

An economist's reflections in a time of prosperity

by [Robin Klay](#) in the [August 11, 1999](#) issue

For those who remember the days of recession, high unemployment and high inflation in the 1970s, the state of the American economy in 1999 is remarkable. We are enjoying the longest peacetime recovery in U.S. history, a record low unemployment rate (4.3 percent in May), and few signs of inflation, despite rapid expansion of output and jobs. The strength of the U.S. economy is largely the result of unusually strong spending by consumers. Increased levels of personal wealth (in the form of rising values of financial capital and housing) have made households more comfortable about borrowing to finance spending. Furthermore, demographic changes have augmented the number of younger households, which borrow against future earnings as they begin to establish families and careers, as well as the share of retired households, which spend beyond their current incomes by gradually reducing savings and selling assets.

Despite all this good news, some have expressed concern about the possible hidden costs of our macroeconomic success. And some wonder if the U.S. has prospered at the expense of other countries. Did the Asian countries, perhaps, suffer a financial recession over the last few years as "payment" for the U.S. economy's continued expansion?

Nothing could be further from the truth. Precisely because demand in the U.S. continued to be strong, export sales from Asia fell less than might have been expected, giving those countries an opportunity to begin to recover from recession. The long U.S. economic expansion of the 1990s has done more than lower domestic unemployment rates (which was especially valuable during a time of welfare reform, because it enabled large numbers of recipients to move off welfare into jobs). Expansion has also provided the needed spending stimulus to prevent Asian and Russian economic crises from drawing the whole world into a recession.

Other critics focus on job losses in particular industries, such as steel, and call for protectionism. Job losses by less-skilled workers, income disparities by race and gender, and the deterioration of our central cities do present real challenges. But the answer is not trade protection. Protectionism usually surfaces when economies are suffering from recessionary levels of unemployment, and governments seek to protect workers from job losses due to foreign imports. It is surprising to see bitter trade skirmishes between the U.S. and the European Union (over items such as bananas and hormone-fed beef) at a time of economic growth.

If the U.S. economy were suffering large job losses due to foreign import competition, raising barriers to trade would still not be the answer. One of the long-lasting lessons of the Great Depression is that raising trade barriers to save jobs easily cascades into a cycle of retaliation, which in the end decreases trade, income and jobs. Furthermore, studies repeatedly show that the cost to a nation of saving a job in an industry facing strong import competition is several times the typical wage in that industry. For example, a recent study of Europe put the average cost per job saved there by protectionism at a cool \$215,000, for a total cost of \$43 billion in one year (from the *Economist*, May 22). Obviously, there are cheaper ways to help workers while keeping markets open and competitive.

Given the present condition of the U.S. economy, which is creating many more jobs than are lost due to changing technology and international competition, protectionist voices should be relatively weak. But economists have long noted that the beneficiaries of free trade—citizens who enjoy more variety, greater quality and lower prices of goods—are poorly organized politically to have their voices heard over those of the well-funded spokespeople for the sectors and industries experiencing job losses. Even more muffled in the power corridors are the voices of many Third World people who stand to suffer when markets for their exports are not strong and expanding.

Recent history shows that whenever the leading economic powers are not actively engaged in further efforts to reduce trade barriers, backsliding is inevitable. The achievements of post-World War II GATT tariff rounds, which successfully ratcheted down tariff barriers among all the major trading nations, have been regularly threatened by perverse innovations in protectionism. "Voluntary export controls" and, more recently, "antidumping procedures" have been introduced whenever there was a lull in negotiations.

President Clinton's administration deserves some credit for the passage of legislation creating the North American Free Trade Area in 1994. This is the first free-trade arrangement ever to include both developed nations and a developing country. However, since then Clinton has been ineffective in persuading Congress to grant him "fast track" negotiating authority either for a new international round of free trade negotiations, through the World Trade Organization (permanent successor to GATT), or for gradual expansion of NAFTA to embrace most of Latin America. This failure is almost certainly the result, in part, of a second term during which the president and Congress were distracted with impeachment proceedings and other wranglings.

The fact that Americans have enjoyed low inflation rates during the current long business boom is surprising. A booming economy typically begins to face upward pressure on prices and wages, because the now fully employed work force cannot keep up with rising demand. Some experts talk of a new economic paradigm, as if the old connection between full employment and inflation has been permanently dismantled. This is not the case. Even those who do not understand (or fully approve of) free markets and economists' models know that the pace at which any economy can expand production is finite. And the price of expansion at a faster clip is rising prices.

What seems to be a bizarre suspension of economic gravity has plain causes—and the situation cannot be expected to last. Productivity has grown faster in recent years than during the preceding 15 (some say computerization is finally showing itself in production statistics). That is clearly good, and a significant counter to any inflationary pressures; but productivity growth cannot be guaranteed to continue at such a pace. Second, the prices of certain key raw materials—notably oil—have been unexpectedly low. That is certainly good for the living standards of people in societies that are dependent on oil imports for production, transportation and heating. But such trends are not permanent, and we have already seen oil prices begin to rise.

Finally, the strong dollar has made foreign goods unusually competitive in U.S. markets. This has been fortunate, because it has siphoned off spending which would have been inflationary if directed toward domestic purchases. On the other hand, nothing ensures that the dollar will not fall again (as it did during the late 1980s), which would aggravate the inflationary pressures of an already strong economy.

As a consequence, Americans should be glad—not angry—that we have experienced a rising trade deficit over this decade. It is silly for Americans to label Japanese and European trade partners as "unfair" on the basis of their trade surpluses with the U.S. Without foreigners' strong exports to the U.S., the Federal Reserve Bank would have been obliged to use restrictive monetary policy to dampen inflationary pressures, prompting higher U.S. interest rates and lower home purchases. Here again, it's evident that trade protectionism is not the answer; it would not only lower American living standards (and those of all our trade partners), but also produce inflation.

Discussion of economic policy among Christians and others often suffers from extreme positioning. Liberals are critical of free markets, finding them suspect from the standpoint of justice and calling for redress by way of government regulation, taxation and spending. In the case of international markets, their call is for tariffs, subsidies and other controls to ensure that low-wage workers are not hurt by the flow of goods, services and capital across international borders.

Conservatives, on the other hand, praise markets, finding them to be the handmaiden of freedom, and they criticize governments for interventions that blunt individual responsibility and reduce incentives for work, investment and saving. They also often reject any role for governments in addressing social-economic problems, such as unemployment or the low wages earned by workers who are trapped in unskilled occupations or isolated in central cities, where financial and physical infrastructures are inadequate and social networks are weak.

Most economists don't entirely rule out a role for government in closing some of these grievous holes in social-economic justice. Instead, they urge that programs be designed to provide help in ways that preserve choice, competition and initiative. Without these, both liberty and economic well-being are compromised.

For most economists, then, earned income tax credits are preferable to direct income assistance in helping those who are able to work. And offering tax credits related to the cost of education and training obviously helps raise relative earnings by enlisting individuals' active involvement in the buildup of their "human capital." A useful parallel can be drawn between policies that encourage education and the work of groups like Habitat for Humanity, where the "sweat equity" of family members, combined with the personal and financial involvement of others, provides better housing for many.

When the American economy is doing so well, and a federal government surplus shines over the immediate future, we should be pressing hard for Social Security and Medicare reform. The fiscal window of opportunity to rescue these programs for the sake of future generations of retirees and workers will soon close. The tempting federal surplus "pie" is already being nibbled away by additional spending proposals from Congress and the president.

Educational reform at the state and local levels remains key to reducing income gaps between skilled and unskilled workers. And any public policies or private initiatives that provide increased access to health care and training for relatively disadvantaged persons are primary means by which, over time, the benefits of economic growth can be more widely shared. During the early and mid-1980s, earnings inequality in the U.S. increased, but then started to fall significantly in 1993. (Between 1981 and 1993, women's earnings relative to men rose from about 52 cents on the dollar to almost 60 cents.) Earnings differences between African-American and white workers have remained constant-African-Americans earn 70 cents to white workers' dollar. It is interesting to note, however, that inequalities of income within both racial groups are much more significant than the difference between average earnings of these groups. (See *Economic Trends*, Federal Reserve Bank of Cleveland, November 1998.)

Prison reform is another cause crying out for action—one that has tremendous possibilities for social benefits and fiscal saving. In addition, tax reform to increase incentives for personal saving has more potential to enhance living standards than any moralizing about credit card overuse.

Finally, attention needs to be paid to retraining displaced workers and to caring for those too young or too disabled to depend on work for their entire income. With the economy prospering, now is the time to address these issues.