

## **Trade deficits and the US economy Part II**

by Michael Knetter

*While increased access to foreign markets would not have large aggregate implications for the U.S. economy, it will have important sectoral effects.*

In the first part of this two part article it was argued that increased access for US firms to foreign markets would have small aggregate effects on the US economy. That is not the same as saying it will have little sectoral effect. Increased exports would matter for the composition of output, since exports are not typical of the overall mix of output in the U.S. Our exports are concentrated in high technology industries (biotechnology, pharmaceuticals, computer hardware and software, aircraft, telecommunications services and equipment, financial services, etc.) and agriculture. This is where U.S. output would be likely to grow if foreign markets opened up more to trade.

In a full employment economy, such as ours today, growth in some sectors implies shrinkage in others. There is no free lunch. The shrinkage would likely occur in industries where global excess capacity has dictated falling prices and profits, such as steel and autos.

Any shift away from heavy and light manufacturing and toward export sectors would also have implications for labor demand. Export growth might serve mainly to increase the demand for highly-educated workers in the U.S., exacerbating the trend toward inequality in the labor market that has developed in recent years. Greater foreign market access sounds great, but chances are it would not be a panacea for blue-collar workers in traditional manufacturing industries.

### *Effect on US manufacturing employment*

The key facts about aggregate performance of U.S. manufacturing are that employment is stagnant, while output and productivity are rising in absolute terms. While unemployment rates are generally low in the economy, employment growth has been completely lacking in the manufacturing sector for several decades. According to the 1999 Economic Report of the President, employment in manufacturing rose from 16.8 million in 1960 to 18.7 million in 1998, with most growth coming in durables (as opposed to non-durables) manufacturing. On the other hand, manufacturing employment has fallen from 31% of total employment in 1960 to merely

14.9% as of 1998. Basically, growth in U.S. employment since 1960 has been outside of the goods-producing sector.

Many people extrapolate from the employment data to conclude that the U.S. is “deindustrializing.” But the truth of the matter is that manufacturing, mining, construction, and agriculture together accounted for nearly \$2 trillion worth of U.S. output in 1998. That volume of output is bigger than all but a handful of national economies in the world.

The level of output of manufacturing has risen substantially since 1960 in nominal and real (inflation-adjusted) terms. But manufacturing’s share of total output has fallen a bit. In 1960, manufacturing output was 27% of U.S. nominal GDP, while in 1997 it was 17%. Since prices of manufactured goods have risen by less than prices of other goods, the decline of manufacturing as a share of real output is much smaller. Data on real output by industry are only available from 1977 to 1997, but over that period of time, manufacturing’s share actually rose from 18.6% to 18.8%! (Table B-13, 1999 Economic Report of the President.)

The employment and output data together have a positive implication: productivity growth in U.S. manufacturing has been substantially higher than productivity growth in the rest of the economy. We are getting more output per worker today than we did in 1960—by a huge margin.

*Doesn't the decline of manufacturing jobs spell doom?*

The shift in employment away from manufacturing is not an unprecedented development. Other countries are undergoing a similar transformation today, and we have experienced similar structural shifts in our past. Many people are troubled by the prospect of shrinkage of employment in the manufacturing sector. After all, aren't those jobs the good jobs? Doesn't the decline of manufacturing jobs spell doom for our future in the international economy?

In my opinion, the contemporary pessimism about the U.S. manufacturing base has a very close parallel in our history. Over a century ago, the mechanization of agriculture set off many of the same reactions we see in manufacturing today. Mechanization raised productivity, which increased output per worker. Not all of the increased output could be absorbed due to inadequate demand for food. As a result, the agricultural workforce shrank. People were concerned by that development, since agriculture was the backbone of the U.S. economy at the time and people could not imagine what could take its place. But the economy didn't fall off a cliff. To the contrary, today we look back on the mechanization of agriculture as one of the great economic

advances in the history of man. Most of those workers were absorbed by job growth in manufacturing and even services. An important step in early economic development is the transition from agriculture to manufacturing in terms of employment.

I suspect that thirty years from now, we will have a similar perspective on the productivity revolution that we are seeing in manufacturing today. It appears that the transition from manufacturing to services is pervasive in advanced economies. That seems largely a consequence of growth in productivity triggered by computerization, although part of it may be explained by “outsourcing” some of manufacturing goods to other countries.

An uncomfortable aspect of these developments is that it is hard to predict how market forces will change manufacturing in the future. In particular, we cannot say which industries will come under pressure in the years ahead. That leads some people to call for government intervention in the marketplace aimed explicitly at preserving certain “critical industries.”

#### *‘Critical industries’ and the pork barrel*

Even if it were possible to objectively identify “critical industries”, which is doubtful, political forces would likely turn any organized attempt at industrial policy into a pork barrel. There is no denying that many government procurement programs, especially Department of Defense procurement, have fostered the development of key private industries. There is no denying that subsidization can help an industry develop. The question is whether we can accurately determine which industries are “undervalued” by the private market. The debate over which industries offer the greatest potential for spillovers is likely to have few objective criteria. And criteria will be plentiful enough that other considerations, such as electoral calculations, might come to play an increasingly important role in industrial policy.

The natural political outcome we would expect is that large industries get the most support. Large industries are easily defined as critical since, by definition, many people depend on them for supplies and employment. But large industries are not always the most deserving of new capital. Success in the past does not guarantee high rates of return in the future. Industrial policy could easily lead to industrial stagnation. Government industrial policy in Japan and Korea has probably played a significant role in the problems we have witnessed in those countries in recent years. Investment rates have been very high, but capital keeps getting funneled to low return activities. While an industrial policy might work well in the short run, when there might be

agreement about the industries that are most essential, the problems with an organized industrial policy would grow more severe with time as needs changed.

In summary, to say that defense spending created some new and valuable private industries does not imply that industrial policy will provide good value. The amount of industry development that was generated per dollar of spending was probably quite small. It is not enough to say that the market is not perfect in allocating capital in order to justify industrial policy. One needs to be able to believe that government allocation of capital would be more efficient than private allocation. History teaches us many sobering lessons on this point.

#### *Current strength of US economy*

The U.S. economy appears remarkably strong entering the new millennium, based on traditional indicators such as GDP growth, unemployment, employment, market capitalization, and inflation. Everyone has seen the glowing articles about the current state of the overall U.S. economy, which has been variously described as a “Miracle Economy”, a “Jobs Machine”, and other colorful monikers. Based on those descriptions alone, we can be pretty sure that on average, things look quite good for the U.S.

To say that things are good on average does not mean that every sector and every worker are benefiting from economic expansion. There is variation around the mean. Plant closings still happen, workers are laid off or otherwise unemployed, and families do suffer. It is impossible to determine the separate contributions of technological change, international trade, government policy, and changes in consumer preferences in generating these adverse outcomes for individuals. More importantly, a full employment economy implies that these adverse outcomes are only one side of the coin. The other side is the growth of the new industries and new jobs that take place in other sectors.

#### *Conclusion*

In summary, there are three important questions in thinking about the role of trade in the US economy are as follows. First, what level of foreign indebtedness or foreign debt service would constitute an undue risk for the U.S. economy as a whole? Where is the danger zone? Second, what factors are most likely to be contributing to our ongoing indebtedness? Perhaps people are saving too little because they overestimate the value of their Social Security benefits. We should

keep our focus on the incentives to save, rather than the incentives to trade. And most importantly, how can we better assist people who are hurt by industrial transformations—whether they are precipitated by trade, technology, or something else? To prevent transformation that is driven by either trade or technology would be to throw the baby out with the bath water. Supporting the continuation of declining industries is not a desirable solution for protecting jobs, since such support comes at the expense of emerging industries which offer higher returns to workers and investors alike.