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The Economy and Free Trade

Before I address the economic outlook, 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 most of Indiana, Illinois, Michigan, Wisconsin and all of Iowa.

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.

At our September FOMC meeting, the Committee left the federal funds rate target at 1¾ percent, the accommodative level it has maintained since last December.

The Committee also kept the accompanying "balance of risks" statement unchanged. From March until August, that statement had said that risks were balanced between economic weakness and inflation.

But during the August meeting, we changed the statement to say that we see the risks as being "weighted mainly toward conditions that may generate economic weakness." And we reiterated that statement the September FOMC meeting.

The Committee noted that, "considerable uncertainty persists about the extent and timing of the expected pickup in production and employment owing in part to the emergence of heightened geopolitical risks." But it also indicated that, "over time, the current accommodative stance of monetary policy, coupled with still robust underlying growth in productivity, should be sufficient to foster an improving business climate."

The national economy

Now let's take a closer look at the U.S. economy.

Following the declines earlier in 2001, real GDP began to rise again in the fourth quarter of last year. Although we won't see the first estimate for this past quarter until October 31, real GDP growth overall looks to have averaged somewhere around the 3 percent mark over the last four quarters. Much of the support has come from the household sector. In addition, businesses are in the process of moving from liquidating inventories to restocking them.

But even though a recovery in overall output has already occurred, the path of GDP growth has been — and could well continue to be — somewhat uneven. Indeed, the consensus outlook, made early this month by private sector forecasters, suggests that the economy is currently experiencing a soft spot. But that consensus forecast still sees output increasing, and growth returning to rates somewhere near the economy's longer-run potential in 2003.

Challenges to economy

Clearly, though, the economy is facing many challenges.

Businesses purchased a great deal of capital equipment during the late 1990s, greatly boosting their productive capacity. However, in some cases the increases exceeded what, in retrospect, was needed to meet demand. The resulting reductions in capital spending were a major factor in the recent downturn. Much of the overhang that led to the decline has been worked off. But even now in some sectors, such as telecommunications, substantial idle capacity remains. Thus it may be some time before the level of capital spending returns to where it was prior to the recession.

And of course, we are living in a different world than we did before 9-11. Even without another terrorist 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 heightened security and back-up contingencies.

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

These scandals have added to an already uncertain business climate. They also undoubtedly have raised the cost of financing new investment. This is evident from the increased risk spreads on corporate borrowing, particularly for lower-grade issues. And, to the extent that the scandals affected the stock market, it is evident through the lower prices coming to any new equity issues. Indeed, if lower stock prices are maintained, the dent in households' balance sheets would also be a negative factor for future household spending.

To be sure, to the extent 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. 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.

That said, capitalism also requires 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.

The other main challenge facing the economy today is that we are operating in a world of increased geopolitical risk, with heightened concerns about developments in the Middle East. No one knows how these events will play out.

But adding the geopolitical situation to the shock of the accounting and corporate governance failures, both so soon after last year's downturn and 9-11, we come up with an economy that is dealing with a substantial amount of uncertainty.

And such uncertainty can inhibit activity. For example, firms may become hesitant to take on capital spending projects or hire permanent workers when the downside risks are more apparent — or if the consequences of such risks appear to have become more serious. Firms may simply decide to hold off doing anything until they feel more certain that the projects would soon start showing positive cash flow.

Factors supporting economic recovery

Despite these challenges, as I noted earlier, the consensus forecast is that the economy will work its way through the soft spots. We at the Chicago Fed agree that — on balance — a moderate economic expansion will continue.

Here's why.

Aggressive inventory control means that stock levels are now very lean. Thus, some further lift from inventory investment can be expected. This would give a temporary boost to growth. But 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 and household spending keeps moving forward.

While many things influence business and household spending, particularly over the near term, several factors should support growth.

Inflation remains low and well contained. This has allowed monetary policy to maintain an accommodative stance for an extended period of time. This accommodative stance bolsters demand throughout the economy. Furthermore, 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.

Importantly, incomes continue to grow. Despite the recession and the modest pace of the early recovery, real disposable personal income currently stands about 5½ percent higher than it was at the time the recession began. In contrast, if we look back over the past 30 years, real disposable incomes a year and half after the onset of a recession were up only modestly, at best.

Of course, part of the difference is that output fell less this time than during those earlier downturns. In addition, the inflation picture and tax legislation have helped.

Real income also has been supported by strong gains in productivity, or output per unit of input. Since the mid-1990s, the rate of productivity growth has been more than double the pace of the previous 25 years. Furthermore, productivity was unusually well maintained during last year's downturn, and, on average, it has increased at a remarkably robust pace in recent quarters. The rapid gains we've seen in productivity support the growth in incomes and profits needed to maintain the economy's forward momentum.

And this is a positive sign for the U.S. economy for more than just the near term. Productivity is the key to the longer-run prospects for both the household and business sectors. Ultimately, it is productivity growth that determines our standard of living.

The role of productivity growth

So let's take a closer look at productivity.

How does the U.S. experience compare with that abroad? In the 1980s, Japan and many European countries achieved larger increases in productivity than the U.S. But with its recent performance, productivity growth in the U.S. has surpassed that in Japan and Europe.

Recent research estimates that the pickup in U.S. productivity growth is in large part due to the increased use of Information Technology — or IT- capital (that is, computer hardware, software, and communication equipment, etc.). The increased investment in IT has resulted in what economists call 'capital deepening.' That is, workers have more and better capital to work with.

At the heart of these developments is the microprocessor. The technology industry has used its ability to manipulate, store, and move vast amounts of information to provide all kinds of innovative products and services to businesses and consumers.

But the increase in efficiency we've seen since the mid-1990s was not due simply to the highly publicized Internet and hi-tech computer applications. We also learned to run our businesses smarter through improved management practices and significant advances in the overall logistics of producing and distributing goods and services. And the U.S. labor market is functioning more efficiently

than it used to. These factors allow us to organize and allocate our productive resources much more efficiently, which boosts overall output in the economy.

Open markets and expanded trade foster prosperity

Just as this dynamic process helps raise U.S. GDP, the more efficient allocation and use of resources internationally helps foster global economic growth as well. That's why I'd like to spend some time now addressing open markets and expanded trade. These are vital to helping new technologies and business practices percolate across international borders, allowing countries to share each other's productive innovations, and increasing standards of living throughout the world.

In recent months, free trade has been much in the news, whether concerning steel, lumber, agriculture or "Fast Track" legislation. Just last weekend, President Bush met in Mexico with 20 other heads of state from Pacific Rim nations, where they discussed challenges to further lowering barriers to trade. I'm sure Gary Edson will discuss this with you in detail tomorrow.

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.

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. 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.

In the United States, for example, total trade (measured as exports plus imports) has increased from 11 percent of GDP in 1970 to nearly 25 percent today. This 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. So this trend is not unique to the U.S. That is because — as I just alluded to — 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.

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. Furthermore, freer trade helps foster cross-border investment and the diffusion of new technologies and ideas. These can help improve productivity, which, in turn, leads to higher economic growth and, most important, a higher standard of living.

Addressing barriers to open markets

If expanded trade is such a powerful influence on our standard of living, what has hampered its expansion? There are a number of barriers to open markets, from interventionist governments to concerned interest groups, that must be addressed.

In most cases, lowering barriers to trade promotes an efficient allocation of resources. However, market distortions can prevent this from happening. 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 producers in the U.S. or abroad 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 in that instance is not freer trade. The problem is government subsidy policies that work to keep inefficient plants open.

One way to overcome this hurdle is to continue to encourage multilateral efforts that, over time, will reduce government subsidies that cause these problems. The new Trade Promotion Authority granted to the President by Congress — known as "Fast Track" — should make it easier to negotiate such agreements for the U.S.

While government subsidies are one barrier to more open trade, others oppose more open trade because they are concerned with job losses. It is true that as trade barriers fall, some industries and their workers inevitably find themselves facing sharp competition from imports. Competitive pressures will cause some firms to contract their businesses and reduce their work forces.

However, dislocation caused by trade is relatively small. Economic studies generally suggest that it accounts for no more than 10 percent of all displaced workers in the U.S.

Moreover, while increased competition will cause some firms to contract, other firms will see their input costs fall, allowing them to expand production and increase hiring. Net exporters, in particular, will see expanded opportunities as other countries lower their barriers to our goods. From a broader perspective, then, expanded trade promotes faster economic growth and thus job creation, not job loss.

One example of this dynamic is the North American Free Trade Agreement, or NAFTA. While it was being debated in the U.S. prior to enactment, the arguments focused on the benefits or costs in terms of jobs created or lost. That was almost certainly the wrong emphasis. Basic economic theory tells us that job creation depends primarily on the state of the macro-economy, with a relatively small and mainly transitory effect from trade. Because of the strength of the North American economy, millions of jobs have been created since NAFTA was enacted — 24 million in the U.S. alone.

Thanks to NAFTA, North America now has one of the largest and most dynamic trading regions in the world. The success of NAFTA in raising living standards throughout the continent underscores the importance of expanding free trade globally. Indeed, NAFTA provides a clear example that trade agreements between developed and developing countries can work to the benefit of both.

Despite all this, those who are displaced by trade simply cannot be ignored, even if their numbers are relatively small. The shifts towards more efficient markets can be extremely difficult for workers and firms in the industries that compete most directly with imports. 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 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.

The barriers to greater openness between nations extend beyond displaced workers and subsidies — and so must the solutions. As we move towards openness, nations must address issues such as income inequality, the environment, health care and working conditions, to name just a few.

Though these are difficult issues, they are well worth addressing. I firmly believe that firms, workers and nations benefit from producing and selling goods globally. I believed it 10 years ago when I negotiated trade agreements. I still believe it today.

Conclusion

Let me conclude with some final thoughts on the U.S. economy and free trade.

During the last 20 years or so, we've deregulated financial markets, developed more flexible labor markets and made major advances in technology, which fostered dramatic improvement in productivity. We're also committed to free trade, and have worked to strengthen our partnerships with countries around the world. These efforts help foster solid noninflationary economic growth at home and contribute to greater openness and prosperity abroad.

Looking ahead, while we are faced with some uncertainties in the near term, the long-term prospects for the U.S. economy are good. This bodes well for the U.S. and for our trading partners around the world.