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# US Economic Performance and Lessons for Other Countries

Jeffrey A. Frankel, Harpel Professor, Harvard University

The 20th Century turns out to have had quite an interesting plot. It begins with the US as the new economic power. After the trials and tribulations of the World Wars and Depression the century reached its mid-point with the US striding the world like a colossus, the US economy constituting roughly half of Gross World Product at one point. Then two decades with the US at the top were followed by two decades when the US was perceived to be in decline, a victim of imperial overreach, fated to give way to others, especially Japan. East Asia was expected by many to dominate the 21st century. But in the last decade of the millennium, we have had an unexpected twist in the plot, with the US economic and political system seemingly triumphing, not just over the Soviet system, but over the Japanese/Asian model of capitalism as well.

My topic today is the reasons for the outstandingly good US economic performance of recent years, and lessons for other countries. There is nothing worse than a listless lunch speaker. So I have come with several lists. I developed a list of possible explanations for good US economic performance while I was serving on President Clinton's Council of Economic Advisers. I propose today to compare that list to the list of policies that we urge on developing countries, the so-called Washington consensus. Some say that the Washington consensus has been invalidated by recent financial crises, and point out that it involves some policies that we would never apply ourselves. But I found a greater overlap than you would think.

## US Economic Performance

As of early 2000, the length of the current US economic expansion surpasses that of the 1960s, and thus is the longest on record, whether in time or war or peace. It is all the more remarkable that this has been 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 by expansionary fiscal or monetary policies, with the result that by the 6- or 8-year mark debt ratios and inflation rates were high, sowing the seeds for a subsequent contraction. The present expansion, to the contrary, has been led by private sector spending and private sector employment. There is little reason why it cannot continue B little inflation that the Fed needs to rein in, no inventory overhang. The one possible exception is the US stock market; I agree with many that it is overvalued. But a bubble stock market does not necessarily make a bubble economy.

What are the reasons for the good US economic performance of the 1990s? There are lots of contributing factors. I classify them into three categories: short-term, medium term and long-term.

## _ Short-term factors: Temporary good luck on prices

Declining prices for computers, and health care
Low world prices for oil until 1999
Other low US import prices, due in part to the 1995-98 appreciation of the dollar, deflation in some partner countries, and the East Asia crisis

We have known all along that these trends were unlikely to continue for long and indeed some, most obviously low oil prices, did indeed end in 1999. But even if one adjusts the inflation rate for such short-term factors, inflation performance has still been good, given the low unemployment rate (now 4 %)

## _ Medium-term factors: Good macroeconomic policy

**Fiscal policy**: Our seemingly intractable budget deficits have been eliminated. In their place we have the largest surpluses in history. (Social security should come next. It is too bad that Washington has muffed its best opportunity in 1998-99.) Overall, I found the political economy trend in the 1990s encouraging. The public learned from the experience of the 1980s that the upswing phase of the business cycle is not the time to cut taxes. A decade ago it looked like the country was doomed to a pro-cyclical fiscal policy B 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 have taken advantage of the opportunity offered by the current expansion to eliminate the deficit, exactly as we should. As a consequence of our new budget surpluses, national saving is up. This in turn has helped keep interest rates low and investment booming (especially business equipment).

**Monetary policy**: The Clinton Administration=s monetary policy has been simple to state: leave it to the Fed. Of course this has worked so well because the Fed has been skillful.

It turns out that the economy runs pretty well if the government avoids major macroeconomic policy mistakes. Some say it is a ABrave New World.@ But perhaps we are instead just ABack to [the stability of] the 1950s.@ Or some of each.

## _ Long-term factors

Some important factors stretch back over two decades or more. My list subdivides into three categories: deregulation, globalization, and innovation.

- **Deregulation**
  Trucking, airlines, natural gas, and banking in the late 1970s.
  Telecommunications in the 1980s
  Now, electricity deregulation.

- **Globalization**
  The ratio of merchandise trade to GDP has doubled since 1971,
  And tripled since mid-century; it is now at 9%
  Plus another 3 percent for services,
  implies all-told a quadrupling, to a total of 12%.
  Theory B old (classical comparative advantage) and new (dynamic) B as well as empirical evidence[1], tells us that openness contributes to growth.

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1 There are many statistical tests of the relationship between trade and growth. My 1999 paper with David Romer adjusts for possible reverse causation. We find that every additional 1% in the openness ratio (X+M/GDP) raised a country's income roughly .33 percent over the period 1960-85. E.g., the difference between Albania and Singapore (say 200%) is an additional 66% of income. For the US that works out to a 4 % contribution to income from increased openness since 1960.)

The increase in exports over the last six years **B** even including the period of the East Asia crisis **B** has constituted **3** of the growth in US GDP.

Imports have increased too, but they too are beneficial.

- **Innovation**

I would in turn break down innovation into three types: technology, competitive goods and labor markets, and the government.

Technological: especially IT

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 last few years, and is still relatively modest. 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 seen similar lags with steam power and the automobile.

Competitive goods and labor markets

Corporate restructuring
The move to managed health care, and
Flexible labor markets.

Public sector

Welfare reform
Defense reconversion, and
Reinventing government.

Each of these factors has contributed a bit to the flexibility and strength of the economy.

## Danger signals?

Are we due for a recession? Not necessarily. Expansions don=t die of old age. We are no more likely to have a recession in the 10th year than in the 9th or 6th years. Furthermore, most of the usual signs of fragility are absent.

There has probably been a bubble component in the stock market. But a bubble market does not imply a bubble economy. Even if the market were to experience a 25% correction, the direct effect on spending could be absorbed, given the current momentum of the economy: 25% of $ 12 trillion = $ 3 trillion; x..03 = $90 billion = 1% GDP. This looks small compared to recent 4% growth rates. It would take more than that to put the economy into negative territory. (It would take some large general multiplier effect or loss in confidence to put us into a recession.)

To be sure there are other black linings in the silver cloud:

- Low private saving is a concern for the longer term
- Large wage differentials and urban problems are still there
- The sharp increase in oil prices over the last year, and new political uncertainty in the Mideast raises issues
- The rising trade deficit is to some extent a source of concern, but only because of (1) risk of feeding protectionist/isolationist backlash, and (2) rising international indebtedness that in the long run may not be sustainable at the current exchange rate.

I am not concerned that the trade deficit subtracts from US growth, given where we are in the business cycle. To the contrary, it has been a useful safety valve, releasing pressure from what otherwise would be excessive growth in domestic demand, thereby helping to keep inflation and interest rates down.

## Lessons for Other Countries

Recent US economic success is particularly striking when viewed in contrast to the 1997-99 crises in emerging markets and the decade-long stagnation in Japan. The trials and tribulations abroad can be interpreted in two ways: One view is that laissez-faire capitalism has now been revealed to fall short of its promise; another is that the American model of pure competitive capitalism has been shown superior to the Asian model. At the risk of simplistically lumping together countries with important differences: the Asian model featured greater government involvement in allocating resources in the economy, imperfect competition among large companies and groups of companies, a financial structure based more on personal banking relationships rather than arms-length capital markets, high leverage, and corporate governance that inclines to empire-building. I incline to the second view, that the American model turns out to be better overall, at least for countries that are no longer low-income. At the same time, I would want to avoid the excesses of American triumphalism and analysis by hindsight. Some of these financial traits, such as high leverage and relationship banking, are appropriate to countries at the initial stages of development and high growth, but are no longer appropriate when the economy has accomplished some degree of convergence with the industrialized countries.

## Addendum: The Washington consensus

Questions

1. ) Have we learned from recent crises in emerging markets that the Washington consensus is not right after all?
2. ) Does the US practice what it preaches? And if not, is it because different rules apply to emerging markets and industrialized countries?

Let us go back and check the original list of recommended policies that John Williamson in 1990 pronounced "the Washington consensus."

1. Fiscal discipline: deficits should be small [I and dd monetary discipline.]

2. Within public spending: education, health and public infrastructure investment are priorities, while subsidies (e.g., to energy) should be eliminated.

3. Tax system: the tax base should be broad and marginal rates moderate

4. Interest rates: should be market-determined, and positive in real terms

5. Exchange rate : should be at a competitive level (whether fixed or flexible), as an essential element of an outward-oriented trade policy (and Athere is relatively little support for the notion that liberalization of international capital [portfolio] flows is a priority objective@).

6. Trade policy: imports should be liberalized; import licenses are the worst (they give rise to corruption), uniform tariffs are preferable if necessary.

7. Foreign Direct Investment: good

8. Privatization: private industry managed more efficiently

9. Deregulation: as in the U.S. starting in the late 1970s.

10.Property rights: matter. They are taken for granted in the US. But one of the things we have learned in the 1990s, especially from the difficult transition of the formerly communist countries, is how hard it in fact is to establish the rule of law and property rights for the first time.

One thing striking about this list is how little it needs to be revised. Hardly at all, I would say. A major lesson to come out of the East Asian crises is that one should try to eliminate Acrony capitalism@ before opening a country to short-term capital inflows. But Williamson already had some of that on his list -- that liberalizing portfolio inflows should be low priority and that property rights and corruption were serious problems.

To be sure,
some other factors are also important to growth; but they tend to be not always amenable to policy. High saving and investment are (along with human capital and openness B both natural geographical openness and outward-oriented policies) the most important determinants. An equal initial distribution of income helps, but forcible redistribution is divisive and disruptive and undermines incentives and property rights. Political stability and economic freedom are both important, but are sometimes thought to conflict with each other. Finally, conditional on the right fundamentals, countries that start out farther behind will have a tendency to catch up, to grow faster than the front-runners. But, again, these are factors that are important in the sense that they help explain growth in statistical studies, but they are not policy levers that national governments can use.

Williamson said AWashington does not always practice what it preaches,"[1] but AIn most of the microeconomic areasYWashington=s actions are consistent with its rhetoric@ (p.18). The most important example of not practicing what we were preaching was the record budget deficits of the 1980s. But fiscal discipline, which we lacked at the start of the decade, has since been attained.

We do well in the areas of Privatization, Deregulation, the financial system, and Property rights. I, like many, think we should give higher priority to education and public infrastructure. Our tax system is better than most. It could certainly use improvement, but the likelihood that reform efforts would make it worse rather than better persuade me that we are better off leaving it alone. In the area of Trade policy, its alarming that progress (e.g., fast track) are stymied by the forces of protectionism, unilateralism, isolationism, and political opportunism. But the economy remains quite open, relatively, and these forces are not currently a threat to US prosperity

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[1] " e.g., corruption and budget deficits, exchange rate and trade policy@ p.17.