Challenges and Opportunities in a Global Economy: Perspectives on Outsourcing, Exchange Rates, and Free Trade

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Introduction

Welcome to the Philadelphia Fed's Fourth Annual Policy Forum. The purpose of this annual conference is to assemble financial economists, academics, and policymakers to analyze and discuss the central policy issues of the day.

This year our focus is on **Challenges and Opportunities in the Global Economy**. As this conference approached, its theme proved to be increasingly topical. Over the past year, the widening U.S. trade deficit and the rising international price of oil have been among the most closely watched and widely discussed factors bearing on U.S. economic performance. No doubt, ongoing developments in these areas will command considerable attention in the year ahead. So, as I said, the topic of today's forum is certainly timely.

However, the impact of developments in the global economy extends well beyond our concerns surrounding the current level of the U.S. trade deficit. The topic is bigger than that and its effects will be more long-lasting. The emergence of new market economies around the world and the ongoing revolution in information technology are combining to create an ever larger, more diverse, and more closely integrated global marketplace. As this evolution continues, a host of international economic and finance issues are emerging, and these will command ever greater attention from policymakers and researchers alike. Discussion of these longer-term, more fundamental issues is the focus of this year's Policy Forum.

To set the stage for today's program, I would like to open with a few words about the starting point for this broader, deeper discussion, namely, the current status of the U.S. economy. Then I will move on to some of the more fundamental issues that I look forward to hearing about in today's sessions.

The Outlook for the Economy

So, where is the U.S. economy at the moment? As I indicated several weeks ago in Pittsburgh when discussing the current outlook for the economy, I believe we are now in a period of sustained, moderately paced expansion. The soft patch seems behind us, and labor markets are improving. In fact, despite a significant increase in international oil prices, the economy has performed quite well this year. Real GDP growth will likely be close to 4 percent from fourth quarter to fourth quarter.

Looking ahead, I expect real GDP growth to be in the neighborhood of 4 percent for 2005. This kind of growth, combined with a return of productivity to its long-run trend, should support continued solid but moderate gains in employment through next year.

Given this scenario, the Fed should continue moving monetary policy toward a neutral stance at a measured pace and thus keep inflationary pressures well-contained. Indeed, honoring our commitment to price stability is essential to ensuring the longevity of the expansion. In the context of today's forum, it is appropriate for me to note that my outlook for 2005 is predicated on relative stability in both the U.S. trade deficit and international oil prices.

The trade deficit has widened considerably over the past decade. Through the first three quarters of this year, our real net exports fell by $60 billion. In accounting terms, this represents a reduction in real GDP growth of roughly three-fourths of a percentage point.

As I have noted before, in some respects, the persistent and widening trade deficit can be seen as an indication of the strength of the U.S. economy. Strong GDP growth in the U.S., relative to that of our trade partners, has contributed to our strong and growing demand for imports relative to the demand for our exports. In addition, the relatively strong demand among foreigners for dollar-denominated assets has kept the value of the dollar high, both financing the trade gap and tipping it further into deficit.

Now, the trade deficit has reached a record level of 5 percent of GDP, and economists are saying it cannot continue to widen indefinitely. I agree with that assessment in principle. However, realistically speaking, the relative strength of the U.S. economy, both in terms of its rate of growth and its attractiveness to investors, is unlikely to diminish significantly for the foreseeable future. Hence, we are likely to see sizable U.S. trade deficits for some time.

In the short run, my best guess is that the trade deficit will neither widen nor narrow significantly in 2005. This is because the recent declines in the value of the dollar, combined with reasonable growth in the economies of our trading partners, should help stabilize our net export position, significantly diminishing its negative impact on GDP growth.

But this is truly a situation where “still waters run deep.” Beneath the surface, developments in the global economy are transforming the basic structure of the economy, the issues policymakers must address, and the questions researchers choose to study.

The pervasive impact of the global economy

Indeed, today’s sessions highlight the breadth and depth of the global economy’s influence. In our opening session on **Outsourcing**, we will be examining the impact of the growing globalization of the labor market. The next session on **Exchange Rates** underscores the important role of international capital markets and the free flow of financial assets around the world. The closing session on Free Trade is a reminder that arrangements for the international exchange of goods and services continues to evolve.

Today’s presentations also highlight the widening geography of the international marketplace. Our discussions will touch on the U.S.’s evolving relationships with its traditional trading partners in North America and Europe, with Japan, and with the emerging markets of Asia.

I would also note the breadth of methodologies economists bring to their analysis of these global economic issues. The presentations you will hear today are based upon research ranging from purely statistical VAR models to traditional structural macro-econometric models, to more recently developed general equilibrium models. You will also hear presenters draw on everything from traditional trade theory to the microeconomics of the firm.

Examining these important issues from different perspectives and using different analytical tools provides us with a deeper level of insight and will help answer some important questions on my mind as well as on the minds of my fellow policymakers.

Let me highlight three topics that I think are of particular importance in this area and that might help focus the current policy debate on the fundamentals behind today’s headlines and tomorrow’s news.

1. The globalization of production

The globalization of production processes must be listed first. It is on our minds; it is on the news; and it was recently an area of deep contention in the national debates around the presidential elections.

We know that the revolution in information technology and the emergence of new market economies are opening up tremendous new opportunities to reallocate production and distribution around the globe. As economists we see this as an opportunity to more fully realize the benefits of comparative advantage. Nonetheless, developments thus far have not met with universal support. Further, while we know the impact of this phenomenon is powerful, we have not yet been able to quantify it and we are just beginning to understand its potential. Improving our knowledge of this trend will require us to sharpen our analysis of changes to the economy at every level — from the macroeconomics of the nation, to the organizational structure of various industries, to the microeconomics of the value chain within and among organizations.

The three papers in our outsourcing session will highlight the breadth of perspectives we must bring to bear on this important issue. The first discusses the impact of outsourcing on the aggregate labor market. The second focuses on the impact outsourcing is having on the industrial sector in particular. And the third emphasizes that the extent to which the individual firm will outsource is contingent upon the characteristics of its production process. I look forward to our discussion of the growing implications of outsourcing from these three different perspectives.

2. The role of exchange rates and tariffs on the terms of trade

With that, let me turn to a second issue of interest, the impact of exchange rates and tariffs on trade. We know that policymakers attempt to affect the terms of trade — sometimes by managing exchange rates and sometimes by imposing or reducing tariffs. An interesting question is how the impact of these two strategies differs.

An examination of the sharp decline in the value of the dollar during the mid-1980s suggests that a substantial change in the relative value of currencies causes a well-defined response. A substantial relative price change caused an expansion or contraction of economic activity in well-established sectors, but did not open up broad new areas of international trade. In short, the 1980s decline in the dollar can be seen as having a simple price effect on trade, causing existing U.S. exports to expand over the course of several years, gradually narrowing the trade deficit.

On the other hand, declining trade barriers seem to bring more fundamental change to the economies affected. For instance, one of today's papers examines the impact of NAFTA and finds that it had an unexpectedly powerful effect, increasing trade in goods and services that were previously traded in very small quantities or not at all. Moreover, the trade agreement generated a significant increase in productivity and accelerated the trans-border transfer of new technologies.

One might conjecture a rationale for this difference. A decrease in tariffs is perceived as a permanent change and therefore evokes larger responses and more fundamental changes, while fluctuations in exchange rates are viewed as more transitory. In fact, some research done at the European Central Bank, and referenced here today, suggests that volatility in exchange rates — and the uncertainty it creates — can actually decrease trade flows.

Another possibility is that changes in exchange rates affect relative prices across a broader array of goods and services, and so evoke smaller adjustments across that array, while changes in tariffs and the like are more selective, and so generate narrower, but more substantial, effects.

Whether this conjecture is accurate I cannot say, but it surfaces the difficult issue of the distribution of costs and benefits from free trade. That brings me to a third important issue on which today's program will shed some light.

3. Policy paths to a global marketplace

As economists, we have long espoused the benefits of free trade. Economists are quick to point out that free trade brings all participating nations a general improvement in their standard of living. But we also know that opening up to free trade creates dislocations and imposes costs on individual sectors within nations.

So, while it is widely agreed that free trade is good, this assertion is subject to an important caveat: that the people and firms who gain from free trade are able to compensate the people and firms who lose from it. Economists recognize this as the "Pareto criterion," a sort of litmus test that policy measures must pass to qualify as socially desirable in principle. But there is a pragmatic dimension to this as well. To move their economies toward freer trade, policymakers must solve the political problem of how to redistribute the benefits that accrue in order to build supportive constituencies both within and among nations.

You will hear new and different perspectives on this idea in our third session today. I will not prejudge the discussion, but a key question here is: What is the best path to globalization from a policy perspective? Different paths are being pursued by policymakers around the globe, which range from global trade arrangements, to free trade areas, to bilateral trade agreements. The effectiveness of each of these types of agreements in building the necessary support for free trade is a practical issue that we must continue to examine closely.

Conclusion

Let me now conclude. I think all of us here today recognize that the global economy brings, and will continue to bring, new opportunities and new challenges to the nations of the world. Seizing those opportunities and meeting those challenges in a manner that benefits all will not be easy. But, as always, the odds of success are improved when policy decisions are based on solid research and considered judgment.

And so the global economy brings both challenge and opportunity to us personally — researchers, market economists, and policymakers alike. In that spirit, I hope you find today's program valuable.

Thank you for attending the Policy Forum. I look forward to hearing your insights. And now, I will turn the podium over to Kei-Mu Yi to get our first session under way.