

## **Globalization and Its Effects on the U.S. Economy**

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Paoli, Pa.  
March 20, 1998

### **The Outlook**

We have been experiencing remarkably good economic performance. This economic expansion is now in its eighth straight year. With rapid economic growth for several years, the unemployment rate has fallen to near 4-1/2 percent, its lowest level in nearly a quarter of a century. Last year more than 3 million new jobs were created. And all of this was accomplished without a resurgence in inflation. In fact, consumer price inflation slowed to a little less than 2 percent in 1997, after rising more than 3 percent in 1996.

Last year's slowing inflation came as something of a surprise to economic forecasters. With demand for goods and services growing rapidly at a time when the unemployment rate is lower than it has been in decades, wages are rising more rapidly. Forecasters thought that pressure on wages would translate into bigger price increases. Indeed, a year ago the major risk facing the U.S. economy was that too rapid growth in demand would lead to overheating and rising inflation. But businesses continue to find ways to improve productivity and keep their unit labor costs down. Businesses also continue to expand their capacity at a rapid clip, with the result that capacity utilization rates in industry are now generally lower than they were three years ago. Faster productivity growth and enlarged industrial capacity both contribute to keeping inflation down. So does a strong dollar and the intense competition that American firms face from their foreign rivals.

This year the risks facing the economy are less one-sided than they were a year ago. Today, there is less concern that overheating will occur. In fact, downside risks loom much larger now than they have for the past two years. And as testimony to the growing globalization of our economy, the concern about downside risks to our nation's economy stems not so much from domestic developments, but from international ones.

Although there are downside risks, my judgment is that the U.S. economy will continue to grow at a healthy pace. Developments in Asia will mean slower growth of U.S. exports and a rising U.S. trade deficit, but those factors will only partly offset the momentum in consumer spending and business fixed investment. The net result is likely to be more moderate growth than in 1997.

### **Globalization**

More generally, the effects of globalization on the U.S. economy go well beyond the issue of Asia's effects on the U.S. economy this year. The effects of globalization are going to be more far-reaching and more permanent.

"Globalization" means different things to different people, so let me begin by giving you my definition: Globalization is the process of moving toward a world in which we produce, distribute, sell, finance, and invest without regard to national boundaries.

Are we in a world in which national boundaries are irrelevant? No, and we won't be anytime soon. But we have been moving in that direction, and we will continue to do so. A German company manufactures cars in Mexico for sale in the United States. Japanese consumers calling a U.S. mail order company to buy sweaters made in Scotland may find themselves talking to telephone operators in Ireland. And portfolio managers in the Hong Kong offices of New York financial firms buy and sell Korean stocks on behalf of British as well as American investors. Globalization, in the sense that I am using it, is driven by reductions in trade barriers and capital controls, by attempts to capture economies of scale, and by dramatic quality improvements and cost reductions in long-distance communications.

While many people fear globalization, the process is not fundamentally different from the relocation of manufacturing and the integration of financial markets that occurred within the U.S. in the 20th century. We know that manufacturing plants and jobs moved from the Northeast to the South and Southwest. At the same time, companies established nationwide distribution systems and nationwide brands. Now a company headquartered in Pennsylvania may have production facilities in 6 states, buy inputs produced in 12 states, and sell goods in all 50 states.

Similarly, all but the largest Pennsylvania companies used to rely on local banks for the bulk of their financing. Now they borrow not only from local banks but also from a variety of financial firms headquartered in other parts of the country.

And residents of Pennsylvania, who used to keep their savings on deposit at local banks, now entrust much of their wealth to portfolio managers in New York who buy stocks and bonds issued by companies in all 50 states. Similarly, portfolio managers in Valley Forge handle money for residents of states other than Pennsylvania.

Substitute "countries" for "states" and you have described globalization.

Globalization has benefits, but also costs. Let's focus first on the benefits. U.S. firms gain access to new markets -- Coca Cola, Procter and Gamble, and Merck, for example, sell their products in virtually all countries. These activities generate profits for their American shareholders. U.S. companies also gain access to new sources of raw materials and intermediate inputs, and to lower-cost locations for assembly operations that use unskilled labor -- think of liquefied natural gas from the Arabian Gulf, computer boards from Taiwan, and running shoes assembled in Malaysia.

Still focusing on benefits of globalization, we know that as consumers we have gained access to new products, including compact disks, digital cameras, and fresh raspberries and blackberries in January and February. And as savers, we have gained the ability to diversify more broadly. Academic literature shows that over the long-run internationally diversified equity portfolios have a better risk-return tradeoff than domestic-only equity portfolios. These benefits have led to a higher standard of living in the U.S. and abroad.

Firms also benefit from globalization. They gain the ability to diversify more broadly. A U.S. firm that operates in many countries will find that recessions and booms in the many markets in which it operates are likely to be out of sync. This helps to stabilize companies' profits. Firms also gain the ability to make use of financial markets worldwide.

In the last few years, we have seen that globalization can also provide a safety valve against overheating of the U.S. economy. One reason inflation has remained so low in the U.S. during this business cycle is that competition from foreign producers has made it difficult for firms producing in the U.S. to raise prices even when they face robust demand for their products. And firms that produce not only in the U.S. but also in other countries have been able to expand production abroad, and then ship to the U.S. as their U.S. production facilities run out of slack. That has helped avoid bottlenecks.

As with the relocation of manufacturing in the U.S., globalization generates some of its gains by allowing -- or sometimes forcing -- relocation of production. Not everyone benefits. Just as relocation of manufacturing from Pennsylvania to South Carolina generates losers as well as winners, so does globalization.

The U.S. as a whole gains from reductions in trade barriers and capital controls, but not everyone shares in those gains. In particular, globalization appears to have contributed to the decline in real wages of those with few skills and little education, though more of the decline appears to have resulted from computerization and the widespread adoption of new technologies generally.

It is important to note that the costs of globalization do not come from losing jobs overall. Total employment in the U.S. has grown dramatically as globalization has proceeded. And we need to remember that while some U.S. companies have moved jobs abroad, foreign firms have set up shop in the U.S. and hired American workers. The costs of globalization come from the fact that it is costly to shift resources from one

use to another and to retrain workers as the mix of jobs changes. In the process of shifting resources, some production facilities are abandoned and some workers suffer unemployment. They do not share the gains, at least not immediately.

Globalization also increases the U.S. economy's exposure to foreign shocks. An economic slowdown in Europe or Asia, for example, has a bigger effect on the U.S. economy now than it did when exports and imports were smaller relative to GDP. And greater international financial linkages mean that the U.S. financial sector is more exposed to foreign financial shocks than used to be the case. Recent financial problems in Asia provide a good example.

Because globalization brings costs as well as benefits, policymakers face a challenge: to maximize the benefits while minimizing the costs.

The first task is to ensure a "level playing field" for U.S. and foreign firms in trade, foreign direct investment, financial services, and other areas. This is an important task, but it should not be an excuse for protecting particular industries in the U.S. from foreign competition.

Another challenge is to ensure that workers displaced by the more intense competition that globalization allows are able to acquire new skills, to move into new industries, and sometimes even to move to new locations.

Policymakers need to consider foreign as well as domestic economic conditions as they make macroeconomic policy decisions, and they also need to consider international ramifications of domestic policy decisions. Thus there is a need for consultation and sometimes for coordination with foreign policymakers. The need for coordinated policymaking is particularly strong in the arena of supervision and regulation of financial services firms, because problems in one country's financial sector can be quickly transmitted to other countries' financial systems once they are tightly integrated. The recent problems of financial institutions in Asia have driven this lesson home again.

In general, policymakers in the U.S. have been successful in meeting these challenges. There is always more work to do, but there are real successes. We have seen continuing reductions in trade barriers and expanding free trade around the world. We have seen declining barriers to international capital movements as new computer and telecommunications technology has helped to make financial markets more global.

## **Pursuing Good Economic Policies**

Pursuing reductions in trade barriers and encouraging expanded international trade have been good economic policy for the U.S. We need good trade policy; declining trade barriers and the globalization of financial markets are part of the reason for our prosperity. But they are not the only reason.

In recent years we have seen how well our economy can operate when it is close to price stability -- an environment we last enjoyed in the 1950s and early 1960s, about 40 years ago. Good economic policies have helped us achieve the strong economic results we have been enjoying, and we must continue making good economic policy to keep the economy strong. By that I don't mean just good monetary policy. Widespread deregulation of various industries has spurred competition and helped reduce prices to consumers and costs to businesses. And much improved fiscal policy has restrained federal spending and reduced the budget deficit.

Last year the country began to address longer-term budget issues by passing the Balanced Budget Act, which was intended to balance the budget in 2002. In fact, federal tax receipts have continued to exceed expectations, so now slight federal budget surpluses are in sight even before the year 2002. But just as monetary policy ought not reflect complacency about our success in restraining inflation, fiscal policy ought not reflect complacency about fiscal discipline. We still have several major, long-term budget issues to address with regard to Social Security and Medicare.

The nation's recent good economic performance and low inflation also ought not make us complacent about the risks facing the economy. Certainly there are both downside and upside risks this year. Asian problems could spread and lead to a significantly weaker U.S. economy than we currently foresee. So we must be on

guard against such a possibility. But significant upside risks remain as well. Whenever the economy is operating as close to full capacity of its labor and industrial resources as it has been recently, any sharp rise in aggregate demand is likely to lead to a resurgence of inflationary pressures. So we must remain on guard against inflation as well as being watchful for signs that problems in Asia are leading to a more marked slowing of the U.S. economy.

We also cannot become complacent about our trade policies and the threat of protectionism. The U.S. must follow the good policies that helped bring us prosperity -- good monetary policy, good fiscal policy, and good trade policy. If the problems in Asia lead to a resurgence of protectionist legislation in our nation, the result will be significant harm to world trade. If so, we would lose a key contributor to our nation's prosperity.