Globalization's Impact on U.S. Growth and Inflation

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It is a pleasure to address the Dallas Assembly. I was a member of the Assembly during the 1980s when I was young enough to qualify for it, and I am delighted to see that it is as spry and active as ever.

I am also delighted to see Stuart Bumpas sitting in the audience—one of Dallas' most distinguished lawyers—less spry but no less wry. Stuart is uniquely wise. When I was licking my wounds from my midlife crisis—running for the U.S. Senate in 1994—he gave me the perfect restorative: a first edition of P. G. Wodehouse's *The Code of the Woosters*. It was the Doubleday Doran first printing of 1938, which I added to the 30-odd works of Wodehouse I had been collecting since my undergraduate days.

Many of you may not be familiar with Wodehouse, the creator of Jeeves and Bertie Wooster, among countless comedic figures. He wrote over 70 novels, some 300 short stories, 18 plays, and, with Jerome Kern and other greats of the musical theater, the book for more than 30 musical comedies. Evelyn Waugh, George Orwell, John le Carré and almost every other writer of his day considered Wodehouse the single best writer of the English language.

I am old-fashioned enough that I still read and reread Wodehouse, in order to keep a whimsical balance to an otherwise too-serious life. And being a money man at heart, I display *Code of the Woosters*, Stuart's gift, prominently among my Wodehouse collection. It trades at around $800 in rare book circles. Which effectively means I am the first Texan in history to actually take money off a lawyer.

Wodehouse once set out to read all of Shakespeare. "But you know how it is," he wrote. "Just as you have got *Hamlet* and *Macbeth* under your belt, and are preparing to read the stuffing out of *Henry the Sixth* … something of Agatha Christie's catches your eye and you weaken."

Today, you are going to get the hard stuff, not the Agatha Christie or a more modern version or anything else that might be remotely titillating or of immediate gratification. Were I trendy, I suppose I could remind you that in the devout culture of central bankers, every numerary wears the cilice of inflation on his or her intellectual thigh as we pursue our avowed goal of providing the monetary conditions for sustainable non-inflationary economic growth. But there is nothing new or mysterious there. That has always gone with the territory and always will.

What is new is the way in which globalization is affecting the gearing of our economy and what an increasingly integrated world means for operating the levers and pulleys of monetary policy. I want to share some personal thoughts on this important subject with you today, for it is what I and the Dallas Fed research team spend a great deal of time grappling with.

I know many of you are eager for some clue about the latest direction of interest rates or some tidbit that might be turned to profit. I will do my best to disappoint you on that front. It was not for nothing that *New York Times* columnist Bill Safire taunted the Fed a few weeks ago for being coy when those who watch us want a full frontal view. He referred to us as "the House of Hints," which, being old-fashioned, I consider totally complimentary.

Should I impart any hints at all today, please bear in mind that I am speaking strictly in a personal capacity. I speak neither for my Fed colleagues nor for the other participants in the deliberations of the Federal Open Market Committee.

A little over a week ago, I beetled off to Argentina. After meetings and a speech at the Argentine central bank, my wife Nancy and I visited what we believe to be the eighth natural wonder of the world. On the speck of the map where Argentina touches Brazil and Paraguay is a little place called Cataratas del Iguazú. Surrounded by hundreds of miles of rain forest and dense jungle, Mother Nature created there the most beautiful waterfalls imaginable. No town is within miles of this place. And no economic activity invades its pristine scenery, except for ecotourism. So I was astonished when my BlackBerry started buzzing. Harvey Rosenblum, the Dallas Fed's research director, needed an answer to something or other. There I was, in the middle of a South American jungle, thumbing out an e-mail so work could get done thousands of miles away.

Picture that in your mind's eye—and kindly ignore the image of my Nancy's annoyance!

Being able to work almost anytime from almost anyplace is globalization at work. Technology, capital, labor and ideas, now able to move at unprecedented speed across national boundaries, have integrated the world to an unprecedented degree.

Imagine if this had been 10 years ago and I had been manager of a manufacturing operation or a retailer or a service provider that was malfunctioning in my absence. Imagine the painful and slow process that would have been required to ask and answer that question. Operations would have had to shut down for hours or even days as the folks here waited for me to return from vacation or at least reach my hotel, where I could receive a phone call or fax and transmit my decision back to Dallas. My company's profitability would have been hurt, and the nation's GDP would have taken a slight hit.

With BlackBerry in hand in today's wireless, interconnected world, it made scant difference whether I was in the jungles of Iguazú or here in my office.

In this and countless other ways, globalization is reconfiguring the economic engine of America. Our citizens and companies do not seek to utilize inputs that are shipped over the surface of the sea or through cyberspace from faraway places for the sheer adventure of it or to brag that their BlackBerry works even in Iguazú. They do it because it makes them better off; because it enhances efficiency. This is the natural process of capitalism as it spreads across the world at brushfire speed, blown hither and yon by the incessant desire of businesswomen and men to drive down costs, make greater profits and grow their enterprises, and in doing so raise the bottom line for the world economy—a higher GWP.

Let me give you a few numbers that illustrate the breadth and depth of the world's march toward globalization:

- Trade as a percentage of gross world product has risen from 15 percent in 1986 to nearly 27 percent today.

- Since 1986, the stock of foreign direct investment assets has nearly quadrupled as a percentage of gross world product, and the stock of cross-border portfolio investment assets has increased by a multiple of eight.
- More people than ever are crossing national borders—for business and pleasure. On average around the globe, countries received just one foreign visitor for every 100 people in 1950. By the mid-1980s there were six. Since then that number has doubled to 12.
- The world communicates much more and in whole new ways. Since 1991, international telephone traffic has more than tripled. The number of cell phone subscribers has grown from virtually zero to 1.8 billion—30 percent of the world population—and Internet users will soon hit 1 billion. (That number, by the way, includes one husband whose wife gave him a blistering lecture on the purpose of getting away from it all in Iguazú.)

From these data alone, it is clear that globalization unleashes competition and accelerates the forces of creative destruction, to borrow the term coined by the great economist Joseph Schumpeter.

In this turbulent sea of change, there are challenges and opportunities. Business leaders, like many of you here, confront them every day. The men and women who manage America's businesses—the busy fingers of Adam Smith's fabled invisible hand—work 24/7 to hone their companies' productivity and competitiveness. They get it. They understand that America's workers and businesses prosper by tapping into the opportunities inherent in a hyper-interconnected, integrated world.

I am not sure those of us in the policymaking realm "get it"—at least not yet. Just as globalization has created new dashboards for business operators, it has rewired the lights and switches on policymakers' control panels. My guess is that the relationship between these lights and switches and the real world of production, prices and jobs is not what it was two decades ago—or a decade ago or even two years ago. It is important that policymakers begin to better understand what is actually going on. Traditional theories and economic models that do not adequately incorporate globalization are likely to result in policy responses that might be too strong or too weak, too soon or too late.

In the world of central banking, as I said earlier, we are keenly interested in how globalization affects our ability to deliver on our mandate for economic growth with stable prices. We know, of course, that more open economies bring added competition—much of it from places like China and India—that can produce in great volume at lower cost. So we see, for example, that the prices of clothing, electronics, white goods, toys and other heavily traded goods have been held in check. That is the obvious part of globalization—the impact on the availability and prices of traded goods. That is a no-brainer.

Less visible, but no less important, is the incentive foreign competition gives U.S. producers to increase efficiency and remain competitive. We at the Fed talk regularly with hundreds of CEOs, COOs and CFOs, from companies big and small, throughout this vast nation. Almost all of them dwell on the growing internationalization of their businesses and the need for driving productivity up and holding costs down. Under relentless pressure from both consumers and shareholders, they profit by finding the most attractive inputs and processes available anyplace on earth and anywhere within cyberspace.

One obvious assist to business has come from the fact that globalization has enormously increased labor supply. The math here is pretty simple. In the early '90s, the disintegration of the stranglehold of the Soviet Union released millions of hungry workers into the system, from little Estonia to bigger countries like Poland. China joined the World Trade Organization at the turn of the century, and over 700 million workers came into play. And now India, with its hundreds of millions of working-age people, has joined the game.

The U.S. economy has benefited from this surge of new workers. While China gains as an important source of the world's manufacturing output, its gains have come at the expense of former powerhouses like France and Italy and Japan and other more rigid, less competitive countries. We, on the other hand, have been better able to innovate and adapt and compete. Fear-mongering to the contrary, the United States is not losing ground to this growing Asian giant, despite the long-term shrinking of our manufacturing sector relative to our services sector. It may surprise you to know that, despite the fact that the U.S. remains the world's largest manufacturer, only 10.5 percent of U.S. jobs are in the manufacturing sector (and only 1.5 percent are in agriculture). We have prospered, and we have driven unemployment down to the lowest level in over four years, by moving up the value-added ladder and becoming the world's dominant power in creating innovative services.

Increasing competition in the labor market, I should note, does not come just from vast labor pools making goods and equipment in factories located abroad. It also comes from immigrants, who have contributed more than half of U.S. labor force growth in the past decade. The spread of Information Age technology and the removal of the isolationist yoke of communism and statist regimes create opportunities for virtual immigration as well. In a world wired with fiber-optic cables, foreign workers deliver services from far off—a software program written in Estonia, a call-processing center in Bangalore, or back-office work sent to the Caribbean.

It would thus appear that one clear consequence of the spread of globalization, the global workforce's increasing integration into the U.S. economy, has dulled wage pressures here, exerting downward pressure on inflation.

What about the impact of imported goods? Analysts who focus only on traditional measures of trade deny globalization's impact on inflation, noting that imported goods make up a mere 10 percent of U.S. consumption. In nations more integrated with the rest of the world, the import share may rise to 20 percent or 25 percent. The tail never wags the dog, so other countries' impact on our inflation has to be remote—or so the theory goes.

I beg to differ.

To be sure, anybody who wanders down the aisle of a Wal-Mart or a Costco or Target store knows that whatever the portion of imported tradable goods, prices of clothing and electronics and almost everything else that you can feel, smell, watch or listen to have become more affordable because of globalization. But the impact is more invasive than that. The distinction between tradables and nontradables is not fixed and absolute. Over time, more and more items become tradable as technological barriers fall and transport costs shrink.

Alan Blinder, a thoughtful economist with a much bigger brain than mine, points out that we can no longer follow the traditional dichotomy between tradables as things that can be put in a container and shipped and nontradables as things that cannot be packed up and sent. "In the future, and to a great extent already in the present," Blinder writes, "the key distinction for international trade will no longer be between things that can be put in a box and things that cannot. It will, instead, be between services that can be delivered electronically over long distances with little or no degradation of quality, and those that cannot."

Professor Blinder teaches economics at Princeton, which shows he has a healthy sense of humor. But he is also a former Fed vice chairman, which tells you he is a serious player. He is well aware that the preponderance of our economic activity and household income derives from services.

Even when you think in terms of labor rather than products, you see a blurring of the concept of what is "tradable." Real estate, the leisure and hospitality industries, and medical services are generally considered purely domestic, immune from the vagaries of global competition. It is not difficult, however, to detect important global influences in all of them. Who does much of the construction work? Who cleans the rooms and cooks the meals at many of our hotels and resorts? How many doctors and nurses have come to this country from overseas?

The supplies, and therefore the prices, of many so-called nontradable goods and services are clearly impacted by globalization—at least by my notion of globalization, which includes the cross-border movement of labor and capital as well as goods. You don't have to live on the border with Mexico to grasp that notion. Just go to a construction site in Chicago or Miami or Seattle and watch and listen. As the great economist Yogi Berra once said, "You can observe a lot just by watching."

Without added labor from overseas in all of its forms, U.S. wages would be rising faster. Many might welcome that. After all, Americans would be receiving fatter paychecks. But we would also be facing higher inflation, with all its unpleasant consequences. Without the contribution of the global workforce, moreover, the quantity and variety of goods and services available in the United States would diminish.

I have argued, within the temple of the Fed and without, that globalization has in these and many other ways expanded our concept of "capacity constraints" and redefined our sense of "resource utilization." It has helped *tame* inflation. That has been the trend of recent years. But it has not *exorcised* for once and for all time the demon of inflation.

The International Monetary Fund recently released its *World Economic Outlook*, which includes a chapter on globalization and inflation. The report issues a warning that I think bears repeating. "Globalization," the IMF concludes, "has undoubtedly provided some brake on inflation in the industrial economies in recent years and has allowed for a more measured monetary policy [*meaning we have been able to keep interest rates low*].... However, globalization cannot be relied upon to keep a lid on inflationary pressures.... Strong global growth and diminishing [global] economic slack have reduced the restraining impact of declining import prices on inflation."

Even if you argue, as I do, that globalization's effect is not limited simply to prices of imported goods and services, one can envision a scenario in which increased resource utilization in other countries might add to inflation rather than mitigate it. We might well be seeing evidence of this as growing demand in emerging economies drives up the prices of oil, copper, zinc and other commodities, even after netting out the speculative excess that has been impacting those markets.

My point is that even though the playing field has been enlarged and reconfigured by globalization, and even though the world is a far more exciting place, moving at the pace and with the suspense of a modern thriller, there still are some time-tested risks that Federal Reserve officials and other central bankers must fear and manage. We are cursed with still having to "read the stuffing out of" the classic texts, even as some of us seek to improve upon them and adapt them to modern society. The advent of China and India, the introduction of the Internet, new frontiers of science like the Human Genome Project and yes, even the BlackBerry and the iPod and other drivers of greater efficiency, productivity, interconnectivity and economic homogenization, do not overturn the basic premise, for example, that too much money chasing too few goods or productive investments leads to inflation—regardless of whether the sources or placement of those monies are in new places and in new technologies.

That said, globalization is not going to go away, even if politicians given to the expediency of protectionism or building walls or other costly follies draw up laws that attempt to slow it down. Globalization is here to stay.

Globalization is not a one-off event; its effects are dynamic and profound. An analogy is the deregulation of U.S. banks and airlines in the late 1970s, both supposedly one-off events. Who would argue that these companies aren't still adjusting to these one-time shocks? When I helped negotiate China into the World Trade Organization, a process that was not completed until the start of the Bush 43 administration, I knew my yet-to-be-born grandchildren would be dealing with the tail end of the changes wrought by China's entry into the global marketplace.

I think it is pretty clear that with the emergence of China—and, following in its wake, India, Vietnam and practically everyone else—countries will face heightened competition for valuable factors of production, especially for capital to finance them. Many of these nations, including our own, will have to adjust their fiscal, monetary, legal and regulatory policies if they are to attract capital. We discuss this in the Dallas Fed's 2005 annual report, which, by the way, reads more like Agatha Christie than Shakespeare, despite its being rooted in fact, not fiction. You might want to go to our web site. Our study finds that the most successful countries in a globalized world place the least burden on the free flow of capital, ideas, people, goods and services.

Even politicians, regardless of party or country, who are genetically wired to thrive on spending O.P.M.—other people's money—are getting the message. The *Financial Times* recently reported that Peer Steinbrück, Germany's finance minister, "pledged to fight back against low taxation in competing European countries, promising a tax system that improved German companies' global competitiveness." By way of explanation, Steinbrück said, "An effective tax rate of 39 percent is not internationally competitive." His words contrast sharply with those of his predecessor, who argued that the Poles, Estonians and other new Europeans should *raise* their taxes if they want to play nice. Taxes impact costs, and costs impact inflation. Who knows what chain of events a reduction or restructuring in German taxes would set off in Europe and around the world?

This is what keeps the economists at the Fed on their toes. Economists like to model things. They take the real world, distilling it into equations and graphs to measure how *this* affects *that*. The models have enhanced our understanding of the choices consumers, workers, companies, investors and governments make every day. Without them, central bankers would be handicapped in making informed decisions.

Economic models dealing with global influences have been around for hundreds of years. Modeling evolves along with the economy. The problem is that few models deal with today's rapidly changing manifestation of globalization. Tremendous complexity is required to capture the sophisticated working and resulting impacts of the changes we are experiencing.

So far, the models I have seen in the academic literature look at globalization the way a mechanic might look at a vintage Mustang and time how long it takes for it to go from zero to 60 both before and after replacing the rear axle. The problem is, our globalizing economy is not a vintage car. It is more like a 2006 BMW Z4 roadster, fully equipped and Bluetooth enabled. It is a very complex, highly integrated, technologically advanced and brilliantly engineered vehicle that just cannot help exceeding the posted speed limit. Models telling us that changes in the classic Mustang's rear axle will barely impact its performance are of little use to anyone trying to estimate the top speeds at which a new BMW can handle curves safely. We need to continue devising and refining economic models for a new generation, so we can negotiate the curves on the superhighway that is the modern economy. This is what the research team at the Dallas Fed has been called on to do.

Many of the new realities of globalization are obvious. Unless you have been on another planet, you all know the forces of globalization, now unleashed, continue to remake our world. The challenge lies in understanding what's going on around us and then harnessing that knowledge so that the U.S. can continue to prosper in a rapidly changing, hypercompetitive world economy. As members of the Dallas Assembly, you have to constantly do this in your businesses, in your law firms and in the many ways you serve this great community. At the Federal Reserve, we must do the same. We will keep you posted on what we learn. And we ask you to return the favor.

Thank you.