Trade Deficits and the Health of the U.S. Economy

Remarks before the Little Rock Rotary Club

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

Little Rock, Arkansas
February 14, 2006

Trade Deficits and the Health of the U.S. Economy

Richard W. Fisher

As was just mentioned, I spent three years negotiating trade agreements around the world for President Clinton, whom I first met when he was governor, right here in Little Rock. My oldest son was an intern in Mack McLarty's office when he was chief of staff to the president, and after my work as a trade representative, I had the pleasure of being Mack's partner in his venture with Henry Kissinger.

This is all by way of saying that the president and Mack taught me a lot about Arkansas.

That Patmos, with a population, I recall, of 32, is the smallest town in Arkansas—unless two or three die or move out of Oakhaven.

That Hope is the state's heart and Little Rock the brains and that Bentonville, as anybody who shops knows, has a whole lot of muscle.

That Blanchard Springs Caverns in Stone County ought to be one of the Ten Natural Wonders of the World.

That the Razorbacks ought to be another one.

I like Mack so much that I would always just grin at him and nod when he bragged on Arkansas. And no matter who the president is, Democrat or Republican, you almost always say, "Yes, sir, Mr. President."

But I hope you will forgive me for telling you that I drew the line at their referring to the great state of Texas as "Baja Arkansas," refusing to do so even when Mack would put me in a hammerlock and give me noogies.

Let's just say that on a beautiful, springlike day like this, reading about those snowstorms up East in this morning's *Democrat-Gazette*, Arkansans and Texans are one and the same at having been blessed to be joined at the hip, right here in the sweet spot of America.

I want to talk to you today about the global economy and America's position within it. Before doing so, I'll issue the standard disclaimer of all Federal Reserve officials and those who sit on the Federal Open Market Committee: My views are just that—my own, assisted greatly by the magnificent research team I have backing me up in Dallas.

I will give you the bottom line up front: The U.S. economy is strong and very competitive. The economy is in a sweet spot of its own, thanks to private-sector leadership. One hundred and thirty-five million Americans are at work. Unemployment has dropped to 4.7 percent, the lowest rate in four years. We have faced terrorist attacks and natural disasters, and yet our economy continues to steam along at a pace that the consensus of economists estimates will be somewhere north of 4 percent in this current quarter, after netting out inflation, which we have maintained at or near the 2 percent level despite record-high energy prices.

The Federal Reserve, as your central bank, is and will remain ever vigilant in pursuing its mandate of providing the monetary policy required for sustainable non-inflationary growth.

That said, we all know what the threats are to our long-term prosperity and what needs to be done to prevent them from metastasizing. In addition to protecting our nation from Al Qaeda and other aggressors, on top of most lists would be the urgent need to rein in the fiscal deficits, solve the long-term imbalances built into our retirement and health care systems, and repair our educational system.

Some will argue that we also need to protect ourselves from new sources of competition, like China and India and Vietnam, and the nations liberated from Soviet dominance by the fall of the Berlin Wall.

Today, I am going to argue that that is precisely the wrong thing to do. Rather than protect ourselves from competition, we should embrace it and exploit it in order to make ourselves even stronger.

But first, let me put the United States in perspective.

The United States produces $12.6 trillion a year in goods and services. That is big.

How big? Well, let's be conservative. Let's assume that in 2006 we grow at what was estimated as last year's rate of 3.5 percent (before the data for the last quarter are revised upward, which I expect they will be).

If we grew at 3.5 percent for a year, we would add $440 billion in incremental activity. That exceeds the entire output of all but 15 other countries. Every year, we create the economic equivalent of a Sweden—or two Irelands, or three Argentinas. Year, after year, after year.

Nobody else has that heft.

In dollar terms, a growth rate of 3.5 percent in the U.S. is equivalent to growth surges of 16 percent in Germany, 20 percent in the U.K., 26 percent in China and 70 percent in India.

Of course, our growth is driven by consumption, a significant portion of which is fed by imports, which totaled $2 trillion last year. Our annual import volume—what we buy in a single year from abroad—exceeds the total output, the GDP, of all but four other countries: Japan, Germany, Britain and France.

We buy from the world a heck of a lot more than we sell. Last year, the trade deficit was estimated to have been $726 billion, a mighty big amount. A fourth of that was with China.

Some see this as a threat. After the recent trade deficit was announced, the *Financial Times* of London quoted one commentator as saying, "These exploding deficit numbers are not a sign of strength; they are a sign of weakness. They indicate a slow bleeding at the wrists economically for the United States." Some of you in this audience might be tempted to agree.

Before you do so, let's look at the numbers.

Let's examine the assertion that trade deficits are a sign of weakness by going back to look at what has happened to the U.S. economy since we last ran a trade surplus, which was in 1975. After 1975, we began to run up trade deficits. In each successive year they have increased: to one-half of 1 percent of GDP in 1980, 1.3 percent of GDP in 1990, 3.9 percent of GDP in 2000 and 5.8 percent of GDP last year.

Has the economy weakened? You be the judge. Here are the numbers.

In 2005 dollars, per capita disposable personal income in 1975 was $17,019. Today, it's $30,429.

In 2005 dollars, per capita GDP in 1975 was $22,383. Today, it's $42,047.

In 2005 dollars, mean household net worth was $195,000 in 1975 (fourth quarter). Today, it's $434,000.

What these numbers tell us is that since 1975, the American people have become better off by a factor of two, net of inflation.

What about those among you who are investors? How have you done?

The Standard & Poor's 500 Index closed 1975 at 90. It closed yesterday over 14 times higher, at 1,263.

The Dow Jones industrial average closed at 852 in 1975. Last night the Dow closed at 10,892.

The purchasing power of consumers and investors has increased to a far greater degree than just their income levels and net worth, because many of the things you buy and use have become better at ever-cheaper prices since 1975.

In 1975, a 19-inch Sears color TV cost $359.95 and a 25-inch console was $599.95. Today, a 20-inch Magnavox is $118.99 and a Sharp 27-inch model is $200.99. Today's models have a much better picture, last longer, use less electricity, and come with a whole host of added features such as remote control.

The first PC, the Apple I computer, sold for $667 in 1976. It ran at the speed of 1 to 2 megahertz and had a 4k memory. Just $500 spent today on, say, a Dell Dimension E310 with a Pentium 4 processor will get you 2.87 billion times the processing power and millions of times the memory, with a free flat-panel screen and lots of other features.

In 1975, when I graduated from Stanford Business School, they didn't have very sophisticated handheld calculators for use by financial analysts. In 1981, I bought this little guy, an HP12C calculator, which most investors will tell you is all you need to do financial calculations for portfolio management; I use it to this day. It cost me $150. Yesterday, if you were to have looked on eBay at 11:32 a.m., you could have bought an HP12C for $5.

What the numbers tell you is that we are far richer as individuals and as a nation than when we last ran a trade surplus. We are hardly "bleeding at the wrists economically" or becoming weaker as we have incurred trade deficits.

This is not to say that we can sit back, indifferent to the future. Presently, the countries we buy from—oil from the OPEC countries, consumer electronics from the Asians, foodstuffs from Mexico—are not providing significant venues at home for investing their surplus savings. To be able to finance our external trade and current account imbalances, we have to remain a magnet for that surplus capital, attracting investments from those whom we buy goods and services, recycling what we pay out to make purchases abroad back into our economy in the form of investments that make us still richer and stronger, and meanwhile position us to compete more aggressively in trade markets.

That is a mouthful. Here is the point: To be able to afford what we consume, we must continually improve ourselves. We must continue moving up the value-added ladder while others replace the work we used to do on the lower rungs of that ladder.

One of my favorite economists was a Czech-born professor from my alma mater, named Joseph Schumpeter. He coined a term that appears to be a contradiction in terms but captures the essence of what is required to succeed in a fiercely competitive world: "creative destruction." The United States has harnessed this process and made it work to constantly improve our global economic standing. Americans are masters of creative destruction.

What do I mean when I say that? Well, let's go back to the original expression of the term.

In his book *Capitalism, Socialism, and Democracy,* Schumpeter wrote the following: "The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization…[and] incessantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is … what every capitalist concern has got to live in."

In his book, *Business Cycles,* he wrote: "A railroad through new country, *i.e.*, country not yet served by railroads, as soon as it gets into working order upsets all conditions of location, all cost calculations, all production functions within its radius of influence; and hardly any 'ways of doing things' which have been optimal before remain so afterward."

Here is where China and India and all the bristling new economic entrants come in. They are today's equivalent of Schumpeter's railroads. They and the phenomenon of globalization are agents of creative destruction writ large. From now on, hardly any way of doing things which used to be optimal will ever be the same.

Or as that master of the creative destruction of syntax, Yogi Berra, would say, now that China and India and the others have entered the game, history just ain't what it used to be.

Creative destruction is by no means painless. Let's go back to 1975 again.

Since 1975, as we started down the path of running ever-larger trade and deficits, over 141 million Americans have filed unemployment claims. If you assume that there were more who either didn't qualify to file or didn't bother, you might reasonably conclude that 175 million jobs have been lost since 1975. That is the destructive side of creative destruction. That is the painful side for people like my dad who lost their jobs and more than once had to retrain for another one.

But then the creative side steps forward. Since 1975, the economy has replaced the jobs lost and more, adding another 57 million net new jobs to accommodate youth entering the workforce, a surge in immigrants and—very important—significant numbers of women who joined and enriched the workplace. This is the gratifying part of the process. This is the good news. If we create the conditions to let our private sector do what it does by its very nature— constantly adapt and reposition itself—then we have nothing to fear from competition from our trading partners, including those with whom we presently run big deficits.

We do, indeed, have some tough competitors out there.

But we have some unique advantages.

America's economy encourages change. We provide a healthy environment to nurture entrepreneurs. We have not saddled the private sector with regulations that interfere with hiring and firing or dictate outmoded methods of production.

Consider this: Starting a business takes five days in the United States, compared with 45 days in Germany, 108 in Spain and no one knows how many in China. We let labor, capital and companies compete—within the country and with the rest of the world. Our economy continually reorganizes itself to take advantage of new technologies, freeing labor from old jobs so it can move to new, higher-value uses.

The agent of reorganization is not the government or the central bank but the talent of our business managers, something that economists rarely talk about. The managers of our businesses are the key to our continued adaptation and growth. They are our greatest comparative advantage.

I like to say that the managers in our business community serve as the nerve endings in Adam Smith's invisible hand, stretching capitalism's fingers into every corner of the world to extract value at the lowest cost—in order to enhance productivity.

I am not talking just about CEOs who get paid big bucks. I am talking about the millions of middle managers who operate supply chains, control inventories and fine-tune operations.

Every day, these managers get up and go to work to exploit those competitors who come to market with cheaper products by buying those products and using them as inputs for providing better deals to their customers.

They are the masters of the best manifestation of "creative destruction."

They are the folks who exert the gravitational pull for the recycling of those monies we pay out to secure cheaper inputs. Their ability to wring value out of all sources, everywhere, is what makes the United States the preferred risk-adjusted destination for surplus investment monies.

They are the people who enable us to finance our external deficits, and inevitably redress them.

They are the key to our transforming what some perceive as a weakness into a fundamental strength.

As long as the Federal Reserve does its job of holding inflation at bay, and as long as our political leaders resist protectionism and other forms of interference with creative destruction and let the private sector get on with its work, we will remain the world's predominant economic machine.