

**USA**

# **ECONOMY**

**IN BRIEF**







**W**hen the United States sneezes, an economists' proverb says, the rest of the world catches a cold.

Between 1995 and 2005, the United States accounted directly for one-third of global economic expansion, according to the nonprofit Council on Competitiveness. Between 1983 and 2004, soaring U.S. imports added nearly 20 percent of the increase of the world's exports.

"Developing countries accounted for an increasing share of U.S. exports, 32.8 percent in 1985 versus 47.0 percent in 2006," a Congressional Research Service (CRS) report says. "Developing countries accounted for 34.5 percent of U.S. imports in 1985 and 54.7 percent ... in 2006."

Like a rugged four-wheel-drive vehicle crossing rough terrain, the U.S. economy cruised along in the early 2000s, even while hitting some big rocks: a stock market crash, terrorist attacks, wars in Iraq and Afghanistan, corporate accounting scandals, widespread hurricane destruction, surging energy prices, sliding real estate values.

After a mild recession in March-November 2001, the U.S. economy resumed expanding, an average 2.9 percent during 2002-2006, while price inflation, unemployment, and interest rates remained relatively low.

By various measures the United States remains the world's most productive, competitive, and influential large economy. Yet more and more the U.S. economy is itself influenced by

dynamic economies overseas. And it faces challenges both at home and abroad.

But what do we mean by the U.S. economy anyway?

## Goods and Services

**A** national economy comprises a country's production of goods and services. Real gross domestic product (GDP) measures such output produced by labor and property in the United States.

Workers use capital and natural resources to produce goods and services. Natural resources are those supplied by planet Earth: air, water, trees, coal, soil.

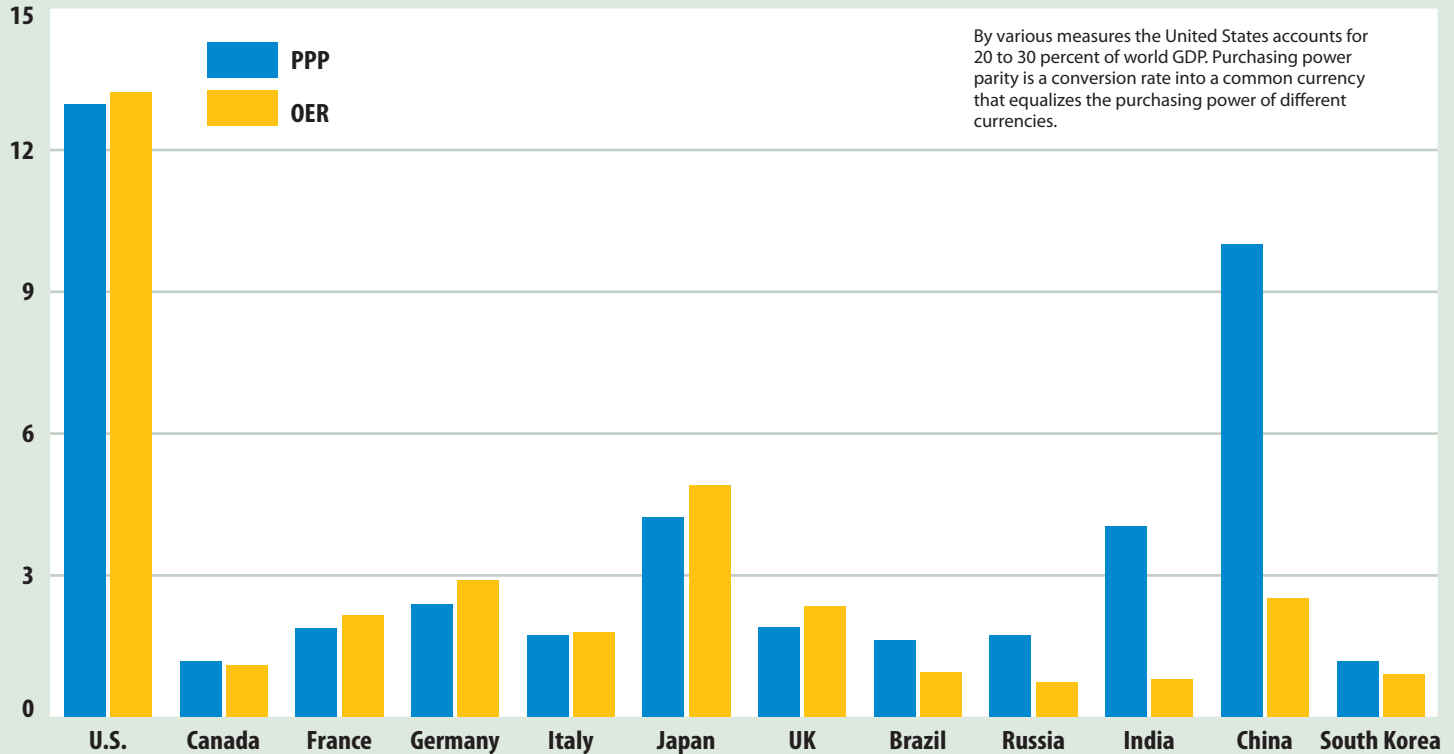
Capital includes physical capital: tools, machines, technology (high and low). It includes intellectual property: copyrights, patents, trademarks. It includes human capital: training, skills, experience.

Most natural resources in the United States come from land privately owned by individuals or corporations or leased from governments at the national and state levels. Governments set rules for using natural resources, such as controlling pollution.

The United States is rich in mineral resources, although it has already passed the point of peak production for some, including oil. It has much fertile farm soil and a moderate climate. It has extensive coastlines on the Atlantic and Pacific

## 2006 GDP, both PPP (purchasing power parity) and OER (official exchange rate)

Trillions of U.S. dollars



By various measures the United States accounts for 20 to 30 percent of world GDP. Purchasing power parity is a conversion rate into a common currency that equalizes the purchasing power of different currencies.

oceans and the Gulf of Mexico. Rivers flow from far within the continent, and the five Great Lakes on the border with Canada provide additional shipping access. Extensive waterways, railroads, highways, and air transportation shape the 50 individual states into a single economic unit.

Individuals or corporations own most U.S. technology and other physical capital. The U.S. economy is especially rich in information technology, accounting for major gains in productivity over the past decade. Governments set rules for buying, selling, and using capital.

Individuals, corporations, universities, and other research institutions own intellectual property. Worldwide theft of U.S. copyrighted films, music CDs, and software, as well as patented designs, is estimated at billions of dollars a year.

Since the United States abolished slavery during the Civil War in 1863, all U.S. workers own their own labor and are free to sell it to employers for wages or work for themselves — self-employment. Governments set rules for hiring and employing workers.

To produce goods and services, business managers organize and direct labor, capital, and natural resources in response to market signals. In a traditional business structure, management works through a top-down chain of command. In a typical factory, for example, authority flows from the chief executive, who aims to run the entire business efficiently,

through lower levels of management down to the foremen on the shop floor.

Some businesses use a more flexible organization, especially in high-technology industries where skilled workers develop, modify, and customize products rapidly. These companies have “flattened” their organizations, reducing the number of managers and delegating more authority to interdisciplinary teams of workers. Often teams form to carry out a project and then disband when the project is completed, with team members moving to new challenges with other groups.

So what does the U.S. economy actually produce?

## A Service Economy

**S**ervices produced by private industry accounted for 67.8 percent of U.S. gross domestic product in 2006, with real estate and financial services such as banking, insurance, and investment on top. Some other categories of services are wholesale and retail sales; transportation; health care; legal, scientific, and management services; education; arts; entertainment; recreation; hotels and other accommodation; restaurants, bars, and other food and beverage services.

Production of goods accounted for 19.8 percent of GDP: manufacturing — such as computers, autos, aircraft, machinery



Hills of corn in Kansas are reminders that agriculture, accounting for a small share of GDP, remains an important part of the U.S. economy.

— 12.1 percent; construction, 4.9 percent; oil and gas drilling and other mining, 1.9 percent; agriculture, less than 1 percent.

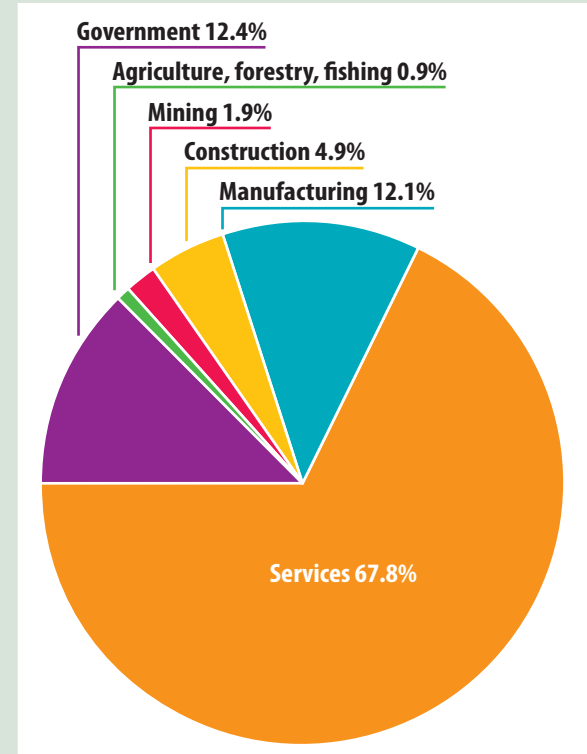
Federal, state, and local governments accounted for the rest — 12.4 percent of GDP.

The most rapidly expanding sectors are financial services; professional, scientific, and technical services; durable goods manufacturing, especially computers and electronic products; real estate; and health care.

Decreasing their share of GDP growth are agriculture and mining and some other kinds of manufacturing, such as textiles.

## 2006 GDP value added by industry

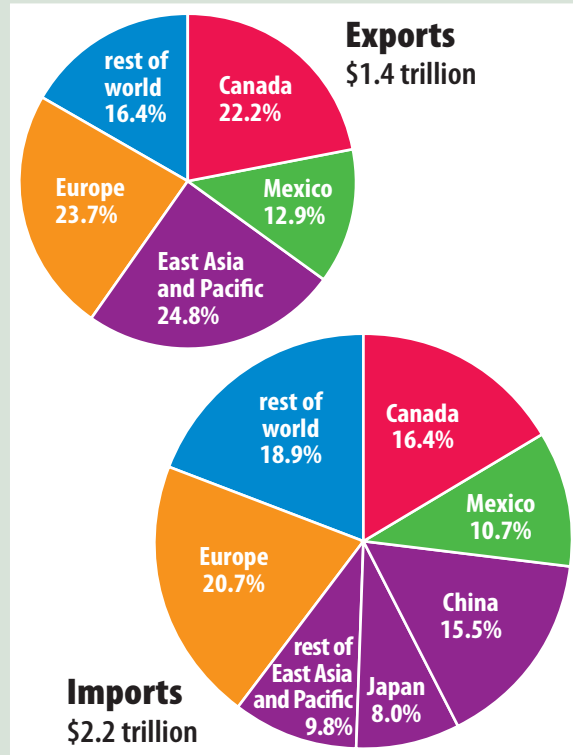
Percent



Services such as banking, retail sales, transportation, and health care account for two-thirds of the value of U.S. GDP.

## 2006 U.S. exports and imports

Percent



While the United States maintains a trade surplus in services, it runs a large deficit in merchandise goods trade.

“Low-value, commodity-based manufacturing is disappearing from the United States, moving to developing nations where routine manufacturing can be performed at low cost,” the Council on Competitiveness says.

Yet the United States remains the world’s top manufacturing country, its factories producing goods worth \$1.49 trillion in 2005, 1.5 times the level in the next country, Japan. And the value of U.S. agricultural production trails that of only China and India.

Even though agriculture now has a small share of GDP, farmers remain economically and politically powerful forces. In 2002 the market value of U.S. farm production amounted to more than \$200 billion, including \$45 billion for cattle and calves; nearly \$40 billion for grains, such as corn and wheat, and oilseeds such as soybeans; nearly \$24 billion for poultry and eggs; \$20 billion for milk and other dairy products; and \$12 billion for hogs and pigs.

Even though the United States has more than 2 million farms, a relatively tiny number of big corporate farms dominate — 1.6 percent of farms in 2002 accounted for half of all sales.

Despite its overall trade deficit, the United States has a surplus in agriculture. U.S. farm exports in 2007 are forecast at \$78 billion, with the largest share going to Asian countries, although Canada and Mexico account for the largest share of



Construction accounts for nearly 5 percent of the U.S. economy; here a worker fits pipe on a gasoline station under construction in Georgia.

recent growth in agricultural exports. About one-fourth of U.S. farm output is exported.

The United States also maintains a trade surplus in services, \$79.7 billion in 2006. The biggest U.S. services export category was travel by foreigners to the United States, \$85.8 billion that year.

In contrast, the United States runs a large and growing deficit in merchandise goods trade. While the United States exported more than \$1 trillion in goods in 2006, it imported more than \$1.8 trillion worth.

By far the top imports that year were autos and auto parts, \$211.9 billion, and crude oil, \$225.2 billion. The top sources of U.S. imports were Canada, China, Mexico, Japan, and Germany.

Among the top U.S. exports in 2006 were autos and auto parts, semiconductors, and civilian aircraft. The top U.S. export destinations were Canada, Mexico, Japan, China, and the United Kingdom.

In 2000-2006, even though U.S. goods exports increased 33 percent, U.S. goods imports went up even faster, 52 percent; the goods deficit nearly doubled over those years.

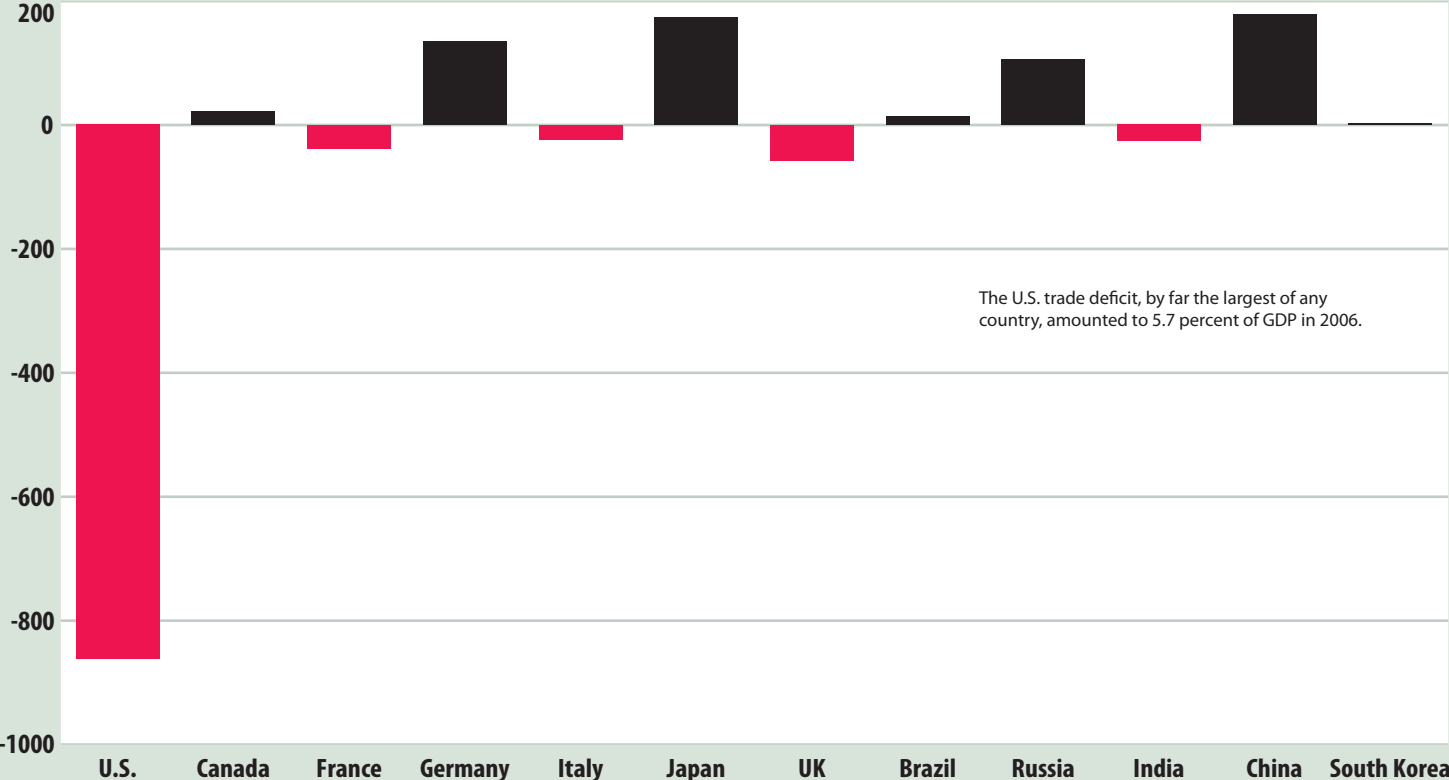
The \$758.5 billion trade deficit amounted to 5.7 percent of 2006 GDP, a level viewed as unsustainable by many economists because it relies on continuing inflows of foreign investment to pay for it.

But what makes the U.S. economy so dynamic?



# 2006 trade surplus or deficit

Billions of U.S. dollars



The U.S. trade deficit, by far the largest of any country, amounted to 5.7 percent of GDP in 2006.

## Creative Destruction

**W**ith a large land mass, natural resources, a stable government, and a relatively well-educated workforce, the U.S. economy has some competitive advantages in the world marketplace. Importantly, it also has a willingness to endure, even embrace, change.

The U.S. economic system reflects what 20th-century Austrian economist Joseph Schumpeter described as free-market capitalism’s “creative destruction.” Jobs, companies, entire industries come and go.

Even cities and regions expand and, if they cannot adjust to change, contract — some old industrialized cities in the “Rust Belt” of the Northeast and Midwest and some agricultural states in the Great Plains have lost lots of people to other cities and regions over decades.

In a free market, decisions about what to produce and what prices to charge for products are made through the give and take of independent buyers and sellers — sometimes a few, sometimes millions — not by government or powerful private interests. Prices set this way best reflect the value of goods and services and best guide production of what is most needed.

Americans also view free markets as a way of promoting individual freedom and political pluralism and opposing concentrations of power. The U.S. federal government renewed



Trans World Airlines was one of the tens of thousands of businesses that file for bankruptcy every year, some shutting down permanently.

its commitment to market forces from the 1970s on by dismantling regulations that had sheltered some industries — such as trucking, airlines, and telecommunications — from market competition for decades.

Vigorous competition and a regulatory system that embraces technological change have made the U.S. economy productive and provided American households with relatively high incomes. U.S. productivity went up briskly in the 1990s, with a peak 4.1 percent gain in 2002. This widened a lead over the European Union and Japan, mostly by more effective

application of information technology. Since then, productivity gains have fallen off, only 1.6 percent in 2006.

A dynamic economy implies the freedom to fail. In the United States, business failure does not carry the social stigma it does in some countries. Failure, in fact, is often viewed as a valuable learning experience for the entrepreneur, who may succeed the next time.

In 2005 the U.S. government recorded the creation of about 671,800 businesses and the demise of about 544,800 others. Many small, little-known businesses start up each year; some succeed, some fail.

Tens of thousands of businesses enter bankruptcy each year, and some of them shut down permanently. In 2005 more than 39,000 businesses filed for bankruptcy.

In the United States even well-known big businesses fail. Trans World Airlines, United Air Lines, Delta Air Lines, Northwest Airlines, US Airways, Continental Airlines, Eastern Airlines, and Pan Am are just some of the major commercial airlines that have filed for bankruptcy since air travel deregulation in 1979 led to more vigorous competition. Some have re-emerged; others have disappeared forever, their assets scavenged by surviving competitors.

Another measure of the U.S. economy's dynamism: Of the 12 companies that Dow Jones listed in 1896 when it created its famous stock index to represent the industrial sector, only one,

General Electric, remains on the index now. Others disappeared from the index as they were acquired by other companies, split into smaller companies, became relatively smaller players in the economy, or simply dissolved. Some of the companies that replaced them started out as small businesses.

So does the large number of small businesses help explain the U.S. economy's dynamism?

## Businesses Large and Small

**S**mall businesses, those having fewer than 500 employees, loom large in the U.S. economy. They can respond quickly to changing economic conditions and customer needs with innovative technical solutions to production problems. Their share of nonfarm GDP reached 50.7 percent in 2004.

“Of the nearly 26 million firms in the United States, most are very small — 97.5 percent — have fewer than 20 employees,” the U.S. Small Business Administration says. “Yet cumulatively, these firms account for half of our nonfarm real gross domestic product, and they have generated 60 to 80 percent of the net new jobs over the past decade.”

Many entrepreneurs began by tinkering with hand-assembled machines in a home garage. A few expanded small businesses quickly into large, powerful corporations. Some



Federal Express, which delivers the goods here in San Francisco and lots of other places around the world, started out as a small business.

examples: software manufacturer Microsoft, delivery service Federal Express, sports clothing manufacturer Nike, online service provider AOL, and ice cream maker Ben & Jerry's.

Women own and operate many small businesses. In 2002, women-owned businesses accounted for 28 percent of all U.S. companies except for farms, 6 percent of all U.S. workers, and 4 percent of U.S. business receipts.

Persons from minority groups run many small businesses. Of all U.S. nonfarm firms in 2002, 6.8 percent were owned by Hispanic Americans, 5.2 percent by African Americans, 4.8 percent by Asian Americans, 0.9 percent by American Indians or Alaskan Natives, and 0.1 percent by Native Hawaiian or other Pacific Islanders.

Small businesses employ almost exactly half the private U.S. labor force of about 153 million. In 2003 the average small business had one location and 10 employees; the average big business, 61 locations and 3,300 employees.

Many U.S. businesses large and small are organized as publicly traded corporations. Corporations have proved especially effective at accumulating the money needed to pay for launching and expanding operations.

To raise money, corporations sell stock (ownership shares in their assets) or bonds (loans of money) to investors. Commercial banks also lend money directly to businesses large and small. Federal and state governments enforce detailed regulations to





Women-owned businesses, such as Sharon Cote's trucking and construction business in Alaska, account for more than a quarter of all U.S. companies.

ensure the safety and soundness of this financial system and give investors the information they need to make well-informed decisions.

A major corporation may be owned by a million or more people, most of them holding shares worth tiny fractions of the company's total worth. About half of all U.S. households own

common stock, directly or through mutual funds or retirement pension investment plans.

"The majority of America's workers are participants in our capital markets," Christopher Cox, Securities and Exchange Commission chairman, said in a 2007 speech. "It is increasingly true — and increasingly apparent — that what's good for American investors is good for the American people."

Because shareholders generally cannot manage a corporation's business themselves, they elect a board of directors to make broad policy. Corporate boards place day-to-day management decisions in the hands of a chief executive officer (CEO).

As long as a CEO has the confidence of the board of directors, he or she generally is given broad freedom in running a corporation. But stockholders, acting in concert, can force a change in management. In an extraordinary display of assertiveness in 2004-2006, boards forced out the chairmen or CEOs of several major corporations for perceived failures in ethical behavior or performance.

Most corporations are small; some are gigantic. In 2006, a year of record oil prices, Exxon Mobil Corporation reported a record annual profit for a U.S. corporation of \$39.5 billion — more than \$75,000 per minute — on revenue of \$347 billion. Wal-Mart stores topped the list for 2006 corporate revenue at \$351 billion.

But aren't workers the ones making the U.S. economy productive?

## Workers and Productivity

**A**merica's high standard of living "is due to the fact that American workers are among the most productive in the world, and a greater share of the American population works than in many other countries," according to the Council on Competitiveness.



This Intel Corporation semiconductor plant in California demonstrates how productivity rises as workers get training and embrace change.

Through most of U.S. history, the labor force grew steadily, sustaining economic expansion. Immigrants have been a major source of labor, tending to increase in number especially during times of low unemployment, when demand for workers goes up.

About 146 million people in the United States were working in paid jobs at the end of 2006, with another 7 million unemployed; the 153 million total makes up the world's third largest labor force, after China's and India's.

Nearly two-thirds of U.S. working-age people participate in the labor force. Males and females each account for about half. About 15 percent of them are foreign born. Some 5 to 6 percent of them work more than one job.

The private sector employs most U.S. workers, 85.5 percent, and governments employ the rest.

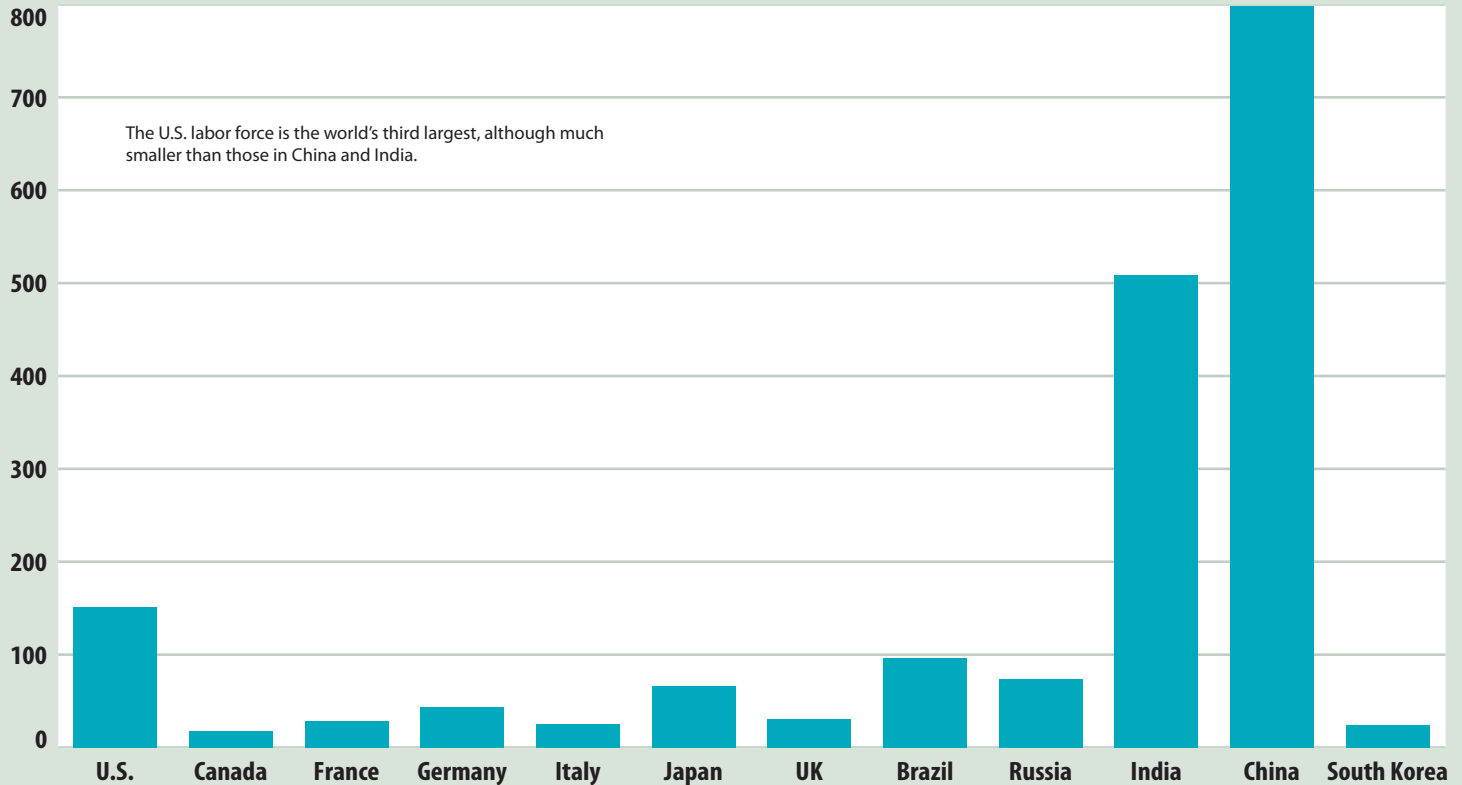
A lot of people are self-employed, more than 10 million in 2005, although some of them split their time between working for other people and for themselves. Most working people work for someone else in nearly 6 million U.S. companies. Most of these companies have fewer than 20 employees.

U.S. workers are flexible. Fairly steady growth in the number of jobs conceals a lot of churning — people changing jobs. Most years, on average, 10 percent of jobs disappear while a somewhat larger proportion is created.

"The data show that each month millions of Americans

## 2006 labor force

Millions





This ironworker at a construction site in New York City is one of about 153 million U.S. workers, half of them men and half women.

leave their jobs — most of them voluntarily — and millions more are hired,” Robert Kimmitt, deputy secretary of the U.S. Treasury, wrote in 2006. “This is what we want: an economy in which people looking to move up have as many opportunities as possible from which to choose.”

U.S. workers do not typically endure long-term unemployment. In 2005 only 12 percent of unemployed U.S. workers could not find work within

a year, compared to 46 percent in the European Union.

Contributing to U.S. workers’ productivity has been the emphasis on education, including technical and vocational training, as well as willingness to experiment and change.

Change includes Americans’ willingness to move from place to place to find work. In the 18th and 19th centuries, people moved from the coasts to the interior to till new farmland. In the

early 20th century, African Americans moved from farms in the South to find factory jobs in northern cities.

Not all workers leave jobs voluntarily, of course. Mass layoffs by big companies occur commonly — 13,998 companies



Students in Georgia get training to become skilled auto technicians and find work on race car crews.



reported mass layoffs during 2006. From late 2005 through early 2007, the Big Three U.S. automakers — General Motors Corporation, Ford Motor Company, and DaimlerChrysler AG — eliminated more than 90,000 U.S. jobs. U.S. airlines laid off 170,000 workers from August 2001 to October 2006.

Although U.S. workers have long had the right to organize, only 12 percent of them were labor union members in 2006, down from about 35 percent half a century earlier.

The biggest group of U.S. workers comprises nearly 23 million in office and administrative support jobs, such as telephone receptionists, secretaries, and hotel clerks. The groups of workers getting the highest average wages, more than \$80,000 a year, have jobs in management and law. The people getting the lowest average wages, less than \$20,000 a year, work in food preparation and service.

And what role does government play in the U.S. economy?

## The Role of Government

**S**ome people complain that government regulation of the economy is too little, too late. Others scoff that the U.S. economy is no free market at all, with so much regulation. Some of the most enduring debates of U.S. economic history focus on the role of government.

Emphasis on private ownership jibes with U.S. beliefs about



Some state governments, especially California's, have exerted leadership in reducing air pollution.

personal freedom. Since independence, Americans have most often sought to limit government's authority over individuals, including its role in the economic realm. And most Americans have believed that private ownership of business is more likely than government ownership to achieve the best economic outcomes.

Even so, most Americans want governments to perform



California state workers, like this one measuring the flow on Butte Creek, assure proper allocation of scarce water to rights holders.

certain tasks in the economy, and the U.S. legal system provides a sound infrastructure on which to do business.

Businesses — at least legitimate businesses — need permission from governments to operate at all. Corporations need a charter from one of the 50 state governments. (More than half of U.S. publicly traded corporations are incorporated in the tiny state of Delaware because they like its regulatory regime.) Businesses need various registrations, licenses, and permits from local governments.

Businesses need the court system for protecting property rights, enforcing contracts, and resolving commercial disputes.

Governments protect consumers from business. The federal government, for example, uses antitrust laws to control or break up monopolistic business combinations that become powerful enough to escape competition. Governments redress consumers' grievances about business fraud and enforce recalls of dangerous products.

Governments regulate private companies' activities to protect public health and safety or maintain a healthy environment. The U.S. Food and Drug Administration bans harmful drugs, for example, and the Occupational Safety and Health Administration protects workers from hazards on the job.

Since Americans have become increasingly concerned about the environmental impact of industry, Congress has passed many laws to control air, water, and ground pollution. Establishment of the U.S. Environmental Protection Agency (EPA) in 1970 brought together many federal programs charged with protecting the environment. The EPA sets and enforces limits on pollution and establishes timetables to bring polluters into line with standards.

Government involvement in the economy increased significantly during the most serious economic downturn in U.S. history, the Great Depression (1929-1940). President Franklin D. Roosevelt launched what he called the New Deal to rescue the economy.

Many of the laws and institutions that define the modern

U.S. economy emerged from New Deal legislation extending federal authority in regulating business and providing public welfare. The New Deal established minimum standards for wages and hours on the job. It created programs and agencies now deemed indispensable, including the Securities and Exchange Commission, which regulates the stock market; the Federal Deposit Insurance Corporation, which guarantees bank deposits; and the Social Security system, which provides retirees' pensions based on contributions they made while in the workforce.

Even with all its regulations, the United States in 2007 was ranked No. 3 by the World Bank in ease of doing business, after Singapore and New Zealand. All 10 ranking categories pertain in some way to government policy: starting a business, dealing with licenses, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, closing a business.

Government policies can also promote businesses. For example, tax breaks not only promote the public goal of home ownership — nearly 70 percent of U.S. households own their own home — but also expand business opportunities for real estate, construction, and mortgage finance companies.

Governments conduct research and development. Federal government research spending goes mostly to developing and testing weapons systems, but also helps keep the United States

as the center of biological science research, for example.

Governments aim to advance U.S. business goals in international trade. State governments promote exports of their industries. The federal government aims to negotiate lower tariffs and other foreign barriers to U.S. imports and to protect U.S. companies from unfair foreign competition.

Governments provide certain services — such as national defense, administration of justice, education, environmental protection, road construction, space exploration — for which they are viewed as better suited than private businesses.

Governments take care of needs beyond the reach of market forces. They provide insurance payments to people who lose their jobs and low-cost loans to people who lose their homes in natural disasters. The Social Security system, financed by a tax on employers and employees, accounts for the largest portion of Americans' retirement income. The Medicare program pays for some medical costs of the elderly; the Medicaid program, for medical costs of low-income families. In many states, government maintains institutions for the mentally ill or people with severe disabilities. The federal government provides food stamps for poor families to purchase food. The federal and state governments jointly provide grants to support low-income parents with children.

What about government's role steering the economy?

## A NUMBER OF NUMBERS TO CONSIDER

**F**or better or worse, the U.S. economy is at or near the top in a number of international rankings:

- No. 1 in economic output, called gross domestic product, amounting to \$13.13 trillion in 2006. With less than 5 percent of the world's population, at about 302 million, the United States accounts, by different measures, for between 20 and 30 percent of world GDP. The GDP of just one state, California, amounting to \$1.5 trillion in 2006, exceeded the GDP in all but about eight countries that year.
- No. 1 in total imports, some \$2.2 trillion in 2006, about twice that for the country with the next highest level, Germany.
- No. 2 in exports of goods, \$1 trillion in 2006, behind only Germany, although China is predicted to surpass the United States in 2007. No. 1 in exports of services, \$422 billion in 2006.
- No. 1 trade deficit, \$765.3 billion in 2006, many times that of any other country.
- No. 2 in maritime container traffic in 2006, behind only China.
- No. 1 in external debt, estimated at more than \$10 trillion mid-2006.

- No. 1 destination for foreign investment, an inflow of more than \$1.5 trillion in 2006.
- No. 1 for inflow of foreign direct investment — businesses and real estate — about \$177.3 billion in 2006. No. 1 destination for foreign direct investment by the world's 100 biggest multinational corporations, including corporations from developing countries.
- No. 5 in holdings of reserve assets in 2005 at \$188.3 billion, 4 percent of the world's share, behind Japan and China (each with 18 percent), Taiwan, and South Korea, and just ahead of Russia. No. 15 in reserves of foreign exchange and gold, about \$69 billion in mid-2006.
- No. 1 source of remittances to Latin America and the Caribbean, about three-fourths of the total \$62 billion in 2006, from people who migrated out of those regions to find work abroad.
- No. 1 in petroleum consumption, about 20.6 million barrels a day in 2006, and No. 1 in crude oil imports, more than 10 million barrels a day.
- No. 3 in ease of doing business in 2007, after Singapore and New Zealand.
- No. 20 of 163, tied with Belgium and Chile, in Transparency International's 2006 index measuring perceptions about corruption (lowest-numbered economies are viewed as least corrupt).



# Macroeconomic Policy

**T**he federal government aims to promote the conditions required for steady economic expansion and high levels of employment, especially a stable general price level and a tolerable tax burden. The Federal Reserve, the independent U.S. central bank, manages the money supply and use of credit (monetary policy), while the president and Congress adjust federal spending and taxes (fiscal policy).

Since the inflation of the 1970s, Federal Reserve monetary policy has emphasized preventing rapid escalation of general price levels. When the general price level is rising too fast, the Federal Reserve acts to slow economic expansion by reducing the money supply, thus raising short-term interest rates.

When the economy is slowing down too fast, or contracting, the Federal Reserve increases the money supply, thus lowering short-term interest rates. The most common way it effects these changes in interest rates, called open-market operations, is by buying and selling government securities among a small group of major banks and bond dealers.

A particularly tricky situation for monetary policy makers, called stagflation, occurs when the economy is slowing down and inflation is rising too fast.

The usefulness of fiscal policy has been subjected to intense academic and political debate. Some people view even massive



The Federal Reserve, the U.S. central bank, aims to control expansion of the money supply in a way that prevents inflation.

additional government spending as too small to make any difference in the huge U.S. economy, although specific projects can have locally important effects. Some experts emphasize benefits to the economy from low tax rates; others emphasize harm to the economy from government borrowing.

What happens as the U.S. economy keeps evolving?

## The Times They Are A-Changing

**F**rom a developing country of mostly subsistence farmers little more than 200 years ago, the United States became the world's center of manufacturing in the 19th and 20th centuries. At the beginning of the 21st century, the United States remains the world's top manufacturing country and top provider of services.

And as the global landscape of production and sales rapidly changes, the U.S. economy is changing with it. More production happens in stages and across borders. More sales take place in massive discount stores and over the Internet.

For decades, U.S. multinational corporations have sold



The Tower Records chain of retail music adapted to change by shutting down its stores and selling CDs online.

goods and services to foreign customers through foreign subsidiaries. Increasingly now, multinationals are combining labor, capital, and natural resources from their own units and allied suppliers scattered around the world to capture cost efficiencies at different stages of production and marketing. More and more, foreign trade comprises intermediate goods on their way to further processing.

A 2006 report by the National Research Council says that “the volume and range of functions that are being transferred across borders is new. ... The growing ability and willingness of firms to fragment the production process — locating design in one place, parts manufacturing in another place, and assembly in a third place — has implications for U.S. competitiveness, wages, and employment.”

With customers in scores of countries, U.S. multinationals now make more than one-fourth of their total sales revenue from subsidiaries outside the United States. Sales by such U.S. foreign affiliates amount to more than three times total U.S. exports of goods and services.

Another change is the emergence of e-commerce, the sales of goods and services taking place on the Internet. E-commerce accounted for 3 percent of all U.S. retail sales by the end of 2006, up from less than 1 percent in 1999.

Online access is changing industries' fortunes. Major newspapers, watching subscription numbers slide, are trying



Superstores such as this massive Lowe's hardware store in Oregon have shaken up U.S. retailing.

to figure out a new way to make money on their Web sites at a time when people have nearly instantaneous access to so much free information on the Internet.

Also changing retail sales is the rise of “superstore” chains that sell thousands of products in massive warehouse-like buildings at sharply lower prices than smaller stores charge.

Profound change in the music industry reflects the competition from e-commerce and superstores. Compact disc sales, declining since 2000, dropped 13 percent in 2006 and plunged at an even faster rate at the start of 2007. Music

retailers face competition from online sources, both legal, such as Apple Inc.'s iTunes Store, and illegal (perhaps 1 billion songs are downloaded each month from file-sharing networks without regard to copyright). They also face competition from giant discount chain stores for the most popular CDs. The well-known Tower Records chain of music stores filed for bankruptcy and closed its U.S. retail stores in 2006, but Tower.com continues to operate online, selling CDs and individual songs for downloading.



The online auction company eBay Inc., headquartered in California, is one of the businesses that have pioneered the rise of e-commerce.



Multinational companies such as Nike, headquartered in Oregon, produce around the world, including at this athletic shoe factory in Vietnam.

It is hard to speculate how the U.S. economy will abide through these changes — even how it is measured, how it is defined.

What are some of the other challenges facing the U.S. economy?

## Trouble Ahead, Trouble Behind

**T**he U.S. economy has not only fundamental strengths but also fundamental problems.

The U.S. Central Intelligence Agency summarizes economic conditions in nearly 200 countries. Here is what its 2007 *World Factbook* says about the home country: “Long-term problems include inadequate investment in economic infrastructure, rapidly rising medical and pension costs of an aging population, sizable trade and budget deficits, and stagnation of family income in the lower economic groups.”

Like U.S. economic strengths, however, U.S. economic problems evolve over time.

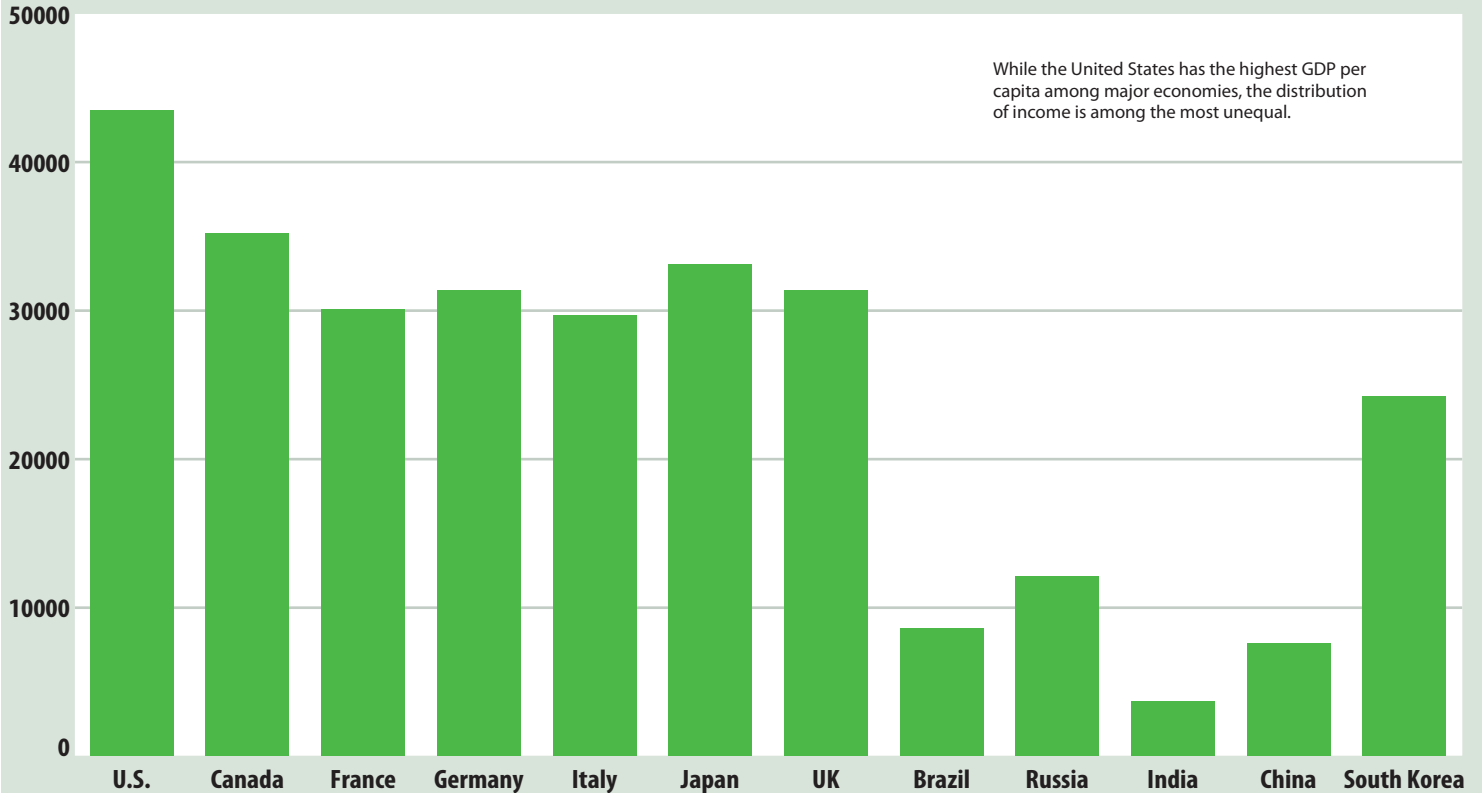
Consider income inequality. The United States is No. 10 in gross domestic product per person (adjusted for what the same money actually affords in different countries), at about \$43,500 in 2006, behind Bermuda, Luxembourg, Jersey, Equatorial Guinea, United Arab Emirates, Norway, Guernsey, the Cayman Islands, and Ireland, but ahead of all other major economies.

The distribution of income in the United States, however, is the most unequal of all major economies. It is becoming more so over decades. In 2004, according to the Congressional Budget Office, the top fifth of U.S. households earned 53.5 percent of all U.S. income, while the bottom fifth earned only



## 2006 GDP per capita

*U.S. dollars PPP (purchasing power parity)*



4.1 percent. The top 1 percent alone earned 16.3 percent of all income, twice the proportion of the 1960s-1970s.

While income went up some for all U.S. households, the biggest gains went to the group of top earners.

“The bottom 60 percent of households have seen gains of less than 10 percent in real terms between 1986 and 2005, while incomes for the top quintile have risen 32.5 percent and those for the top 5 percent have risen 49 percent,” the Council on Competitiveness says.

What is the reason for this two-tier labor market? The prevailing view is that those at the bottom lack the education or skills of those at the top. Struggling to grapple with technological change and to compete against low-wage workers elsewhere in the global economy, they fail to get comparable pay raises and other benefits.

Yet the statistics conceal dynamic changes going on in income mobility; the incomes of many Americans rise and fall over time. From 1989 to 1998, for example, 47 percent of households in the bottom fifth moved up into one of the other groups, and 47 percent of those in the top fifth moved down. Among all households, about 60 percent moved up or down from one group to another over those years.

Still, U.S. policy makers recognize the potential damage to the economy from stagnant incomes for people at the bottom.

“If we did not place some limits on the downside risks to

individuals affected by economic change,” Federal Reserve Chairman Ben Bernanke said in a 2007 speech, “the public at large might become less willing to accept the dynamism that is so essential to economic progress.”

Americans have long held ambivalent feelings about the rich and famous. Aggressive businessmen have at different times been praised as captains of industry and scorned as robber barons. These days some of the wealthiest of the wealthy are celebrities in entertainment and sports, supported by a public willing to pay for their unique star qualities.

And how does the U.S. energy problem figure into all this?

## All That Energy

**T**he U.S. economy uses a lot of energy — in 2005, 99.89 quadrillion British thermal units (Btu). Nearly all of the energy produced in the United States is consumed within country, and then the United States imports a lot more.

“Fossil fuels — coal, oil, and natural gas — currently provide more than 85 percent of all the energy consumed in the United States, nearly two-thirds of our electricity, and virtually all of our transportation fuels,” reports the U.S. Department of Energy.

The department predicts that U.S. reliance on fossil fuels will continue increasing for decades, “even with aggressive

development and deployment of new renewable and nuclear technologies.”

Less than 8 percent of the U.S. energy supply comes from nuclear energy and less than 6 percent from renewable energy, mostly hydroelectric and biomass.


Energy is costing more money around the world as demand rises, especially in rapidly expanding economies such as China and India. At the same time, energy supplies, notably petroleum, fall increasingly under the control of state-owned companies outside the major economies.

Nearly one-third of the U.S. energy supply is imported, as is nearly two-thirds of its petroleum. In 2006 the U.S. economy used, on average, 20.6 million barrels of petroleum a day, nearly one-fourth of the world supply. U.S. dependence on foreign oil has become a major political issue.

“Since there are few readily available substitutes for oil, even a relatively minor disruption of the global oil supply has the potential to cause economic dislocation for tens of millions of Americans,” a report from the Energy Security Leadership Council says.

Conserving energy through better efficiency and developing energy supplies other than fossil fuels are U.S. policy goals, but getting to a political consensus about achieving those goals is tough.

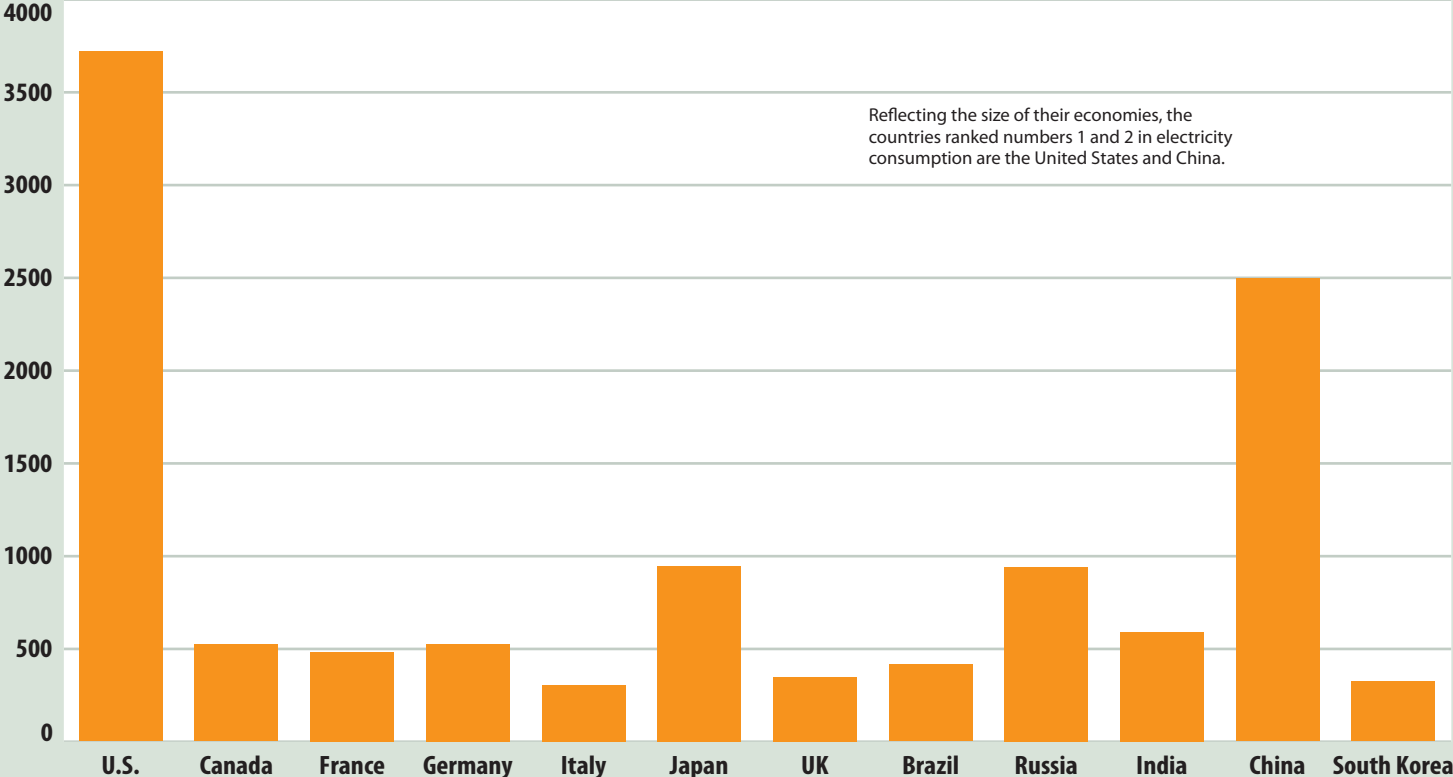
The U.S. economy has already accomplished some energy



Renewable energy sources like these windmills in Colorado's Rocky Mountains account for less than 6 percent of the U.S. energy supply.

# 2006 electricity consumption

Billions of kilowatt hours



Reflecting the size of their economies, the countries ranked numbers 1 and 2 in electricity consumption are the United States and China.



Oil refineries like this one in Texas supply the 20.6 million barrels of oil the U.S. economy uses each day.

efficiency. It now uses only half as much oil to produce an (inflation-adjusted) dollar of GDP as it did at the time of the 1970s oil price shocks. The reasons? Expanding sectors of the economy that rely less on energy, raising auto fuel efficiency standards, and slashing use of oil for electric power.

Even so, as of 2004, U.S. energy efficiency still ranked behind that in other major economies except Canada.

A 2005 energy law passed by Congress provides many different incentives, such as loan guarantees, tax breaks, and subsidies for energy industries (including nuclear, biomass such as ethanol, and fossil fuels). Cleaner-burning coal is a major objective — the United States has big supplies of coal. The law also provides limited tax breaks for home improvements for energy efficiency and for purchases of energy-efficient motor vehicles.

For environmental as well as economic reasons, some state governments, especially California's, have gone further than the federal government in raising energy efficiency standards for housing, businesses, and motor vehicles.

Still, federal, state, and local governments are wrangling over how to accomplish much more to bolster energy security.

Does foreign investment also pose a problem for the U.S. economy?



## Foreign Investment

Some economists identify as another serious challenge the dependence of the U.S. economy on inflows of foreign capital for investment in a situation of low U.S. saving rates.

Even as the United States has prospered, its workers have built high and rising levels of household debt. By official statistics, what was a tiny but positive savings rate has turned negative in some years since 2000. For the first time since the 1930s' Great Depression, households overall are actually spending more than they earn in after-tax income.

At the same time, the federal government has been running budget deficits — \$435 billion in 2006 — much of it financed by foreign central banks. U.S. federal public debt, approaching \$9 trillion, is estimated at about 65 percent of GDP, about the same proportion as in France and Germany, and a lot smaller proportion than in Japan and Italy.

Meanwhile, foreign countries — especially rapidly expanding emerging Asian economies and oil-producing countries — are experiencing a savings glut. Individuals and central banks and other institutions, even from developing countries such as China with many poor people, have been pouring enormous sums of money into U.S. markets.

“The large inflows of foreign capital to the United States

likely arise from the relatively more robust economic growth that occurred in the United States compared with almost any other area, the well-developed U.S. financial system, and the overall stability of the U.S. economy,” the Congressional Research Service says.

According to CRS, foreign investors own about 10 percent of total U.S. publicly traded financial assets, including corporate stocks and bonds and marketable government securities. They also invest directly in U.S. business plant and equipment and in real estate.

In 2006 foreigners invested nearly \$1.8 trillion in the U.S. economy, about \$184 billion of that in direct investment and the rest in stocks and bonds. By different measures, the cumulative amount of foreign direct investment in the United States in 2005 came out somewhere between \$1.6 trillion and \$2.8 trillion.

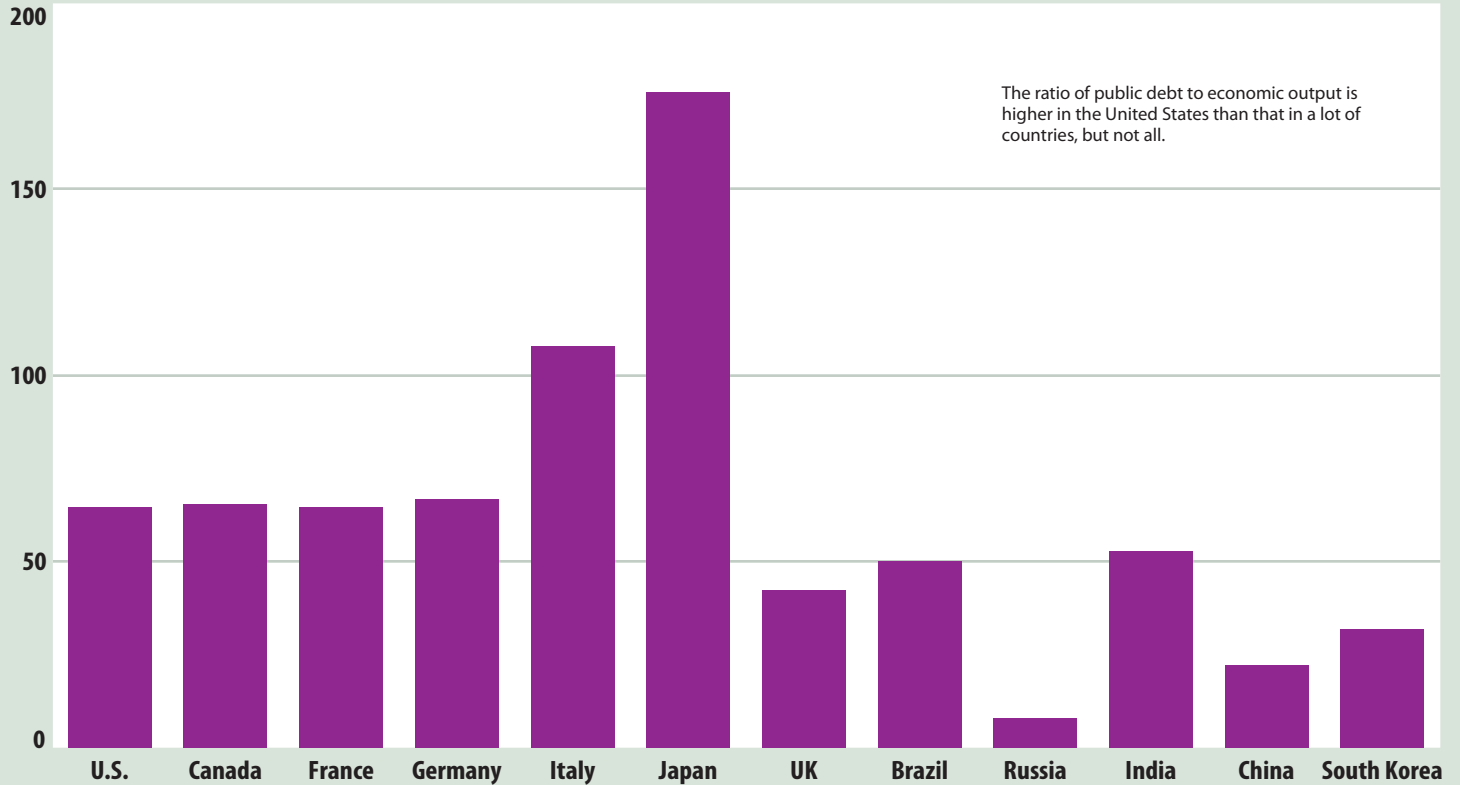
“The United States is unique in that it is the largest foreign direct investor in the world and also the largest recipient of foreign direct investment,” CRS says.

Some experts worry about the proportion of investment in the U.S. economy by foreign governments, about 16 percent of all foreign investment in 2005.

Foreign investors own more than half of all publicly traded U.S. Treasury securities. In 2006, Japan was the country having the largest holdings of long-term Treasury securities, about \$644 billion, followed by China, about \$350 billion.

## Public debt in relation to GDP

Percent



Some U.S. industries and their representatives in Congress assert that East Asian central banks use their U.S. Treasury securities to manipulate foreign exchange rates to boost exports to the United States.

“At times, such acquisitions are used by foreign governments, either through coordinated actions or by themselves, to affect the foreign exchange price of the dollar,” CRS says.

Some experts fear that any rapid sell-offs by foreign governments of their U.S. assets could trigger serious trouble for the world economy. Adversarial foreign governments could attempt to provoke a coordinated withdrawal from U.S. securities markets in order to destabilize the U.S. economy. Or foreign governments could decide to take their money elsewhere if their U.S. assets’ value started to drop sharply.

In the meantime, all that foreign money flowing into U.S. markets has kept U.S. interest rates and prices lower than they would otherwise have been, fostering massive consumption of goods, including imports. Except for 1991, the U.S. current account deficit has risen steadily from about \$12 billion in 1982 to \$856.7 billion in 2006.

“The U.S. current account deficit is financed largely by China’s current account surplus and growing investments by major oil exporters,” a World Bank report says.

By the end of 2005, U.S. residents held about \$9.6 trillion in

foreign assets, while residents of foreign countries held about \$12.5 trillion in U.S. assets. As a result, what is called the U.S. net international investment position reached a negative \$2.8 trillion in 2005.

In 2006, for the first time since the net investment position turned negative in 1986, foreigners earned more income from their investments in the United States than U.S. investors earned on their assets abroad.

As the Council on Competitiveness sums up the situation: “To put it simply, foreign savings finance U.S. consumption, which drives foreign export-led growth. The situation is mutually beneficial in the short term but creates increasing risk of a global financial crisis.”

So what’s next for the U.S. economy?

## On the Move

**E**conomic expansions don’t go on forever, of course. Since 1854, the U.S. economy has gone through 32 cycles of expansion and contraction. In modern times, the expansions have become longer and the contractions shorter on average: In the 10 cycles 1945-2001, expansions averaged 57 months, contractions 10 months; during all 32 cycles, by comparison, expansions averaged 38 months, contractions 17 months.

Continually increasing productivity — output of a worker per hour — is the only way to achieve continually increasing economic expansion and rising incomes. Gains in U.S. productivity have been slowing down since peaking in 2002.

Middle-class U.S. workers' anxiety about job security is mounting as they face continued technological change and competition from low-wage foreign workers. While most economists promote unequivocally the enormous gains from trade, a small but growing number are warning that perhaps tens of millions of U.S. jobs could move to foreign lands and that the United States could even lose entire industries.



Workers at the Fairchild Semiconductor headquarters in Maine, like most U.S. workers, face continued technological change.



At a career fair in New York City, people line up hoping to find that next economic opportunity.

Yet retreating from integration with the world economy seems almost unthinkable. Two-way trade of goods and services represented 27 percent of U.S. GDP in 2005, up from 11 percent in 1970. The jobs of at least 12 million U.S. workers now depend on exports.

While many U.S. workers face big challenges ahead, none more crucial than attaining adequate education and training, optimists view the United States as well positioned to benefit in a churning global economy because of its strong positive record on adapting to change.

“The United States will almost inevitably be a smaller part of a growing world economy due to the structural changes under way across the globe,” the Council on Competitiveness says. “But there is no reason why the United States cannot retain its position as the most prosperous country in the world.”

## Glossary

**Asset:** A possession of value, usually measured in terms of money.

**Balance of trade:** That part of a nation’s balance of payments dealing with imports and exports — that is, trade in goods and services — over a given period. If exports of goods exceed imports, the trade balance is said to be in surplus; if imports exceed exports, the trade balance is said to be in deficit.

**Bond:** A certificate reflecting a firm’s promise to pay the holder a periodic interest payment until the date of maturity and a fixed sum of money on the designated maturing date.

**Budget deficit:** The amount each year by which government spending is greater than government income.

**Budget surplus:** The amount each year by which government income exceeds government spending.

**Capital:** The physical equipment (buildings, equipment, human skills) used in the production of goods and services. Also used to refer to corporate equity, debt securities, and cash.

**Capitalism:** An economic system in which the means of production are privately owned and controlled and which is characterized by competition and the profit motive.



**Central bank:** A country's principal monetary authority, responsible for such key functions as issuing currency and regulating the supply of credit in the economy.

**Commercial bank:** A bank that offers a broad range of deposit accounts, including checking, savings, and time deposits, and extends loans to individuals and businesses — in contrast to investment banking firms such as brokerage firms, which generally are involved in arranging for the sale of corporate or municipal securities.

**Demand:** The total quantity of goods and services consumers are willing and able to buy at all possible prices during some time period.

**Depression:** A severe decline in general economic activity in terms of magnitude and/or length.

**Deregulation:** Lifting of government controls over an industry.

**Dow Jones Industrial Average:** A stock price index, based on 30 prominent stocks, that is a commonly used indicator of general trends in the prices of stocks and bonds in the United States.

**Economic growth:** An increase in a nation's capacity to produce goods and services.

**Electronic commerce:** Business conducted via the World Wide Web.

**Exchange rate:** The rate, or price, at which one country's currency is exchanged for the currency of another country.

**Exports:** Goods and services that are produced domestically and sold to buyers in another country.

**Federal Reserve System:** The principal monetary authority (central bank) of the United States, which issues currency and regulates the supply of credit in the economy. It is made up of a seven-member Board of Governors in Washington, D.C., 12 regional Federal Reserve Banks, and their 25 branches.

**Fiscal policy:** The federal government's decisions about the amount of money it spends and collects in taxes to achieve full employment and a noninflationary economy.

**Free trade:** The absence of tariffs and regulations designed to curtail or prevent trade among nations.

**Gross domestic product:** The total value of a nation's output, income, or expenditure produced within its physical boundaries.

**Human capital:** The health, strength, education, training, and skills that people bring to their jobs.

**Imports:** Goods or services that are produced in another country and sold domestically.

**Inflation:** A rate of increase in the general price level of all goods and services. (This should not be confused with increases in the prices of specific goods relative to the prices of other goods.)

**Intellectual property:** Ownership, as evidenced by patents, trademarks, and copyrights, conferring the right to possess, use, or dispose of products created by human ingenuity.

**Investment:** The purchase of a security, such as a stock or bond.

**Labor force:** As measured in the United States, the total number of people employed or looking for work.

**Market:** A setting in which buyers and sellers establish prices for identical or very similar products, and exchange goods or services.

**Market economy:** The national economy of a country that relies on market forces to determine levels of production, consumption, investment, and savings without government intervention.

**Monetary policy:** Federal Reserve System actions to influence the availability and cost of money and credit as a means of helping to promote high employment, economic growth, price stability, and a sustainable pattern of international transactions.

**Money supply:** The amount of money (coins, paper currency, and checking accounts) that is in circulation in the economy.

**Mutual fund:** An investment company that continually offers new shares and buys existing shares back on demand and uses its capital to invest in diversified securities of other companies. Money is collected from individuals and invested on their behalf in varied portfolios of stocks.

**New Deal:** U.S. economic reform programs of the 1930s established to help lift the United States out of the Great Depression.

**Nontariff barrier:** Government measures, such as import monitoring systems and variable levies, other than tariffs that restrict imports or that have the potential for restricting international trade.

**Productivity:** The ratio of output (goods and services) produced per unit of input (productive resources) over some period of time.

**Protectionism:** The deliberate use or encouragement of restrictions on imports to enable relatively inefficient domestic producers to compete successfully with foreign producers.

**Purchasing power parity:** A conversion rate into a common currency that equalizes the purchasing power of different currencies.

**Recession:** A significant decline in general economic activity extending over a period of time.

**Regulation:** The formulation and issuance by authorized agencies of specific rules or regulations, under governing law, for the conduct and structure of a certain industry or activity.

**Revenue:** Payments received by businesses from selling goods and services.

**Securities:** Paper certificates (definitive securities) or electronic records (book-entry securities) evidencing ownership of equity (stocks) or debt obligations (bonds).

**Securities and Exchange Commission:** An independent, non-partisan, quasi-judicial regulatory agency with responsibility for administering the federal securities laws. The purpose of these laws is to protect investors and to ensure that they have access to disclosure of all material information concerning publicly traded securities.

**Services:** Economic activities — such as transportation, banking, insurance, tourism, telecommunications, advertising, entertainment, data processing, and consulting — that normally are consumed as they are produced, as contrasted with economic goods, which are more tangible.

**Socialism:** An economic system in which the basic means of production are primarily owned and controlled collectively, usually by government under some system of central planning.

**Social regulation:** Government-imposed restrictions designed to discourage or prohibit harmful corporate behavior (such as polluting the environment or putting workers in dangerous work situations) or to encourage behavior deemed socially desirable.

**Social Security:** A U.S. government pension program that provides benefits to retirees based on their own and their employers' contributions to the program while they were working.

**Stagflation:** An economic condition of both continuing inflation and stagnant business activity.

**Stock:** Ownership shares in the assets of a corporation.

**Stock exchange:** An organized market for the buying and selling of stocks and bonds.

**Subsidy:** An economic benefit, direct or indirect, granted by a government to domestic producers of goods or services, often to strengthen their competitive position against foreign companies.

**Supply:** A schedule of how much producers are willing and able to sell at all possible prices during some time period.

**Tariff:** A duty levied on goods transported from one customs area to another either for protective or revenue purposes.

**Trade deficit:** The amount by which a country's imports exceed its exports.

**Trade surplus:** The amount by which a country's exports exceed its imports.

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