STANFORD INSTITUTE FOR ECONOMIC POLICY RESEARCH
SIEPR

Policy Brief

Stanford Institute for Economic Policy Research

U.S. Fiscal Deficits and Lost Jobs in Manufacturing

Ronald I. McKinnon, Stanford University

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 in the Labor Department's payroll survey.

Budget deficits arising from large tax cuts without offsetting spending cuts decrease U.S. savings and increase the current account deficit. On October 6, House and Senate negotiators approved a new tax bill that gives corporations and farmers about $145 billion worth of rate cuts-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 a further decline 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 bourgeoning 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, 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.

October 2004

But the upcoming election is 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?

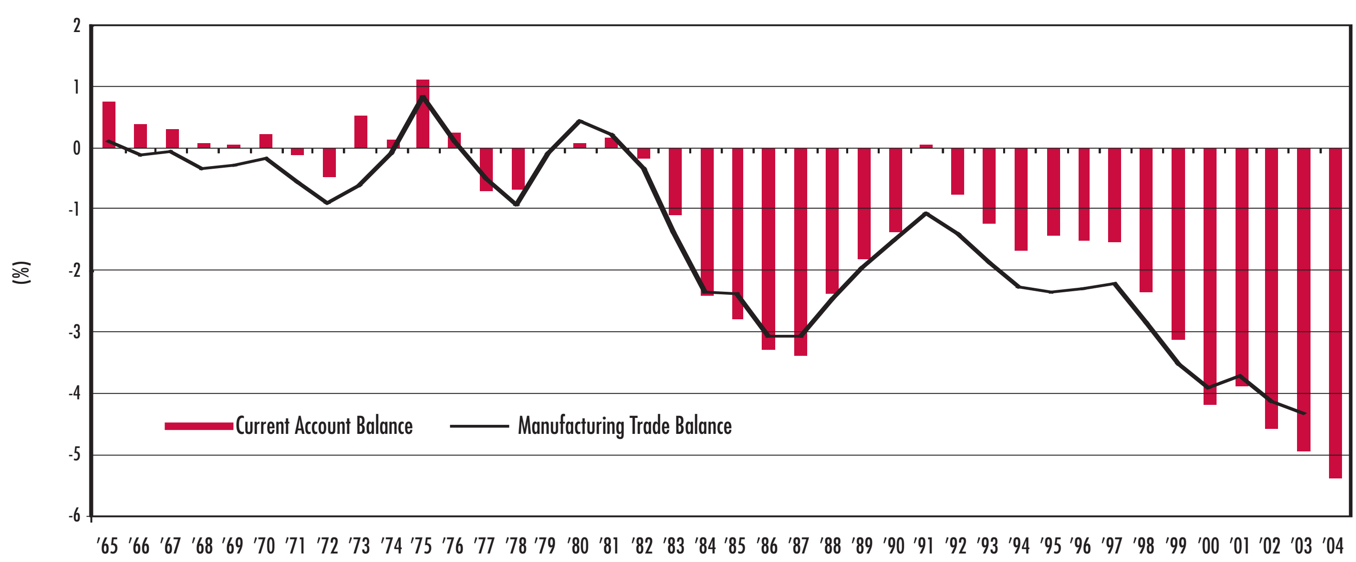
The transfer of foreign saving to the United States is embodied more in goods than in services. Outsourcing to India aside, most services are not so easily traded internationally. Thus, when American spending rises above output (income), the net absorption of foreign goods-largely raw materials and manufactures-increases. 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 Chart 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 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 Chart 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 (Chart 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

Chart 1: US Current Account Balance and Manufacturing Sector Trade Balance (% of GDP)



Source: Bureau of Economic Analysis

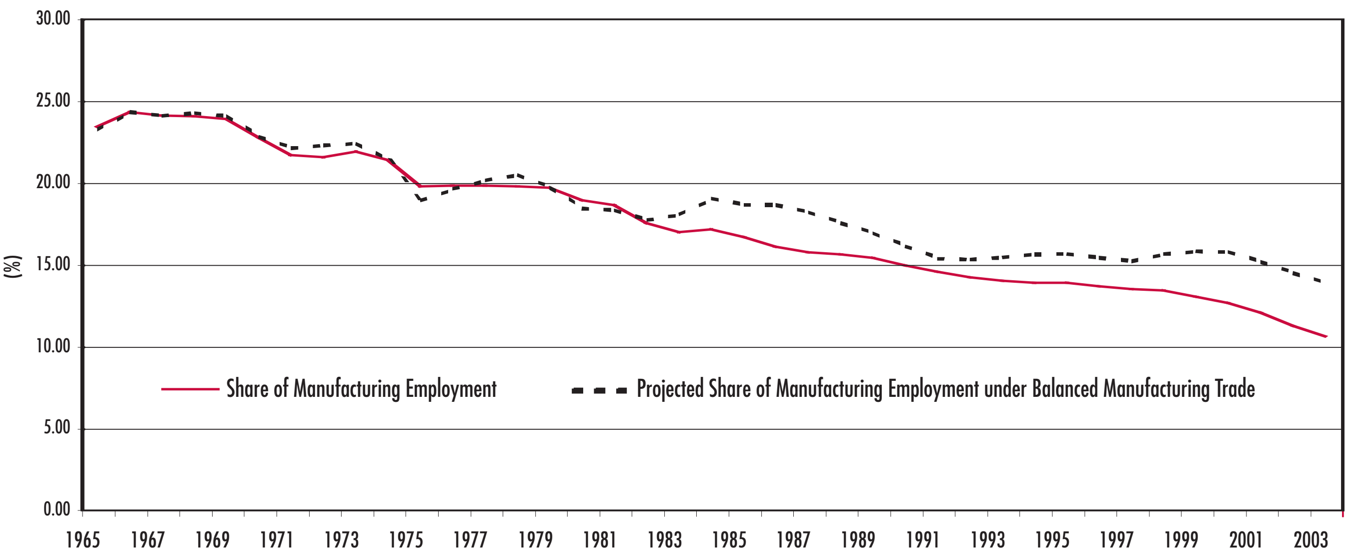
2004 — also shown in Chart 1. The main component remains the trade deficit in manufactures, leading to intensified shrinkage in American manufacturing employment.

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 U.S. sustaining its technological leadership with no manufacturing sector at all.

More uncomfortably, congressmen, pundits, and voters increasingly 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 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, or quotas, or exchange rate changes, or 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.

Chart 2: Projection of Labor Growth in Manufacturing under Balanced Manufacturing Trade

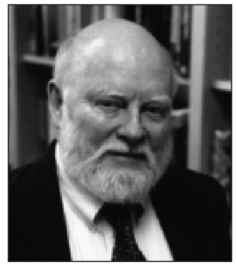


Source: Bureau of Economic Analysis, Survey of Current Business

Thanks to Prakash Kannan of Stanford University for his invaluable help.

SIEPR Policy Briefs
are underwritten by a generous grant from the Taube Family Foundation.

About the Author



Ronald McKinnon is the William D. Eberle Professor of International Economics at Stanford University, where he has taught since 1961. He is also a SIEPR/SCID Senior Fellow.

His fields of interest are international economics and development finance. McKinnon has written over 100 articles and several books, which include: *Money and Capital in Economic Development (1973); Money in International Exchange: The Convertible-Currency System (1979); The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy, 1993; The Rules of the Game: International Money and Exchange Rates, 1996; Dollar and Yen: Resolving Economic Conflict Between the United States and Japan (with Kenichi Ohno), 1997;* and *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue,* forthcoming in 2005.

His books have been translated into many European and Asian languages, and he has been a consultant to central banks and finance ministries the world over-including international agencies such as the World Bank and International Monetary Fund.

The Stanford Institute for Economic Policy Research (SIEPR) conducts research on important economic policy issues facing the United States and other countries. SIEPR's goal is to inform policy makers and to influence their decisions with long-term policy solutions.

With this goal in mind SIEPR policy briefs are meant to inform and summarize important research by SIEPR faculty. Selecting a different economic topic each month, SIEPR will bring you up-to-date information and analysis on the issues involved.

SIEPR Policy Briefs reflect the views of the author. SIEPR is a non-partisan institute and does not take a stand on any issue.

For additional copies, please see SIEPR website at: http://SIEPR.stanford.edu

SIEPR *Policy Brief*

A publication of the
Stanford Institute for Economic Policy Research
Stanford University
579 Serra Mall at Galvez Street
Stanford, CA 94305
MC 6015

NON-PROFIT
ORG.
U.S. POSTAGE
PAID
PALO ALTO, CA
PERMIT NO. 28