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Open Markets and Expanded Trade

It's a real pleasure to be here at your Forecast 2003 Conference. I'm a central banker focused on monetary policy — and an economist by training. As an economist, I'm often asked to make predictions at conferences such as this, and I'm happy to do so.

But you know what some people say…that we economists predicted nine out of the last five recessions.

And others say that if you laid all the economists in the world end to end, we still couldn't reach a conclusion…

All kidding aside, 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 expanded trade to economic prosperity.

Background on Federal Reserve

First, I'd like to give a little background on the Federal Reserve and its role in the economy.

The Federal Reserve System comprises 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 Federal Reserve Bank of Chicago, 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 regional economic conditions and share our outlook and policy recommendation for the national economy. After our discussion of the outlook, the FOMC makes a decision on where to set its target for the federal funds rate. Our goal is to foster the monetary conditions that are most conducive to the economy achieving maximum sustainable growth and price stability.

Clearly, this is a tough job. With regard to our current situation, while overall output has recovered from the recession we suffered last year, the economy is still experiencing uncertain times. The road to recovery is turning out to be bumpy. Now the Fed cannot — and should not — try to smooth out every bump. Monetary policy simply is not capable of doing so.

But we do try to set conditions that best support sustainable noninflationary growth. At our August FOMC meeting, the Committee left the federal funds rate target at 1¾ percent, the accommodative level it has maintained since last December.

However, the Committee did change the accompanying "balance of risks" statement. Since March, that statement had said that risks were balanced between economic weakness and inflation. Now, we see the risks as being weighted mainly toward conditions that may generate economic weakness.

We made the change because "...the softening of growth of aggregate demand that emerged this spring has been prolonged in large measure by weakness in financial markets and heightened uncertainty related to problems in corporate reporting and governance." I'll address this issue a little later in my talk.

Recession and recovery

Although the recession we've just been through was painful, it was relatively mild by historical standards. Now, I do not want to dismiss the recession as inconsequential. It was severe in a number of sectors, particularly manufacturing, where more than 1.8 million jobs were lost over the past two years.

But we did not experience the sharp and widespread unraveling of activity that has characterized some previous deep recessions. This time, although GDP fell for three quarters, the overall decline was relatively small — just 0.6 percent. By comparison, real GDP fell 1½ percent during the 1990-91 recession and 2¼ percent, on average, during the previous four recessions.

Why was the most recent fall in GDP relatively small? Mainly because household sector spending was better maintained than one might have expected. Significantly, home sales and spending on big-ticket items — especially motor vehicles — were remarkably strong. The fact that households were not deterred from making these large financial commitments indicated that they remained confident about their long-run job and income prospects.

Since the declines of last year, real GDP has risen for three consecutive quarters. Overall, growth since last year's third quarter has averaged 3 percent at an annual rate, with much of the support coming from the household sector and businesses moving from liquidating inventories to restocking them. But even though a recovery in overall output clearly has already occurred, the path of GDP growth has been uneven.

Factors supporting economic recovery

We expect that the economic expansion now underway will continue. But what will keep the economy growing?

Aggressive inventory control means that stock levels are relatively lean. Thus, some further 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. Furthermore, household spending needs to keep moving forward.

While a large number of factors will influence business and household spending over the near term, the key to the longer-run prospects for both of them is productivity, or output per unit of input. On this front, we have reason to be optimistic. Productivity accelerated beginning in the mid-1990s, more than doubling the rate of growth of the previous 25 years. It was unusually well maintained during last year's downturn, and, on average, productivity has increased at a robust pace over the past three quarters.

Most significantly, the long-term prospects for heightened productivity growth appear bright, thanks to more flexible labor markets and improvements in technology and the skills of workers. Ultimately, faster productivity growth enables our standard of living to improve more quickly.

In our current situation, monetary and fiscal policies also have supported aggregate demand. 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 9-11, the Fed cut rates by another 175 basis points in the last four months of 2001, and since then we have maintained the funds rate at the low level of 1¾ percent.

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 early this year, also have been stimulative.

Finally, inflation remains relatively low and reasonably well contained.

Challenges to economy

I have just cited a number of factors supporting the economy. Yet challenges lie ahead. We now are all aware of the risk of potential 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 the costs of providing heighten security and back-up contingencies.

Furthermore, businesses purchased a great deal of capital equipment during the 1990s, boosting their productive capacity. Much of this capacity is now idle, particularly in the telecommunications industry. Capital spending clearly has a long way to go before the level of activity returns to where it was prior to the recession.

The economy is facing another important challenge today — How do we deal with the recent revelations of accounting improprieties and failures in corporate governance?

One of the cornerstones of capitalism is a transparent system of laws and regulations that are enforced in a fair manner. So if we find evidence of criminal behavior or fraud in the executive suite, we must root it out and prosecute. Those found guilty must be punished…which in some cases should include jail time.

These revelations have added a great deal of skittishness to an already uncertain business climate. They also have undoubtedly raised the cost of financing new investment — as evident from both the increased risk spreads on corporate borrowing, particularly for lower-grade issues, and the lower prices that would be coming to any new equity issues. And if lower stock prices were maintained, the resulting dent in households' balance sheets would be a negative factor for future household spending.

To be sure, to the extent that the news on misreported earnings and other accounting irregularities reveals that markets had been mis-evaluating risks and returns, then investors should be demanding higher premiums. The concern, however, is that they may go overboard in this regard.

Indeed, capitalism cannot thrive without entrepreneurial risk taking. If we are too risk-averse, we will stifle innovation and, with it, our ability to generate continual increases in our standard of living.

So the proper pricing — and regulation — of risk is a key element in shaping the future of our economy.

Economic outlook

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

On average, the Chicago Fed expects real GDP to increase over the next several quarters, and growth eventually 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.

Although the stages of any expansion are often bumpy for some, it might be more noticeable this time. And the shock of accounting and corporate governance failures, so soon after last year's downturn, certainly has added to the uneasiness about the course of the economy.

Open markets and expanded trade

Let me turn now to a subject that I believe is vitally important to our long-term prospects. And that's open markets and expanded trade. This is an area I've been involved with in the past as a deputy trade representative, and it's an area of particular interest to you in this audience.

In recent months, free trade has been much in the news.

This past spring, the United States increased tariffs for steel and lumber. The European Union, Canada and Japan threatened to increase tariffs on a variety of products, including steel, citrus fruit, textiles and paper.

The World Trade Organization recently ruled that the European Union can impose up to $4 billion in penalties on the U.S. because its reduced tax rate on exports amounts to an illegal subsidy under international law.

Earlier this summer, U.S. lawmakers recognized the importance of giving the President greater flexibility to negotiate, by passing the Trade Promotion Authority bill, also known as "Fast Track." This will enable the U.S. to participate fully in the current round of WTO multilateral negotiations.

And recently the Bush administration provided exemptions to its steel tariffs by excluding an additional 178 products, while the U.S. International Trade Commission ruled not to impose additional antidumping duties on cold-rolled steel.

In viewing these different actions, some commentators have questioned which way the world trading system is moving. Is it towards more openness or less? The issues are extraordinarily complex. But as part of the 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, real disposable personal income in the U.S. in 2001, on a per capita basis, was double the 1967 level and 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, freer trade makes economies more efficient. 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.

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.

Similarly, in the aluminum industry, an excess of aluminum on the world market is causing prices to continue their decline and inventories to remain high.

So American 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 government subsidy policies that work to keep inefficient plants open. We should encourage multilateral efforts that, over time, will reduce government subsidies that cause these problems. The new Trade Promotion Authority granted by Congress should make it easier to negotiate such agreements.

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. However, 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

In fact, we must find ways to 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.

It’s encouraging to see that the new Trade Promotion Authority legislation will lead to more reductions in trade barriers through the negotiation of bilateral and multilateral trade agreements. Moreover, this Fast Track legislation will cushion the blow to trade-displaced workers by providing them with job retraining, health-care benefits and wage insurance.

Despite the noise level surrounding this issue, I firmly believe that U.S. firms and workers benefit from producing and selling goods globally. I believed it 10 years ago when I negotiated trade agreements. I still believe it today. In addition, I believe countries on both sides of the transaction stand to gain — particularly developing countries.

Conclusion

Let me conclude with some final thoughts on the future of the U.S. economy…

Looking ahead, we may continue to receive negative news from some sectors of the economy or regions of the nation. But, the long-term prospects for the U.S. economy appear to be 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.