

America's Financial Mess

It's time to eliminate the U.S. saving deficiency.

BY RONALD I. MCKINNON

Are federal fiscal deficits accelerating deindustrialization in the United States? For four decades, employment in U.S. manufacturing as a share of the labor force has fallen further and faster than in other industrial countries. In the mid-1960s, manufacturing output was 27 percent of GNP and its share of employment was 24 percent. By 2003, these numbers had fallen to about 13.8 percent and 10.5 percent, respectively. Employment in manufacturing remains particularly weak in 2004, with an absolute decline of 18,000 jobs in September shown in the Labor Department's payroll survey.

Moreover, the orgy of tax cutting with major revenue losses continues unabated. On October 6, House and Senate negotiators approved an expansive tax bill that showers corporations and farmers with about \$145 billion worth of rate cuts and new loopholes in the tax code—on top of what were already unprecedented fiscal deficits. Ironically, the net result of this new bill, called the "American Jobs Creation Act of 2004," is likely to be further declines in manufacturing employment.

The United States is the world's champion borrower in international markets. Foreign central banks, which hold more than half the outstanding stock of U.S. Treasury bonds, have become the principal source of finance for the federal government's burgeoning fiscal deficits—about 4 percent of GDP in 2004. Besides this massive government dissaving, meager saving by American households forces U.S. corporations also to borrow abroad to supplement finance for domestic investment.

The upshot is a current account deficit of more than \$600 billion per year, a measure of overall net borrowing from foreigners, and amounting to almost 5.5 percent of U.S. GDP in 2004. Although reaching a crescendo in 2004, heavy foreign borrowing and associated trade deficits really began in earnest in the 1980s. Now America's cumulative net foreign indebtedness is about 30 percent of GDP and rising fast.

But the 2004 election was more about employment and jobs—particularly in manufacturing—than about arcane international financial statistics. In the long run, how does America's heavy foreign borrowing impinge on the size of its manufacturing sector?

The transfer of foreign saving to the United States is embodied more in goods than in services. Outsourcing to India aside, most services are not so easily traded internationally. Thus when American spending rises above output (income), the net absorption of foreign goods—largely raw materials and manufactures—increases. True, in 2003 and 2004, the unusually high price of oil also significantly increased the U.S. current account deficit. However, since the early 1980s, the trade deficit in manufactures alone has been about as big as the current account deficit, i.e., as big as America's saving shortfall—as shown in Figure 1.

If American households' and firms' spending for manufactures is more or less independent of whether the goods are produced at home or abroad, domestic production shrinks by the amount of the trade deficit in manufactures. The consequent job loss depends inversely on labor productivity in manufacturing, which rises strongly through time. If the trade deficit in manufactures is added back to

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domestic production to get “adjusted manufactured output,” and labor productivity (output per person) in manufacturing remains the same, we get projected employment in manufacturing.

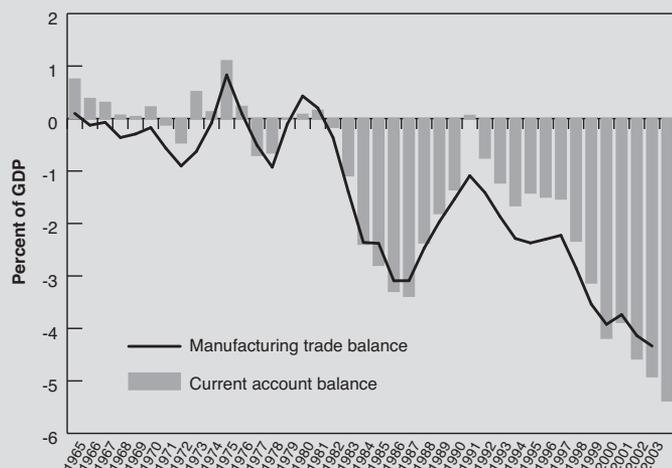
In Figure 2, the unbroken dark line traces the actual share of manufacturing in total employment from 1965 to 2003. The dashed line is the projected share of manufacturing employment as if there had been no current account deficit (or trade deficit in manufacturing), i.e., no saving deficiency in the American economy. For example, in 2003, actual employment in manufacturing was just 10.5 percent of the American labor force, but it would have been 13.9 percent without a trade deficit in manufactures: the difference is 4.7 million lost jobs in manufacturing.

In the 1980s, employment in manufacturing began to shrink substantially because of the then-large current account deficit (Figure 1) attributed to the then-large fiscal deficit: the infamous twin deficits of Ronald Reagan’s presidency. With fiscal consolidation in the 1990s under President Clinton, the saving gap narrowed but wasn’t closed because American household saving weakened. Now under President George W. Bush, the fiscal deficit has exploded while household saving remains weak. The result is heavy borrowing from foreigners, leading to all-time highs in the U.S. current account deficit in 2003 and 2004. The main component remains the trade deficit in manufactures, leading to intensified shrinkage in American manufacturing employment.

Is there cause for concern? Note that I do not suggest that the trend in overall employment has decreased, but only that its composition has been tilted away from tradable goods—largely manufactures. In the long run, the U.S. economy remains a very efficient job-creating machine, with growth in service-sector employment largely offsetting the decline in manufacturing. However, the rate of technical change in manufacturing is much higher than in other sectors. And it is hard to imagine the United States sustaining its technological leadership with no manufacturing sector at all.

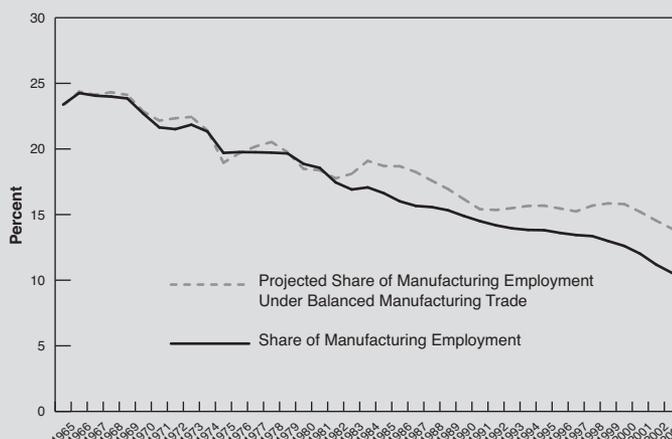
More uncomfortably, more Congressmen, pundits, and voters feel justified in claiming that foreigners use unfair trade practices to steal American jobs, particularly in manufacturing. Protectionists can use the concern with outsourcing, the claim that East Asian countries (particularly China) undervalue their exchange rates, the existence of poor working conditions in countries which are naturally poor, and so on, as pretexts for imposing tariffs or other restraints on manufactured imports into the United States. Ironically, if imports from foreigners were somehow greatly reduced, this would prevent the

Figure 1 U.S. Current Account Balance and Manufacturing Sector Trade Balance



Source: Bureau of Economic Analysis

Figure 2 Projection of Labor Growth in Manufacturing Under Balanced Manufacturing Trade



Source: Bureau of Economic Analysis, Survey of Current Business.

transfer of foreign saving to the United States and lead to a credit crunch with a possibly even greater loss of American jobs.

The answer is not tariffs, nor quotas, nor exchange rate changes, nor tax and other subsidies to American manufacturing that further increase the U.S. fiscal deficit. The proper way of reducing protectionist pressure and relieving anxiety about American manufacturing is for the U.S. federal government to consolidate its finances and move deliberately toward running surpluses, i.e., to eliminate the saving deficiency in the American economy. ♦