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Remarks by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

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Interest in issues of trade, tariffs, and protectionism has ebbed and flowed in this country since our founding. The widened trade deficit of recent years, in the context of a prolonged bout of job loss, has again elevated cries of distress to special prominence.

The sensitivity of our economy to foreign competition does appear to have intensified recently as technological obsolescence has continued to foreshorten the expected profitable life of the nation's capital stock. The more rapid turnover of our equipment and plant, as one might expect, is mirrored in an increased turnover of jobs. A million workers leave their jobs every week, two-fifths involuntarily, often in association with facilities that have been displaced or abandoned. A million, more or less, are also newly hired or returned from layoffs every week, in part as new facilities come on stream.

Related to this process, jobs in the United States have been perceived as migrating over the years, to low-wage Japan in the 1950s and 1960s, to low-wage Mexico in the 1990s, and most recently to low-wage China. Japan, of course, is no longer characterized by a low-wage workforce, and many in Mexico are now complaining of job losses to low-wage China.

In the United States, conceptual jobs, fostered by cutting-edge technologies, especially information technologies, are occupying an ever increasing share of the workforce and are gradually replacing work requiring manual skills. Those industries in which labor costs are a significant part of overall costs have been under increasing competition from foreign producers with labor costs, adjusted for productivity, less than ours.

This process is not new. For generations American ingenuity has been creating industries and jobs that never existed before, from vehicle assemblers to computer software engineers. With those jobs come new opportunities for workers with the necessary skills. In recent years, competition from abroad has risen to a point at which our lowest skilled workers are being priced

out of the global labor market. This diminishing of opportunities for such workers is why retraining for new job skills that meet the evolving opportunities created by our economy has become so urgent in this country. A major source of such retraining has been our community colleges, which have proliferated over the past two decades.

We can usually identify somewhat in advance which tasks are most vulnerable to being displaced by foreign or domestic competition. But in economies on the forefront of technology, most new jobs are the consequence of innovation, which by its nature is not easily predictable. What we do know is that over the years, more than 94 percent of the workforce, on average, has been employed as markets matched idled workers seeking employment to new jobs. We can thus be confident that new jobs will displace old ones as they always have, but not without a high degree of pain for those in the job-losing segment of our massive job turnover.

The American economy has been in the forefront of what Joseph Schumpeter, the renowned Harvard professor, called “creative destruction,” the continuous scrapping of old technologies to make way for the new. Standards of living rise because the depreciation and other cash flows of industries employing older, increasingly obsolescent, technologies are marshaled, along with new savings, to finance the production of capital assets that almost always embody cutting-edge technologies. Workers migrate with the capital. This is the process by which wealth is created, incremental step by incremental step. It presupposes a continuous churning of an economy in which the new displaces the old, a process that brings both progress and stress.

Disoriented by the quickened pace of today’s competition, some in our society look back with nostalgia to the seemingly more tranquil years of the early post-World War II period, when

tariff walls were perceived as providing job security from imports. Were we to yield to such selective nostalgia and shut out a large part, or all, of imports of manufactured goods and produce them ourselves, our overall standards of living would fall. In today's flexible markets, our large, but finite, capital and labor resources are generally employed most effectively. Any diversion of resources from the market-guided activities would, of necessity, engender a less productive mix.

For the most part, we as a nation have not engaged in significant and widespread protectionism for more than five decades. The consequences of moving in that direction in today's far more globalized financial world could be unexpectedly destabilizing. A likely fall in wage incomes and profits could lead, ironically, to a fall in jobs and job security in the shorter term. So, yes, we can shut out part or all foreign competition, but we would pay a price for doing so--perhaps a rather large price.

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I do not doubt that the vast majority of us would prefer to work in a less stressful, less competitive environment. Yet, in our roles as consumers, we seem to relentlessly seek the low product prices and high quality that are prominent features of our current frenetic economic structure. In particular, America's discount retailers have responded by learning to profit as intermediaries between consumers and low-cost producers, whether located in Guangdong province in China or Peoria, Illinois.

Retailers who do not choose their suppliers with price and quality uppermost in mind risk finding themselves in liquidation. If a producer can offer quality at a lower price than the

competition, retailers are pressed to respond because the consumer will otherwise shop at the retailer who does. Retailers are afforded little leeway in product sourcing.

If consumers are stern taskmasters of their marketplace, business purchasers of capital equipment and production materials inputs have taken the competitive paradigm a step further and applied it on a global scale. Understandably, as a consequence, trade discussions under the aegis of the World Trade Organization have become increasingly contentious. After four decades of more or less successful negotiations, the “low-hanging trade agreement fruit,” so to speak, has already been picked. Current trade negotiators, accordingly, now must grapple with the remaining, more difficult issues, such as intellectual property rights and agricultural subsidies. Debates over trade restrictions have understandably become far more confrontational than in earlier years.

For example, a strain of so-called conventional wisdom has attributed the weak labor market in the United States to the widening trade deficit, and a loss of jobs since the beginning of the recession of 2001 to low-priced competition from abroad (often deemed “unfair”) and increased foreign outsourcing on the part of corporate America. In fact, as Council of Economic Advisers Chairman Greg Mankiw recently pointed out, U.S. “job losses are ... more closely related to declines in domestic investment and weak exports than to import competition.”<sup>1</sup> In addition, of course, increased productivity has enabled ongoing demand to be met with fewer workers.

Noteworthy is the singling out of a particular exchange rate, the Chinese renminbi, as a significant cause of American job loss. The renminbi is widely believed to be markedly

undervalued, and it is claimed that a rise in the renminbi will slow exports from China to the United States, which according to some, will create increased job opportunities for Americans at home.

The story on trade and jobs, in my judgment, is a bit more complex, especially with respect to China, than this strain of conventional wisdom would lead one to believe. If the renminbi were to rise, presumably U.S. imports from China would fall as China loses competitive position to other low-wage economies. But would, for example, reduced imports of textiles from China induce increased output in American factories? Far more likely is that our imports from other low-wage countries would replace Chinese textiles.

Despite the very large surplus of China's trade with the United States, overall Chinese trade is much closer to balance. Chinese exports, a majority of which are from foreign-owned firms or affiliates, many American, depend on purchases from East Asian companies that supply inputs to the products the Chinese sell to the United States and elsewhere. Emerging Asia used to manufacture many goods that were then directly exported to the United States. However, a growing fraction of these goods are now partially assembled with capital-intensive, high-value-added manufacturing in the rest of emerging Asia; exported to China, where final processing is done--typically with labor-intensive, lower-value-added manufacturing; and then exported to the United States. This situation implies a deterioration in the Chinese trade balance

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<sup>1</sup>Statement to the Committee on Ways and Means, U.S. House of Representatives, October 30, 2003.

with the rest of emerging Asia, along with a growing surplus with the United States. In large part, the increase in China's share of U.S. imports has come at the expense of other East Asian exporters.

China's imports overall have risen dramatically over this year, from approximately \$25 billion per month a year ago to \$33 billion per month more recently, as China has become a major consumer of the world's commodities. Doubtless, part of the recent firmness in non-high-tech commodity prices is attributable to China's voracious appetite for raw materials.

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A rise in the value of the renminbi would be unlikely to have much, if any, effect on aggregate employment in the United States, but a misaligned Chinese currency, if that is indeed the case, could have adverse effects on the global financial market and, hence, indirectly on U.S. output and jobs.

In order to maintain the tight relationship with the dollar initiated in the 1990s, the Chinese central bank has had to purchase large quantities of U.S. Treasury securities with renminbi. What is not clear is how much of the unquestioned current upward pressure on the renminbi results from underlying market forces, how much from capital inflows due to speculation on potential revaluation, and how much from capital controls that suppress Chinese residents' demand for dollars.

No one truly knows whether easing or ending of capital controls would ease pressure on the currency without central bank intervention and, in the process, also eliminate inflows from speculation on a revaluation. Many in China, however, fear that an immediate ending of controls

could induce capital outflows large enough to destabilize the nation's fragile banking system. Others believe that decontrol, but at a gradual pace, could conceivably temper such concerns.

Central bank purchases of dollars, unless offset, threaten an excess of so-called high-powered money expansion and consequent overheating of the Chinese economy. The Chinese central bank this year has indeed offset, that is, sterilized, much of its heavy dollar purchases by reducing its loans to commercial banks, by selling bonds, and by increasing reserve requirements. But currency and commercial bank reserves have been rising enough to support a growth of the money supply well in excess of a 20 percent annual rate so far this year. Should this pattern continue, the central bank will be confronted with the choice of an overheated economy, with its potential recessionary consequences, or a curtailing of dollar asset purchases. The latter presumably would allow the renminbi to appreciate against the dollar.

China has become an important addition to the global trading system. A prosperous China will bring substantial positive benefits to the rest of the trading world. It is, thus, important to all of us that they succeed in navigating through their current economic and financial imbalances.

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The challenges represented by China's large surplus with the United States and the efforts to repair a recent breach in the current round of trade negotiations have engaged the attention of policymakers worldwide. But these are subplots in a much larger debate about the benefits and costs of expanding globalization.

At the risk of oversimplification, I would separate the parties in that debate into three groups. First, there are those who believe that relatively unfettered capitalism is the only



economic organization consistent with individual and political freedom. In a second group are those who accept capitalism as the only practical means to achieve higher standards of living but who are disturbed by the seeming incivility of many market practices and outcomes. In very broad terms, the prevalence with which one encounters allegations of incivility defines an important difference in economic views that distinguishes the United States from continental Europe--two peoples having deeply similar roots in political freedom and democracy.

A more pronounced distinction separates both of these groups from a third group, which views societal organization based on the profit motive and corporate culture as fundamentally immoral.

This group questions, in particular, whether the distribution of wealth that results from greater economic interactions among countries is, in some sense, “fair.” Here terms such as “exploitation,” “subversion of democratic choice,” and other value-charged notions dominate the debate. These terms too often substitute for a rigorous discussion of the difficult tradeoffs that we confront in advancing the economic welfare of our nations. Such an antipathy to “corporate culture” has sent tens of thousands into the streets to protest what they see as “exploitive capitalism” in its most visible form--the increased globalization of our economies.

As solutions to these alleged failures of globalization, dissidents frequently appear to favor politically imposed systems, employing the power of the state to override the outcomes arrived at through voluntary exchange. The historical record of such approaches does not offer much encouragement. One would be hard pressed to cite examples of free and prosperous societies that suppressed the marketplace.

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Setting aside the arguments of the protesters, even among those committed to market-oriented economies, important differences remain about capitalism and the role of globalization. These differences are captured most clearly for me in a soliloquy attributed to a prominent European leader several years ago. He asked, "What is the market? It is the law of the jungle, the law of nature. And what is civilization? It is the struggle against nature." While acknowledging the ability of competition to promote growth, many such observers, nonetheless, remain concerned that economic actors, to achieve that growth, are required to behave in a manner governed by the law of the jungle.

In contrast to these skeptical views, others argue for the ethical merits of market-driven outcomes posited on the value preferences of individuals as reflected in their choices in a free marketplace. The ultimate arbiter of an economy's ethics is, or should be, the material welfare of the individuals in a society. The crux of the largely laissez-faire argument is that, because unencumbered competitive markets reflect the value preferences of consumers, the resulting price signals direct a nation's savings into those capital assets that maximize the production of goods and services most valued by consumers. Wages, profits, and other sources of income are determined, for the most part, by how successfully the participants in an economy contribute to the welfare of consumers.

Clearly not all activities undertaken in markets are civil. Many, though legal, are decidedly unsavory. Violation of law and breaches of trust do undermine the efficiency of markets. But the legal foundations and the discipline of the marketplace are sufficiently rooted in a rule of law to limit these aberrations. It is instructive that despite the egregious breaches of

trust in recent years by a number of the nation's business and financial leaders, productivity, an important metric of corporate efficiency, has accelerated.

On net, vigorous economic competition over the years has produced a significant rise in the quality of life for the vast majority of the population in market-oriented economies, including those at the bottom of the income distribution.

The highly competitive free market paradigm, however, is viewed by many at the other end of the philosophical spectrum as obsessively materialistic and largely lacking in meaningful cultural values. This view gained adherents with the recent uncovering of much scandalous business behavior during the boom years of the 1990s.

But is there a simple tradeoff between civil conduct, as defined by those who find raw competitive behavior demeaning, and the quality of material life they, nonetheless, seek? It is not obvious that such a tradeoff exists in any meaningful sense when viewed from a longer-term perspective.

During the past century, for example, economic growth created resources far in excess of those required to maintain subsistence. That surplus in democratic capitalist societies has been, in large measure, employed to improve the quality of life along many dimensions. To cite a short list: (1) greater longevity, owing first to the widespread development of clean, potable water and later to rapid advances in medical technology; (2) a universal system of education that enabled greatly increased social mobility; (3) vastly improved conditions of work; and (4) the ability to enhance our environment by setting aside natural resources rather than having to employ them to sustain a minimum level of subsistence. At a fundamental level, Americans have used the

substantial increases in wealth generated by our market-driven economy to purchase what many would view as greater civility.

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Debates on the pros and cons of market capitalism have waged for generations. The collapse of the Soviet empire, and with it central planning, has left market capitalism as the principal, but not universally revered, model of economic organization.

The vigorous debates on how economies should be organized and by what rules individuals' trading should be governed surfaced most prominently in the latter part of the eighteenth century. Those debates appear destined to continue through the twenty-first century and presumably beyond.