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Benefits of Open Markets and Expanded Trade

It's a real pleasure to be here at your 110th general meeting. I appreciate your invitation to share my perspective on the economy and, in addition, to have the opportunity to discuss something I feel very strongly about, and that's the importance of free trade to economic prosperity.

Background on Federal Reserve

But first I thought I'd talk a little about the Federal Reserve and its role in the economy.

By way of background, the Federal Reserve Bank of Chicago is one of 12 regional reserve banks that, together with the Board of Governors in Washington, D.C., serve as the nation's central bank. The Chicago District covers a five-state area that includes all of Iowa and most of Indiana, Illinois, Michigan and Wisconsin.

As president of the Chicago bank, I serve on the Fed's key policymaking group, the Federal Open Market Committee, or FOMC. This is the group chaired by Alan Greenspan that is responsible for determining monetary policy.

At each meeting, we report on economic conditions and share our outlook and policy recommendation for the national economy. That's why it's important to connect with business leaders such as yourselves, in preparing for our FOMC meetings.

After discussing current and prospective economic conditions, the FOMC makes a decision on where to set its target for the federal funds rate. As you may know, that's the short-term interest rate at which banks borrow and lend funds among one another. Our goal is to foster the monetary conditions that are most conducive to the economy achieving maximum sustainable growth and price stability.

I should mention here that the Chicago Fed board of directors plays a key role in the FOMC process. Board members provide insight into various sectors of the economy. And when it comes to the steel industry, one of our directors is particularly helpful. He is Bob Darnall, former chairman and CEO of Inland Steel, and currently the chairman of our board. Bob's perspective is invaluable in helping us understand developments in the steel industry in relation to the regional and national economy.

Today I would like begin by talking about my view of current and prospective economic conditions, and some of the challenges they pose for monetary policy. The bottom line is that, while certain sectors of the economy are still experiencing hard times, overall activity has recovered from the recession we suffered last year and we appear to be on our way to a moderate expansion.

Of course, there are risks and uncertainties to this outlook that monetary policy must be ready to respond to if necessary. But, overall, the long-term prospects for the U.S. economy remain good.

Historical background

The second half of the 1990s was a period of remarkable change and prosperity in the U.S. economy. Advances in technology, increased efficiency of capital and labor markets, soaring investment — especially on high-tech equipment — all helped fuel a sustained burst of productivity growth, the likes of which we had not seen since the 1960s. As a result, economic activity surged.

But, as we turned the millennium, the picture began to change. By early 2000, it became clear that some firms had been too optimistic about the potential returns on certain capital investments — again particularly in the high-tech sector. This ultimately resulted in a sharp retrenchment in business investment for equipment and software and moves to reduce inventories as well.

These developments were major factors in the economy entering a period of slower growth in the second half of 2000. The weakness intensified in early 2001, but there were tentative signs during the summer of '01 that activity was stabilizing.

Then we experienced the shock of 9-11. The terrorist attacks had a sharp direct impact on several sectors of the economy, particularly air travel, aircraft production and tourism. Furthermore, the blow to confidence resulted in sharp and broad-based drops in consumer spending and business orders.

The National Bureau of Economic Research — the private organization that declares when recessions begin and end — dated the onset of the recession at March 2001. This was the month in which payroll employment peaked in the U.S. Even though March predates the terrorist attacks, we might have avoided a recession without the events of 9-11. This is because the declines in economic activity may not have been deep or prolonged enough to have broken that recession threshold. Economists will study this question extensively in future years, but we will never know the answer to the question for sure.

In any event, it appears that the recession, while painful, was relatively mild by historical standards. Now, I do not want to dismiss the recession as inconsequential. It was severe enough in a number of sectors, particularly manufacturing, where 1.7 million jobs were lost over the past two years. But we did not experience the more widespread severe unraveling of activity that has characterized some previous deep recessions. This time, real GDP fell in only one quarter, and the decline was small — just 0.3 percent.

So, why was the impact on real GDP so modest? Mainly it is because the household sector held up well. Consumers curtailed their spending, but by less than one might have expected. Significantly, the housing market remained remarkably buoyant — a record number of homes were bought last year. And sales of cars and light trucks surged during this period due to generous sales incentives. This activity showed that households were not deterred from making the large financial commitments that such purchases entail. Instead, they remained confident about the long-run prospects.

Signs are accumulating that recovery is well underway. Real GDP rose at an annual rate of 1.7 percent in the fourth quarter of 2001 and 5.8 percent last quarter. The gains were again led by the household sector. A significant portion of last quarter's growth also came from a reduced pace of inventory liquidation.

However, business firms continue to be somewhat cautious about taking on new capital spending projects. Recent employment reports indicate that firms also are hesitant about hiring permanent workers. But some leading indicators of labor market conditions, especially the increased use of overtime and strong job growth in the temporary help industry, may be indicative of good news to come on the hiring front.

Cyclical uncertainty going forward

Still, we are facing a good deal of uncertainty over how the early stages of this expansion will unfold.

Aggressive inventory control means that stock levels are relatively lean, so that some future lift from inventory investment can be expected. But this can only give a temporary boost to growth — to solidify the expansion, final demand needs to gain a firmer footing. Important to this will be the degree to which business fixed investment turns around. Here, the incoming data suggest that demand may be improving somewhat; importantly, the high-tech sector appears to be stabilizing. Furthermore, household spending needs to keep moving forward.

The key to prospects for both business and household spending is growth in productivity, or output per unit of input. On this front, we have reason to be optimistic. Productivity growth has been unusually robust over the last year, and stunningly so over the past two quarters.

Why is this news so encouraging? Typically, productivity falls during contractions, in part because firms initially retain too many workers in the face of weaker demand for their products. Today, however, temporary help service firms and outside contractors help make the labor market more flexible. Companies can more quickly adjust their payrolls to match changing conditions. This adaptability, combined with longer-run improvements in technology and the skills of workers, has helped keep productivity growth healthier than in past slowdowns, and bodes well for its longer-run trends. And these longer-run trends are the key determinants of rates of return on investment projects and the sustainable rates of growth in household income and spending. In turn, and most important, faster productivity growth enables our standard of living to improve more quickly.

Now, monetary policy and fiscal policy have also played a positive role in this expansion. Recognizing weaknesses in the national economy, the Fed began a process in January 2001 that reduced the federal funds rate target by 300 basis points over the course of the next eight months. After the shock of 9-11, the Fed cut rates again by another 175 basis points. This accommodative stance bolstered demand throughout the economy. Fiscal policy moves, including last year's tax legislation and bills signed into law after 9-11 and earlier this year, also have been stimulative.

Finally, inflation remains reasonably well contained. When the Fed began lowering rates in January 2001, it was against a background of low inflation and low expected inflation. This gave us considerable room for maneuver when working to mitigate the impact of the recession. This is a direct consequence of credibility earned over the past two decades. Financial markets do not expect the Fed to let inflation get out of hand.

Yet, challenges lie ahead. A great deal of capacity was added in the 1990s, some of which is now unused, particularly in the telecommunications equipment industry. This excess capacity could be a drag on investment during this year.

Additionally, external developments could weigh on the future. Growth abroad looks to be recovering. However, the pace of expansion outside the U.S. does not appear to be that robust, so we cannot expect demand for our exports to be particularly strong in the near term.

Furthermore, oil prices have been rising since December. Increases in oil prices act like a tax on the imported oil used by the economy, sapping consumer purchasing power and reducing business margins. Futures markets expect oil prices to recede, but the current situation in the Middle East adds a good deal of uncertainty to this outlook.

Finally, we now are all aware of the risk of terrorist attack. Even without another incident, the emphasis on heightened security has impacted, and will continue to impact, the economy. The cost of doing business is now higher, both through increased insurance premiums and spending to heighten security and provide backup contingencies. Such costs may lower the rate of productivity growth for a time, but so far it is not evident in the reported data.

Projecting a moderate early expansion

Both positive and negative factors are influencing the outlook. So, how do we see these balancing out?

On average, at the Chicago Fed, we expect real GDP growth over the next few quarters to run close to the economy's potential long-run rate — which many analysts now put in the range of 3 to 3½ percent. However, on a quarter-to-quarter basis, growth could be uneven due to swings in inventory investment and other transitory developments.

Relative to some past recoveries, this performance might appear disappointing. For example, output expanded by 7½ percent in the year following the end of the 1982 recession. However, that was a very deep recession, during which both households and businesses cut back spending sharply. The pent-up demand that resulted from this left room for a strong recovery. In contrast, given the strength in consumer spending and housing over the past year, there currently is little such pent-up demand in the pipeline.

While we believe that the expansion will solidify, it likely will take some time for vigorous growth to extend to all industries and all regions of the nation. Although the early months of any expansion are often bumpy for some, it might be more noticeable this time.

Recovery from a deep recession introduces a surge in demand that can reverberate throughout the economy. Such sharp gains would feel like a more dramatic and widespread turn of fortunes than the more modest advances that are likely to follow a mild recession. As a result, in our current situation, we shouldn't be surprised to hear negative news from some sectors or regions even as the expansion matures.

The challenge for monetary policy

Now, as I mentioned earlier, the current stance of monetary policy is accommodative. Of course, we moved policy to this position to help counter the forces that had pushed us into a period of sub-par activity, and we were able to do so because inflation was so well contained.

Clearly, however, we cannot maintain our current stance forever. Growth in private final demand will firm as the factors that produced economic weakness are unwound. So if we simply left in place the extra stimulus from accommodative policy, gains in demand would eventually strain the economy's ability to supply goods and services, resulting in the emergence of inflationary pressures.

We are faced with several challenges in deciding when and how to step back from this accommodative stance:

- One challenge is to gauge the staying power of growth in final demand.
- A second is to balance this growth against our reading of the economy's ability to supply the demand in a noninflationary manner.
- And a third is the fact that changes in monetary policy affect the economy with a lag. This means that, in addition to looking at the alignment between spending, productivity, and inflation that we see in today's data, we also must make a judgment about what these factors will look like in the quarters ahead given the policy option that we decide on today.

Economic outlook

Bottom line, we at the Chicago Fed expect the expansion that currently is underway to continue. Because the downturn was moderate, we expect that the early stages of this expansion will also be moderate by historical standards. Inflation likely will be well contained. And over the broader horizon, the prospects for our economy are bright.

Open markets and expanded trade

Let me turn now to a subject that I believe is vitally important to these long-term prospects. It's an area I've been involved with in the past and which has been much in the news lately. And that's open markets and expanded trade. A 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, advances in free trade have been overshadowed by increases in tariffs. The United States has increased tariffs for steel and lumber. The European Union, Canada and Japan have threatened to increase tariffs on a variety of products, including steel, citrus fruit, textiles and paper.

Some commentators have questioned which way the world trading system is moving. Is it towards more openness or less? I don't want to discuss any specific legislation, since the issues are extraordinarily complex. But as part of this dialog, it is appropriate to take a step back and consider in broad terms who benefits and who loses from open markets and expanded trade. 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.

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, higher economic growth and, most important, as I said before, a higher standard of living..

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 and better choices, which spread broadly throughout entire societies.

Conversely, high tariff barriers can directly increase costs of production. One example is the U.S. sugar industry, where 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 candy factories here in the Midwest are relocating to countries such as Canada, where the price of sugar is not artificially increased.

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.

Dealing with arguments against open markets

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 inevitably find themselves facing sharp competition from imports. While competitive pressures may cause some firms to contract their businesses and reduce their work forces, other firms will see input costs fall, allowing them to expand production and increase hiring. Moreover, net exporters, in particular, will see expanded opportunities as other countries lower their barriers to our goods.

In most cases, lowering barriers to trade promotes an efficient allocation of resources. But in some industries, like steel, many governments around the world have chosen to subsidize firms in order to keep high-cost factories in operation. The result has been persistent overcapacity in the global steel industry, high levels of production and low prices. So American steel producers in the U.S. may find themselves facing sharp competition from firms that are not necessarily more efficient than they are, but instead, receive subsidies. It's important to recognize that the problem there is not freer trade; the problem is (foreign) government subsidy policies that work to keep inefficient plants open.

Regardless of whether the patterns of trade reflect economic fundamentals or, instead, government subsidies, the shifts can be extremely difficult for workers and firms in the industries that compete most directly with imports. Overall, economic studies generally suggest that worker dislocation caused by trade accounts for no more than 10 percent of all displaced workers in the U.S. If you are one of those 10 percent, competition from trade can clearly make you worse off, and it is little comfort to know that U.S. consumers overall are benefiting from low prices.

The steel industry provides a clear example. Although much of the problem facing the domestic steel industry is one of global overcapacity, the surge of imports associated with the Asian crisis also led to layoffs of American workers. Steel industry employment in the U.S. fell from 163,000 in 1997 before the Asian crisis to about 142,000 in early 2001, before the recession began. Steel workers aren't alone — 225,000 people participated in government programs for trade-dislocated workers in 1999.

I should emphasize, though, that the adjustments that arise from expanded trade do not reduce the total number of jobs in the United States. In fact, total employment is determined by aggregate demand and supply. You all will recall the prediction that NAFTA would result in a "giant sucking sound" as U.S. jobs fled to Mexico. But in the 10-year expansion that ended in 2001, trade relative to GDP grew steadily, and at the same time jobs increased by more than 24 million.

Thus from a broader perspective, society at large benefits when we open our borders. Indeed, the overall benefits to society of freer trade are large enough that we can afford to help those who are displaced by changes in tariff and non-tariff barriers.

Policy options

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

One way this can be done is to lower barriers and increase openness gradually, in a process that more closely mirrors natural innovations in the economy. Technological innovation, for example, usually takes place in incremental steps without creating large amounts of unemployment.

Workers and businesses have come to expect technological innovation to change the nature of their enterprises. And, because it takes place incrementally, this allows workers and firms time to find new uses for their skills and equipment.

Sometimes, surges in imports — even when they are positive for the economy over the long term — can occur suddenly, dislocating major industries and causing significant and rapid unemployment in concentrated regions.

Thus it behooves us to look at policies that can ease these short-term disruptions. For instance,

- Trade reforms can be phased in gradually to allow businesses and workers more time to adjust;

- Training programs can augment the skills of some dislocated workers so they can obtain higher paying jobs;

- And the government could give monetary compensation to the losers in a way that incents them to become re-employed quickly in a different industry.

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, I firmly believe that U.S. firms and workers benefit from producing and selling goods globally. In addition, countries on both sides of the transaction stand to gain — particularly in developing countries.

Looking ahead, overall economic activity has recovered from last year's recession and moderate expansion has begun. As I mentioned earlier, we may hear negative news from some sectors or regions during the early phase of the expansion, but the long-term prospects for the U.S. economy are good.

During the last 20 years or so, we've deregulated financial markets, we've developed more flexible labor markets and we've made major advances in technology. These efforts have enhanced the American economy's ability to absorb disruptions, and have provided us with the foundation to foster solid noninflationary economic growth in the years ahead.

Thank you.