MGRECON301: Global Economic Environment of the Firm
Pre-Reading Assignment

Instructor: Prof. Ravi Bansal

Greetings to all --- I look forward to having an exciting course in Global Economics. This pre-reading highlights some of the methods and ideas that we develop in the course.

Required Textbook for the course: *Macroeconomics*, by Andrew Abel, Ben Bernanke and Dean Croushore, publisher: Addison-Wesley.

Pre-reading

i) Read Chapters 1 and 2 of the textbook and the most recent trend analysis provided by Goldman Sachs (included in this package)---I use this for motivating our class discussion.

ii) Also included are additional articles and questions, which give you a sense of what the course is about. You should think about these questions prior to the first lecture.

The objective of the following two questions is to make you think about the global economic issues; you should not worry about getting the right answer. We will discuss the issues in these articles in considerable detail in the course.

Question:
What is the impact of outsourcing on U.S. corporations and workers? Is this good for the U.S. economy?

Outsourcing Abroad Draws Debate at Home

By CLARE ANSBERRY
Staff Reporter of THE WALL STREET JOURNAL

PITTSBURGH -- With the job outlook grim, outsourcing overseas is an increasingly thorny issue.

Those opposed say it effectively means exporting work and jobs, a controversial strategy given that the overall number of people collecting unemployment benefits reached a 20-year high last week. Those in favor say it enables U.S. companies to compete globally. One thing is clear: The debate is bound to escalate as the practice spreads.
Forrester Research Inc. predicts that American employers will move about 3.3 million white-collar service jobs and $136 billion in wages overseas in the next 15 years. Concern about the impact on the nation's economy and its workers is prompting union protests and congressional hearings. At least five states introduced legislation aimed at keeping jobs in the U.S., among other things, by blocking companies from using foreign workers on state contracts. The House Small Business Committee held a hearing last month on outsourcing, just one week before high-tech workers protested outside New York's Waldorf-Astoria, site of an outsourcing conference. In Seattle, high-tech workers rallied outside the city Chamber of Commerce, where local officials were meeting with a British outsourcing firm.

Outsourcing took off in the 1990s when companies, mainly manufacturers, wanted to cut costs and concentrate on their core high profit-margin tasks. The price didn't seem high. The lost jobs were lower-skilled and lower-paid. The labor market was tight. But then the recession hit. Companies, looking for ways to further slash costs in the face of global competition, sent more work overseas, and laid off workers at home. Affected were not only those unemployed workers, but midsize and small suppliers who couldn't compete on price. But now the practice is spreading well beyond assembly and data-entry. Business-processing outsourcing company iGate Corp., Pittsburgh, started a life-science unit to outsource clinical trials of new drugs in India and elsewhere for pharmaceutical companies that want to get drugs to the market faster, but are required by regulators to conduct larger trials. General Motors Corp. built a $21 million research and engineering center in Bangalore, India, which is also home to a General Electric Co. lab where scientists and engineers work on next-generation refrigerators and jet engines.

Pradip Kamat, who runs Indus International Inc., a Cleveland-based business-consulting firm, has organized a delegation of 30 companies from India to tour Ohio, including one that wants to design and produce parts for huge cellular telephone towers. The tower parts would then be shipped to the U.S. and constructed here. It's a cost-savings issue, he says, noting that engineers in India earn about $5,000 to $10,000 compared with at least $50,000 in the U.S. "In the short run, it raises unemployment issues in the U.S., but in the long run it's necessary to compete."

For the most part, companies say they aren't taking jobs from the U.S. and moving them overseas, but rather getting additional resources at a lower cost. Moreover, in the case of moving research and development functions overseas, they can get products to the market faster, because work can be done 24/7 with scientists and engineers in one part of the world passing off the project at the end of their day, to those just waking up overseas. That makes them more competitive and nimble to compete in the world market.

Smaller and midsize companies are getting into the act, too. A recent study by the Outsourcing Institute found that 60% of companies with fewer than 500 employees expect to spend between $1 million and $5 million on outsourcing in the next 12 months for technology, manufacturing and logistics. "Growing an enterprise has evolved," according to Frank Casale, chief executive of the institute. "It's no longer about what you own or build; success is hinged to the resources and talent you can access."
For many it's a matter of survival, having found they can't compete with low-cost foreign producers or service providers. But, they are also able to tap into a growing number of organizations clearing the way for them. Plante & Moran, an accounting and consulting firm, is holding a session for midsize manufacturers in the Midwest this week on business in China. The session, drawing close to 500 top executives, was sold out.

One 25-employee company, which had been told by its biggest customer that it needed to lower its prices, looked to the World Trade Center Cleveland for advice. David Yen, executive director, helped find a partner in Taiwan to make low-cost circuit boards and win the company a $1 million contract.

Many companies, though, are feeling only the downside. Wes Smith says outsourcing by big automotive customers puts the squeeze on his 250-employee metal-stamping company in Michigan. "As our customers go offshore, that's where the jobs are going. There are a lot of guys like me who wonder if there is going to be anything left to hand to our children," he says.
Bernanke Raises Prospect of 'Debt Spiral'
Warning Could Bolster Attempts to Overhaul Entitlement Programs
By GREG IP, Wall Street Journal
January 19, 2007; Page A2
WASHINGTON -- Federal Reserve Chairman Ben Bernanke warned that rising health-care and Social Security spending could create a "vicious cycle" of rising debt and interest payments and an eventual fiscal crisis.

Though Mr. Bernanke lacks the stature of his predecessor, Alan Greenspan, his strong language, coupled with what appears to be a growing respect for his views from lawmakers in both parties, could add impetus to efforts to overhaul entitlement programs, principally Social Security, Medicare and Medicaid.

They currently amount to almost half of federal noninterest spending and 9% of gross domestic product, or the value of all goods and services produced in a nation. The Congressional Budget Office, assuming no change in the programs, extension of Mr. Bush's tax cuts and continued moderate growth in health-care spending, projects that will rise to 75% of spending and 19% of GDP by 2050.

Mr. Bernanke's advice, delivered at a hearing of the Senate Budget Committee yesterday, comes days before President Bush's State of the Union address and weeks before his 2008 budget request. In the first six years of his presidency, Mr. Bush expanded Medicare significantly while cutting taxes repeatedly. He is seeking to preserve those tax cuts in the face of a Democratic-controlled Congress, while seeking -- through Treasury Secretary Henry Paulson -- to revive an overhaul of Social Security.

Since taking office last year, Mr. Bernanke has met extensively with members of both parties, and the outreach appears to be paying off. Budget Committee Chairman Sen. Kent Conrad of North Dakota yesterday thanked Mr. Bernanke for insights he provided over lunch a few weeks ago. "You've sent a very clear message and one that I hope people are paying close attention to," Mr. Conrad said. The panel's senior Republican, Judd Gregg of New Hampshire, called Mr. Bernanke's testimony "a clarion call."

The bipartisan praise also reflects the fact that Mr. Bernanke's diagnosis was generally uncontroversial. While that protects the Fed's reputation for political independence, it may limit Mr. Bernanke's impact on the fiscal debate. Mr. Greenspan was influential in part because he made specific recommendations, such as the passage of tax cuts in 2001. Democrats often cited his support for Paygo -- a budget rule meant to keep tax cuts and
new entitlement programs from boosting the deficit -- in making it a key plank in their fiscal platform.

Mr. Bernanke steered clear of specifics on entitlement overhaul in his testimony and anything that could be construed as criticism of President Bush, for whom Mr. Bernanke previously served as an adviser. Despite senators' praise, it is unclear whether his advice will have much direct impact.

The Fed chief noted that last year's budget deficit, spending and revenue were, as shares of GDP, close to averages that have prevailed since 1960. That is a point the White House often makes to deflect charges that its tax cuts have led to dangerously large deficits. Mr. Bernanke said this was the "calm before the storm." Spending on Social Security, Medicare, and Medicaid are about to ramp up, he said, as the population ages.

While breaking no new ground, Mr. Bernanke's testimony was notable for its emphasis on the consequences of a rising national debt -- the sum of all annual budget deficits -- rather than the annual deficit alone. The debt, he noted, would reach almost 100% of GDP by 2030 according to the Congressional Budget Office, a level previously reached only during World War II. The annual interest on that debt would be 4.6% of GDP, triple the current level.

"A vicious cycle may develop in which large deficits lead to rapid growth in debt and interest payments, which in turn adds to subsequent deficits," he said. Similar "debt spirals" have contributed to financial crises in other countries, a subject Mr. Bernanke studied as an academic. "Ultimately, this expansion of debt would spark a fiscal crisis, which could be addressed only by very sharp spending cuts or tax increases, or both," he said.

Mr. Bernanke didn't predict -- as more pessimistic analysts have -- that such a crisis would entail sharply higher interest rates or a sharply weaker dollar. Still, he noted higher debts would divert capital from growth-enhancing investments and funnel more of Americans' income to foreign bondholders. This will "have an effect on the vibrancy, efficiency and growth rate of our economy, which will be palpable," he said.

Mr. Bernanke took office promising to be less outspoken on fiscal policy than Mr. Greenspan. In his initial appearances before Congress, he irritated some legislators by refusing to comment on specific topics. Yesterday's appearance suggests he has refined his approach. Asked a year ago about restoring Paygo, he said the Fed chairman "should not be involved in making specific recommendations about [Congress's] internal decision-making process." Asked the same question yesterday, he said, "I don't really have the expertise to advise on [those] types of rules."
Bernanke's Bridge Over Troubled Waters

This issue of the US Economics Analyst is in an abridged, four-page format. The center section and the table of historical and forecast data have been omitted. Our regular format will resume with our issue dated February 23, 2007.

- Chairman Bernanke testified before Congress this week about the state of the economy and the stance of monetary policy. On both, he appeared quite satisfied. The FOMC projects a gradual return to trend growth and gradual moderation of core PCE inflation with current policy. By implication, the committee seems to expect a stable 5¼% federal funds rate.

- Our view that the housing sector’s precipitous decline and several quarters of below-trend GDP growth will feed through into a weaker labor market drives our outlook for a rise in the unemployment rate to just over 5% and 75 basis points of rate cuts this year. The data this week were broadly supportive of our view, with weakness in retail sales, initial and continuing claims and housing starts.

- The most important data release next week is the January CPI. We estimate an increase of +0.2% for the core rate, broadly in line with the Fed’s expected moderation of inflation. After large increases this week, initial and continuing claims warrant close attention to see if these increases are the start of a trend.
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Bernanke Sees Smooth Sailing Ahead …

In his testimony to the Senate (Wednesday) and House (Thursday), Chairman Bernanke plotted a course for the Fed that envisions sailing through quite calm waters. The FOMC sees unemployment holding steady at a low level and inflation converging smoothly toward the committee’s desired range during 2007, and then remaining there in 2008. In fact, the word moderate, both as a verb describing what he expected inflation to do and as an adjective describing the type of growth he expected, was prominent.

The FOMC expects inflation (as measured by the core PCE deflator) to move gradually into Chairman Bernanke’s “comfort zone” of 1%-2% from the elevated levels of mid-2006. However, Exhibit 1 shows that it takes a while to get there. Using the middle of the FOMC’s central tendency projections, inflation stays slightly above the comfort zone throughout 2007 before falling back into it in 2008. The deceleration of inflation that the committee foresees, especially in 2007, comes at a more gradual pace than has been occurring over the last several months.

This deceleration occurs despite an expectation that the unemployment rate stays essentially flat through both 2007 and 2008. The FOMC’s central tendency forecast has the unemployment rate stabilizing at close to the current level, now only 0.2% above its cycle low of 4.4%. This suggests that the FOMC has significantly lowered its estimate of NAIRU, from around 5% in the past to 4½% or less now. Otherwise, it would be difficult to explain why the committee expects declines in both price and wage inflation at the current low level of unemployment.

Bernanke noted one major upside and one major downside risk to monetary policy. On the upside, the main concern is a reacceleration of inflation, caused by high resource utilization, which would necessitate a resumption of rate increases. The downside risk to the federal funds rate comes from further declines in the housing sector, with an explicit note of the potential for “spillover effects.” Of the two, the FOMC still seems more concerned about the inflation risk—at least officially—as Chairman Bernanke devoted much more discussion to it.

… But Housing and the Labor Market Could Blow the Fed Off Course

We view the likely evolution of the economy differently than Chairman Bernanke. The main differences concern the labor market and, to a lesser degree, inflation. In contrast to the committee, we expect economic weakness over the last several quarters and ongoing weakness in housing to push unemployment up. Further, we expect more disinflation, driven in large part by moderation in the rental components (see “Prospects for Further Disinflation,” US Economics Analyst, 07/06), than the Fed. On balance, data over the past week look supportive of our view.

Perhaps most importantly, there has been a string of news causing us to mark down our estimates of Q4 GDP from the robust 3.5% annualized growth originally reported. Revisions to inventories, international trade and retail sales were all negative; in consequence, we now estimate that GDP grew at only 2% in the fourth quarter. As Exhibit 2 shows, this revision paints a different picture than when GDP growth was estimated to have returned to an above trend level. Now, instead of the second and third

Exhibit 1: Bernanke Projects Further Inflation Moderation with Constant Unemployment

Sources: Dept. of Commerce. Dept. of Labor. Federal Reserve.
quarters looking like a brief downward episode before a return to potential growth, it looks as if GDP growth has remained below potential for the third quarter in a row, hardly indicative of robust economic growth.

Flat retail sales in January extended the downward trend that sales growth has followed since peaking in late 2006 (Exhibit 3). There are two caveats to the rather alarming message of this graph. First, the year-on-year numbers were adversely affected by unfavorable comparisons. Second, the data are nominal and therefore reflect the decline in inflation that is partly a result of lower gas prices. However, neither of these caveats changes the fundamental message that retail sales growth, especially recently, is well off of earlier highs.

Today’s report of a nearly 15% drop in housing starts in January makes November’s and December’s recovery appear to be a mainly weather induced interruption in the sector’s downward slide (Exhibit 4). This weakness contrasts with an increase in the homebuilder’s survey to 40 from 35. However, a reading of 40 is still quite low by historical standards and substantially below 50, the dividing line between contraction and expansion in the sector. The exhibit also shows residential construction employment, which moved up almost in lockstep with starts over the housing boom. Despite the decline in housing starts since the peak, this sector has lost few jobs. We expect employment in this sector eventually to move down along with activity, a main driver of our forecast of lower payroll growth and a rise in the unemployment rate.

The recent initial and continuing unemployment claims data provide tentative support for our view. Both types of claims posted large gains that can be explained only in part by the recent colder weather (perhaps 10,000 of the 44,000 jump for initial claims). The rise in continuing claims is more pronounced and suggests that those who have become unemployed might be having trouble finding new jobs. Together these might indicate the start of the labor market weakness that we have been expecting.

Seamus Smyth
Focus for the Week Ahead

■ We estimate the core CPI rose 0.2% in January. A PPI that contained more inflation than we expected, especially in food, poses a bit of upside risk to our headline CPI forecast, but not enough to make us change our call (February 21).

■ Wednesday also features the release of the minutes from the January 31 meeting of the FOMC. This may be less informative than usual as Chairman Bernanke gave a comprehensive outline of monetary policy views in his testimony. However, the minutes may provide more color on the degree to which FOMC members share his views on the economy (February 21).

■ Though we do not normally highlight weekly claims data, this week’s release bears watching. After large rises of 44,000 initial claims and 71,000 continuing claims, we will be watching closely to see whether these indications of labor market weakness persist (February 22).

Economic Releases and Other Events

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<td>Wed</td>
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<td>Minutes of Jan. 31 FOMC Meeting</td>
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