The American Economy in a Changing Global Context – Self-Inflicted Wounds?

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Introduction

Three issues dominate today's discussions about the economy:

- Tariffs and Trade
- Affordability
- Artificial Intelligence

But mostly focused on short-term, first order effects. Little consideration for longer-term implications, which can be significant and adverse.

Intro…(cont.)

Problematic because…

- The solutions require action today, but manifest over the long term
- The solutions chosen may be suboptimal because focus is the short term
- Lasting solutions imply international cooperation (e.g. trade, finance, and technology)

Structure of the talk

Tariffs and Trade

- Myopic view – we don't just trade goods
- Faulty analysis of the reasons of the trade deficit – a trade deficit does NOT always equate to economic weakness
- The political narrative ignores the other half of the equation – the financial account
- The American Economy in a Changing International Context

Affordability

- Reflects structural changes in society and economy – long-term trends in income, education, labor markets, demographics
- Distributional issues paramount

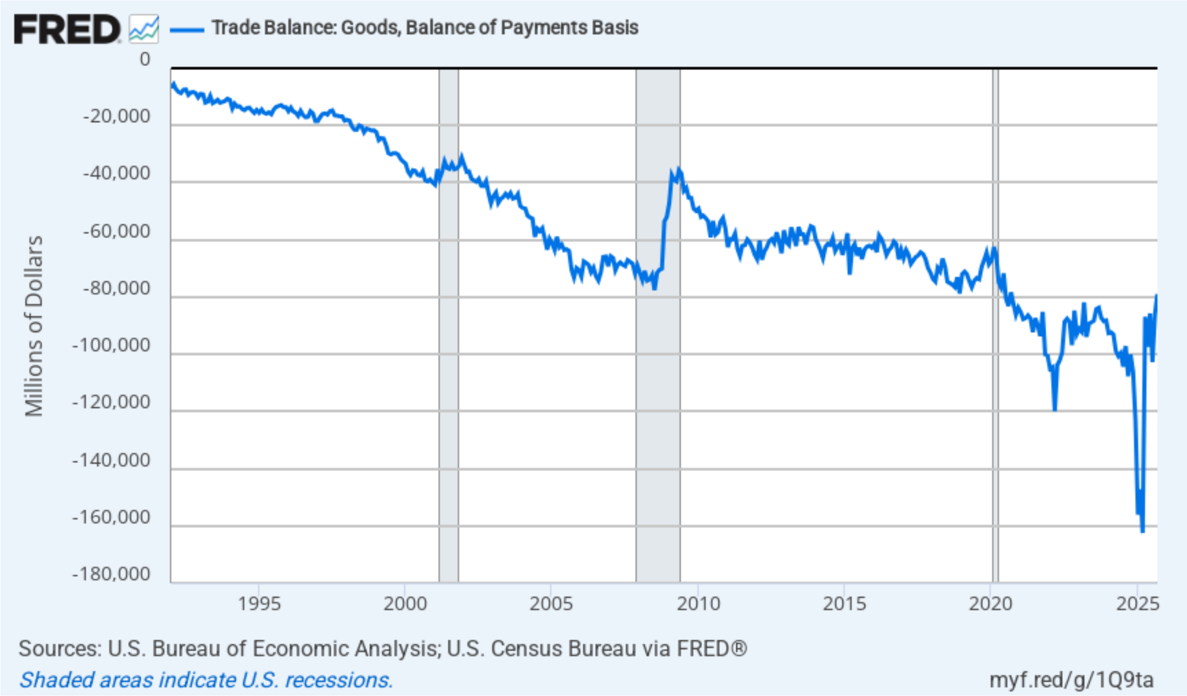
Artificial Intelligence – a footnote

- An AI arms race causing geopolitical instability and insecurity
- Existential and Control Risks of Artificial Superintelligence – preventing it from happening anywhere
- Ethical and regulatory issues

I.1 Trade and Tariffs

- Deficits in goods trade reflect the economic structure
  - Very high private demand for consumer goods enabled in part by cheap(er) imports
  - Trade specialization based on comparative advantage, efficient global supply chains
  - Strong dollar and persistent foreign demand for US financial assets
  - Federal budget deficits
- Trade in Goods is not the whole story. There is also trade in services
  - Robust growth and persistent surpluses over the past 20 years.
  - Digital/tech-enabled sectors like financial services, intellectual property, professional services
  - Reflects shift in economic structure away from standard manufacturing towards specialized manufacturing with high-tech orientation
- Combination of deficit in goods trade and surplus in services trade – persistent deficits of the current account over the last 20 years
- ***Driven by the savings/investment gap and the global demand for US financial assets***

Balance of Trade in Goods (left);
Balance of Trade in Services (right) 1994-2025



Services are an increasingly important part of the trade equation, but strangely not part of the current trade debate.

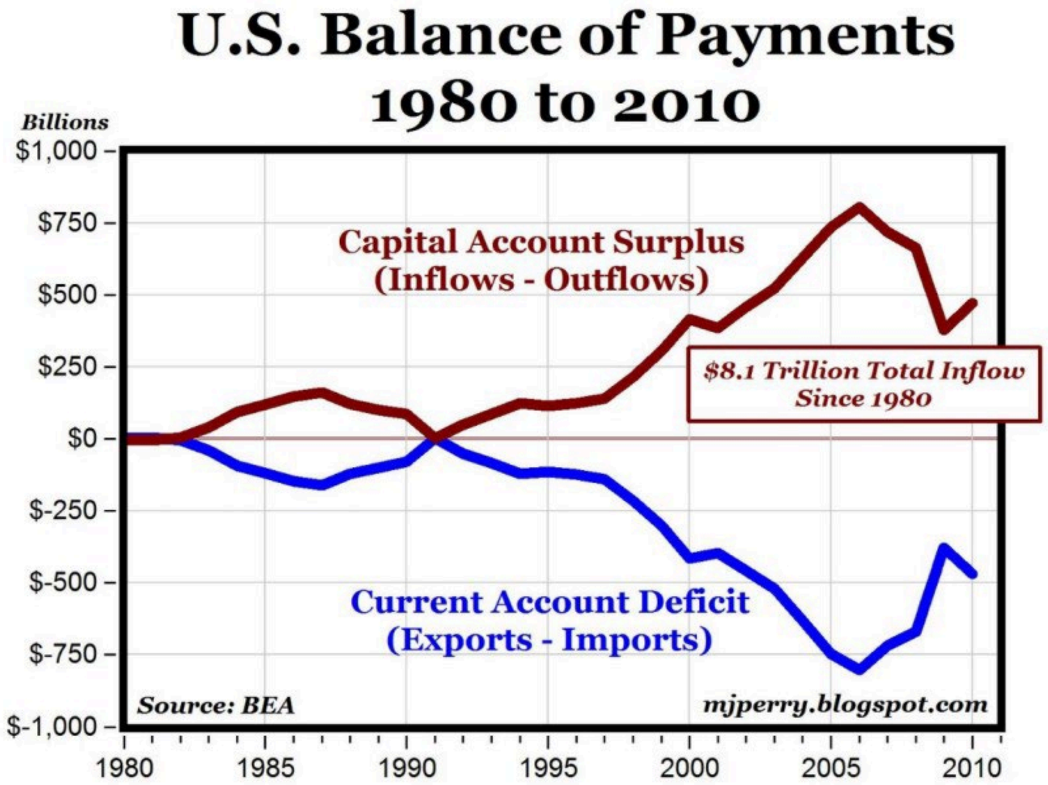
I.2 Trade and Tariffs

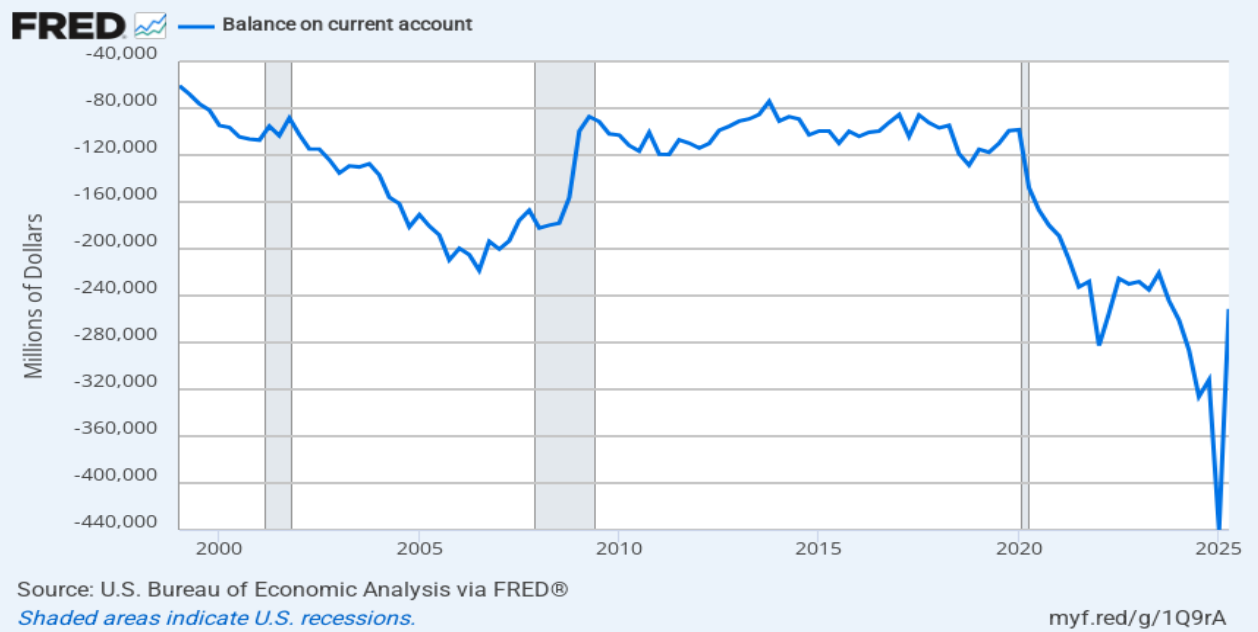
- The Current account deficit results from…
  - The savings – investment imbalance, resulting from low household and government savings relative to the desired level o f investment; or alternatively, the imbalance between aggregate demand and aggregate supply;

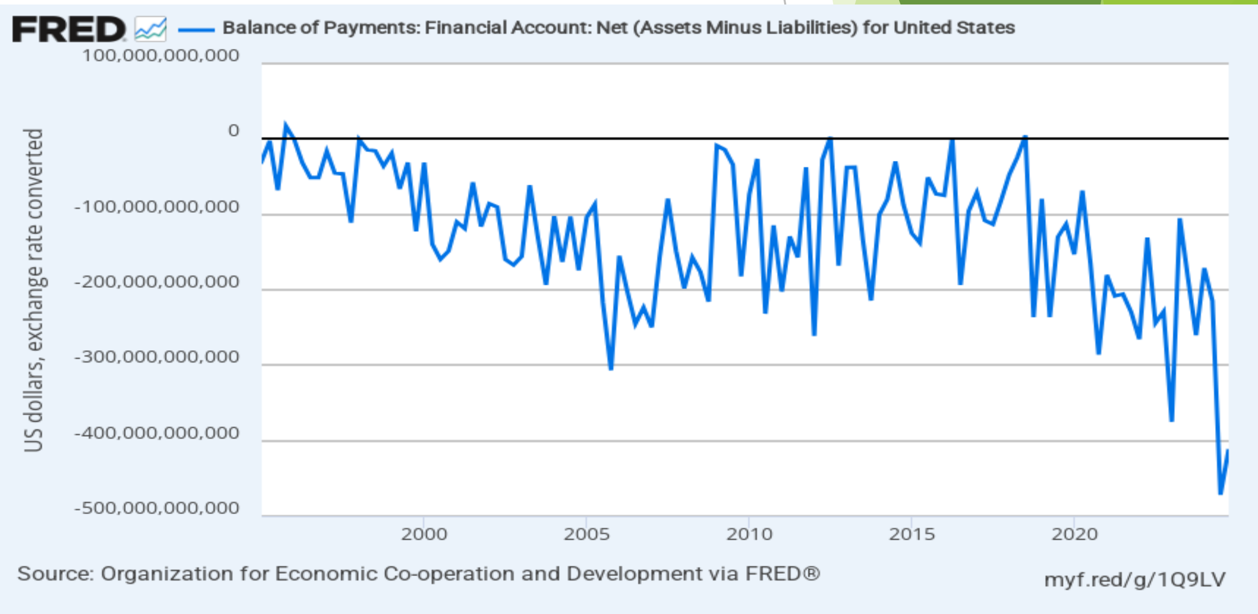
…and because the current account and the net capital/financial account always sum to zero in the balance of payment, the current account deficit corresponds to

- A Surplus on the net capital account/financial account, i.e. Capital inflows, in the form of
  - Investment in private US firms, and investments in US equities, stocks and bonds (funding the private savings/investment gap).
  - Purchasing US Treasuries (helping fund the federal budget deficit)

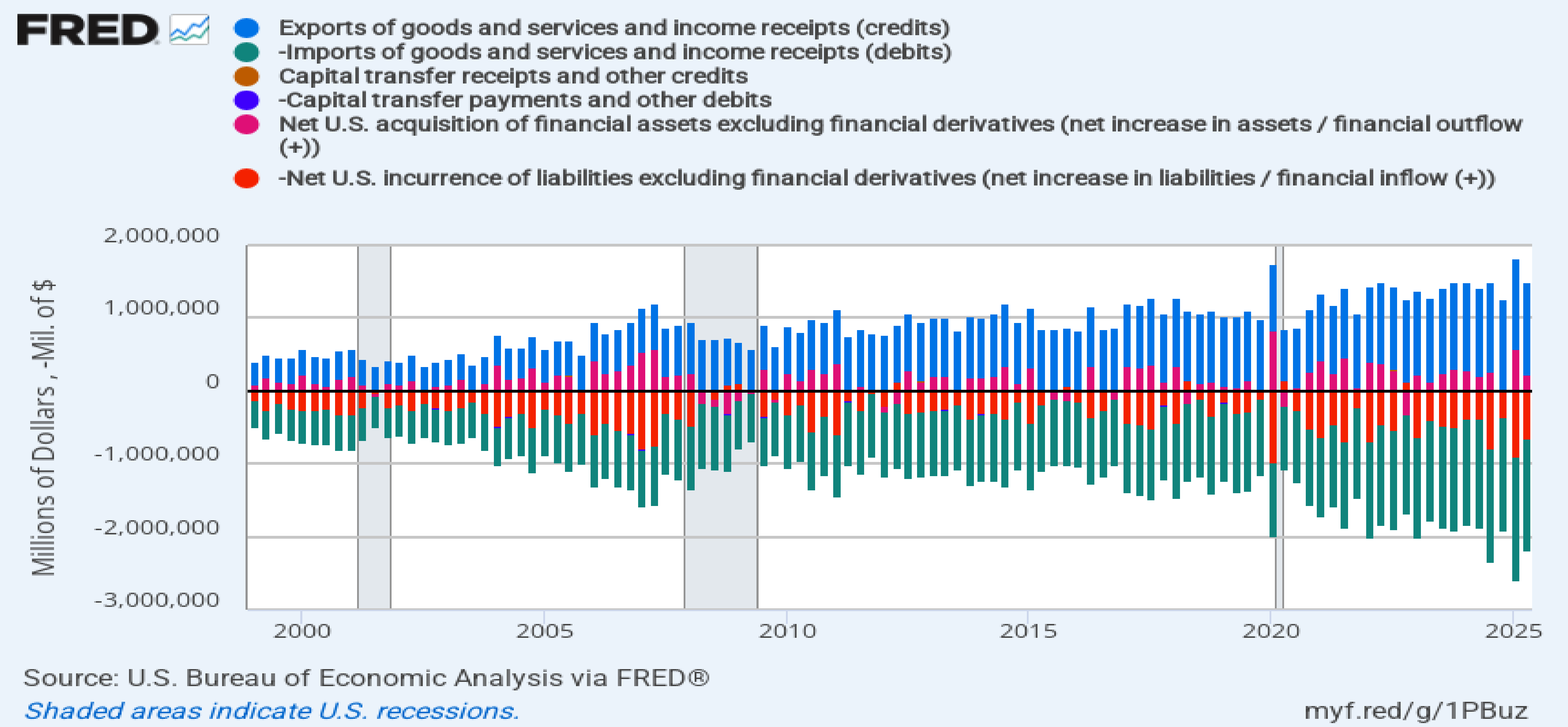
Balance of Payments: Balance on the Current Account Balance; and Financial Account Balance







The Overall Balance of Payments



I.3 What Drives Changes in the Current Account?

The Trade-driven view

- The excess of imports over exports requires borrowing from abroad to finance the deficit, resulting in capital inflows.

It is probably a combination of both.

The Capital-Driven View

- As foreigners invest more into US assets than American invest abroad, net capital inflows to the US increase. This further drives up the demand for dollars, strengthening the currency—it makes US exports less competitive, and imports to the US less expensive. This widens the trade deficit.

I.3 Trade and Tariffs

- Foreigners demand US assets
  - Strength of the economy
    - growth, productivity increases, innovation) and
  - The economic environment
    - quality of economic and financial policy;
    - depth and sophistication of markets;
    - rule of law and contract enforcement, protection of intellectual property

- Foreigners demand US Treasuries
  - The US dollar is the world's principal reserve currency, and the currency of most international transactions
  - US Treasuries perceived as a solid. very low-risk financial investment.

If any of these conditions change, that demand might change as well

I.4 The Changing International Context

- Trade doesn't happen in a vacuum
  - trust and confidence between the trading partners
  - rules-based and contractual, with clear obligations and responsibilities

- US trade and financial relations are supported by a range of other formal and informal international agreements
  - military and security alliances, primary among them NATO;
  - global agreements on exchange rates, agriculture, on maritime trade, on telecommunications, etc.

- These forms of international cooperation were a source of US influence/soft power

I.4 The Changing International Context (cont.)

- Geopolitical changes undermine major post-war. achievements
  - Peace
    - Marked decline in scale and intensity of inter-state armed conflict from 2000-2022, but resurgence since
    - Turning inward of major powers
  - Multilateral cooperation
    - Enabled MDGs and poverty reduction, SDGs, environmental agreements (cooperation on climate action, biodiversity protection, chemicals), disaster risk reduction, law of the sea
    - Cooperation supplanted by confrontation and competition, esp. around AI
  - Economic and Financial Integration
    - Huge global benefits but also risks and downsides
    - Globalization and financial integration no longer seen by many as in the national interest

II.1 Possible Impacts on the US Economy (1)

- Other things being equal, there is no reason at present to assume significant change in the relative weight of the US economy
  - Still the most technologically advanced economy, with the largest, deepest and most sophisticated financial markets.
  - Productivity gains and growth still strong
  - US attracts about 40 percent of global capital inflows (pull and push factors)
  - Still the primary reserve currency - Share of USD in global reserves steady
  - Still considered a safe haven

- But perceptions can change, and if they do, it will reflect US choices/actions

II.2 Possible Impacts on the US Economy (1)

- What could cause a change in the standing of the US economy?
  - Withdrawal of US support for the international economic order it created.
  - Global economic and financial re-fragmentation, endangering the gains of integrated trade and finance
  - Loss of reputation of US government policymaking
    - Declining quality of official data and – staff and budget cuts
    - Political interference in previously independent expert agencies, weakening of state institutions
    - Ineffectual Congress progressively stripped of its traditional role
    - Political polarization and positioning prevent credible fiscal policy, undermine trust
    - Potential loss of independence of the Fed
  - Longer-term consequences of short-term budget decisions to slash staff and spending
    - Cutting support for education and basic research could weaken the productivity advantage
    - Willful abandonment of sustainability considerations only put the US at a competitive disadvantage in key technologies of the future

II.3 Possible Impacts on the US Economy (cont)

- Incoherent trade policy
  - Stated objectives of tariffs are mutually exclusive (reducing trade deficit; generating massive new revenues; resuscitating domestic manufacturing; restructuring global trade) - uncertainty about which aim prevails
  - Tariffs don't address the savings/investment gap driving the trade deficit
  - Lower trade deficit means lower capital inflows – the federal deficit, or private investment, or private consumption would have to fall.
  - The unilaterally imposed tariffs are all breaches of contract and trade agreements. Their uneven implementation undermines confidence

- Non-respect of international commitments - commercial, military, partnerships undermine US influence/soft power
  - US reliability as a partner becomes doubtful
  - Alternatives look more attractive to erstwhile partners.

II.4 Possible Impacts on the US Economy (cont)

- Lack of focus on key structural changes needed in economy and society
  - Demographic changes – ageing and population decline, shrinking labor force
    - Consequences for the health, personal care and pension systems and for fiscal and financial policies Properly managed legal migration could help, but the trend today is toward closed borders.
  - Creating sustainability - Economic growth that
    - Does not harm people or planet
    - Creates decent and sustainable jobs
    - Balances efficiency and equity
  - Inequality
    - Addressing the skewed distribution of income and wealth, and of access to education and opportunity
  - Strategically managing rapidly changing technologies

III.1 Affordability

- Affordability has become a catch-all phrase encompassing for many a deep discontent with current economic and financial situation
  - Fear of Inflation
  - Prices of everyday goods and essential services too high and still rising
- The factors contributing to problems of affordability
  - Inadequate affordable housing
  - Utility prices rising, especially electricity
  - Public transportation needs improvement in infrastructure, service quality, accessibility, and policy planning
  - The healthcare system needs fundamental reform/costs rising further
  - Education expenses rising, squeezing equitable access to opportunity

III.2 Affordability

- Mismatch between disposable incomes and costs of essentials. Solutions should address both sides.
  - Not just wage and income levels, but also the distribution of income is an issue. The factors causing this include:
    - technological change, globalization, declining unionization, and minimum wage fluctuations.
    - globalization and technological change, such as economies of scale, winner-takes-all markets, may have boosted wages for very high-wage workers.
    - Lower-income households have seen their share of national income decline while the upper-income brackets earnings have skyrocketed – compounded by the wealth effects.
- These are structural issues that require coherent solutions implemented over medium-to longer term.

IV.1 Artificial Intelligence

- AI will fundamentally change labor markets.
- AI’s net effects on productivity and employment still under debate
- AI will accentuate the shift from labor to capital income – distributional implications
  - AI also widens the wage gap –

    immediate productivity boosts from AI favor high-income professionals using AI to enhance existing skills
  - Skills premium - those able to use the technology are well compensated while others face stagnant wages or displacement.
- Policies to boost AI literacy and share AI-related productivity gains more equitably as response

- ***BUT: More than any other technological innovation before it, AI is being pursued in a handful of technologically advanced economies in outright competition with each other – with the expectation that the winner will take it all***

IV.2 Artificial Intelligence

- Precluding Possible Dangers of Unfettered Errant AI Development
  - An AI arms race causing geopolitical instability and insecurity
  - Existential and Control Risks of Artificial Superintelligence – preventing it from happening anywhere
  - Ethical and regulatory issues to build a relatively even playing field

Ensure that AI systems operate within human control and are aligned with human welfare

- Equitable affordable access for the sectors and the countries that are the ‘adopters’ not the innovators

This will require close cooperation among the innovators and leaders.

Unfortunately, the prospects of that are dim

V. Conclusion

- At a time when the domestic and external challenges require collaboration and careful policymaking, the US Administration rejecting the collaborative approach
- The thrust of the US eternal economic stance is confrontational, not collaborative. Long-standing partnerships are devalued.
- Policymaking is short-term, partisan, inconsistent and unreliable: reputational risks are rising.
- The Administration seems intent on turning inward, rejecting the existing global order that the US built.
- But, a re-fragmentation economic and financial integration would harm all participants, including the US, far beyond any possible short-term gains
- The undisputed American primacy of the last eight decades can come under strain under the weight of present policy choices. But unlike the post-World War Two period, the rest of the world does have alternatives.