Economic Advantages of America

Jeffrey A. Frankel
Harpel Professor of Capital Formation and Growth, Harvard University;
And Former Member of the President’s Council of Economic Advisers

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It seems that in each successive decade, a new economic model reigns. In the 1980s, the Japanese economic model was all the rage. The US was said to be on the decline. But the plot changed dramatically toward the end of the century: the American model triumphed in the 1990s. What lies in store for the coming decade? History will probably surprise us once again. Is it Europe’s turn? The adoption in 1999 of a common currency among 11 European countries—now 12—is a truly historic experiment. EMU, and the possibility of eastward expansion of the EU, are events of sufficiently great historic import that Europe might lay claim to the new decade as its own.

It is easy to forget how widespread was the conventional wisdom in the 1980s that Japan had demonstrated a superior economic model. Journalists said that Japanese firms were buying up America. Political scientists said that Japan was using strategic trade policy to overtake competitive rivals in key sectors. Historians said that the United States was guilty of imperial overreach, and would go the way of Britain and others before it. Even we economists became persuaded that the Japanese financial system, with its emphasis on relationship banking, had successfully overcome some of the problems that afflicted the Anglo-American system with its emphasis on securities markets and its short horizons.

In the 1990s it became apparent that all that was wrong. Between 1993 and 2000, the United States exhibited by far the best economic performance of its last three decades. Others around the world sought to import or emulate American success. Meanwhile, Japan and East Asia experienced by far the worst economic developments of its last three decades. Relationship banking and other aspects of their economies became features to be altered or avoided, rather than to be emulated.

In truth, I do not much like the sport of figuring out “who is up and who is down.” I do not believe that countries are competing in a zero-sum game. We can each benefit from each other, whether it concerns our economic objectives or other objectives. We each benefit through trade and investment when other economies are growing rapidly. We can benefit further through cooperation among governments, especially as concerns objectives such as environmental quality that can spill over national borders. And we
can also benefit by learning from each other, observing the example of each other’s mistakes, and in the long run adopting and adapting what seems to work well.

Every country is different. Nevertheless, it is possible to analyze the statistics across many countries and come up with general patterns that seem to determine whether a country achieves good economic performance in the long run.

[For example, some of the legendary strengths of Japan remain strengths despite recent set-backs and still offer lessons for other countries. The positive factors for Japan included good initial conditions after World War II: They improved income distribution through land redistribution and acquired skilled labor through basic education. The positive factors for Japan also include high saving rates, hard work, and attention to quality. These lessons from Japanese success remain valid.]

**Benefits of Size**

My topic is the economic advantages of being America. First, it helps to be large. Other things equal, a country that is the size of the largest (that is, the US) has an advantage relative to the average-sized country. In a sample of 101 countries, the advantage shows up as an estimated difference in income per capita of 54%.\(^1\) The advantage is all the greater if there are no internal barriers to trade. The United States since its inception has always been fortunate to have free trade internally, due to the Interstate Commerce Clause of the U.S. Constitution, which specifies that only the federal government can regulate trade among the 50 states. Other large countries such as Canada, China, and Russia have many internal barriers obstructing goods and services from crossing among their provinces.\(^2\)

Having a large area within which goods and services can move freely promotes economic performance for a number of reasons. First, a large internal market allows economies of scale. A small economy will not constitute a large enough market to support efficient production of some goods, or some varieties of goods. Second, a large area is likely to have a good variety of natural resources and other endowments. The United States had most of what a country needs to develop: capital and skilled labor in the northeast; coal, iron ore, and good agricultural land in the Midwest; minerals and other natural resources farther West; labor in the South, and so forth. A small country is unlikely to have all that within its borders. Also, labor and capital can move among regions of a country. Migration within the United States has historically been a major

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\(^2\) The United States has long had a number of economic advantages deriving from its history and geography, in addition to mere size. It shares with Europe a temperate climate and some advantages of navigation and accessibility. Initially, its remoteness relative to Europe was a disadvantage. On the other hand, the circumstances of America’s birth and the existence of the frontier helped give us a relatively equal income distribution, and a sense that anyone could get ahead by hard work. Except under slavery, of course.
source of long-run growth, as well as an important shock-absorber in the short run. Finally, technological and economic innovations are easily transmitted within national borders.

All of these same benefits can to some extent also be achieved by trade with foreign countries. Increased openness to trade has a substantial effect on real growth. Some countries are fortunate enough to be geographically located so as to make trade easy -- for example in the heart of Europe. Others are less blessed by geography -- examples include New Zealand, which is remote, and Chad, which is landlocked. But even a country that is unlucky geographically can promote trade, by removing tariffs and other barriers. According to econometric analysis, joining a Free Trade Area eventually triples trade with one’s partners, as does adopting a common currency. For a country like Poland joining the EU would mean eventually doubling its overall openness to trade. This in turn would raise Poland’s income per capita by an estimated 20% over the subsequent 20 years. The estimated benefit of having joined the EU or EMU is comparable for Austria.

For reasons that are somewhat mysterious, the benefits of international trade come less easily than the effects of trade within a country. Perhaps it has something to do with differences across nations in legal systems, or with domestically oriented networks of communications and transportation. Residents of every country find it far easier to trade with their fellow citizens than with non-residents, even when there are no gaps of geography, language, currencies or trade policy. In this sense, globalization still has much further to go than most people think. The implication, again, is that countries that are large and thereby relatively self-sufficient are at an advantage. Another implication is that European trade and growth will benefit from the EU and EMU, in the long run, but that full political union, were it practical, would add much more.

**Pitfalls of EMU**

Americans are generally believed to have doubts about EMU. I see major benefits of European integration for trade and growth in the long run, as I have indicated. But before I give the impression that I have no doubts, let me hasten to add some qualifications.

First qualification: After a change in borders, in Free Trade Areas, or in currencies, it usually takes time before the economic effects show up. How do I know this? It is too early to observe effects from EMU, and we have only a little historical evidence regarding the effects of past unions. But we have more historical evidence regarding the effects of break-ups. The break-up of the Austro-Hungarian Empire after World War I is a good example. As of 1913, the existence of the Empire worked to increase trade among the constituent parts -- Austria, Hungary and Czechoslovakia -- by an estimated eightfold. Only half of this effect had disappeared by 1924, roughly; the rest took longer. Consider a second example. The trade effects of the big French and British colonial empires persisted well after the colonies were granted their independence some
forty years ago.\(^3\) Third, when countries leave currency unions, roughly half of the effect on trading patterns seems to remain even after some years have past.\(^4\) Conversely, it seem like that the formation of a currency union or political union is not fully reflected in patterns of trade and growth for many years to come.

Now the second qualification to my enthusiasm for EMU: it can be dangerous economically if one form of regional integration, in this case the common currency, gets out too far in front of other forms of regional integration, such as trade, labor mobility, and fiscal integration. Because these other forms of integration in are still limited in Europe, EMU may turn out to make individual European countries more variable cyclically. When a state joins a monetary union, it gives up the right to devalue its currency or to lower its own interest rate. That is not so bad if there are alternative ways that a state entering a slump can respond. Within the United States, workers move fairly easily from high-unemployment states to low-unemployment states. Thus the high-unemployment states have less need of monetary stimulus. In Europe this is much harder. Americans are six times more prone to move between states, than Europeans are to move between countries.\(^5\) Despite the current high unemployment rate in Italy and Spain, workers there are reluctant to move to low-unemployment Ireland or the Netherlands. For this reason, it is harder for Italy and Ireland to share a common monetary policy than it is for Massachusetts and Montana.

Third, it can be dangerous politically for monetary union to get out too far ahead of other kinds of integration. I speak of the much-discussed democratic deficit. It seems to me desirable that European countries that are considering joining EMU, or Latin American countries considering dollarizing, should first hold plebiscites. In the event that the loss of monetary independence in the future becomes burdensome -- in the event that some national populations are asked to accept interest rates from Frankfurt or Washington that are too high to suit their own local conditions -- the public needs to have a sense that this is a path that they chose for themselves voluntarily. Otherwise they will direct their anger at Frankfurt or Washington.

**US Economic Performance in the 1990s**

In early 2000, the US economic expansion surpassed in length that of the 1960s, and thus became the longest on record. Early this year, the expansion reached the ten-year mark. It is all the more remarkable that this was accomplished with record budget surpluses, and low inflation. I say this not just because budget surpluses and low inflation are good, but also because earlier long expansions had been fueled in large part

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\(^5\) Migration among American states was 2.4% in 1998, while only 0.4% of EU citizens move from one country to another each year. Only two percent of Europeans work outside their home countries. CEPS, Brussels, and *NYT*, 12 May, 2001.
by expansionary fiscal or monetary policies, with the result that by the 6-year mark debt ratios and inflation rates were high, sowing the seeds for a subsequent contraction. The 1990s expansion, to the contrary, was led by private sector spending and private sector employment.

Even now, positive growth can continue, despite all the talk about recession, including from the White House, in an ill-advised attempt simultaneously to lower expectations and to pass its proposed tax cut. So far, the last three quarters do not differ in an essential way from what we were all forecasting a couple of years ago: a slowdown from the unsustainably rapid growth rates of 4-plus % that we experienced from 1996 to 2000, to about half that rate.

What are the reasons for the good US economic performance of the 1990s? There were many contributing factors. I classify them into three categories: short-term, medium term and long-term. The short-term factors were luck, the medium term factors were skill, and the long-term factors are ongoing favorable structural trends in the US economy. I will elaborate on each.

**Short-term factors: Temporary good luck on prices**

In the 1990s we had declining relative prices for computers and health care. We also had low world prices for oil, until 1999. And US import prices were low generally, due both to the appreciation of the dollar in the second half of the 1990s, and to deflation in some partner countries, particularly in East Asia. All these factors put downward pressure on inflation, and thus prevented overheating despite rapid growth in the economy. We knew all along that these trends were unlikely to continue for long and indeed some of them did come to an end at the close of the decade. But even if one adjusted the inflation rate for such short-term factors, overall performance was still good.

**Medium-term factors: Good macroeconomic policy**

The 1990s saw skillful exercise of macroeconomic policy, both fiscal and monetary. In one of its greatest accomplishments, the Clinton Administration, which took office with seemingly intractable budget deficits, proceeded to eliminate them. In their place we now have the largest surpluses in history. There was a new political economy trend in the 1990s that I found encouraging. The public learned from the experience of the 1980s to be skeptical of politicians selling snake-oil tax cuts, particularly those cuts inappropriately timed during the upswing phase of the business cycle, or that do little to advance the causes of either equity or efficiency. A decade ago it looked like the country was doomed to a pro-cyclical fiscal policy of pursuing fiscal expansion when times were good and finding discipline only in time of recession, the one point in the business cycle when raising taxes was least appropriate. We took advantage of the opportunity offered by the Clinton expansion to eliminate the deficit, exactly as we should have. As a consequence of our new budget surpluses, national saving rose. This in turn helped keep interest rates low and investment booming (especially business equipment).

President Bush has now made a tax cut the centerpiece of his program. He traveled around the country seeking to build popular support for it, with less success than one
might expect: polls show that Americans would rather spend the money on paying off the debt and putting Social Security on a sound footing. He is getting most of his tax cut, thanks to a majority in the Congress and a partly-manufactured recession scare. But it is a sign of the times that it is considered a political accomplishment when the President is able to convince people to accept a tax cut. In the past, presidents either responsibly resisted popular desires for tax cuts, explaining why the country’s future wellbeing required current abstinence, or else went along with the popular will. I can’t think of another time when a president went out among a public that was fiscally more mature than he was, and had to persuade them to take the free candy.

Let us turn now from fiscal policy to monetary policy. The elimination of the budget deficit was a huge contribution to monetary policy, in that it allowed the Fed to lower interest rates. Beyond that, the Clinton Administration’s monetary policy was simple to state: leave it to the Fed. This is more difficult than it sounds. First, the political temptation is always strong to nudge the central bank toward an easier monetary policy. Even if the monetary authorities don’t respond, it will give the government someone to blame if the economy slows down. The Reagan and first Bush Administrations did this in a heavy-handed way -- for example putting sufficient pressure on Chairman Paul Volcker that he eventually asked not to be reappointed. Such tactics often backfire, as the financial markets become alarmed and the central bank feels obliged to keep interest rates higher than it otherwise might, in order to demonstrate its independence. Second, even for a government that has wisely made a deliberate policy decision not to pressure the central bank, the human temptation is irresistible to respond to reporters’ inquiries with statements that, while not intended to be critical, are nevertheless inevitably interpreted as second-guessing the Fed. When I was in the Administration, we had an iron-clad rule not to comment on the Fed or on monetary policy in any way.

The sole exception to this rule, I believe, involved the President and came in response to the financial crisis occasioned by Russian devaluation in August 1998 and the subsequent collapse of LTCM. In September 1998 President Clinton gave a key speech on the international financial crisis. In it, he opined that inflation was no longer the biggest fear for monetary policy. Soon thereafter, the Fed lowered interest rates, and the world’s other central banks followed. This turned out to be the critical point for turning the corner on the year-old financial crisis in the world’s emerging markets.

With this sole exception, the Administration left monetary policy to the Fed, and I think this strategy was a resounding success. Of course this worked well because the Fed was skillful. Even if, in retrospect, the tightening of 1999-2000 may have gone one step too far, Greenspan’s record overall was quite good. Like Volcker before him, he followed a tight monetary policy early in his term, established a reputation for discipline,

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7 The speech included other steps to address the financial situation as well. The President escalated the rhetoric urging the Congress to vote the US share of a quota increase for the IMF and the New Arrangements to Borrow. Michael Waldman, POTUS Speaks, (Simon and Shuster, New York, 2000); and J. Frankel and N. Roubini, “The Role of Industrial Country Policies in Emerging Market Crises,” in Economic and Financial Crises in Emerging Market Economies, edited by Martin Feldstein; forthcoming (University of Chicago Press, Chicago)
and was thereby able to take a more moderate stance during the remainder of his term. His forbearance during 1995-1998, even as growth and employment exceeded levels previously considered inflationary, was a gamble; but it turned out to be a wise gamble and an important component of the expansion’s longevity. Incidentally, the pattern of central bankers who seek to establish a reputation for monetary discipline early on in their career fits the new ECB well. That is the reasonable explanation for what looks like a fairly high-interest-rate monetary policy.

Perhaps the simplest overall conclusion one can draw from the 1990s is that it turns out that the US economy runs pretty well if the government avoids major macroeconomic policy mistakes.8

Long-term factors

Many of the most important factors in explaining US economic performance stretch back over two decades or more. My list subdivides into three categories: deregulation, globalization, and innovation.

• Deregulation

The US economy has long been less highly regulated than most European economies. But the last 25 years has seen important further deregulation. Most people don’t realize it, but the deregulation trend began during the Carter Administration, in the sectors of trucking, airlines, natural gas, and banking. In the 1980s, during the Reagan Administration, deregulation was extended to the telecommunications sector. More recently, we have had electricity deregulation. Some of these deregulation efforts have faced bumps in the road, particularly banking and electricity. (And in some areas, Europe has actually crept ahead of the US recently.) Nevertheless, I believe the overall effect has been to make the US economy more efficient in the long run.

• Globalization

The United States has not always been an open market. During much of the 19th century, and again in the 1930s, tariff walls were high. And we are not angels on trade policy now. But the US has had a basic free trade orientation since World War II. The ratio of our trade to GDP has more than tripled since the middle of the 20th century. It now stands at 26% (imports plus exports, including services, which have increased especially rapidly).9

Economic theory tells us that trade raises living standards. This is true both of old theory -- classical “comparative advantage” -- and of new theory -- “dynamic” [which allows for changing technology, increasing returns to scale, and imperfect competition]. Perhaps more convincingly, the statistical evidence also tells us that openness contributes

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8 Some said it was a “Brave New World.” But I thought we were perhaps instead “Back to [the stability of] the 1950s.”
9 [($1097b+$1468b)/$9963b = .257 in 2000]. Taking merchandise alone, the number is 20% of GDP; this is the measure that has tripled.
to growth. The increase in exports over 1993-2000 -- even including the period of the East Asia crisis -- constituted 20% of the growth in US GDP over this period. Imports increased even more rapidly. But imports too are beneficial. The increases in imports and in the trade deficit, though politically unpopular, was a useful safety valve during the strongest phase of the US expansion. They released pressure from very rapidly-growing domestic demand, pressure that would otherwise have shown up as higher inflation and interest rates.

- **Innovation**

  The third category of favorable long-run structural factors is innovation. I would in turn break down innovation into three types: technology, more competitive goods and labor markets, and the public sector.

  Technological innovation, especially information technology, has received so much attention that I will say little more about it. Clearly the Nasdaq rise as of a year ago was far overdone. And the IT revolution was not the sole reason for good US economic performance in the 1990s. But it certainly was a positive factor. [Concrete examples of the benefits of IT for the economy include firms’ inventory practices and out-sourcing. The rise in measured productivity did not begin to show up until the late 1990s. But I am a fan of the Paul David hypothesis: it may take 20-40 years for the benefits of a technological revolution to be fully realized. The electricity revolution did not show up in productivity until the 1920s, even thought the dynamo had been invented in the late 19th century. Some have discerned similar lags with steam power and the automobile.]

  The United States has always had relatively competitive goods and labor markets, compared with Europe for example. But the last two decades have seen a further movement in this direction, including the initially unpopular corporate restructuring of the 1980s and the initially popular dot-com start-up firms of the 1990s. Particularly important are our labor markets, which are substantially more flexible than Europe’s. Even though many of Europe’s labor regulations were designed with the intention of protecting employment in Europe, they have often had the effect of retarding growth in employment. It is because our labor markets are flexible that we were able to create 17 million new jobs between 1991 and 2000. During this period, the working-age population increased by 14 million. In other words, private employment expanded so rapidly that we easily absorbed a reduction in the number of people in the military plus a substantial number of immigrants, while simultaneously bringing the unemployment rate down from 7 per cent to 4 per cent.

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10 The statistical relationship that I used earlier says that every additional 1% in the openness ratio (merchandise X+M/GDP) raised a country’s income roughly .33 percent over the period 1970-90. E.g., the difference between Albania and Singapore (say 200%) is an additional 66% of income. For the US, a .12 rise in openness since 1960 works out to a 4% contribution to per capita income.

11 ($1126.3b-$672.7b)/($ 9318.5b-$7062.6b)=.201.

12 I would also include the very unpopular move to managed health care in the 1990s, which helped reverse a strong upward trend in relative health care costs.
The last category on my list is innovation in the public sector. I have in mind here three examples: welfare reform, which was more successful in moving people off of public assistance and into jobs than anybody could have hoped; defense reconversion, where we actually managed to shut down some unneeded bases; and reinventing government, where the big innovation was trying to make government more efficient rather than just giving speeches about the need to do so.

Each of the many factors I have mentioned has contributed a bit to the flexibility and strength of the economy, and to the good economic performance of the 1990s.

**Benefits of global leadership**

I mentioned early on that size is an advantage. This goes beyond the absolute size of the internal market. Being the largest economy in the world also has some other advantages. It is not entirely obvious that the United States should have more influence in international markets or international politics than the EU, which after all is larger in the aggregate. But I think it is clear that our foreign policy ends up carrying more weight in the world than anybody’s. So far, the Fed’s interest rate moves carry somewhat more weight than the ECB’s interest rate moves. So far, the dollar is a more important international currency than the euro.

Why is this so? I am not going to give a long analysis for two reasons. First, I have already gone on long enough. And second, I don’t know the answer. But I think it has something to do with the fact that the United States is one large country, which speaks with a relatively unified voice, whereas the EU still consists of many countries that speak with different voices.

**Conclusion**

Of course things are far from perfect in the United States. Examples of the negatives are the related problems of guns, crime, drugs and the size of the prison population. Also, inequality is greater than we would like. Our system of primary and secondary education is poor. After the last election, we no longer have a claim to special expertise in electoral democracy. Nevertheless, the main negative I see for the US now, paradoxically, is something quite different: We fail to realize that we have rarely had it so good overall.

Americans are given the impression in the media that we have now moved into a time of economic difficulty, when it seems to me that in fact, by most measures, our economic wellbeing is still close to its all-time high. Thus we need to think about using our budget surplus to provide for the retirement of the baby boom generation, not to blow it on a big tax cut. Americans think we have high energy prices, when I think they have been too low. Thus we need to emphasize curbing the growth in demand for fossil fuels, not maximizing the supply. Some Americans have the impression it is a time of heightened threats from abroad, when it seems to me that the potential for international
peace has rarely been better. Thus we need to think about encouraging North Korea and China and Russia to continue moving in friendly directions, and not to try to put up futile walls or to turn them back into enemies as the current US Administration may risk doing.

But perhaps our greatest contribution to world peace is the demonstration effect. The existence of the United States shows that a large, ethnically and culturally diverse, population can live in relative harmony and prosperity. If that inspires emulation in other parts of the world, that is the best foreign policy of all.