The United States in a Global Economy

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We live in a global economy, and we need to think and act accordingly. To be sure, the United States has the world's largest, most dynamic economy, one that is the envy of the rest of the world, and we are less dependent on international trade than many other nations. But our exports and imports have grown strongly as shares of GDP in recent decades. Your car may have been made in Germany or Japan. If you are in the cattle industry, your beef may be sold in Mexico or Southeast Asia. And the cartoons that your children watch on television may have been animated in the Philippines or India, if they were not drawn by a computer. International financial linkages have also expanded, and the current account deficit is at record levels. These international linkages have become important considerations in business decisions and economic policy.

Tonight, I will begin by reviewing recent U.S. economic performance and the outlook for 2004. All in all, that outlook is favorable, with real output growth likely to be strong and consumer price inflation low. And, although labor market conditions remain a concern, employment growth appears to be strengthening as well.

After discussing the national outlook, I will turn to two important international issues, the offshoring of jobs and the large U.S. current account deficit. I will argue that our nation needs to be proactive in addressing these issues. However, protectionism is not a good response to international competition and, in fact, would do more harm than good. Better responses include improving the assistance that we give to workers

displaced by import competition, investing more in education and research, and reducing our large federal budget deficit.

Recent Economic Conditions

But first, let's review how the U.S. economy has been performing lately. Economic growth picked up substantially last year. Real GDP grew 4.3 percent because of continued solid spending by households and a recovery in business spending. Low mortgage rates produced an outstanding year for housing, and business spending on equipment and software rose about 10 percent. Moreover, businesses began building their inventories at the end of last year as they became more optimistic about the outlook and struggled to keep up with growing demand.

Two sectors that slowed last year were government spending and international trade. Although federal purchases grew nearly 6 percent, that was slower than the year before, and state and local government spending was flat. The trade deficit also worsened, although international trade was less of a drag on growth than in 2002. On a more positive note, our exports grew much faster in the second half of last year, suggesting the dollar's depreciation and foreign economic recoveries were boosting demand for U.S.-made goods and services.

Although overall growth was strong last year, the labor market remained soft. Nonfarm payroll employment declined slightly in the third quarter of 2003, and grew by only about 60,000 jobs per month in the fourth quarter. The unemployment rate declined in that period, but part of the decline was due to people dropping out of the labor force rather than strong hiring. The unemployment rate was 5.7 percent in March, which is not unusually high by historical standards but still implies unused labor resources.

Recent statistics suggest, however, some further improvement in the labor market. Payroll employment grew by a stronger than expected 308,000 jobs in March, which pulled average employment growth up to 171,000 jobs per month in the first quarter of 2004. In addition, initial claims for unemployment insurance are trending lower, suggesting that firms are laying off fewer workers, and help-wanted advertising is rising.

Despite recent gains in energy prices, consumer price inflation is low. The consumer price index rose by a moderate 1.7 percent over the last year, and if you exclude volatile food and energy prices, core CPI inflation was 1.6 percent over the last year. With the improved growth of the economy, concerns about harmful deflationary pressures are receding.

The Economic Outlook

The current year is also shaping up as a good one. Several factors imply economic growth will be strong enough to continue putting unemployed factories and labor back to work. Accommodative monetary policy is a key factor. The federal funds rate remains at 1 percent, its lowest level in decades. Accommodative monetary policy encourages growth in many ways, such as keeping mortgage rates low and creating a favorable financial environment for business investment.

Fiscal policy also is stimulative at the national level, although the amount of stimulus is waning over time. Lower federal tax rates are producing refunds for many households, and the tax code gives businesses an incentive to invest in equipment before the end of this year. Federal spending is also expected to grow solidly this year, and state and local government spending may pick up somewhat after a difficult year in 2003.

Other financial factors should encourage solid economic growth this year. Stock prices gained last year as corporations reported stronger profits, and rising single-family home prices boosted the net worth of many households. In addition, the foreign exchange value of the dollar against other major currencies has declined more than 20 percent from its peak in February 2002.[1] A lower value for the dollar makes U.S. goods and services more competitive in foreign markets, and it makes foreign products less competitive here. As a result, many economists expect a slower deterioration of the trade deficit this year, with some even predicting an improved trade deficit by year's end.

Accommodative monetary and fiscal policy and favorable financial conditions should keep the economy moving ahead strongly. Real GDP growth will likely be about 4.5 percent from the fourth quarter of 2003 to the fourth quarter of 2004. Household spending should grow solidly because of improved labor market conditions, gains in household wealth, and lower federal taxes. But the mix of spending is likely to shift this year, with more support for the recovery from the business sector. Business equipment purchases should rise briskly because of improved corporate profits, a favorable financial environment, and expiring tax incentives. In addition, business confidence has improved substantially—the Conference Board's index of business confidence surged in the first quarter to its highest level in 20 years.

Economic growth of about 4.5 percent should lower the civilian unemployment rate further this year. Hiring is likely to pick up gradually over the course of the year as productivity growth slows to a more sustainable pace. Progress in reducing the unemployment rate may be limited by people reentering the labor force as they become

[1] The Board's major currency index declined 23 percent from February 2002 to the first part of April 2004.

more optimistic about job prospects, but I expect some further reduction in the unemployment rate to about 5.5 percent in the fourth quarter.

Inflationary pressures should remain moderate this year. Although there is some upward pressure on the prices of oil, steel, and other commodities, reflecting strong world demand and dollar depreciation, such commodities are a small part of production costs. Consumer price inflation is not likely to rise sharply from recent levels because of excess manufacturing capacity and continued slack in the labor market. I expect core CPI inflation to be around 1 ½ percent this year. But clearly with strong growth and diminishing excess capacity, the Federal Open Market Committee will need to monitor inflationary pressures closely.

International Economic Issues

Although there are both upside and downside risks to the outlook and plenty of domestic issues that could be discussed, I want to turn to the U.S. role in the global economy. International factors play a growing role in our economic performance, and international economic issues are prominent in the newspaper headlines and political debates. Offshoring of service jobs, such as computer programming and call-center jobs, is a hot topic right now, so let me tackle that one first and see how much trouble I can get into. Then I will turn to the large current account deficit and its relation to the federal budget deficit.

Offshoring and the Job Market

Although offshoring of jobs may have some effect on hiring and unemployment, offshoring is not the main reason for sluggish job growth. Two other factors are probably more important—rapid productivity growth and business caution. Rapid productivity

growth means businesses have boosted their output substantially without adding many workers. Recent productivity growth has been well above its long-term trend because businesses are still finding ways to use their past IT investments to become more efficient. But many economists expect productivity growth to gradually move back toward its trend rate, requiring firms to hire more workers.

Moreover, businesses have been cautious about hiring and other long-term commitments because of an uncertain economic outlook. As I noted earlier, chief executives of major corporations are now becoming more optimistic about the economy and seem more willing to hire new employees. Sharp increases in employee benefit costs, particularly health care costs, remain a deterrent to hiring, however.

Offshoring of computer programming jobs has not been a big factor in sluggish employment growth because the offshoring of service jobs is still relatively small despite all the headlines. Offshoring in the service sector has probably been no more than 100,000 jobs per year, which is less than 0.1 percent of total U.S. employment and only about 1/3 of net job creation in March.

The offshoring of manufacturing jobs is probably a bigger factor—perhaps several hundred thousand jobs per year—but such offshoring has been going on for decades without a lasting effect on the unemployment rate.[2] Americans have worried over the years about losing manufacturing jobs to Japan, South Korea, Mexico, and now China, yet our flexible economy managed to generate millions of new jobs, many of them quite good jobs.

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[2] For example, Mark Zandi of Economy.com estimated that about 1 million jobs were offshored between February 2001 and October 2003. In his estimates, about 800,000 jobs were offshored in manufacturing, which implies an annual rate of about 300,000 manufacturing jobs offshored per year.

But I don't want to minimize the effect of offshoring. Those who lose their jobs because of import competition can sometimes suffer badly. The offshoring of service jobs is a new phenomenon, and there are few studies that look specifically at the loss of service jobs. But studies for manufacturing have found that the economic loss can be large. Older, less skilled workers are more likely to experience lengthy periods of unemployment or large income losses when they are reemployed. Since displaced computer programmers and other IT workers tend to be younger and better educated, their reemployment prospects may be better, but some still face painful adjustments.

Offshoring of service jobs is likely to continue in the future, and probably will accelerate. Projections by Forrester Research, a consulting firm, suggest that more than 3.3 million service jobs will be moved abroad by 2015, and some estimates put the job loss even higher.

Although offshoring may temporarily affect the unemployment rate, most displaced workers eventually go back to work, and some even find jobs that are better than the ones that they lost. Offshoring temporarily raises the unemployment rate because displaced workers need time to find a new job, which may be difficult if they have to change professions or move to another part of the country. But over time, monetary and fiscal policy can keep the work force fully employed. And if workers move to other good jobs, our living standard is not likely to be harmed—in fact, it could improve because some goods and services become available at a lower cost.

From a policy standpoint, our nation should be proactive about offshoring, but protectionism is not a good response. Economic studies find that protectionism is costly to U.S. consumers and businesses. For example, the recently expired steel safeguards

may have cost more jobs in the steel-consuming industries than they saved at steel producers.[3] Better policy responses might include expanded job training programs for displaced workers, investing more in education and research, and negotiating to open foreign markets to our products and to protect the intellectual property of our businesses.

The Current Account Deficit

A related topic is the large U.S. current account deficit. The current account is a broad measure of U.S. international transactions. It combines the balances on trade in goods and services, international investment income, and net transfers. This deficit has been growing in dollar terms and relative to the size of our economy in recent years. In 2003, the current account deficit was $542 billion, or about 5 percent of GDP. To cover the deficit, our nation must borrow abroad or sell some of its assets to foreigners.

Mostly, the large current account deficit reflects the strength of the American economy. Our spending on goods and services has been strong, which led to increased imports of foreign products. Much of that spending has gone to import capital goods that make our economy more productive over the long run. In contrast, some of our major trading partners, such as Europe and Japan, had relatively weak growth of domestic spending, and this weak foreign growth reduced the demand for our exports.

But the large and growing current account deficit is still a source of concern. Because we borrow heavily abroad to finance the deficit, a loss of foreign confidence in our economy might require sharp increases in interest rates or large exchange rate changes to attract needed foreign investment. Such financial adjustments could harm our

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[3] Gary Clyde Hufbauer and Ben Goodrich, “Next Move in Steel: Revocation or Retaliation?” *International Economics Policy Briefs*, Institute for International Economics, October 2003.

economy—sharp increases in interest rates, for example, might hurt business investment and housing market activity.

To date, the United States has not experienced major difficulties in financing the current account deficit. This country still offers strong investment opportunities, and U.S. assets are viewed appropriately as being safe and highly desirable. But history shows that large current account deficits, even in developed economies, have sometimes caused financial market crises. There is no magic line to indicate exactly when the size of the current account deficit becomes an issue, but historically, a current account deficit of 5 percent is relatively large. To avoid any possibility of economic disruptions in the future, our nation should try to narrow its current account deficit.

Reducing the federal budget deficit would be a good place to start. Although there is not a one-to-one link between the federal budget deficit and the current account deficit, the two are related. When the budget deficit absorbs a large part of domestic savings, these savings are no longer available to finance private investment. If high levels of productive investment are to be maintained, U.S. companies and households must borrow abroad, raising the dollar's value and reducing U.S. export competitiveness. All other things equal, large federal budget deficits encourage trade deficits in a world of international capital mobility.

To reduce our nation's dependence on foreign capital and narrow the current account deficit, we should set fiscal policy on a course that will reduce the federal budget deficit. Increased domestic saving could also help to narrow our current account deficit. Policies to boost domestic saving, such as new tax-exempt savings accounts or enhancements to existing accounts, are a possibility.

Again, the United States has not experienced difficulties so far in financing its large current account deficit. Given the size of our economy , its attractive investment opportunities, and the dollar's importance as an international currency, we may be able to run a larger current account deficit than other countries without experiencing a crisis. But to avoid any risk of a sharp financial adjustments in the future, we would be wise to start narrowing the current account deficit by reducing our federal budget deficit and finding ways to boost private savings.

Summary

To summarize, recent U.S. economic performance has been good. Growth has been strong, inflation has been low, and even the labor market seems to be improving. Real GDP growth should be strong enough this year to lower the unemployment rate somewhat by year's end, and inflation should remain low.

In the months ahead, international economic policy will get more attention than usual. Offshoring of jobs and the large current account deficit are two important international economic issues. The United States should be proactive in addressing these issues, but it should also be careful to pursue sound policies rather than quick fixes. Although protectionism may seem like a quick fix, it would more likely be a costly mistake. Instead, we should focus on sound economic fundamentals, such as investing in education and research, improving our trade adjustment programs, and reducing the federal budget deficit.