

# Asia, Trade Deficits and the Health of the U.S. Economy

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Chamber of Commerce*



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*The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.*

# Asia, Trade Deficits and the Health of the U.S. Economy

Richard W. Fisher

I want to thank the Greater Dallas Asian American Chamber of Commerce for the opportunity to speak here today. I was truly impressed to learn that your organization is the largest Asian-American chamber in the United States, with 1,200 members.

Asian-Americans have achieved remarkable success and are a shining example of what can be achieved in this ongoing, unfinished experiment we call America. If you take a look at the Census Bureau's Current Population Survey, you will see that the average income of Asian households was \$56,664—more than \$12,000 above the U.S. average of \$44,473. But the importance of the Asian-American community is not measured only by income level. You have ties to a wide range of countries where I spent a great deal of time during the second four years of the Clinton administration negotiating market-opening trade agreements—China, Japan, Korea, Taiwan, Vietnam, India and many others. The economies of Dallas and of Texas benefit from the presence of the many internationally savvy businesspeople who belong to this chamber.

You are part of a growing economic connection between Texas and Asia. I am not sure how many of you know that Texas ranks No. 1 among the states in exports—with 14.5 percent of the U.S. total, eclipsing California's 13 percent. Mexico, of course, is far and away our leading foreign market due to geographic proximity, but Asia has become quite important, too. Overall, nations across the Pacific buy 24 percent of our exports, more than twice Canada's share. Five of Texas' top seven overseas markets are in Asia—China, Korea, Taiwan, Singapore and Japan. China has been Texas' fastest growing export market since 2002.

Texas' growing exports are just part of the larger topic I want to talk about today: the global economy and America's position in 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 backing me up at the Dallas Fed.

The U.S. economy is strong and very competitive. The economy is in something of a sweet spot right now. We have faced terrorist attacks and natural disasters, and yet our economy continues to steam along at a pace that forecasters estimate will in this current quarter be somewhere north of 4 percent, net of inflation. A total of 135 million Americans are at work. Unemployment has dropped to 4.7 percent, the lowest rate in four years. The underlying trend of core inflation has been running at roughly 2 percent, despite record-high energy prices.

Our economy is performing well, but we all know about threats 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. Indeed, there is a movement afoot in the Senate to impose a 27.5 percent levy

on \$243 billion of Chinese imports; in effect, it seeks to make American consumers and other importers pay a tax of \$67 billion to protect themselves from cheap imports from China. Today, I am going to argue that that is precisely the wrong thing to do—not because it is readily transparent that an onerous tax on Chinese imports would be inflationary or because it would simply lead to the displacement of imports from China to other foreign sources, such as Vietnam. The underlying instinct implicit in this proposal—that we must protect ourselves from competition—is, in my humble opinion, faulty. We should embrace competition and exploit it to continue making 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, the Twelfth Federal Reserve District, headquartered in San Francisco, produces more output than all of China. The Eleventh District, headquartered here in Dallas, produces 20 percent more than India.

The incremental growth of the U.S. economy is in and of itself impressive. Let's be conservative and assume we grow in 2006 at last year's estimated rate of 3.5 percent, a rate that stands a good chance of being recalibrated upward when the final numbers are done. Growing at 3.5 percent for a year, we 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 two Indonesias, three Thailands, four Malaysias or 11 Vietnams. Year, after year, after year.

In dollar terms, America's 3.5 percent is equivalent to 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 imports—what we buy in a single year from abroad—exceed the total output, the GDP, of all but four other countries. Our consumption provides a significant impetus for economic growth in the rest of the world.

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 very influential policymakers and analysts, maybe even some of you in this very audience, are tempted to agree.

Before doing so, I would respectfully suggest that they do some simple math.

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 in 1975. Since that year, we have been running trade deficits that increase with each successive decade: 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? Here are the numbers. You be the judge.

In 2005 dollars—that is, adjusted for inflation—per capita GDP in 1975 was \$22,383. Today, it's \$42,047.

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

In 2005 dollars, mean household net worth was \$195,000 at the end of 1975. 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.

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 1,292.

The Dow Jones industrial average closed at 852 in 1975. Last night the Dow closed at 11,137.

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 we 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 financial analysts. In 1981, I bought this little guy, an HP12C calculator, which most investors will tell you is all you need to do the financial calculations of portfolio management. I use it to this day. It cost me \$150. A couple of days ago, if you were to have looked on eBay as I did, 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, what we buy—oil from the OPEC countries, consumer electronics from the Asians, foodstuffs from Mexico—comes from countries that are not providing significant outlets at home for investing their savings. To continue to finance our external trade and current account imbalances, we have to be a magnet for the world's surplus capital, attracting the investment money of those from whom we buy goods and services. The process recycles the money we pay out for purchases abroad back into our economy in the form of investments that make us richer, stronger and better positioned to compete more aggressively in trade markets.

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 ladder's lower rungs.

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*, Schumpeter 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 so again.

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 deficits, over 141 million Americans have filed unemployment claims. If you assume that there are others 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. These managers 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 let the private sector get on with its work, we will

remain the world's predominant economic machine. If we resort to protectionism and other forms of interference with creative destruction, then we will indeed be slitting our own wrists, draining the world of the lifeblood of U.S. economic growth.