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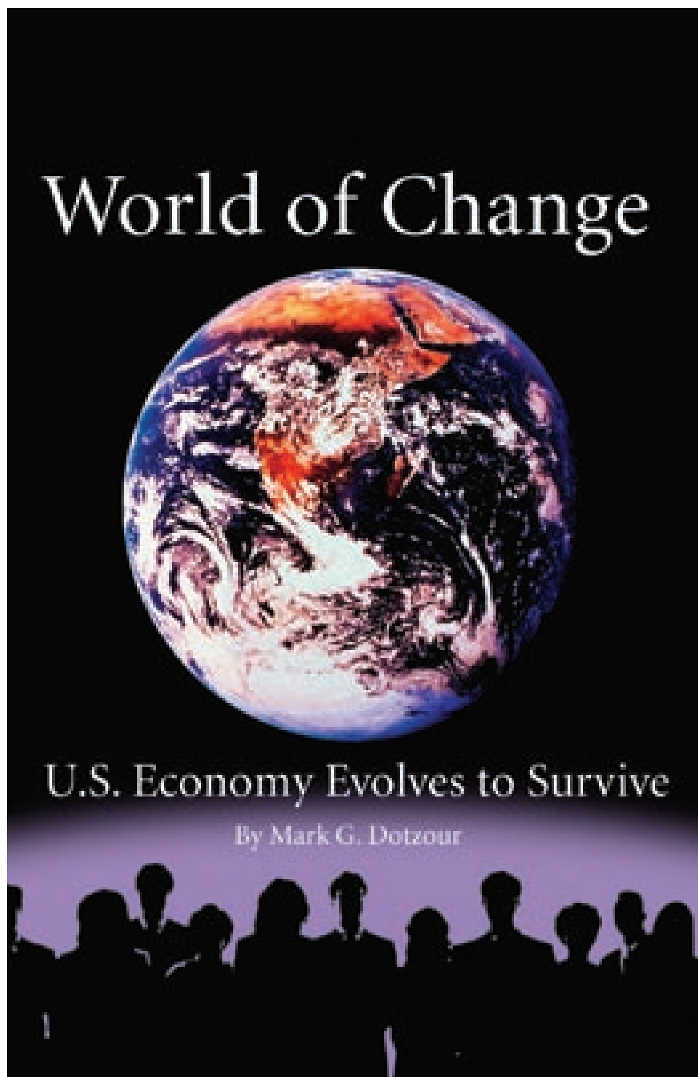

Sixty years ago, economist Joseph Schumpeter described the American capitalistic system as a "process of creative destruction." He recognized that innovation is the key driver to success. New products, new ways of making things, new means of communication, new methods of offering services to customers all compete to make old methods obsolete.

Amid this vortex of creative destruction, economic conditions and governmental policies are always changing. The National Association of Business Economics held its 2004 Economic Policy Conference in Washington, D.C., to assess the major factors buffeting American businesses. This article summarizes the issues and ideas presented at the conference.

Job Growth Ahead

The United States is currently in a period of high growth in productivity, according to Secretary of the Treasury John Snow. Productivity leads to abundance and higher standards of living, but at the current pace, generating job growth is difficult.

Business surveys indicate that hiring will pick up. Private sector economists are forecasting good job growth in the next 12 months. The Bureau of Labor Statistics' household survey of employment indicates a considerable increase in the self-employed, Secretary Snow said. He speculated that the Internet has decreased the transaction cost of doing business, allowing more small businesses to successfully compete with bigger firms.

Will the deficit lead to higher interest rates? Snow remarked that if experts believe deficits will be imbedded in financial markets, they exact a price through higher interest rates. The low interest rates in the current credit markets reflect a belief that deficits will not be extended indefinitely.

Greg Mankiw, chair of the president's Council of Economic Advisors, noted a number of positive indicators. Net worth of U.S. households hit a record high recently because of a higher stock market and the surge in housing prices. Productivity is not only causing a rise in real wages but also is enhancing corporate profits.

According to Mankiw, the tax cuts have stimulated consumer spending and need to be made permanent to further expand the economy. Most signs indicate that the economy will increase significantly in 2004.

Free trade is essential to future prosperity, Mankiw stressed. It creates jobs, but it also causes some jobs to be eliminated. Public policy needs to be crafted in a way that helps people retool for the next generation of jobs.

Profit Margins Increasing

Donald Kohn of the Federal Reserve Board of Governors asserted that the economy "has made the transition from weak to solid growth in demand." He noted several factors suggesting that demand will increase in the near future.

Overinvestment in the 1990s, Kohn said, has led to excess physical capital that has finally been worked off in most sectors. Corporate balance sheets have been restored with lower interest rate loans, resulting in higher profit margins. Household wealth has increased along with house prices and stock values. The decline in the value of the U.S. dollar relative to the euro will lower imports and increase exports. Higher productivity will ultimately lead to higher wages.

The extraordinary growth in supply is another trend. Kohn noted that changes in potential supply have been "among the most important influences on the behavior of the economy over the past ten years." Demand has fallen well below the economy's productive potential in recent years. Some of these supply changes are just one-time process enhancements, Kohn said, while others are permanent.

One-time changes include use of newly acquired technology and more efficient use of the existing workforce. Ongoing changes stem from the low cost of technology and investment capital. Not only are machines and computers faster and cheaper, but the interest rate to borrow money is low.

Higher Interest Rates Likely

Capital investment enhances productivity. Kohn noted that if America continues to see large increases in productivity, aggregate demand will need to expand to produce job growth.

According to Kohn, the risk of inflation and deflation is now balanced, but three scenarios could contribute to upward pressure on prices:

- if higher energy prices are passed through to other goods,
- if bottlenecks occur in the supply pipeline of inputs and
- if the drop in the U.S. dollar increases prices of imports.

So far, the lower dollar has not resulted in higher prices of imports as foreign companies have absorbed the change with lower profits. Kohn said the slack in factory use and intense competition for jobs will keep wage inflation in check.

As the output gap narrows, higher interest rates are likely. A considerable output gap currently exists, and unused capacity is high enough to support stable prices for the near future. The implication is that the Fed is unlikely to raise interest rates substantially in the immediate future.

Easy monetary policy has contributed to the rise in asset prices. A move to a more neutral interest rate policy (that is, higher interest rates) will likely have an impact on asset prices. Low interest rates have caused stock prices and real estate to rise substantially as investors search for alternative investments. When rates begin to rise, the value of commercial real estate may be hurt.

U.S. Dollar Must Fall

Michael Rosenberg, managing director and global head of FX research for Deutsche Bank, addressed foreign exchange issues. Despite a huge current account deficit, he said, U.S. interest rates have gone lower. It appears that interest rates are below equilibrium levels. This encourages speculation in stock, bond and real estate markets. By conventional yardsticks, the current fed funds rate of 1 percent is well below what should be expected.

The United States has limited control over foreign exchange, Rosenberg said, because China and Japan are accumulating foreign reserves at an enormous rate. Normally, an increase in the current account deficit leads to higher interest rates. Now, yields are going down instead because the central banks of Japan and China are purchasing U.S. Treasury securities.

If interest rates do not go up, said Rosenberg, the U.S. current account deficit will likely grow from 4 percent to 8 percent of gross domestic product (GDP) by 2008. If the U.S. dollar drops by 20 percent in 2004–2005, then the account deficit will stay at 4 percent of GDP. The U.S. dollar must fall 30 percent to get the account deficit down to 3 percent of GDP by 2008.

According to Rosenberg, changes of 30 to 40 percent or more in U.S. dollars are needed to make a difference in trade. Changes less than 30 percent do not have much impact on trading behavior.

"No one believes Treasury Secretary Snow that the United States wants to support a strong dollar," said Rosenberg.

Catherine Mann of the Institute for International Economics pointed out that the United States "has an insatiable thirst" for foreign consumer goods and automobiles. "We run trade deficits with countries all over the world," she said. "The only area where we run a trade surplus is in services and intellectual property."

Mann maintains that the United States is "codependent with Japan and China. They buy U.S. bonds and intervene in the currency market to keep the price of their goods low in the United States."

Mann asserted that the U.S. dollar needs to decline 20 to 30 percent just to keep the trade deficit from getting worse. Interest rates must rise, U.S. spending must fall or Japanese consumption of U.S. goods and services must increase.

"The big question" said Mann, "is why don't the Japanese spend money?"

Services Next to Move Offshore

"I haven't seen this level of anxiety about America's ability to compete since the concern about competing with Japan in the 1980s," said Lael Brainard, senior fellow at the Brookings Institution. The topic in question was "offshoring," or moving jobs to other countries.

According to Brainard, jobs in manufacturing have declined in many of the largest industrialized countries including Japan, Germany and China. Corporate profits have risen much higher in the past year than they did following the 1991 recession. The anxiety, she said, is coming from educated white-collar workers who thought they were immune to offshoring.

Services offshoring is the next wave. Somewhere between three and 14 million workers are vulnerable, with customer service and telecommunications at the top of the list.

The low cost of Internet bandwidth is exacerbating the issue. The glut of fiberoptic capacity has dropped the cost of global communications and transportation of data enormously.

To combat the consequences of offshoring, Brainard said the United States needs to produce a better-educated workforce, cheaper health care, more advantageous tax treatment for businesses and a "safety net" to aid workers caught in a transition. This safety net would include the ability to keep and transfer health care coverage if a worker loses a job, more assurance that the worker can keep a pension, and loss-of-income insurance when the loss is the result of trade.

"Economies around the world are more competitive than they were ten years ago," said Thomas Seims of the Dallas Federal Reserve Bank. Seims said 309 million jobs have been lost in the United States the past ten years. During the same period, 327 million jobs have been gained.

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Health Care Biggest Problem

David Walker, comptroller general of the United States, voiced concern about the U.S. government's estimated $31 trillion unfunded liability for Social Security and Medicare. This breaks down to about $3.7 trillion in expected payments for Social Security and $28 trillion for Medicare.

Current gross U.S. debt stands at about $24,000 per person, Walker said. When all the new Medicare-related claims are added, it rises to $100,000 per person.

Health care's portion of the total U.S. economy continues to grow. In 1970, it was 7 percent of GDP. It rose to 13 percent of GDP in 2000, and is expected to be 16 percent in 2010. Rising health care costs are impairing job growth in the United States, impacting the economy in four ways: offshoring of jobs, slower job growth, slower federal revenue growth and slower wage growth.

Federal revenue growth is slowed because health care benefits are not subject to income tax. Wage growth has slowed as wage-earners forego compensation in lieu of health care coverage.

"Health care is the biggest problem in the United States," said Walker. "It's not the baby boom causing the health care problem but the rise in per capita spending in health care," said Dr. Uwe Reinhardt of Princeton University.

GDP has grown at about 2 percent over the inflation rate per year since 1960. Health care spending grew at about 4.5 percent per year during that period.

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Reinhardt said businesses need relief from the relentless growth in health care costs. He suggested that the government should step in and provide "catastrophic coverage." According to Reinhardt, 80 percent of the health care costs businesses pay are for a small percentage of people with catastrophic illnesses, such as AIDs and lung cancer.

Manufacturing Down, Banking Up

U.S. manufacturing employment is at its lowest level since the 1950s, noted Kristin Forbes of the Council of Economic Advisors and Robert Kuttner, co-editor of *The American Prospect*. Manufacturing employment has fallen 16 percent in Japan. China has also had a decline in manufacturing jobs since 1995.

Manufacturing jobs have declined in the United States for several reasons. The massive level of investment in the United States in the late 1990s caused a slowdown in investment after 2000. Slow growth in Japan and other foreign countries led to a weak export market for American products, and corporate governance issues have created a level of uncertainty for all investors.

The nation's commercial banks are healthy, earning $120 billion last year, with mortgage loans being the major growth area, said Donald Powell, chairman of the Federal Deposit Insurance Corporation (FDIC). Powell identified two major trends in the industry: consolidation of the banking industry and banks moving into other commercial businesses.

Powell said there are now two tiers of banks in the United States — about a dozen large, complex banks and thousands of community banks. Community banks have declined by about 50 percent since 1985, and their number is likely to decrease another 50 percent.

The largest banks are likely to continue to get larger, said Powell. They are global in scope, diversified and subject to global economic trends and events.

Powell noted how slowly banks are moving into other businesses. This trend is being countered by other businesses getting into banking. For example, GMAC is a huge provider of car loans. Should other retailers be allowed to hold a bank charter? The FDIC wants to let the marketplace decide this issue.

Corporate Governance Scrutinized

"We have just been through the worst era of corporate fraud since the 1930s," said Harvey Goldschmid, a commissioner of the Securities and Exchange Commission (SEC). "The keys to remedying this situation are accountability and deterrence. We need good people who are independent and dispassionate to serve on boards.

"For the past 30 years, the SEC has tried to establish checks and balances of corporate executives," Goldschmid went on to say.

Recent legislation has expanded the responsibilities of directors of U.S. companies. Corporate directors now work over 200 hours per year, compared to 30 hours per year in the 1970s.

Goldschmid said the biggest issue in corporate governance has been that outside directors are not properly advised, consulted and listened to. Also, directors are not held legally liable when they certify quarterly reports.

According to Goldschmid, the most frequently observed corporate fraud tactic observed by the SEC is "earnings smoothing." This occurs when earnings are "borrowed" from the next quarter and reported in the current quarter to cause investors to think operations were more profitable than they really were. The second most frequently observed fraud is failing to recognize expenses.

Repercussions Widespread

What does all this mean? First, interest rates are likely to rise in 2004. Huge demand from China and a growing U.S. economy have resulted in dramatic increases in commodity prices. As hiring increases throughout the year, labor costs will likely increase as well. These trends typically lead to higher inflation and mortgage rates.

Second, health care is a signal problem for the United States. High health care costs have made businesses reluctant to hire. Employers are more likely to automate jobs and replace people with machines. Third, offshoring of information service jobs to India and other areas will continue as firms strive to increase profits by using cheaper workers.

Fourth, rising corporate profits will encourage more hiring. Job growth should create positive absorption for office, industrial and retail properties in Texas. Fifth, rising interest rates will make some people postpone buying a house. Expect occupancy rates for apartments to begin to rise.

The long battle against inflation that began in the late 1970s has been won. Now the Fed is continuing its three-year effort to gently reinflate our sluggish economy. As the nation switches from a declining to an increasing rate scenario, repercussions will be widespread.

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