbalance, and its dependence on foreign capital, would not be reduced. If we wish to reduce our dependence on foreign capital--and our vulnerability to its sharp interruption--we need to boost savings at home. Without that, the much focused on goal of an adjustment in the dollar/Chinese RMB exchange rate, or any other bilateral measure for that matter, will have negligible effect.

A different set of issues relates to where the capital that fill the U.S. savings shortfall comes from--and the answer is, increasingly, from world's the emerging nations. In recent years there has been a dramatic shift in the current account positions of the emerging economies. This represents their export of surplus savings to the rest of the world--and constitutes a new and unusual feature in the world economy. Their growing current account surpluses collectively are the major counterpart to the growing U.S. current account deficit.

It is the enormous amount of net savings in these countries--as reflected by their current account surpluses--rather than their reserves or central bank purchases of securities per se that enable them to be large capital exporters. Although reserves and central bank purchases have receive the lion's share of attention, the underlying factor in their current account surpluses is this unusually high rate of savings. And their surplus savings goes to countries that have the largest savings deficits--at the top of the list being the U.S.

Although the world's largest savers have included a shifting cast of nations during the last decade, the vast increase over the last three years comes from two sources: China and the major oil producers. While China gets most of the attention, and has the largest reserves and savings surplus of any nation, collectively the largest increase in savings over the last three years has been by the large oil producers (such as Saudi Arabia, Russia, Iran, Nigeria and Kuwait), who are recycling enormous sums of windfall oil revenues into the world's financial markets.

Recent increases in oil prices caused the value of export revenues of these nations to climb from $743 billion in 2004 to $1.245 billion in 2006--an increase of $500 billion. About half of that added income was spent on imported goods and services and half was recycled back into global capital markets. Together these countries had a net trade surplus of $533 billion in 2006; but that is expected to fall to below $400 billion in 2007 due to lower oil revenues and increasing level of imports. China's balance of payments surplus continues to rise at a rapid rate and the country recorded a current account surplus of $250 billion in 2006.

It is important to recognize that all of the accumulated savings and surpluses do not necessarily find their way into the foreign exchange reserve holdings of central banks. That occurs when a central bank buys dollars, or other foreign currency, with local currency. For instance, Saudi Arabia might have a large trade surplus, but unless the Saudi central bank buys those foreign currencies up from private holders and corporations with its local currency, the riyal, they will not be added to its reserves. If a country does intervene in the currency markets, e.g. China buys up dollars with its currency, the RMB, the dollars are added to its reserves. Much of the reserve accumulation of recent years has occurred because foreign central banks buy dollars that they earn on the trade account or that come in as the result of foreign investment or speculation in their local currency to avoid a sharp rise in their currencies vis-a-vis the dollar, and then put dollars they buy into dollar denominated assets which they add to their reserves.

All told, as of May, 2007 China's foreign exchange reserves amounted to over $1.2 trillion; Japan, $887 billion; Russia, over $250 billion; and South Korea, $244 billion. Of China's reserves, over $400 billion is held in the form of U.S. Treasury securities and--based on recent estimates--between $300 and $400 billion in the securities of U.S. agencies, dollar denominated issues of the World Bank and corporate bonds. All told, foreign official holdings of U.S. Treasuries are approaching $1.2 trillion. But, it is again worth emphasizing that America's dependence on foreign capital--and outstanding foreign holdings of American assets--would be just as great if none of the dollars in the hands of foreigners were added to central bank reserves, but instead remained in private hands.

The enormous increase in the global accumulation of net savings and their investment in the U.S. financial market are key factors producing, inter alia, very low real interest rates in this country, which in turn has helped to fuel the U.S. housing boom and other aspects of growth. They also have been instrumental in narrowing credit spreads between the highest rated creditors and lower rated creditors, because lower interest rates encourage investors to push money into higher yielding assets--usually of lower quality--and thus push down interest rates on those securities as well.

the impact of a reduction in capital flows

The heavy reliance of the U.S. on capital flows from abroad raises the question of the likely impact of a reduction or reversal of those flows on the U.S. economy and financial markets. There are several possible scenarios for this occurring.

Benign Scenarios

A relatively benign scenario is already at play among the oil producers--not as the result of a any conscious effort to cut off funds from the U.S. or any other country but as the result of lower prices for their exports (until recently) and their rapidly growing demand for imports as they use their added wealth to build new public infrastructure and factories and to boost domestic consumption. Their trade surpluses are expected to fall from an annual level of $533 billion in 2006 to under $400 billion this year to under $300 billion in 2008, which means they will have less available savings to invest abroad.

Similar developments are likely to occur in some of the other surplus countries, for instance in the emerging markets of Asia, other than China. China itself is likely to continue to record substantial additional trade surpluses and thus generate substantial amounts of excess and exportable savings for several years at least. But even that could eventually change as domestic demand grows due to a broadening of domestic consumption and purchasing power (as the Chinese government seeks to increase living standards in central and western China and especially in rural areas which feel left behind by the surge in urban prosperity) and improved capital markets that enable the Chinese to use more of their large savings at home rather than exporting such a large portion abroad. These are rather benign and demand led scenarios--that could evolve over time and enable adjustment to be quite smooth. But they should also serve as a reminder that the U.S. cannot indefinitely relay on abundant supplies of external capital.

In the case of a gradual decline in net available savings from, say, China the impact on the U.S. rest of the world would be gradual--increasing real interest rates and widening interest rate spreads between the best credits and lower rated credits. However, as noted above, this would be less of an interest rate story than a demand story, as higher domestic demand in China would boost U.S. and other nations' exports to that nation and would channel more goods produced in China away from the world export market into meeting domestic demand.

Disruptive Scenarios

But what if the scenario were less benign? Suppose, for instance, a high savings nation such as China or Saudi Arabia or Russia were to consciously and abruptly shift a large portion of its funds away from the U.S. dollar market and put them into assets denominated in other currencies? That risk is often posed in discussions over U.S. dependence on foreign capital. The likelihood of China, for instance, doing this in current circumstances is very low because such a move would be profoundly disruptive to its trade and therefore, to its domestic economy. One of the reasons authorities in Beijing have adopted a gradual approach to currency revaluation is that too rapid an appreciation of the RMB vis-a-vis the dollar would weaken the competitiveness of PRC exports in the U.S. and other dollar markets and that would slow the growth of jobs in China, risking social unease in a nation that has to find new jobs for some 30 to 40 million people annually.

But were such a scenario to occur, there would be significant implications for U.S. financial markets and the U.S. economy. Let's suppose, hypothetically, there were a major dispute that caused a large creditor nation to deliberately shift a substantial portion of its foreign exchange accumulation to other currencies, such as the Euro. In that circumstance, the dollar would drop sharply and interest rates in the U.S. would spike, as a savings-short American economy would find itself with insufficient funds. As the dollar fell and bonds weakened, other investors, foreign and American alike, could sell off dollar assets and buy those denominated in other currencies.

Such measures would cause a sharp drop in bond prices and thus higher interest rates as the government and corporations scrambled to obtain needed capital. That would produce a market slowdown in U.S. growth--or possibly a recession. Of course, as the dollar dropped and interest rates rose in the U.S. those countries that were the recipients of this new money--the result of investors fleeing dollar assets--might well come to see American assets as a desirable investment and buy them, helping to reverse the deterioration. But this would likely take a lot of time--and considerable damage could be done in the interim.

Highly Disruptive Scenarios

Other scenarios would be even more worrisome. Consider, for example, the implications of a terrorist attack on America's physical infrastructure--such as a dirty bomb that renders a large section of an American city uninhabitable for decades, or incapacitates a large American port such as Long Beach or New York, or an anthrax attack in a major airport, railway stadium or subway system that takes many months to clean up. In such circumstances, foreign investors, particularly foreign private sector investors, would perceive a significant risk to their U.S. investments.

One response would be to sell their stocks, causing a plunge in the U.S. market--already doubtless rocked by the attack. And the budget deficit would widen significantly after such an attack--due to weaker revenues resulting from the decline in and disruption of economic activity after the attack and the need for tens or even hundreds of billions of dollars of added government spending for reconstruction, recovery and retaliation. Foreign central banks then might be reluctant to add to their already large stock of U.S. government assets, pushing up interest rates and thus further harming an already damaged economy.

And even if central banks did not panic into selling dollars, and continued to buy dollar assets at their accustomed pace, private holders of dollars might engage in panic bond selling or simply hedge by selling dollars for foreign securities. As noted above, not all foreign held dollar assets are in the hands of foreign central banks. Enormous amounts are held by large financial institutions such as insurance companies, pension funds, and corporate treasuries as well as by individuals. And many American institutions and individuals might engage in similar behavior as they see the dollar drop and bond and stock prices fall. Whether a massive joint effort by central banks could counter this sharp sell off is highly questionable. And it doesn't need to be a terrorist attack to trigger such a calamity; a devastating earthquake or a catastrophic hurricane could have similar effects.

How much damage would be done, and for how long, would likely depend on the soundness of America's fiscal policy and the nation's overall financial soundness at the time. It is worth recalling that the country had recorded four years of budget surplus before 9/11 and at the time was paying down earlier accumulated debt; also it was far less dependent on foreign savings than it is today (the current account deficit was only 4% of GDP compared to 6.5% today).

By most projections, this imbalance will grow in the future. Sharply rising Social Security, Medicare and Medicaid payments plus climbing interest payments on the federal debt will produce bloated deficits and rapidly rising debt levels. And given the nation's low savings rate, these would entail even greater dependence on foreign capital and still greater amounts of dollar holdings in foreign central banks and institutional accounts if, in fact, foreigners continued to be willing to supply funds abundantly during this period.

In such circumstances, a catastrophic terrorist attack would be far more likely to cause large numbers of foreign investors to curb flows of capital to the U.S. or sell off dollar-denominated assets, and to cause Americans to do likewise, than were the nation in better financial shape--with a budget surplus, a far lower level of domestic debt, and less holdings of dollars abroad. Even if there were significant central bank cooperation to mitigate the financial implications of such an event, the task would be made more difficult if this nation's underlying fiscal position had been eroded by a widening of domestic and international imbalances.

Because we know that one of the stated objectives of terrorists is to cause massive disruption in the U.S. economy, such financial vulnerabilities could lead potential perpetrators to feel that they can do a great deal of damage not simply by their initial act, but also because of the secondary and tertiary economic disruptions that would occur because of the subsequent turmoil in a more vulnerable financial environment. In finances as in military affairs, vulnerability frequently invites aggression.

ALEXANDER HAMILTON AND ``THE PRICE OF LIBERTY''

So a key point in determining the implications of such scenarios is the soundness of American finances at the time. In the book that many of you have before you, The Price of Liberty: Paying for America's Wars, I trace the history of American wartime financing from the Revolution, through the War of 1812, the Civil War, the two World Wars, and the Cold War to the present.

Alexander Hamilton recognized from the very beginning that America's financial strength was vital to its security. If the country did not manage its finances well, he reasoned, it would not have the resources needed to defend itself in time of war and it would lose credibility in the eyes of creditors, making borrowing in time of war or other national emergency all the more difficult. He was especially zealous about maintaining the confidence of foreigners, whose funds had been critical to the Continental Army's success in the Revolution. Failing to retain their confidence, he surmised, would mean that they would be reluctant to lend the nation money in a crisis, rendering its economy vulnerable to disruption and perhaps depriving it of the resources to defend itself.

Over two centuries have passed since Hamilton held office, but these principles are just as relevant today. And indeed this nation is more dependent on foreign capital during this war than during any in our history.

The Iraq War is the first significant conflict during which the U.S. has not raised taxes, cut non-security domestic spending and has relied so heavily on foreign funds to finance its budget deficit. During all other major wars, taxes were increased, non-security programs were cut substantially, and borrowing was financed almost entirely by Americans. While the current war represents only a small portion of GDP--around one percent per annum compared to World War II, over 35%; the Korean War, over 10%; and the Vietnam war, a bit less than that--it soon will become the second most expensive war in American history, second only to World War II. It represents such a small portion of GDP because the underlying economy has grown so dramatically during the last 60 years.

But that does not mean that future funding for national security will be easy.

First, as after the Vietnam War, there will be demands for a large ``peace dividend'' after the U.S. leaves or downsizes in Iraq;

Second, many national security needs--of the military, the intelligence community and homeland defense--have been postponed as the Iraq War has sucked up roughly $100 billion annually in budget resources. Many of these will need funding in the future;

Third, the government will have a large bill to meet the medical needs of wounded veterans for decades to come;

Forth, entitlement payments will grow dramatically in the next decade, possibly squeezing down the discretionary portion of the budget, of which defense constitutes the single largest component. If that is to be avoided, taxes will have to rise and/or borrowing will have to increase; and,

Finally, if the U.S. remains a savings short economy and borrowing needs rise due to increased entitlement payments and growth in other areas of the budget, dependence on foreign funds will increase, adding to the county's vulnerability in the face of a disruption of such funds.

All of this suggests that reliance on foreign capital will increase and that as this nation attempts to meet its domestic social agenda and its national security agenda we run the risk of greater vulnerability to a disruption in the flow of foreign funds. Stepping up to the hard realities of putting our entitlement programs on a more sustainable footing, developing a multiyear strategy to fight the War on Terror and meet other security needs, while ensuring the fiscal resilience to address unexpected demands on our nation, will be a major challenge for this and future Congresses and for the next president.

Chairman Spratt. Dr. Levy.

STATEMENT OF MICKEY LEVY

Mr. Levy. Yes, Mr. Chairman. Thank you very much for the opportunity to speak today.

The debate about the high U.S. current trade account deficits have been going on for quite a while, many decades. The long-standing concerns about the current account imbalances and that they would cause severe damage to the U.S. economy have not unfolded. They are overstated. And I think one of the reasons why they are overstated is so many people in the United States think parochially and they do not think about what is going on in the world.

In fact, foreign capital inflows have fueled economic growth. If you look over the last couple decades or through history, rising trade and current account deficits occur when the U.S. economy is strong, when there is stronger job creation, when there is stronger investment.

Now, I would say that these will not unhinge the economy as long as international trade and capital is allowed to flow freely, the U.S. dollar is allowed to fluctuate, and the policy makers, both the monetary and the fiscal policy makers, pursue low inflation, pro-growth economic policies.

Now, the debate about fiscal policy should not be influenced by the current account deficit. If you look at the U.S. or if you look at other countries like Japan and Germany that have budget deficits higher than the U.S. but large current account surpluses, the twin deficit framework does not work. They do not hold water. They do not move in tandem.

What fiscal policy makers have to do is address what they are capable of doing and that is address the long-run unfunded liabilities, particularly the entitlement programs.

Efforts to adjust fiscal policy to reduce the current account deficit without considering how the changes in fiscal policy, that is the tax spending structures underlying the deficit changes or the allocative impacts of those on the economy could lead to undesirable side effects not just in the U.S. but internationally.

Now, if the world, if every country had about the same rate of economic growth, same rate of savings, same rate of investment, imbalances would be minor. But the reason why we have imbalances around the world is countries are growing at different rates, different rates of saving, different rates of investment.

The U.S. for about 15 years straight grew dramatically faster than all of Europe and Japan, from 1990 until 2004. Capital flowed in to the strong United States. At the same time as Europe, particularly Germany and Japan languished, they had excess saving relative to weak investment opportunities. They had excess saving and they had to do something with that saving.

Now, more recently China, India, other countries have accumulated large amounts of assets. They are excess savers. Now the OPEC nations and Russia are also excess savers. The excess savers that invest in the United States do not do so to bail out the United States. They do so because it is in their economic best interest to do so.

And I would like to touch on that a touch more. They voluntarily invest in U.S. assets. And I must note in my position, I am able to sit down with the heads of portfolios of all the leading central banks around the world and a lot of the private investors as Bob does also. And what I find is they are absolutely economically rational in over-weighting ownership of dollar denominate assets. They have no intention of changing. They are attracted by the U.S.'s rule of law, historic stability, high interest rates, et cetera, et cetera.

So once again, it is not just that the U.S. benefits because if we did not have capital inflows, our investment would be constrained to saving and we would not have the same pace of economic growth or job creation or investment or economic future. But foreigners who invest in the U.S. benefit just as much.

The decades long worries that foreign investors are abruptly going to pull out of U.S. assets, they are just absolutely misplaced. The reason why they are misplaced is they do not think about it from the other side of the balance sheet. What do excess saving nations do with their excess saving?

Now, if you take the central banks that have accumulated a tremendous amount of assets and have to invest internationally, they respond to the same variables that we do in the U.S. What drives interest rates are U.S. economic growth, inflation, and the Federal Reserve's inflation fighting credibility, fiscal policy and fiscal credibility, and they make their investment decisions the same as U.S. investors.

And I just ask the following question. Do you think we would be any less vulnerable if our U.S. debt were held by leveraged hedge funds or pension funds for all U.S. managers?

Think of the following. Over the last six, seven years as the U.S. publicly-held debt has increased and a large portion of it has been bought by foreign sovereign institutions, real interest rates have been low. Our cost of financing the deficit has been very, very low. They have actually gotten the short end of the stick because not only have they gotten higher interest rates than they would in other industrialized nations, but they have also incurred a weaker dollar.

I would also note that the financial variables that are crucial to a sound U.S. economy like interest rates, corporate bond yields, the stock market, foreign exchange, these are driven by economic and inflation fundamentals.

Once again, foreign investors, be them private investors or foreign central banks, they are affected by the same day-to-day fluctuations. They respond to the same economic data. And what would lead them to shift would be a significant change in policy that led them to believe there would be a decline in their expected rate of return on dollar denominated assets.

Now, earlier Congressman Edwards and others said, well, what if China sells all their U.S. Government debt. Well, it is not going to happen, but let us speculate, just hypothesize it did. They would be hurt more than anybody else, including the U.S. Maybe Japan would be hurt more because the dollar would fall and the mark to market on their asset books would get clobbered.

Now, the initial response may be a rise in interest rates. Okay? Other investors around the world, including hedge funds in Chicago and Los Angeles and London, would jump on the higher interest rates and buy. And while there would be higher volatility in the short run, rates would not be that much higher.

And some of the discussion about just static analysis, what would happen, do you think, not to use names, but do you think Goldman Sachs or Bank of America portfolio managers would sit on the sidelines if rates went through the ceiling while the economy is growing moderately and the Fed is doing a great job keeping inflation under control? Absolutely not.

So, yes, you would have higher volatility, but I would emphasize the point that the United States benefits by net foreign capital inflows. It always has through history. It will continue to do so. Foreigners that have excessive saving benefit by being able to invest in the United States.

And let me make one other point here. There is also a lot of concerns that the recent decline in the dollar could push up inflation. Not so. The Federal Reserve is the gatekeeper on inflation. As long as it follows low inflation, monetary policy with credibility, the lowered dollar will not push up inflation. It will change relative prices.

And all you have to do is look at the pricing behavior of European, say, auto exporters to the U.S. as the dollar has fallen about 25 percent. They have not increased prices materially and the reason is the Fed has been doing a very good job.

So let me just wrap up here. We have imbalances around the world. The imbalances reflect imbalances in economic growth. It just so happens that the U.S. rate of economic growth has slowed while Germany and Japan have maintained their momentum. So rates of growth among industrialized nations are narrowing and the trade deficits actually started to come down as has the current account deficit.

If you look at it from both sides of the balance sheet, it is not that big a problem, but let me just conclude by saying we live in an internationalized world. It is imbalanced. And the trade deficit which, by the way, the trade and current account deficit soared during the Clinton years. That is good because it was associated with economic strength and job creation and investment. Okay. That is actually good. So it was positive.

But I would just conclude by saying the fiscal policy makers should address the long-run problem. And let me give you the best example of how you should think about how fiscal policy should not be considered in the context of the current account deficit.

The best fiscal policy you can come up with now is a meaningful reform of the long-run entitlements. Okay? If it is properly structured to grandfather in changes in the benefit structure, it will not have any benefit. It will not do anything to the current account or trade deficit in the near term, but it will still be the best thing for the nation in the long run.

And let me just conclude by saying I think it would increase Congress' credibility to come up with a long-run solution.

[The prepared statement of Mickey Levy follows:]

Prepared Statement of Mickey D. Levy, Chief Economist, Bank of America

The debate about the high U.S. trade and current account imbalances--and worries about their dire consequences--has been going on for decades. Long-standing concerns that these imbalances will severely damage U.S. economic and financial performance have not unfolded and are overstated. The foreign capital inflows have fueled U.S. economic growth, and contributed to job creation and business investment, homeownership and higher standards of living. The large U.S. current account deficit and foreign accumulation of U.S. debt will not unhinge the U.S. economy, as long as international trade and capital are allowed to flow freely, the U.S. dollar is allowed to fluctuate and the U.S. policymakers continue to pursue low inflation pro-growth economic policies.

The debate about fiscal policy should not be influenced by the debate about the U.S. current account deficit. Sustained healthy economic performance requires coming to grips with the long-run Federal budget imbalance, which requires reforming the entitlement programs by making their benefit structures economically rational and fair. Delaying necessary reform only increases the eventual cost of adjustment. Fiscal reform must focus on improving U.S. government finances and making them conducive to maximum sustainable economic growth. Efforts to adjust fiscal policy to reduce the current account deficit without regard to how changes in the structure of the underlying tax and spending programs would affect economic performance are unwise and could generate unintended and undesirable economic and financial side effects.

History shows that budget imbalances and current account imbalances do not move in tandem in the U.S. or overseas. The so-called ``twin deficit'' framework is not a rational basis for conducting fiscal policy or for thinking about global imbalances. Currently, the

U.S. budget deficit is 1.3 percent of GDP while its current account deficit is 5.6 percent; both Japan and Germany have large current account surpluses (3.9 percent and 5.1 percent, respectively) despite running budget deficits (Japan's is 5.8 percent of GDP).

The U.S. trade and current account imbalances and the large current account surpluses overseas and the large net accumulations of foreign holdings of U.S. debt have been a natural consequence of global differences in rates of economic growth, investment and saving. From the early 1990s through 2005, the U.S. economy expanded significantly more rapidly than other industrialized nations, raising demand for capital and imports. The U.S. has insufficient national saving relative to investment. Until recently, foreign industrialized nations have grown more slowly, both in terms of GDP and investment, dampening their demand for imports and capital. China, other Asian nations and more recently, OPEC nations as well as Russia, benefiting from higher oil prices, have excess saving relative to investment. The capital inflows into the U.S. from excess saving nations--largely through their accumulation of U.S. debt--provide the U.S. capital necessary to continue healthy economic expansion.

Foreign assets owned by the U.S. have risen, but U.S. assets owned by foreigners have risen more rapidly, so the U.S. net foreign debt is $2.5 trillion. U.S. ownership of foreign assets is heavily in equity and direct investment, which provides relatively high returns, while foreign investment in U.S. assets is largely in U.S. debt securities, which provide relatively low yields. Consequently, the U.S. net international income position is near balance.

Foreign investors, including Asian central banks, which have accumulated over $2 trillion of foreign currency reserves, voluntarily invest their surpluses heavily in U.S. assets. Their investment decisions are economically rational: they are attracted by the U.S.'s rule of law and historic stability; healthy economic performance and relatively high real interest rates; low inflation and credible central bank; and liquid markets. Excess saving nations benefit just as much from their investments in U.S. dollar denominated assets as the U.S. benefits from the net foreign capital inflows. U.S. and global economic growth and standards of living are improved by capital that flows internationally from excess savers to high expected rate of return activities.

Decades-long worries that foreign investors will abruptly sell their U.S. assets are misplaced. Such concerns tend to ignore the objectives and needs of excess savings nations, and what drives their investment decisions and behavior. Foreign investors, including central banks, seek high risk-adjusted rates of return. Foreign nations that have accumulated U.S debt will not shift out of dollars quickly in a way that would jar financial markets unless there is a dramatic shift in economic fundamentals, or shifts in U.S. policies perceived to be damaging to U.S. economic or financial performance. A jarring shift out of U.S. dollars likely would damage foreign owners of U.S. assets as much as it would damage the U.S.

Financial variables that are crucial to sound U.S. economic performance, including interest rates, corporate bond yields, the stock market and foreign exchange rates, are driven primarily by fundamental U.S. and global trends in economy and profits, inflation, and central bank and fiscal policy. Investment decisions by foreign holders of U.S. assets may temporarily affect financial markets, just as decisions by U.S. investors do, but they do not influence Fed behavior or inflation or how the U.S. economy performs.

Foreign investors are subject to many of the same economic, inflation and financial market fluctuations as U.S. investors. Their investment behavior is at least as stable as that of U.S. investors, and their ownership of U.S. assets does not raise the risk or vulnerability of U.S. economic and financial market performance any more than if those assets instead were owned by U.S. pension funds, money managers or hedge funds.

Concerns that the recent decline in the U.S. dollar will push up U.S. inflation and damage financial markets and the economy are misplaced as long as the Federal Reserve pursues a credible low inflation monetary policy. Under a low inflation monetary policy regime, even if the U.S. dollar continues to fall, relative prices would change, and real interest rates may rise modestly, but inflation would not be pushed up. It is inappropriate and misleading to assert that current U.S. dollar weakness will have a similar impact as the 1970s when the Fed was pursuing an inflationary monetary policy.

The U.S. trade and current account deficits have begun to recede from their peaks, and I expect they will decline materially, particularly as shares of GDP. The U.S. demand for capital and imports has slowed in response to the recent soft-patch in U.S. domestic demand, while its exports are growing rapidly, driven by strong global growth and the weak U.S. dollar. The economic momentum in Japan and Europe (particularly Germany), which reflects in part structural improvements, is narrowing economic growth differentials among industrialized nations and increasing expected rates of return on Euro- and yen-denominated assets. Accordingly, the growth of foreign demand for U.S. assets has slowed, while the U.S.'s financing gap between national saving and investment has begun to recede.

The government's net costs of servicing debt owned by foreigners have been low, and concerns are misplaced. My largest concerns are not the magnitude of the global imbalances or the foreign accumulation of U.S. government debt, rather the potential for wrongheaded policies that would interrupt international trade or capital flows, or domestic policies that would damage U.S. growth prospects and reduce expected rates of return on U.S. dollar-denominated assets.

NOTES ON THE WIDE U.S. AND GLOBAL IMBALANCES

If the U.S. and other major nations had similar rates of economic growth, investment and saving, global imbalances would be minor. But they do not. The rising U.S. current account imbalances are largely the story of the relatively stronger U.S. growth from 1990-2005 and global demand for U.S. assets. This has happened before; the U.S. has experienced long periods of relative economic strength simultaneous with large net capital inflows and wide current account imbalances (the best example is the U.S. industrial revolution). In recent decades, periods of rising current account deficits have been associated with strong growth in GDP, investment and jobs, and rising homeownership. This should not come as a surprise: foreign capital flows into the U.S. when it is strong, investment and employment are rising and expected rates of return are high. The only periods recently when the U.S. trade and current account deficits declined occurred when GDP slumped and employment fell.

From the early 1990s, when the U.S. current account was in balance, through 2005, the U.S. economy grew persistently faster both in terms of nominal and real GDP growth and investment than all other industrialized nations (see Chart 1). The growth differentials were sizable and cumulative. Consequently, U.S. imports of goods and services rose significantly faster than foreign demand for U.S. exports, and demand for U.S. assets rose, so the U.S. current account deficit rose commensurately (see Charts 2 and 3). Until recently, the economies of Germany and Japan languished, and so did their imports. Reflecting this, they ran high trade and current account surpluses. That is, they had excess saving relative to investment, and were unattractive to foreign investment flows.

Noteworthy, Japan has run high current account surpluses, despite huge government budget deficits. Its budget deficit is nearly four times higher than the U.S.'s and its government debt is approximately 170 percent of GDP, more than four times higher than the U.S.'s 37 percent. This is not surprising: for over a decade, Japan's economy and investment languished, and it attracted little foreign capital inflows; its saving far exceed investment and it was a sizeable exporter of capital. Devotees of the so-called ``twin deficit'' paradigm should heed the message provided by this international comparison.

The composition of U.S. imports illustrates the strength of U.S. businesses as well as consumer spending growth: presently, 40 percent of U.S. goods imports (and 33 percent of total U.S. imports of goods and services) are industrial supplies and capital goods used for business production and expansion (see Chart 4). Those shares rose during the 1990s. It is inappropriate and misleading to place all of the blame on the U.S. consumer for rising imports and trade and current account deficits.

The rising current account deficit in the 1990s illustrates both the widening gap between U.S. investment and saving, and the strong foreign demand for U.S. dollar-denominated assets. They both occurred simultaneously: as global demand for U.S. assets rose--modestly through the mid-1990s and then jumping during the 1997 Asian crisis--capital availability and rising asset prices fueled U.S. domestic demand. Consumption and business investment rose rapidly--and U.S. saving fell further behind surging investment. The U.S. current account deficit, which rose to approximately 1.5 percent of GDP by mid-1997, jumped dramatically to 4.5 percent by year-end 2000 (see Chart 3). Yet the U.S. dollar appreciated even as the current account deficit rose because foreign capital readily flowed into the U.S. seeking high risk-adjusted rates of return.

The rate of net national saving was flat during the 1990s, as high business saving and a shift from the government's cash flow deficit to surplus was offset by the declining rate of personal saving. Despite the lower rate of personal saving, the real net worth of households was rising with the appreciation of real estate and the stock market. Households felt richer and more confident and so they spent a larger portion of their take-home pay. The rate of personal saving, which only measures the portion of disposable personal income that is spent, does not capture appreciation of real estate or stocks or bonds, and as such is a very limited--and misleading--measure of saving.

New Dimensions in Global Imbalances. The trends in global trade and current account imbalances so far this decade reflect new dimensions in global economic performance and international trade and capital flows. First, the U.S. recession in 2001 and associated slump in investment and domestic demand that carried into 2002 reduced the demand for imports, which temporarily lowered trade and current account deficits. Import growth subsequently resumed, contributing to a surge in the trade deficit through 2005. While the trade imbalance has continued to rise in nominal terms, in real terms it has begun to drift down, and as a percent of GDP, it peaked at 5.7 percent in 2005Q1 and has receded to 5.3 percent in 2007Q1. This reflects in part slower import growth since early 2006 that has been associated with weaker consumer and business spending growth in response to the Fed's interest rate hikes and the adjustment in housing.

Second, global economic growth has strengthened and international trade has been growing rapidly. U.S. exports have risen over 8 percent annualized, and the U.S. remains the world's largest exporter of goods and services. The U.S. maintains a healthy ``competitive edge'' in a wide array of industries, and is well positioned, both in terms of what it exports and to where it exports, for export growth to remain strong (see Charts 5 and 6). Importantly, the economic momentum in Japan and Germany reflects structural improvements that will sustain healthier growth. These trends abroad are contributing to narrower economic growth differentials among industrialized nations, and increasing the attractiveness of investing in Europe and Japan. In turn, they will serve to narrow global imbalances.

Third, Asian nations have been large net savers and have accumulated foreign currency reserves at an historic pace (see Tables 1 and 2). Combined they have become the world's largest exporters of capital, which is a twist on history insofar as some of them, most notably China, are relatively poor nations in terms of GDP per capita but also growing rapidly. The largest portions of their surpluses have been invested in U.S. debt securities.

Fourth, China has emerged as a dominant global factor in both international trade and finance. As a major manufacturing hub that imports supplies and materials, and produces and exports finished products, it runs trade deficits with most other Asian nations, and huge trade surpluses with the U.S. (presently, approximately $220 billion) and Europe. Benefiting from its surging trade surpluses, high foreign direct investment and extraordinarily high rate of saving, China has accumulated approximately $1.2 trillion in currency reserves.

Fifth, benefiting from the dramatic rise in oil prices since 2004, OPEC nations and Russia have become large excess savers. In the last several years, the cumulative rise in surpluses by these nations has been dramatic (see Table 3). The fact that global oil transactions are conducted in U.S. dollars is a key factor explaining the large share of these surpluses that have been accumulated in U.S. dollar-denominated assets.

Stronger growth in Europe and Japan, and more moderate growth in U.S. domestic demand, and associated narrowing in real interest rates (as the European Central Bank and Bank of Japan have continued hiking rates, narrowing the gap with the Federal funds rate) and expected rates of return on investment will generate a narrowing of the U.S. trade and current account deficits.

NOTES ON THE FOREIGN ACCUMULATION OF U.S. ASSETS

U.S. economic and financial performance has benefited from the nation's ability to run high current account deficits. The economy is no more vulnerable as a result of the foreign accumulation of U.S. debt than if that debt were owned by U.S. pensions, money managers or hedge funds. Reliance on net foreign capital inflows allows the U.S. to leverage its resources and economic strengths. If U.S. investment were constrained to national saving, there would be insufficient investment, and economic growth, job creation and standards of living would be lower. Similar to U.S. corporations that borrow to leverage their resources and expansion, the key to the sustainability of the current account deficits is what the net capital inflows are used for and what is the rate of return on the capital relative to the costs of financing it. Historically, the benefits have far exceeded the net costs.

The majority of U.S. assets owned by foreign investors are debt securities, primarily U.S. government and agency debt (see Charts 7 and 8). This is particularly true of U.S assets held by foreign central banks. While foreign holdings have increased substantially as a share of outstanding U.S. government debt, foreign purchases of U.S. equity and direct investment are minor relative to the dramatic rise in household and corporate net worth (see Chart 9). According to the Federal Reserve's Flow of Funds Accounts of the United States and the Bureau of Economic Analysis, foreign ownership of U.S. equity assets and direct investments total $4 trillion, compared to U.S. household net worth of $56.2 trillion.

Rather than be concerned about the increased foreign ownership of U.S. government debt, Congress should be thrilled with the highly favorable outcome: the government's real costs of servicing the debt have been very low, and the capital inflows have facilitated stronger

U.S. economic growth. So far this decade, when foreigners have accumulated U.S. government debt rapidly, yields on U.S. government bond have been below their longer-run average in nominal and real terms. The real government bond yields have been far below real GDP growth, while profits and real household net worth have grown significantly faster than output and the unemployment rate has receded. Clearly, the net returns on the foreign purchases of U.S. government debt have been highly favorable.

Foreign purchasers of U.S. government bonds generally have not fared as well. Foreign holders of U.S. government debt receive a yield on their bonds with virtually no credit risk but they do have interest rate and currency risk. In reality, they do not own claims on future U.S. economic performance. Although yields on U.S. government bonds have been significantly higher than yields in other industrialized nations, net real returns to foreign purchasers of U.S. government debt have been reduced by the decline in the U.S. dollar. In contrast, foreign purchasers of U.S. private assets--bonds, equity or direct investments--own claims on returns from U.S. production, and have enjoyed higher rates of return. A reallocation of foreign owned U.S. assets away from government debt and into equities and direct investments would generate higher returns but would involve higher risks.

U.S. purchases of foreign assets, in contrast, have provided substantially higher yields, based on the significantly heavier weighting in equity and direct investments, sharply appreciating global asset values, and the decline in the U.S. dollar.

Concerns about heightened economic vulnerability arising from foreign accumulation of U.S. government debt hinge in part on an assumption that foreign investors have significantly different objectives than U.S. investors. In reality, their objectives are similar: they seek high expected rates of return on a risk-adjusted basis. They base their investment decisions on the same fundamentals as U.S. investors: indicators of economic performance, inflation, expectations about Federal Reserve behavior, and the soundness of fiscal policy. They have little sway over how those variables behave. In practice, particularly in the case of foreign central banks, foreign holders of U.S. debt tend to be less leveraged and more ``buy and hold'' type of investors than their U.S. counterparts.

I am hard-pressed to see any heightened vulnerability arising from foreign ownership of U.S. debt. Expectations of a sharp decline in the U.S. dollar would temper the foreign demand for U.S. assets. However, U.S. bond yields exceed those in other major industrialized nations (except the UK), and U.S. markets are attractive for other reasons. Over time, if overseas industrialized nations maintain their healthy economic expansions, and as financial markets in emerging nations mature and become more liquid, foreign investors may gradually reduce their shares of assets allocated into U.S. dollars. That is not a cause for alarm. As long as U.S. economic performance remains sound, the Fed maintains its inflation-fighting credibility and other polices are conducive to healthy growth, foreign demand for U.S. government debt will remain healthy.

NOTES ON U.S. FISCAL POLICY

The primary problems with Federal government finances are not short-term cash flow issues. The Federal budget deficit is estimated to be approximately 1.3 percent of GDP in Fiscal Year 2007. Tax receipts have risen above 18.5 percent of GDP, modestly above their long-run average, and spending growth has slowed. The Congressional Budget Office projects that under current law, the budget returns to surpluses. Presently, despite the enormous jump in defense and national security spending, the U.S. budget deficit is among the lowest of all industrialized nations, and U.S. government debt as a percent of GDP is far below other nations (see Charts 10 and 11). With the U.S. deficit declining as a share of GDP and well below government interest rates, the debt/GDP ratio is projected to decline in the near term.

However, the longer term outlook for government finances is distinctly negative. Top fiscal policy priorities are entitlement reform, which is necessary to close the long-run gap posed by the unfunded liabilities of the government's retirement and health care programs, and tax reform. Based on current law benefit and tax structures and reasonable economic and demographic assumptions, the long-run projected unfunded liabilities of the social security and Medicare systems are so enormous--the present value of the gap between projected long-run benefits and taxes is estimated to be approximately 6 percent of GDP--that reform requires modifying benefit structures to make them economically rational. Tax hikes to close the gaps would be so large they would damage economic performance.

Fiscal policy decisions about the entitlement programs must be made based on sound economics, and not arithmetic modifications to long-run projections that ignore the allocative impacts of the tax and spending changes. Changes to social security must be phased in so that older workers have time to adjust their retirement plans, and they must be fair. American citizens expect eventual reform because they sense that the current benefit structure cannot be sustained. Congress's credibility will rise when it successfully tackles the issue. Reforms of Medicare and Medicaid are even more imperative and will be more difficult to achieve. Successful reform necessarily will involve the introduction of incentives that influence the supply of and demand for medical services.

Tax policy must deal with the unintended, increasing burden imposed by the Alternative Minimum Tax, the extraordinarily burdensome complexity of the personal and corporate tax systems and the phasing out of key provisions of the 2001, 2002 and 2003 tax legislations.

The details of both entitlement and tax reform are far beyond the scope of these hearings. But the starting point for success requires that fiscal reform must be aimed at improving the government's domestic finances consistent with sustained healthy economic performance, and not for the explicit purpose of trying to reduce the current account deficit. The U.S. current account is affected by numerous factors beyond the scope of fiscal policy--including differing rates of economic growth, investment and saving around the world, demographics, and inflation--which explains why there is no reliable linkage between budget imbalances and current account imbalances. I encourage Congress to pursue sound fiscal policies that will strengthen long-term U.S. economic performance, and to reassess the premises of many concerns about the U.S. current account deficit and the holders of government debt.

Chairman Spratt. Thank you, Dr. Levy.

Dr. Rogoff.

STATEMENT OF KENNETH ROGOFF

Mr. Rogoff. Thank you, Mr. Chairman, and thank you to the Committee for inviting me to testify here.

I want to just start by framing the issue a little bit differently. There has been a lot of discussion about how much U.S. debt is held by foreigners. But, of course, as many of you have pointed out, we have a giant, very liquid, very healthy capital market.

And I think the real number to think about is not the 2.2 trillion but the $14 trillion that foreigners hold overall in U.S. assets, in equity, direct foreign assets, and other liabilities. That is the real number that matters.

Of course, on the other side of the balance sheet, we hold about 11 trillion in assets, abroad less. We are net debtors. However, because we are much better financial managers, we are much more innovative, it is a very strong sector of our economy, we actually earn about as much money on our 11 trillion on average as they earn on their 14 trillion.

And that is part of the reason the problem has not spun out of control faster, that we have gotten a good rate of return. In fact, in recent years, and then this is more of a coincidence, due to circumstances like the dollar going down, foreign stock markets rising particularly faster, U.S. net debt has actually grown quite a bit more slowly than you would think from looking at the trade balance. The trade balance is about 700, 750 billion, but the net debt has been going up at only half that rate. That probably will not continue.

And certainly I think the point to underscore is that, you know, this is part of a much larger picture which is fundamentally a very healthy one for the United States, that financial globalization is something we benefit from a lot.

Now, I do think there is an awfully strong case to improve our tax system and both Dr. Hormats and Dr. Levy have mentioned the entitlement system. And I could not agree more.

I would add to that the tax system has gotten more complex and probably less equitable in recent years. And I wish we would see a big tax simplification, something like the flat tax, a consumption tax, which I think would do a lot to help savings. And I think a combination of those things is really needed and would address a lot of the underlying concerns.

Now, in my testimony, I took to heart the title you gave us which is, is our economy vulnerable, so I went through some doomsday scenarios, largely sarcastically, I suppose, or dismissing them because I do not think the really worst ones are that big a concern.

I mentioned the China one which has already been discussed here and everyone has made the point they shoot themselves in the foot. It is not really an issue.

There is a rise of what are called sovereign wealth funds where, you know, China has $1.2 trillion in assets. They are getting a little tired of holding Treasury bills which do not pay much. And they are starting, all of the big foreign official holders, are moving more into higher return assets. And, of course, the most spectacular recent investment was China buying part of the Blackstone IPO.

I think there is a potential here to have some financial debacles simply because although the previous speaker assures us, you know, that they behave very rationally, I think maybe the ones that are smart enough to be talking to him may be behaving rationally, but there is a lot of nontransparency, bad governance.

And I have no doubt that given the explosion of financial markets, we will see some, you know, financial tales that will surpass anything we have seen before. But I do not think it will bring down international financial markets. It will more likely bring down the country and possibly the government that is the instigator.

And I might add in the meantime our very successful financial sector will probably make even more money off of these guys while they are investing in these sovereign wealth funds. Governments have a terrific record of losing money when they go against the private sector. And I am convinced that will continue.

And then finally, just, you know, forgive me, but I asked the question because I took your title very literally, should we think of any really crazy things we should worry about and I remember Goldfinger where he, of course, tries to corner the gold market. And we have the Hunt brothers in the 1980s.

And I think actually the deeper financial markets that we have probably make us more robust to these things than we used to. It is not easy to corner the commodity markets anymore.

However, although some of these doomsday scenarios, I think, are unlikely and not such a great concern, although more transparency, better regulation, I mean, the usual things is a good idea. And I think this is a growing issue when you are dealing with some of the sovereign wealth entities.

I do think our foreign borrowing is a vulnerability if we are forced to tighten our belts quickly. And I will just start with Dr. Hormats' third scenario because that is the kind of one that worries me where we have something really catastrophic happen here. And then all of a sudden, the fact that we are borrowing $800 billion and suddenly we do not seem that attractive, that is a real problem.

Now, when foreigners just try to simply get their money out, it will drive equity prices down. It will affect bond prices. But, frankly, our economy is pretty resilient to that. We are very widely spread. I mean, there will be losses, but we are resilient to that.

We are not so resilient to all of a sudden not being able to borrow this fresh new money, this $800 billion that we get every year. I would regard this borrowing as a vulnerability, and I strain. I cannot think of a really good analogy.

But I mean, since we are talking about soft landing and hard landing, you know, if you are parachuting down from a very high level and, you know, you are aimed at a nice soft patch of land, fine, you will land softly. But if a gust of wind comes along, you can be in trouble.

It is a ten-year landing here, fifteen-year landing from this soft landing scenario that Dr. Orszag talked about at the beginning and we are vulnerable.

And I think that as Dr. Orszag emphasized, starting to think about policies which would increase our national saving sooner rather than later and working in coordination with international agencies like the International Monetary Fund to try to promote policies in other countries that would help improve the scenario is something that is important to think about.

Now, and, again, to echo Dr. Hormats, you know, I mean, when something happens, it is too late and this is a vulnerability. And the fact that we live in this great world does not mean it will not happen.

Argentina is doing great now. I promise you they will have another default, but they are not worried about it right now.

Thank you.

[The prepared statement of Kenneth Rogoff follows:]

Prepared Statement of Kenneth Rogoff, Thomas D. Cabot Professor of Public Policy and Professor of Economics, Harvard University,\1\ and Visiting Fellow, Brookings Institution

With the United States running a current account deficit at 6 percent of national income, foreign nationals have been accumulating U.S. assets at a spectacular rate. Taking into account recent stock market gains, foreigners now hold well over $14 trillion of U.S. assets, more than a 100% of U.S. gross domestic product. Foreigners, mainly foreign central banks and government investment funds, hold more than $2.5 trillion in U.S. Treasury securities alone. Incredibly, the United States absorbs roughly 70 percent of all net saving produced by the world's current account surplus countries, including China, Japan, Germany and the oil exporting countries. Borrowing on this scale by any large country, much less the world's pre-eminent economy is unprecedented in modern world history.

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Many observers are asking whether U.S. indebtedness to foreigners might pose any subtle hidden threats to the U.S. economy or, even to U.S. national security. With China alone holding $1.2 trillion in reserve assets and foreigners collectively holding more than twice that in U.S. Treasury securities, is there any risk that the United States might be subject to economic blackmail? What about the rapid proliferation of so-called sovereign wealth management funds, most famously China's $3 billion investment in the private equity group Blackstone? Sovereign wealth funds now control nearly $2 trillion in assets, more than stand-alone hedge funds. Is there a risk that foreign governments will use their financial relationships to compromise U.S. security? Is there any danger of exotic ``Goldfinger''-like scenarios where foreign governments might use their massive leverage to precipitate a wholesale financial collapse in the United States?

The short answer is these more extreme risks are unlikely to materialize, but the United States continued dependence on foreign borrowing is a significant vulnerability in the event of shock, such as a collapse in US housing prices, or an extreme national security breach, that might slow the inflow of new funds into the United States. In this testimony, I will first discuss why the more extreme scenarios are relatively implausible, then go on to discuss where the real vulnerabilities lie.

WHEN A DEBTOR IS BIG ENOUGH, IT'S THE BANKS' PROBLEM: THE UNITED STATES AND CHINA

As foreign wealth continues to explode in a number of transparency-challenged countries, we are likely to see some spectacular financial debacles. Governments have a long tradition of losing massive amounts of money in financial markets. This tradition is not likely to end anytime soon, which is good new for global private investors, some of whom continue to reap huge profits at governments' expense. However, any attempt by a well-heeled foreign government to use its financial leverage to upset the US economy will almost certainly backfire. The US economy will not wilt, and the foreign instigator will either lose a bundle of money immediately, or get caught and be forced to forfeit the gains. The key to U.S. resilience is our country's credibility in debt markets; the U.S. governments' credibility in international debt markets is so great that it is virtually impossible for any such crisis to precipitate a default. Absent, this risk, it is very unlikely for a foreign-instigated financial crisis to spin beyond the control of the Federal Reserve and other regulators.

For example, were China to suddenly reallocate a large share of its predominantly dollar portfolio into Euros, the ensuing dollar decline would inflict a massive capital loss on the Central Bank of China. A 20 percent drop in the dollar against the Yuan would cost the Chinese Central Bank well over a hundred billion dollars. Fundamentally, when a debtor owes the bank a large enough amount, the debt becomes the bank's problem. China, whose reserves amount to 50 percent of its GDP, faces risks far to great to ever seriously consider this option. Of course, over time, one can expect China to significantly diversify out of dollar assets, but the time frame will be one that markets can easily accommodate.

RISK POSED BY SOVEREIGN WEALTH FUNDS

One should entirely dismiss the risks posed by the recent trend towards riskier investment strategies by sovereign investors, notably the so-called ``sovereign wealth funds.'' With deep pockets and the potential to draw on vast credit lines, sovereign wealth funds can potentially take larger and more leveraged risk positions than even the most aggressive private hedge funds. Given many of these funds weak governance and lack of transparency, global regulators are rightly concerned that one of these funds may precipitate a significant financial crisis. An ill-considered massive bet by a sovereign wealth fund, or perhaps the actions of a rogue trader within a sovereign wealth fund, could cause a massive price fluctuation in a financially-sensitive part of the global economy. Here again, however, the big loser would be the government that owned the sovereign wealth fund, and would ultimately have to foot the bill for a catastrophic loss. True, there could be substantial collateral damage as in international financial crisis, but again, given the solid fundamentals of the U.S. financial system, prompt response by regulators and the Federal Reserve should be able to contain the problem.

GOLDFINGER RISK

Yes, one can imagine more far-fetched and devious schemes to upend the global financial system. In the James Bond movie ``Goldfinger,'' the villain aims to bid up the value of his own gold holdings by irradiating the gold in Fort Knox, thereby cornering the market. In the real world, the Hunt brothers were accused of cornering the futures market in silver in the early 1980s. Given today's spectacular explosion in global financial assets, it is easy to imagine financial fraud and crime surpassing all previous benchmarks. Yet, in the scheme of things, deeper financial markets probably make things safer not riskier. It is far harder to corner a commodities market today than it was twenty five years ago. Rather than resisting financial globalization, the right approach is to continue to promote better corporate governance at home, and greater transparency on the part of financial entities, including sovereign wealth funds. In pursuing these goals, the United States should continue to work closely with multilateral agencies such as the International Monetary Fund or the Bank for International Settlements.

the united states is a big winner from financial globalization

In contemplating any policy actions, it is important to recognize that the United States is a massive winner from financial globalization. Although it is true that the United States is a large net debtor (with roughly $3 trillion in net debt), the cost to the United States has been relatively modest because, on average, Americans have earned a significantly higher return--about 1.5 percent higher--on their holdings of $10 trillion in foreign assets than foreigners have earned on their holdings of $13 trillion in U.S. assets. This differential has met that U.S. net debt accumulation has been significantly less rapidly than our $800 billion trade balance deficit might suggest, typically half as much. U.S. financial firms are the envy of the world, they arguably constitute the United States' most successful export industry. Any attempt to block foreign entities from engaging in the United States could lead to retribution that backfires and hurts U.S. interests.

ALTHOUGH A SIMPLER, FAIRER TAX SYSTEM IS NEEDED

Of course, this does not mean that US should give privileged tax treatment to hedge funds and private equity any more than it should give better treatment to other export or import-competing industries. But a patchwork fix could prove highly counterproductive. Faced with the rapidly changing winds of globalization, the United States needs--now more than ever--a much cleaner and simpler tax system. A flat tax with a large exemption at low incomes would likely prove far fairer and more efficient in practice than the current labyrinth of taxes.

THE MASSIVE UNITED STATES CURRENT ACCOUNT DEFICIT STILL POSES REAL VULNERABILITIES THAT SHOULD BE ADDRESSED

I have argued that growing international indebtedness does not seriously expose the United States to any of the more extreme doomsday scenarios. This is not to say that we should greet the US current account deficit with equanimity. It is a significant vulnerability that could significantly amplify the effects of growth crisis precipitated either by economic factors (say, a historic collapse in housing prices), or geopolitical factors (a terrorist attack of unprecedented dimensions on U.S. soil.) If the United States were forced to cut back the flow of its new borrowing by say, a half--to $400 billion per year, the trade-weighted dollar could easily fall 20-25 percent, and interest rates could rise by close to one percent across the board.\2\ On impact, it is quite possible that financial markets would overshoot.

\2\ For calibrations on how a closing up of the US current account might affect the trade weighted US exchange rate, see Obstfeld and Rogoff (2005, Brookings Papers on Economic Activity, and 2007, National Bureau of Economic Research.)

Thus, in a crisis, the United States' position as a big net borrower could prove an Achilles' heel that considerably amplifies the magnitude and duration of a crisis. Although this risk has not materialized even after years of very high US deficits, it remains a concern. Policies to raise US public and private savings would be a helpful step towards ameliorating these risks. So, too, would be more flexible exchange rates in Asia and a greater reliance on domestic demand for growth in Europe. Coordinated policies have been advanced by the International Monetary Fund for many years now, though with relatively little traction, especially in China but also in the United States. While it is true that US current account is showing signs of stabilizing this year, the ``soft landing'' scenario will take at least a decade to fully materialize, leaving the U.S. vulnerable to a ``hard landing'' scenario in the interim.

In sum, the United States, with its superior legal system and transparency, is a big winner in financial globalization. Integration of global financial markets has helped lead to lower interest rates and a more stable US economy. Foreign investment in the United States has to be viewed in the context of the larger picture, which takes into account the enormous success of U.S. investors abroad. Doomsday scenarios, while theoretically possible, seem remote. However, although these extreme risks are remote, the United States massive dependence on foreign borrowing remains an important vulnerability. Any global macroeconomic or geopolitical shock that leads to a sharp contraction of the US current account deficit is likely to produce a massive dollar drop, and possibly a sharp interest rate rise, that would considerably amplify the adverse effects of the shock on the U.S. economy. It would be far better to take steps to gradually close up the United States massive borrowing gap than to wait for such a crisis.

Chairman Spratt. Argentina was one of the wealthiest countries in the world in 1925 and in two generations, their whole economic fortune was reversed. And that is why we are sitting here asking if the fundamental decisions we are making now that might have such a profound effect on our future.

Dr. Setser.

STATEMENT OF BRAD SETSER

Mr. Setser. I want to thank the members of the Committee and the Chairman of the Committee for inviting me to testify. It is a particular honor to participate on such a distinguished panel.

I think it is fair to say if Dr. Rogoff thinks foreign holdings of U.S. debt are something of a vulnerability, I tend to think they are somewhat larger of a vulnerability than he does, so I think that you will find that my testimony is a little bit less optimistic than Rogoff's, though I was perhaps not quite as pessimistic as Dr. Hormats and certainly far more worried than Dr. Levy about the consequences of not only large but rapidly growing foreign holdings of U.S. debt.

I am going to focus on overall foreign holdings of U.S. debt stripping out equities but including holdings of assets of U.S. liabilities other than treasuries. So you have foreign holdings of corporate bonds, foreign holdings of housing debt.

In total at the end of 2006, foreigners held about $10 trillion in U.S. debt. About five trillion of that is long term. And of that long term at the end of 2006, the best I can tell, about 800 billion was held by the various entities of the Chinese government and around 700 billion by the Japanese government.

By the end of 2007, given ongoing global financial integration and given the need to take on additional debt to finance the current account deficit, our gross debt will rise to about twelve trillion. Six trillion of that will be long term and Chinese holdings will likely rise to between 1.1 and $1.2 trillion.

I mention China specifically because China's very large and rapidly growing current account surplus which likely will reach $350 billion this year combined with ongoing capital inflows into China means that Chinese reserves are on track to increase by between 450 and $500 billion this year.

To put that into perspective, it means that China's government has the capacity to buy a Unico or similarly sized company every month and still have enough money left over to buy the entire net issuance of U.S. treasuries.

Because of this, China necessarily is financing a relatively large share of investment here in the United States and China is the largest single buyer of U.S. treasuries, largest single buyer of U.S. agencies, the largest potential source of demand for many other securities. And as a result, people will watch Chinese government moves very closely, and it is the largest actor in the world's foreign exchange markets.

Now, I want to focus specifically on three points in more detail. The first is a point that Dr. Rogoff alluded to which is that despite the ongoing deficit the United States has run over the last several years, the United States' net indebtedness or actually its net international investment position, that is the broadest measure of the U.S.'s external position, one that includes equity investments, has not deteriorated by much.

Now, that is a little bit deceptive because the net debt position just looking at changes in debt has deteriorated quite significantly. It has deteriorated by about $4 trillion since 2000 which is about equal to the sum of the ongoing current account deficits.

But that has been offset by a very strong rise in the dollar value of U.S. equity investments abroad. I do not think actually that has so much to do with U.S. financial skill. It probably has more to do with the fact that the U.S. had a lot of investment in Europe and the euro dollar moved by about 40 percent over that period, generating a large gain in the dollar value of U.S. assets.

Even in local currency terms, though, foreign equities have outperformed the U.S. equity market and I think many investors, including some of the central banks around this world, have recognized that they would have been better off instead of lending the U.S. money, they had insisted that to finance the deficit the U.S. hand over some other equity assets.

Now, I do think that over time, the relatively generous terms on which the world has been willing to lend to the U.S. will likely evolve and that over time, the U.S. income balance will change and the U.S. will start making significant interest payments to the rest of the world.

The second point I want to emphasize is the large role that foreign central banks and sovereign wealth funds have played in financing our current account deficit. Back in 2000, the U.S. was attracting about 50 to 100 billion in net inflows from official actors. Between 2002 and 2004, that rose to about 400 billion. It fell a little bit in 2005, then rose to around 450 billion in 2006. And in the first quarter of this year, according to the data from the BA, it was around $600 billion or about 70 to 75 percent of the current account deficit.

Now, that probably in all honesty is an understatement because some of the difficulties in tracking purchases made through London. But in broad terms, as the U.S. slowed relative to the rest of the world, foreign central banks increased the amount of their financing, offsetting a fall in private flows. Had that not happened, the recession that we have experienced would likely have been worse.

That is my third point, which is that to date, official flows have generally been a source of stability, not a source of instability because in general, the official central banks have offset falls in private flows.

Here, I would frame the risk a little bit differently than some have. Now that the market has become accustomed to the expectation that the official sector will increase its financing when private demand for U.S. asset falls, all the official sector has to do to precipitate difficulties is not live up to that expectation.

So if the official sector the next time private demand for U.S. assets falls did not increase its purchases from an already high level, in my view, there would be an impact on U.S. financial markets.

But I think looking ahead, we should be wary of several different kinds of risk. I think the first risk well spelled out by Dr. Hormats is the risk that foreign investors overall and particularly foreign central banks may shift from financing, you know, providing too much financing to the U.S. to providing too much little.

Now, earlier it was mentioned that foreign central banks would be shooting themselves in the foot if they sold. I would actually argue it is the contrary, that they are shooting themselves in the foot whenever they buy.

China right now is investing 15 percent of its GDP in building up its reserves buying U.S. dollars which are likely to depreciate over time. If the dollar depreciates by 33 percent, they are going to lose five percent on GDP on an aggregate and one-third of each marginal dollar that they buy. They would be better off shooting themselves in the foot now because they are going to have to shoot a much bigger bullet in their foot in the future.

So there is some risk that they may reevaluate the policy. And I do not think this policy reflects the financial attractiveness of the United States. I think it is much more a reflection of the necessities created by their decisions to peg to the dollar.

The second risk is ironically the opposite. It is that central banks will continue to provide the U.S. with too much financing, blocking necessary adjustment, and allowing the underlying disequilibrium to build. That implies larger debts over time and eventually more interest payments to the rest of the world.

And I think the third risk, and this would conclude, is that our foreign creditors will change the terms on which they are willing to finance the United States. Dr. Orszag mentioned that foreign central banks may conclude that they are saturated with dollars.

I think most foreign central banks have already concluded that they are saturated with their U.S. Treasury holdings and they are looking to find investments that offer higher yields in large part because they realize that they are stuck in the dollar.

Now, as that happens, there will be tensions associated with the shifting portfolios and I think it is unrealistic to expect that foreigners will be willing to finance the U.S. on as generous of terms, terms which have implied very large losses in their own local currency terms and in very large losses relative to what they would have obtained had they invested in, say, euros. It is unlikely that those generous terms will continue. So even if ongoing flows remain, the cost of those flows to the U.S. economy will likely rise.

My policy recommendations are the same as those that have been put forth before, although I would also add that given that the U.S.'s petroleum deficit is about $300 billion, steps to reduce our energy consumption could also contribute to an orderly adjustment.

Thank you.

[The prepared statement of Brad Setser follows:]

Prepared Statement of Brad Setser, Senior Economist, Roubini Global Economics and Research Associate, Global Economic Governance Programme, University College, Oxford

``FOREIGN HOLDINGS OF US DEBT: IS OUR ECONOMY VULNERABLE?''

I want to thank the members of the committee for inviting me to testify. It is a particular honor to participate in such a distinguished panel.

At the end of 2006, foreigners held an estimated $10 trillion in US debt--roughly $5 trillion in long-term debt securities and $5 in short-term securities and cross-border bank claims. Roughly $800 billion of the $5 trillion in long-term claims were held by China's government (counting some securities held by China's state commercial banks) more than the perhaps $700 billion in long-term US debt securities held by Japan's government.1 By the end of 2007, total foreign holdings of US debt will rise to around $12 trillion, total foreign holdings of long-term debt securities will be close to $6 trillion, and long-term debt held by China's government likely will rise to around $1.1 trillion.

I mention China specifically because the strong recent rise in China's current account surplus, along with ongoing private capital inflows into China, has made China's government the largest single source of (net) financing for the US current account deficit. China's foreign exchange reserves--counting the reserves likely to be shifted to a new investment agency--are set to rise by between $450 and $500 billion in 2007, with between $300 and $350 billion of that increase flowing into US assets (Chart 1). China's foreign assets are growing so rapidly that it could buy a company the size of Unocal every month--and still have enough money left over to buy all the Treasury bonds that the US needs to sell to finance its budget deficit. Right now, China's government is the largest single buyer of US Treasury and US ``Agency'' bonds, the largest potential source of demand for many other dollar-denominated financial assets and--given that it must sell a fraction of the dollars it accumulates intervening in the foreign exchange market to keep the dollar share of its reserves from rising--also the largest actor in the foreign exchange market.

Financial integration implies rising foreign holdings of US assets and rising US holdings of foreign assets. But so long as the US is running a large external deficit, foreign holdings of US assets will need to rise faster than US holdings of foreign assets. The large US current account deficit--roughly $800b in 2006--has been financed primarily by placing debt, and specifically long-term debt securities, with foreign investors. US direct investment abroad, along with US purchases of foreign equities, recently have exceeded foreign direct investment in the US and foreign purchases of US equities.

My testimony will emphasize three points:

To date, the United States' large trade deficit has not resulted to a significant deterioration in the United States' net international investment position (US liabilities to the world net of US holdings of foreign assets) or to a deficit in the income balance (the gap between the interest and dividends the United States receives on its investments abroad and the interest and dividends the United States pays to foreigners). Going forward, that is likely to change. The United States should not expect foreigners--including foreign governments--to finance the United States on as generous terms as the US has enjoyed over the past few years.

Foreign central banks and government-owned investment funds have played an important role financing the US current account deficit over the past several years. As the US economy has slowed relative to the rest of the world in late 2006, reducing the attractiveness of US financial assets to private investors abroad, the share of the US external deficit financed by foreign central banks increased substantially.

Official financial flows have generally been stabilizing rather than destabilizing; foreign central banks have bought dollar-denominated assets, financing the US deficit, when private investors haven't wanted to. Bringing the US deficit down in a gradual, orderly way will require ongoing central bank financing. However, the United States ongoing dependence on inflows from foreign central banks still poses substantial risks. The US should worry both about the possibility that foreign central banks will provide the US with too little financing, forcing rapid and disruptive adjustment, and the possibility that foreign central banks will provide the US with so much financing that a necessary adjustment is deferred.

One theme will run throughout my testimony: the United States has a strong interest in a process of gradual adjustment that reduces the United States' need to borrow from the rest of the world to finance domestic investment. The absence of any adjustment is undesirable: it implies that foreigners will continue to finance a very large share of all US domestic investment and a large buildup of the United States' foreign debt. Too rapid adjustment is also undesirable. A sharp fall in foreign financing of the US would lead the dollar to fall, stimulating US exports, but it would also push up US interest rates, leading other parts of the economy to slow. Gradual adjustment--say 1% of GDP a year--would facilitate the shift of resource from sectors of the economy that have benefited from the low interest rates associated with large (net) inflow of foreign savings to the US toward sectors that would benefit from a weaker dollar. Gradual adjustment also provides foreign governments time to take steps to stimulate domestic demand and wean their economies off export-led growth.

THE ONGOING INCREASE IN FOREIGN HOLDINGS OF US DEBT IS UNLIKELY TO CONTINUE ON SUCH GENEROUS TERMS

The United States' current account deficit topped $800b--roughly 6% of US GDP--in 2006. Its 2007 deficit is likely to be comparable in size. As the US economy emerges from its recent growth slump, the US current account deficit is likely to resume its increase in the absence of a fall in oil prices or large additional falls in the dollar.

Right now, the current account surpluses that offset the US deficit are overwhelmingly found in East Asia and the world's oil-exporting economies. Should oil prices stabilize, rising domestic spending and investment in the oil-exporting economies should reduce their current account surplus. However, East Asia's surplus looks set to continue its rise. China's current account surplus was $250b (a bit under 10% of China's GDP) in 2006. Its 2007 surplus is expected to rise to $350-400b--an unprecedented sum. Japan's current account surplus is also rising, in part because of rising interest income from Japan's large holdings of foreign debt. So long as East Asia's surplus continues to rise, global adjustment will be difficult. Surpluses in one region have to be offset by deficits elsewhere.

A current account deficit indicates that a country saves less than it invests; a surplus indicates a surplus of savings over investment. The US consequently must finance its savings shortfall either by placing debt with investors in the rest of the world, attracting large (net) inflows into its equity market or attracting large net inflows of foreign direct investment. New foreign equity investments in the US--whether direct investment or the purchase of foreign stocks--have been more than offset by new US equity investments abroad. Inflows into the US banking system have generally been offset by outflows from the US banking system. By contrast, foreign purchases of US debt securities have exceeded US purchases of foreign debt, providing the large net inflows needed to cover the United States current account deficit.

As a result, the US net debt position--the gap between what the US has borrowed from the world and what the US has lent to the world--has deteriorated dramatically over the past six years. Since the end of 2000, total foreign holdings of US debt have increased from $4.3 trillion to close to $10.0 trillion while US lending to the rest of the world has increased from $2.9 trillion to an estimated $4.6 trillion. Net US external debt consequently has increased from $1.5 trillion at the end of 2000 to about $5.4 trillion at the end of 2006--the $4 trillion increase is in line with the cumulative $3.6 trillion US current account deficit over this time frame.

However, the overall US net international investment position--the difference between all US assets abroad and all US liabilities to the world--hasn't deteriorated at the same pace. The dollar value of US equity investment abroad has increased far more rapidly that the dollar value of foreign equity investment in the US. The dollar value of US equity investment abroad increased from $4.5 trillion in 2000 to $9.1 trillion in 2006, while the dollar value of foreign equity investment in the US increased from $4.3 trillion to an estimated $5.9 trillion. The United States' net equity position consequently shifted from rough balance to a $3 trillion surplus (Chart 2).

The improvement in the US net equity position largely reflects capital gains on existing US equity investment, not large (net) US purchase of foreign equities.2 Since the end of 2000:

Foreign equity markets generally outperformed the US equity market in local currency terms.

The dollar's slide against European currencies and the Canadian dollar has substantially increased dollar value of existing investment in Europe and Canada.

Indeed, the capital gains on US equity investment abroad since 2002 have been large enough to entirely offset the increase in debt associated with the current account deficit, so the US net international investment position hasn't deteriorated.

The income balance--the gap between the interest and dividends that the US pays to the rest of the world and the interest and dividends that the US receives from the rest of the world--also has not deteriorated as rapidly as many had feared. The revised data from Bureau of Economic Analysis (BEA) indicates that the US actually received more interest and dividend income from the rest of the world than it paid out in 2006 (Chart 3).

Here too the overall balance can be disaggregated into the interest payments on debt and the dividends payments on equity. As one would expect, payments on US external debt have increased substantially. Interest payments on US external debt likely totaled $430b in 2006, up from a low of $170b in 2003 and $250b in 2000 (Chart 4).3 This trend continued in the first quarter of 2007: the q1 data suggests the 2007 US interest bill will be substantially higher than $500b. However, interest income on US lending abroad--which seems to be primarily short-term--also has increased. Right now, the implied interest rate on US lending is close to 6%, while the implied interest rate on US borrowing is close to 4.5% (Chart 5). In my judgment, this large gap is unlikely to persist. As the average interest rate on the United States (large) stock of external debt rises, the US income balance should begin to deteriorate.

The US income balance has also been helped by a large ongoing gap between the reported dividend income of US direct investment abroad and foreign direct investment in the US, a gap that stems more from low reported returns on foreign direct investment in the US than high reported returns on US direct investment abroad (Chart 6).

The ability of the United States to run large deficits without much deterioration in its net international investment position or a significant deterioration in its income deficit reflects the willingness of the United States' external creditors to add to their holdings of US debt when--at least in retrospect--they would have received far larger financial returns had they invested in foreign equities. Foreigners would have fared better if they had forced the US to sell its existing external assets rather just buying US debt.

THE ROLE OF FOREIGN CENTRAL BANKS

No one doubts that foreign central banks--including the People's Bank of China--have been very large buyers of US debt securities. The BEA data show that official purchases of US assets rose from under $100b a year in 2000 and 2001 to nearly $400b in 2004. Official inflows then fell to $275b in 2005--a year when rising US short-term rates and the Homeland Investment Act helped support the dollar--before rising to $440b in 2006 and an annualized $600b in the first quarter of 2006.

Large as these inflows are--the $440b in central bank purchases of US assets in 2006 far exceeded the $155b in marketable Treasuries issued to finance the US fiscal deficit in 2006, and the large cumulative increase in central bank holdings of Treasuries since 2000 has limited the increase in marketable treasuries held privately (Chart 7)--the BEA data likely understate the role central banks and sovereign wealth funds have played in financing the US external deficit. The BEA data do not capture the dollars that central banks have on deposit in banks outside the US. Those dollars are then lent out, and indirectly help to increase private demand for dollar-denominated debt, including US dollar denominated debt.4 Most importantly, recent BEA data do not capture large central bank purchases of US assets made through private custodians in London and other financial centers. The BEA's data is revised annually to reflect the information provided by United States Treasury's annual survey of foreign portfolio investment in the US, which tends to do a better, though still imperfect, 5 job of capturing the ultimate ownership of US debt securities. However, the most recent data points tend to substantially understate central bank purchases of US assets.

A number of technical difficulties complicate efforts to determine the exact impact of central bank demand for US debt on US yields. Custodial bias makes real-time estimates of the size of official inflows hard. The shift in central bank demand from Treasuries to Agencies after 2005 further complicates analysis. But many studies find a substantial impact--100 to 150bp at the peak of central bank demand for US assets in 2004 (Warnock and Warnock, 2005, Moec and Frey, 2005). When the analysis of the recently revised data--which shows far higher central bank purchases in 2006 than the BEA had previously indicated--is completed, I would expect to find that central banks exerted a similar impact in 2006.

Central bank demand for US debt, generally speaking, has allowed the US to finance a larger deficit at lower cost than otherwise would have been the case. Assessing the long-term impact of these policies on the overall US economy is difficult, since strong demand for debt securities and low interest rates help some sectors even as other sectors are hurt by other countries efforts to keep their currencies under-valued.

Central bank demand for US debt has helped lower the interest burden of the US government. It has encouraged heavy household borrowing, both to support consumption growth in excess of income growth and--between 2003 and 2006--a surge in residential investment. More recently, low interest rates have supported strong demand for corporate debt, whether from firms looking to buy back their equity (and thus push up their stock price) or private equity firms, which borrow heavily to buy the listed stock of publicly traded companies.6 Conversely, those sectors of the US economy that compete with imports, particularly imports from emerging economies, and that export goods and services have been hurt by the policies that gave rise to these large official inflows.

In aggregate, I believe the negative long-term impacts of the policies that have given rise to large official inflows to the US outweigh the positive. While many in the US clearly have gained from low interest rates, it is hard to argue that the US has been borrowing from abroad to invest in ways that will generate the future export revenue needed to repay the United States' growing external debt. Suburban housing is not an obvious source of export revenue--and firms that borrow to buy back their equity rather than to finance new investment are not obviously increasing the United States' future export capacity either. Many abroad have also gained from their government's efforts to prop up the dollar--not the least China's export sector. But these policies will also generate losers, notably taxpayers in emerging economies who will at some point incur large losses on their government's dollar holdings.

Nonetheless, it is important to recognize that central banks have generally acted to stabilize rather than to destabilize the foreign exchange and bond markets. Since early 2004, the IMF's data on central bank reserves indicate that central banks effectively have bought dollars--and dollar-denominated bonds--when private market participants have been unwilling to do so, helping to stabilize US and global financial markets. As a result, a fall off in (net) private demand for US assets has not let to a large drop in overall foreign demand for US assets, allowing the US to finance its large deficit at a relatively low costs. Volatility in private demand for US assets has translated into volatility in central bank dollar reserve growth, not volatility in financial markets or in aggregate financial flows to the US.

This has been particularly apparent over the last three quarters. As the US economy slowed and growth abroad picked-up, net private capital inflows to the US fell. US demand for foreign assets rose, and demand for US assets from private investors abroad fell. The BEA's data, for example, show for q1 that central banks provided about $150b in direct financing to the US in the first quarter--a net inflow equal to about 75% of the US current account deficit.

The $150b in official inflows in q1 is if anything an under-estimation of likely central bank financing of the US in the first quarter. The high-frequency data released by the US (The monthly Treasury International capital data and the quarterly BEA balance of payments data) tend to overstate private purchases and understate official purchases. Lower frequency data--notably the United States annual survey of foreign portfolio investment--tends to do a better job of picking-up central bank purchases of US assets. The last survey--which covered the period between June 2005 and June 2006--showed $345 in official purchases of long-term US debt, $125b more than in the unrevised data. The last survey, for example, revised the United States estimate of Chinese purchases of US debt up by $90b. (See Chart 8; Chinese holdings of US Treasuries jump every June, when the survey data is released). There is no reason to think that this pattern will change.7

I consequently prefer high-frequency estimates of the increase in central bank dollar holdings that are derived from reported increase in foreign central bank reserves, along with an estimate of the share of those reserves that are held in dollars. This methodology has its limits. It will, for example, over-estimate central bank purchases of dollars if central banks are reducing the dollar's share of their reserves. Nonetheless, this methodology accurately predicted the large upward revisions in central bank holdings in the last survey (see Charts 9 and 10).

With total global reserve growth topping $250b in q1, this methodology implies that central bank demand for dollar assets now tops $200b a quarter. Preliminary data for q2 suggests global reserve growth will top $300b by a substantial margin, which implies a truly extraordinary $250b in central bank demand for dollar assets in q2. The very strong recent growth in the New York Fed's custodial holdings--which have been running at an annualized pace of close to $500b this year--provide strong indirect evidence of a strong rise in US dependence on inflows from foreign central banks (Chart 11).

RISKS: TOO LITTLE OFFICIAL FINANCING, TOO MUCH OFFICIAL FINANCING AND MORE DEMANDING TERMS FROM THE OFFICIAL SECTOR

Ongoing US dependence on central bank demand for US assets carries with it three risks:

Central banks stop adding to the dollar holdings.

Central banks resist all market pressure for adjustment, allowing the underlying disequilibrium--and total foreign claims on the US, to build.

Foreign governments change the terms of their financing of the US.

Professor Rogoff, a fellow member of this panel, has argued that the large credit line extended by emerging economy central banks to the US constitutes a kind of reverse foreign aid. Both relatively poor emerging economies and wealthy oil exporting economies that are intervening heavily to keep their exchange rates from appreciating are effectively ``over-paying'' for US dollar-denominated assets. Should they stop intervening, their exchange rates will rise--reducing the value of their existing dollar holdings in local currency terms.

The resulting losses potentially are quite significant. Chinese intervention in the foreign exchange market is currently close to 15% of its GDP. If the RMB is undervalued by 33% against a basket of euros and dollars that corresponds with China's foreign currency reserves, the annual cost of this policy is roughly 5% of China's GDP.8 It is possible--though unlikely--that China might conclude that its interests would be better served running a 5% of GDP fiscal deficit to finance a social security system and better health care rather than incurring an expected loss of 5% of its GDP lending to the US and Europe. Of course, the effective subsidy that China extends to American borrowers also benefits China's export sector--there are strong interests inside China that seek to maintain the current policy. However, those who depend on the kindness of strangers shouldn't take their continued kindness for granted.

Emerging economies do not need to sell their existing reserves to shake the system--all they need to do is stop adding to their dollar reserves/ dollar assets of their investment funds. Indeed, if emerging markets just held their purchases of US assets constant at a time when private demand for US assets fell, they could have a substantial impact on US financial markets. The markets now expect that emerging economy central banks will be the dollar's buyer of last resort.

China is the largest single source of financing for the US external deficit. China probably accounted for about 1/3 of all long-term debt purchased by foreigners in 2006, and more like 1/2 of all foreign purchases of Treasuries and Agencies. The strong increase in the pace of Chinese reserve growth implies that China will likely account for a higher share of total purchases in 2007. Changes in how China allocates its immense and rapidly growing portfolio consequently could have a large impact on US markets. A reduction in Chinese purchases of all US debt would have the largest impact, but even shifts in the kinds of assets that China buys now could have a substantial impact. For all the attention that China's $3b investment in Blackstone generated, it likely represents less than one week's worth of Chinese purchases of debt.

China is not the only actor with the potential to shock the US financial system. The Institute for International Finance recently reported that the oil-exporting economies of the Gulf have more accumulated foreign assets than China. They also hold nearly as large a share of their assets in dollars, even though only 10% of their imports come from the US. Should the Gulf states change the dollar's share of their portfolio suddenly, they too could potentially put substantial pressure on the dollar.

This risk isn't new. Back in 2003, Former Treasury Secretary Lawrence Summers warned that the United States dependence on credit from countries selling goods to the US was generating ``a balance of financial terror'': the US was dependent on China for large-scale financing, while China depended on the US to provide sufficient demand for its products. More recently, Summers noted that one lesson of the cold war is that a system based on a balance of terror can be stable for quite some time.

However, the system's current apparent stability is in some ways deceiving, as the costs emerging economies are being asked to bear to sustain the United States existing current account deficit are rising. Emerging market reserve growth has doubled since early 2006, rising from around $600b to around $1.2 trillion, as private investors shifted funds from the US to the emerging world. To be sure, large scale reserve growth generates benefits for exporters in emerging economies. But rapid reserve growth also limits the domestic monetary policy autonomy of many emerging economies, as well as generating financial losses--now generally hidden--that taxpayers in emerging economies will eventually have to absorb. The constellation of interests that supports the status quo may not last forever. At some point, the perceived costs of buying dollars when the dollar is under pressure may exceed the perceived benefits that emerging market economies gain from resisting market pressures for appreciation.

One risk is that emerging economies suddenly stop adding to their dollar holdings, forcing the US to adjust to fall off in foreign financing too rapidly. Another risk, ironically, is that emerging economies will continue to add to their reserves at a pace that allows the US to continue to defer a necessary adjustment.

Substantial swings in the private sector's willingness to finance US external deficits--and a large gap between the size of the US deficit and net private inflows in 2003, 2004, 2006 and so far in 2007--have not translated into large swings in the US external accounts or sharp swings in US economic activity. However, strong central bank demand for US debt--a byproduct of their decision to resist market pressure for their currencies to appreciate--risks thwarting all adjustment, not just thwarting disruptive adjustment.

If the US trade deficit remains constant as a share of GDP, the deterioration in the US income balance associated with a rising stock of external claims on the US implies a growing current account deficit over time. The Congressional Budget Office's recent analysis of the US external deficit accurately noted that a sharp adjustment process would bring the US deficit down quickly, limiting the overall increase in US net external indebtedness. By contrast, a period without any adjustment--or a further rise in the US external deficit--that is followed by a period of gradual adjustment implies that the overall US external debt stock would rise even further than would be the case if the US deficit started to fall now.

This risk is not entirely theoretical. The recent slowdown in US growth--combined with an acceleration in global growth--created close to ideal conditions for the US external deficit to fall. Strong global growth supported US exports. The slowdown in US growth slowed the increase in US imports. Indeed, the US deficit with those regions of the world--Europe and North America--that have allowed their currencies to appreciate has fallen substantially. However, the US deficit with East Asia continues to rise (Chart 12). At a result, the fall in the United States overall deficit has been modest. Most of the improvement in the current account deficit from its recent peak in the third quarter of 2006 stems from lower oil prices.

A final risk that is worth noting: the rest of the world may change the terms associated with its financing.

Countries like China have resisted taking policy steps--like faster RMB appreciation or a major initiative to stimulate domestic consumption--that would lower their current account surplus and reduce the scale of their purchase of US assets. However, such countries are clearly seeking to invest in US assets that offer the prospect for greater returns than US Treasuries.

Such an evolution is natural. China holds far more liquid Treasury and Agency securities than it needs to address even a most draconian shock. Moreover, China's heavy concentration in US fixed income securities (Chart 13)9 is itself a risk. A rise in Chinese holdings of US equities is a natural by-product of China's large surplus, the United States large deficit and a balanced Chinese portfolio of US assets. China's willingness to hold such a high share of its national wealth in low-yielding debt is far more unusual than its interest in exploring alternatives that offer higher potential returns.

The current pace of accumulation of Chinese foreign assets suggests that China's total foreign assets will rise from about $1.5 trillion at the end of 2006 (with about 1.2 trillion of that reserves and reserves-like assets) to more than $3 trillion by 2010. A world where China creates a $1.5 trillion dollar investment fund, rather than adds $1.5 trillion to its reserves, over the next few years isn't impossible to envision. Even if China adds roughly equal sums to its reserves and investment fund over the next few years (Chart 14), its investment fund could reach be the largest in the world by 2010. Creating an investment fund won't eliminate the constraints on China's overall portfolio that stem from China's continued adherence to its dollar peg. However, shifts in the kind of assets that China is purchasing could still influence US markets. A Chinese move away from long-term fixed-income debt could increase US interest rates by as much as 50 basis points.

Other central banks now adding to the reserves rapidly (Russia) and other central banks with large existing stocks of reserves (Korea and Japan) have either announced that they are creating a new investment fund (Russia, Korea) or are rumored to be considering an investment fund (Japan). All seem to be struck by the high returns Singapore has obtained from its investment funds. So long as oil prices remain high, the assets of existing investment funds in Norway will continue to grow as well. All these funds already hold substantial quantities of US equities, both directly and through their investment in private equity and hedge funds.

Trying to shut the investment funds of foreign governments out of US markets is neither feasible nor desirable. So long as the United States is running large external deficits, US government is unlikely to be in a position where it will be able to dictate what kind of U.S. assets its creditors are allowed to buy. Moreover, any move to shut government investment funds out of the US market would invite foreign governments to try to limit US investment in their markets.

Nonetheless, the growing presence of government investment funds in US equity markets raises a host of questions--questions about US capital market regulation as well as questions about the transparency of large investment funds. Edwin Truman of the Peterson Institute has argued that the increased role of central banks and sovereign wealth funds in global capital markets implies that both should adhere to a higher level of transparency. He specifically has called for more disclosure of their investment strategies as well as the currency composition of their portfolios. I second Dr. Truman's suggestion, along with a recent suggestion from the Treasury's Acting Under Secretary, Clay Lowery, that the IMF encourage investment funds to develop a code of best practices.

CONCLUSION

So long as the US is running a large external deficit, foreign holdings of US assets will need to rise faster than US holdings of foreign assets. In many ways, the past few years have been atypical. The United States' external deficit has been financed entirely by the net sale of debt securities rather than by the net sale of equities, in no small part because of unprecedented growth in central bank reserve assets. The low interest rate on US external debt--relative to both the returns the US has achieved on its equity investment and the interest rate on US external lending--has allowed the US to continue to earn more on its foreign investment than it pays on its foreign debts.

These patterns are unlikely to persist. So long as emerging economies are unwilling to allow their currencies to appreciate and run large current account surpluses--especially with private capital flowing in net into emerging economies--many governments around the world will be accumulating external asset rapidly. Over time, though, more of those assets will be handed over investment funds and fewer will be held as central bank reserves. The US will likely both have to sell more equity to the rest of the world and pay a somewhat higher interest rate on its external debt than it has recently.

Foreign investors--and right now that means foreign governments--now finance, directly and indirectly, a larger share of domestic US investment than makes sense over time. While rapid central bank reserve growth and large official financing of the US deficit can help the US postpone the necessary adjustment, the longer the adjustment is deferred, the greater the long-term risks.

The process of adjustment is more likely to be smooth if it is supported both by policy changes here in the US and abroad. The US government should adopt policies that would allow the US to finance more investment out of domestic US savings, just as many emerging economies should put more of their savings to work at home. Further reduction in the fiscal deficit and a new push to reduce our energy import bill--the United States ``petroleum'' deficit is now close to $300b--are the most obvious policies for the United States. Governments in emerging markets need to do more than complain about US profligacy, particularly when their purchases of US debt have masked the consequences of the United States' low level of savings and large resulting external deficit. East Asian economies with high savings rates--notably China--have substantial scope to take policy steps to support domestic consumption. Most governments that now manage their exchange rate against the dollar--whether in the Gulf, Latin America or East Asia--would benefit from additional exchange rate flexibility.

Both the United States large deficit and equally large surpluses in many emerging economies built up gradually over time. Bringing the US deficit and emerging economy surpluses down without tremendous costs will also take time. If the US and the world are to adjust gradually, they need to get started.

ENDNOTES

\1\ The US has not formally released data on the total stock of foreign claims on the US for the end of 2006. I have drawn on the data from the 2005 net international investment position, the 2006 capital account data from the Bureau of Economic Analysis, the 2006 Treasury survey of foreign portfolio investment in the US and China's reserves data to compile these estimates. The actual data should be released at the end of June.

\2\ Since the end of 2000, cumulative US direct investment abroad has exceeded foreign direct investment in the US by about $200b. Portfolio equity inflows and outflows are roughly equal.

\3\ These estimates are derived from the balance of payments data released by the Bureau of Economic Analysis. The exact number for 2006 though depends on dividend payments on foreign portfolio investment in the US--a data point that the BEA has yet to release. I assumed that 2006 dividend payments matched 2005 dividend payments. Since these payments are small, this is not a large source of error.

\4\ Foreign central banks purchases of euro and pound denominated securities also help to generate indirect demand for US debt, as such purchases push down European yields and make US assets relatively more attractive to private investors in the US and Europe.

\5\ The survey data seems to understate the Middle East's likely holdings of US assets, perhaps because neither the high-frequency data BEA data (which is derived from the Treasury's TIC data) nor the annual survey picks up foreign central bank funds--and sovereign wealth funds--that are managed by private portfolio managers.

\6\ Central banks are not large direct participants in this market but by lowering yields in Treasury and Agency bonds (and buying these bonds from pension funds and other investors) they encouraged other investors to reach for yield. Significant central bank deposits in the international banking system have also supported the leveraged loan market.

\7\ In the first quarter of 2007, the increase in the New York Federal Reserve Bank's custodial holdings of US treasury and US Agency bonds exceeded the estimated increase in central bank holdings of US treasury and US Agency bonds in the BEA's balance of payments data by about $20b. Central banks who buy US securities in London sometimes hand those securities over to the New York fed; the transfer of custodianship though is not considered a sale.

\8\ This calculation ignores the ``carry'' the Chinese government gets from borrowing at low interest rates in China to buy US dollar debt. It is clear, though, that these interest gains--which themselves stem from China's artificially low interest rates--are not large enough to offset the capital losses from a substantial RMB appreciation. China's reserves are now roughly 45% of its GDP. China's central bank will eventually face a loss equal to 15% of China's GDP.

\9\ The best data on China's holdings of US assets comes from the annual US survey of foreign portfolio investment. As of June, 2006, China held slightly a bit under $700b in US debt: $375b of US Treasury bills and notes, $260b of ``agency'' bonds, and $60b of corporate debt. In addition, China held slightly over $20b of US equities--and a bit over $15b in plain old bank deposits. Treasuries and Agencies accounted for 90% of all Chinese holdings of US securities, debt securities accounted for 99.5% of China's US portfolio (Chart 5) and US securities accounted for around 70% of China's total reserves (included reserves shifted to the state banks. The US data does not distinguish between US assets held by China's private sector (including its state commercial banks) and US assets held by China's State Administration of Foreign Exchange. However, given the size of China's reserves, it is reasonably to assume that the State Administration of Foreign Exchange accounts for most of China's recorded holdings of US securities.

CHARTS AND GRAPHS

Chairman Spratt. Thank you all for the range of your opinions and for some very provocative proposals.

Let me ask you again about what happens if we have some rapid adjustment, some rough, rocky road that leads to those holders of dollar denominated assets to dump their assets and to the phenomenon that Lester Thoroshe described of having most of the holders decide they did not want to be the last man out on a declining asset.

Could a scenario like this happen if foreign investors looked at the charts that we were looking at earlier and decided that given the projection of the cost of Medicare and Medicaid and Social Security, two multiples as a percentage of our GDP, that it would be inevitable that we might try to inflate our way out of our debt or that we would be asking secondly foreigners to underwrite not just our economy but transfer payments?

Not investment in assets like the British did with the building railroads out west in the second half of the 1800s but for Medicare, for Medicaid, for Social Security, for transfer payments upon which there would be no significant return. Could you imagine a scenario in which foreigners are looking at something like that?

Mickey Levy keeps shaking his head, but is that a scenario to be concerned about?

Mr. Levy. Can I take a crack at that? We are all concerned about the unfunded liabilities of the entitlement programs and there is no question but that they need to eventually be resolved.

If you look through history over time, you will find that interest rates tend not to be that correlated with budget deficits or expected budget deficits, that interest rates tend to be driven by the rate of economic growth, inflation, and the Federal Reserve's inflation fighting credibility.

So if you talk about scenarios of shocking the system, you have to ask, well, if you shock the system, what is going to happen to economic growth and inflation. As long as the economy is growing moderately and inflation is under control and the Fed is conducting its job with credibility, do not look for a sharp rise in interest rates because if one even huge investor sells, whether it is a foreign investor or domestic investor, other investors will look at the fundamentals and be buyers.

So it is a complex issue and I just do not think you could say if you shock the system, then what if.

Chairman Spratt. Others? Dr. Rogoff?

Mr. Rogoff. Yeah. Well, I mean, one piece of your comment I actually think people are not concerned enough about which is that over the--there is this view that inflation will never be a problem again because we solved it. I think we live in a very benign world. Growth has been very fast. The central banks of the world have a relatively easy job in the political economy of bringing down inflation because things are pretty good.

We do not have inflation anywhere. The Congo does not have inflation. They have had, you know, trillions of percent inflation since 1970, same with Brazil. But it is possible that some of the social stresses that we face, not soon, but in 15, 20 years, could put pressures on the system that we do not, you know, fully admit today. But I do not think they would fall uniquely on the United States. So, you know, yes, it is an awkward position, but where would investors go? Are they going to go into Japan which is aging sooner, to Europe which is aging sooner, to China which has a big problem? So there is not a natural----

Chairman Spratt. But all of those countries have substantially higher savings rates.

Mr. Rogoff. Yeah. Partly because their aging problem is upon them. I mean, that is one of the reasons it is argued that they do have higher savings rates. So I think that we could see a generalized decline in asset prices some day when people get worried about this and that could cause a lot of problems.

And I do think our vulnerability of needing to keep borrowing fresh money is a concern. But this is a global phenomenon. I do not think it is uniquely our problem.

Mr. Setser. Yes. I would just add that, you know, there are many different scenarios that worry me. I probably worry too much. But I would argue that the time scale in which the trade deficit needs to correct is more likely to come sooner rather than later while the time scale associated with the entitlement problem is later rather than sooner.

And by that, I mean the trade deficit right now is around six percent of U.S. GDP and it seems to me that that is going to need to adjust downward within the next ten years where the entitlement problem starts to bite perhaps at the end of that ten-year period.

Mr. Hormats. I think it is a sort of a slow motion train wreck and it is also true that other countries have similar problems. In fact, a lot of countries in some cases have even greater amounts of unfunded liabilities relative to their GDP.

But, you know, we are the biggest country in the world in terms of the economy and I think we cannot be responsible for what other countries have done. We can be responsible for what we are not doing.

And I think, Mr. Chairman, you have raised a point of long-term vulnerability. We now have to suck up a huge portion of the world savings. You are quite right. The savings rate in most other countries is considerably higher than here and a lot of it is important in the United States because we have such a large savings gap between our investment and our savings rate.

And I do think that the more dependent we are on this foreign capital, if some disruption should occur, and I associate myself with those who believe that China or any other country is not willingly going to pull the rug out from under the dollar or the capital markets in the United States because they have an interest in American assets and they have an interest in selling here and they do not want the dollar to collapse, but if there were to be some untoward, some unexpected event like, for instance, an act of terrorism, the more reliant we are on foreign capital to fill what will be a greater requirement if the budget deficit rises as a result of entitlements, then we do become more vulnerable if, and even if it is a small if, but if there is a disruption in the inflow of that capital for whatever reason.

So those big numbers down the road, it is not right away, but as you point out, it is somewhere down the road. Those do imply a vulnerability to an interruption that is greater than would be the case today.

And the other point I would add is it is not just foreigners who might pull their money out in the event of a major crisis. It is Americans. In an open global capital market, they may conclude, you know, that if something goes wrong here, they have other options to put their money elsewhere also.

So we tend to focus a lot on the buildup of liabilities and vulnerability to foreigners, but in an open global market, even if we had no liabilities to foreigners, even if we were in balance with a large number of Americans being able to move their capital abroad, if we do not run our fiscal policy properly, they have the option of moving also. So in a global world, they can go both ways.

Chairman Spratt. Mr. Ryan.

Mr. Ryan. Thank you, Mr. Chairman. This is very interesting and enlightening.

I think it seems to me we are getting one solid conclusion out of this hearing and the various testimonies and that is people have difference of opinions on the magnitude of this risk with respect to how foreigners might act. And I do not think you see this. Neither of you said this is the number one risk.

But it seems like the one thing that we know for certain that is an undisputable fact is demographics and the state of the promises that our government has made with respect to our entitlement programs and the trajectory that we are on with those entitlement programs.

So since we are the fiscal policy makers, I will just ask