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The Impact of Open Markets and Expanded Trade

What I would like to do today is talk about the health of the economy and the impact of open markets and expanded trade on economic development. I'll cover where we've been, as well as where we're going.

Overview of the economy

As we look at the overall picture for the country, we are seeing signs of recovery from the recession that the National Bureau of Economic Research said began last March. Analysts are more bullish now; and, on balance, we believe the recovery is underway.

The big question is, How will this recovery unfold?

Going forward, we expect moderate gains in outlays for most household purchases. Important here, is the fact that real incomes have been supported by three factors:

- low overall inflation;
- tax cuts;
- and, most important, wage increases supported by productivity growth.

Indeed, productivity growth has remained unusually high during this recession. Typically, productivity falls during contractions, regaining strength only when the economy's recovery is underway. In

part, this is because firms initially retain too many workers in the face of weaker demand for their products.

However, in this cycle, firms seem to be taking advantage of increased flexibility in the labor market. One example is the use of temporary workers and outside contractors, whose hours can be cut during slow times to temper or avoid employee layoffs. This adaptability, combined with longer run improvements in technology and the skills of workers, has helped keep productivity healthier than in past slowdowns.

With regard to business investment, many firms remain somewhat cautious. That could continue to weigh on discretionary spending and capital outlays. Nevertheless, recent data suggest that the contraction in business spending is at least moderating. The fall in capital spending subtracted about a percentage point from real GDP growth last year. So, even if business investment simply stops falling, this would be a significant improvement relative to the large declines of 2001.

Real GDP growth last year was reduced by about an additional percentage point as businesses moved from rapid stockbuilding to large inventory liquidations. Inventory levels are lean enough that firms are now rebuilding inventories. Accordingly, inventory investment will likely turn from a negative factor to a significant source of growth.

I should note that these developments in capital spending and inventory investment in part reflect the basic functioning of our market economy. That is, the way business and household decisions, prices, wages and interest rates continually interact and adjust to allocate productive resources. Such adjustments can result in periods of sub-par growth, but they also give market economies a natural tendency to recover from periods of activity that are below potential.

Markets seek equilibrium

Though it may take some time for these adjustments to be completed, eventually it will happen — markets seek equilibrium. And in this process, growth in economic activity will tend to move back toward rates that are in line with underlying trends in productivity and income. These trends, of course, determine the longer-run rates of return on investment projects and the sustainable growth rates in aggregate supply and demand.

Currently, these natural market forces are also being supported by government policy.

On the fiscal policy front, incomes were boosted by last year's tax law change. Furthermore, bills signed into law after September 11 are boosting government spending. And the recent economic stimulus bill signed in early March increases incentives for business investment.

In addition, the Federal Open Market Committee reduced the federal funds rate target from 6½ to 1¾ percent last year. Given the usual lags, we probably haven't seen the full effects of those cuts yet. At its March 19 meeting, the Committee kept the target at 1¾ percent and noted that the economy is expanding at a significant pace. The FOMC also cautioned that the degree of strengthening in final demand is still uncertain. Although the stance of monetary policy is currently accommodative, the risks are now balanced with respect to the prospects for price stability and sustainable economic growth.

Other factors to consider

What are some of the other factors to consider as we look ahead at the overall economy?

In the household sector, generous retail discounts and low interest rates could boost spending more than expected.

On the other hand, if this cycle is like previous ones, unemployment rates will continue to rise for a time even after the recovery has begun to take hold. Resulting income losses would likely hold down spending somewhat. And worry over job prospects could cause households to cut back more dramatically as well.

In the business sector, as technology advances, at some point firms will need to upgrade their current equipment with more cutting-edge systems. But the timing and ultimate magnitude remain quite uncertain. Indeed, a great deal of capacity was added in the 1990s, which is now unused. This low capacity utilization may weigh on investment for some time.

On the international front, many central banks cut their policy interest rates. Long term, these policy moves should help foster growth in aggregate demand abroad, which in turn would help support U.S. exports.

Another key factor in economic growth both here and abroad is the long-term process of opening our borders to trade and investment. In recent weeks, these advances have been overshadowed by increases in tariffs. The United States has increased tariffs for steel and lumber. The European Union and Canada have threatened to increase tariffs on a variety of products, including steel, motorcycles and tomatoes.

Some commentators have questioned which way the world trading system is moving. Is it towards more openness or less? As part of this dialog, it is appropriate to take a step back and consider how open markets and expanded trade affect economic growth in general. Let me turn to that subject.

Open markets foster prosperity

Despite recent economic uncertainty, the United States and much of the rest of the world have never before been as affluent as they are today. For example, per capita output in the United States in 2001 was about twice the 1966 level and more than four times the 1940 level. Since 1940, we also have seen a dramatic rise in economic openness among nations. For the United States, total trade — measured as exports plus imports — has increased from less than 10 percent of GDP in 1940 to nearly 25 percent today. The parallel rise in openness and affluence is no coincidence.

Economic studies have repeatedly found that openness promotes prosperity.

Looking across the countries of the world, you find that the economies most open to trade and investment are those with higher per capita income. That is because cross-border investment fosters an efficient reallocation of resources that leads to productivity improvements and higher economic growth.

Moreover, economies benefit from the real efficiency gains brought about by freer trade. When firms can purchase the highest quality and lowest cost materials from anywhere in the world, their production costs fall. These lower costs lead to lower prices, which spread broadly throughout entire societies.

But, it's important to note that the benefits of lower prices are largest for those with low and moderate incomes. Because free trade lowers the price of everything from food and clothing to automobiles, those who spend the largest fraction of their income on these goods reap the largest gains.

In this country, we benefit not only from lower prices brought about by increased imports, but also from the expansion of our export industries. As foreign trade barriers fall, our most efficient industries can increase their production of exports. Workers in these export industries benefit from real wages that are higher than those earned by workers in other manufacturing industries.

Domestic and international benefits of openness

U.S. firms and workers benefit from producing and selling goods globally, but countries on both sides of the transaction stand to gain — particularly in developing countries. Countries that lack capital can develop more quickly because capital inflows allow them to increase their productive capital stock without foregoing current consumption. When the capital inflow takes the form of foreign direct investment, it improves access to international best practices in accounting, banking, legal and other important standards.

As a result, developing countries that have opened their borders to trade and investment are better off. In its examination of 84 developing countries, the World Bank reported that those with the largest tariff reductions in the 1990s also had the most rapid growth in GDP and exports. And American multinationals pay workers in developing nations double the local manufacturing wage. Thus, open markets, from a purely economic perspective, benefit the consumer, the producer and economic development at home and abroad.

Many reasons groups oppose free trade

Despite these benefits, there are a number of groups, both here and abroad, who oppose free trade and open markets. Especially in cases regarding displaced workers, their concerns are serious and deserve our attention. I'd like to discuss some of their concerns and what role, if any, the government can play in addressing these issues.

As trade barriers fall, some industries and their workers find themselves facing sharp competition from imports. Others gain from expanded trade. This is because increased trade redirects resources toward their most productive uses. In the United States, the result is that production shifts to higher value-added products — such as pharmaceuticals, medical equipment and information technology devices — as production of lower value-added goods — such as apparel and consumer electronics — shifts overseas. This dynamic reallocation process is similar to the changes that take place in economies that are growing, and often results in costly adjustments.

Economic studies suggest that worker dislocation caused by trade accounts for no more than 10 percent of all displaced workers in the U.S. Nonetheless, there is widespread support in this country for programs that help them.

Dealing with arguments against open markets

Protectionist policies and high tariffs have their genesis in a variety of groups that oppose open markets for a number of reasons. Let me address a few of their concerns.

It is indeed true that inefficient industries will suffer from increased competition. Free trade helps society through lower prices and more choice for consumers. But it does so by promoting the reallocation of resources — such as capital and labor — from less efficient sectors in the economy to the most productive ones. In a market economy, the allocation of resources is guided by profits and costs, including wages. Factors of production move from low-profit to high-profit industries.

But from a broader perspective, society at large suffers if we choose not to open our borders. While a small number of industries benefit greatly from barriers, a larger number firms, workers and consumers suffer the costs. Here's just one example. In the U.S. sugar industry, trade protection has pushed the domestic price of sugar well above the world price. In 1999, we paid almost five times the world price. That is a huge difference, and one of the unintended consequences is that Midwestern candy factories are relocating to Canada.

Another concern expressed by opponents of open markets is that resources and personnel freed by the inefficient industries will not be reallocated to more efficient uses and will remain idle instead. This is a difficult and important question to address.

The growth process presents ample evidence that resources are surprisingly flexible. They have to be, because technology is constantly changing. For example, 100 years ago, 50 percent of our labor force was engaged in farming. Today, only a little more than 2 percent is. This suggests that, in the long run, resources can reallocate and that the efficiency gains from free trade can indeed be realized.

But 100 years is a long time. Many of us would like to consider the effects of open markets and free trade over a shorter period — say, within our lifetimes.

To gain an idea of how flexible resources are in the short run, consider the large number of technological improvements and innovations that lead to new products and production methods every year. These innovations reduce the market share of older products and may even drive them out of the market completely. Clearly this type of innovation is highly desirable. Who would question the advantages of using a PC instead of a typewriter, a CD instead of an 8-track, or a DVD instead of a VCR?

Moreover, even though they take place continuously, these innovations do not seem to create large amounts of unemployment caused by technological change. Thus, if the transformations introduced by free trade reform were similar to the transformations generated by technological innovations, they would not be a special concern. The resources displaced by foreign competition would soon find better uses. However, a closer look reveals some important differences. Let me explain.

Businesses and workers generally expect technological innovation to change the nature of their enterprises. For example, enhanced information systems and the Internet have dramatically improved how firms make purchases and manage inventories. Moreover, technological innovations usually take place in small steps, allowing workers and firms to find some use for their skills and machinery in the newer technologies.

But future free-trade reforms may be unforeseen at the time workers and businesses commit to long-term investments in human and physical capital.

In fact, drastic trade reforms can make entire industries become unprofitable.

In this context, businesses and workers may find it very difficult to shift their specialized resources to alternative uses, leading to serious dislocations - and idle resources. Job losses in industries such as steel and textiles, for example, are concentrated geographically. Because those workers have skills that don't easily shift to other industries, they tend to have a harder time finding good, high-wage jobs in their locales.

So, the crux of the free trade debate is, "How can we cushion short-term dislocations so that we can achieve the long-term benefits of open markets and expanded trade?"

Free trade issues over long term

There are a number of policy choices that should be considered.

First, free trade reforms could be designed to help the trend towards open markets resemble the trend of continuing technological innovation that the economy normally goes through. In particular, policy reforms could take a more gradual approach.

If tariffs and non-tariff barriers can be phased out over a considerable period of time, this will give businesses and workers more time to accommodate to the transition — as would be the case with other innovations. In fact, this gradual approach has already been implemented in a number of cases. For example, under NAFTA, the tariff on imports of automobiles from Mexico is gradually being reduced from 10 percent in 1994 to zero by 2004.

Second, training programs could be improved to provide dislocated workers with the skills needed to become re-employed in more efficient industries. More than 225,000 people participated in the government's program for trade-dislocated workers in 1999. But of these, only 32,000 received some kind of job training. Fortunately, at the request of Congress, the General Accounting Office has thoroughly studied the Trade Adjustment Assistance program and suggested numerous reforms, including improvements to the training component of the program.

Third, the government could directly compensate the "losers" from trade reform. Efficiency gains for consumers and producers, arising from lower prices and better use of our resources, are large enough that, even after compensating the "losers" for their losses, America would still be better off.

The dislocated workers could be given a one-time sum at the time of trade reform, rather than be subsidized for remaining unemployed. This way, they would receive compensation for being dislocated but would be encouraged to become re-employed in a different industry.

Firms are by nature entrepreneurial risk-takers, so compensation by the government is a more complex issue. That said, another policy could be to compensate businesses for having invested in capital that became unprofitable with the trade reform. But again, this compensation should be a one-time payment, not a subsidy for using that inefficient type of capital. This would compensate the investors for their losses but still give them the correct incentive to move to more efficient activities.

Time does not permit a more detailed discussion of the advantages and disadvantages of these policy choices. But, in my opinion, they are the types of policies that are important to consider as we move forward to open markets and expand trade.

Conclusion

In conclusion, let me say that increased cross-border investment and the long-term reduction of tariffs and non-tariff barriers over the past five decades has benefited America and many other countries around the world, including developing nations. Yet even as we actively promote and encourage free trade, we must confront the very real opposition to expanded trade.

Our response must include addressing the short-term dislocations caused by open markets, through policies such as those we have just discussed. In this way, we can help expand the long-term benefits of free trade both here and abroad.