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Abstract: The article discusses how global forces have taken control of the U.S. economy. It reports that the federal government as of December 2007 will no longer be the most powerful force in the U.S. economy as Americans spend more on imports than the government takes in as revenue. As a consequence, the power of the government to influence weak wage and job growth is curtailed, especially given the rise of China and India and the increase in global competition. INSET: THE FOUR BIG IDEAS OF ECONOMIC POLICY.

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CAN ANYONE STEER THIS ECONOMY?

Global forces have taken control of the economy. And government, regardless of party, will have less influence than ever

SOMETIME NEXT YEAR --perhaps around Christmas 2007, if current trends continue--the U.S. will hit a milestone. For the first time in recent memory, the cost of imported goods and services will exceed federal revenues. In other words, Americans will soon pay more to foreigners than they do to their national government.

We're almost there now. Imports cost us about $2.2 trillion a year; the federal government collects $2.4 trillion in revenues. Why is that important? Because for the past 70 years, Washington has been the 800-pound gorilla, more powerful by far than any other force in the U.S. economy. That's not true anymore. The federal government remains plenty influential, but the global economy is more so.

This will come as a rude shock to Representative Nancy Pelosi (D-Calif.), the presumptive Speaker of the House, Charles B. Rangel (D-N.Y.), the likely chairman of the House Ways & Means Committee, and other newly enfranchised leaders in the Democratic Party. Sure, they're likely to have the power to pass legislation, including boosting the minimum wage. But such a measure, even if President George W. Bush signed it, would help only a small fraction of the workforce. It would do almost nothing to ameliorate the weak wage growth that has plagued most Americans, including college graduates, in recent years. The broad-based drop in incomes is being driven more by the rise of China and India and the intensification of global competition. And there is little Democrats can do to reverse these trends.

No matter which party you belong to, or which Big Idea or school of economic policy you subscribe to, one thing is clear: Globalization has overwhelmed Washington's ability to control the economy. Whether you're a Republican supply-side tax-cutter, a Wall Street deficit hawk of either party, or a Silicon Valley techie type, your preferred levers of economic policy just don't work as well as they once did.

As recently as 10 years ago, the U.S. economy was still relatively self-contained. Then-Federal Reserve Chairman Alan Greenspan--often called the most powerful man in the world--could be sure that the U.S. economic machine would eventually respond when he called for higher or lower rates. Tax and spending decisions made in Washington could set the course for growth, while economic events in the rest of the world, such as the Asian financial crisis of the mid-1990s, were felt as minor bumps.

That has changed. Since 1995 imports have risen from 12% of gross domestic product to about 17%. And foreign money finances about 32% of U.S. domestic investment, up from 7% in 1995. In other words, the U.S. is more open to the global economy than ever before, and the links run in both directions. Now many of the levers affecting the U.S. economy are located not in Washington but in Beijing, London, and even Mexico City.

Greenspan and his successor, Ben S. Bernanke, have found this out the hard way. To restrain economic growth and cool the housing market, the two Fed heads have raised short-term interest rates 17 times since 2004, for a total increase of more than four percentage points. But even as the Fed tightened up on the domestic money supply, foreign investors made up the difference.

As a result, the interest rate on 10-year government bonds today is 4.6%, exactly where it was in 2004, when the Fed started raising rates. Good news for home buyers who want mortgages. Not so good news for the policymakers trying for a soft landing.

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PRESIDENT BUSH ENCOUNTERED a similar problem. His huge tax cuts poured hundreds of billions into the economy and kept output rising at a decent clip. Nevertheless, the fiscal stimulus generated far fewer jobs than anyone expected, as more and more production headed overseas. "Traditional macro policies are less effective than they used to be," says Robert S. Shapiro, a top economic adviser to President Bill Clinton who now runs a Washington economic consulting firm. "We don't know how to ensure strong job creation and strong wage growth anymore."

Pelosi and the congressional Democrats, who embraced fiscal restraint as their pre-election mantra, shouldn't expect much better economic results by pulling the deficit-cutting lever. On the campaign trail, Pelosi promised to contain the budget deficit, telling one Washington audience that "if American families are expected to balance their checkbooks, so, too, should the Congress of the United States." While that commitment may resonate politically, there's growing economic evidence that reducing the budget deficit won't do much to jazz up business investment and growth. A new study from the Federal Reserve Bank of New York, as nonpolitical an organization as you will find, reports that "investment has exhibited only a tenuous response to fiscal policy changes."

Even the Big Idea of devoting more tax dollars to research and development to make the U.S. more competitive--an idea repeatedly advocated by such tech leaders as John T. Chambers of Cisco Systems Inc. and John Doerr of venture capital giant Kleiner Perkins Caufield & Byers--is beginning to look economically and politically troublesome. True, increased funding for R&D appears to be a rare area of agreement between the two parties: Pelosi and the House Democrats came out with their "Innovation Agenda" last November, and Bush followed with his innovation-based "Competitiveness Initiative" in the January State of the Union speech.

But in the brave new world of the global economy, where companies move factories and facilities around the world like game pieces, it's no longer a given that U.S. workers benefit directly from U.S.-funded research. One worrisome example: Despite federal outlays of over $125 billion for medical research over the past five years, the U.S. has a large and growing trade deficit in advanced biotech and medical goods. "The era in which we could assume that increased U.S. public investment in R&D automatically generates domestic growth is over," says Jeff Faux of the liberal Economic Policy Institute.

Policymakers now face the unenviable task of managing the economy in the face of an overwhelming flow of goods and money back and forth across national borders. "The federal government affects the economy only on the margins," says Charles R. Black Jr., Republican consultant and outside adviser to President Bush. Adds Timothy J. Penny, a former Democratic representative from Minnesota who is now at the University of Minnesota: "Washington is far less relevant than it used to be. You don't have to be an economics professional to see the evidence."

And get this: We don't even know how to measure whether we as a country are succeeding or failing. The traditional metrics for economic security and prosperity are capturing impressive signs of life. Unemployment, inflation, and interest rates are low by historical standards. The stock market is rising, and household wealth is higher than it was at the peak of the 1990s boom, even after adjusting for inflation. To a large extent, this is thanks to the global economy, which has been fueling the U.S. expansion with cheap goods and cheap money. Yet real wages are down over the past five years, the trade deficit is enormous, and there are widespread worries about America's continued ability to compete.

Washington has responded to these concerns, in large part, with a series of small fixes, like tinkering with the pension system. But what's needed is a new Big Idea for economic policy--or two or three competing Big Ideas--that accounts for the verities of the global economy.

The first step is to get a better handle on what's really happening to U.S. workers and businesses in today's economy, where wealth is as important as income, and where events in Shanghai are as important as events in Chicago. If the value of a family's home goes way up, but its income dips a bit, is the family better or worse off? If a U.S.-based company opens up an R&D facility in India or China, does its employment of American workers go up or down--and, does its overall contribution to U.S. growth increase or decrease? We don't have the statistics needed to answer these questions.

Second, we need to take hold of the main unused lever of economic policy: health care. Politicians and economists have mainly thought of health care as a cost that is dragging down competitiveness. Health-care spending is the main source of long-term federal, state, and local budget deficits, the prime gobbler of national savings, and one of the biggest tax distortions, in the form of the tax exemption for company-provided health insurance.

All these things are true. But health care is also a huge source of private sector jobs, one of the most technologically advanced sectors of the economy, and frankly, the provider of a service people can't get enough of. It can even be thought of as an investment, to the degree that better health allows Americans to work longer and to better enjoy their lives. We have to view health care as a force for growth, rather than an impediment.

Finally, a Big Big Idea--probably too big to even consider right now--would be the creation of global institutions for governing the world economy. History tells us that market economies are prone to financial crises, to which the only solution is a strong central bank. During the Asian financial crisis of the 1990s, for example, the Fed played that role.

But with the explosive growth of China and India, that sort of role for the Fed is no longer feasible, and no new institution has arisen to take its place. As former Treasury Secretary Robert E. Rubin, now a top official at Citigroup, recently said: "There's no policy mechanism for bringing together the countries that really matter in the global economy." The best solution would be some sort of global central bank with real powers--but that's not going to happen until there's a big enough financial crisis to truly scare people.

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ECONOMIC POLICY, IN THE SENSE that we understand it today, is a comparatively recent invention. It started with John Maynard Keynes in the 1930s. He put forth the Big Idea that governments had the ability to soften a downturn. Keynesian economics, as it was termed, calls for reducing interest rates, cutting taxes, and hiking government spending to ease the worst effects of recession.

Today, Keynes's prescriptions could be called Policy Classic, since even diehard free marketeers agree that fighting recessions is the right thing for governments to do. What's more, Policy Classic still works in the modern global economy, up to a point. When a fire starts in your house, you should still try as hard as you can to douse it with water, even if your hose is leaky.

Consider how Washington responded to the recession of 2001. One could quibble with the exact timing of Greenspan's rate cuts, and the Democrats weren't particularly happy with the Bush tax cuts. But there's no disputing that massive amounts of fiscal and monetary stimulus made the 2001 downturn one of the mildest on record. And the recovery hasn't been half bad, either. Since the economy peaked in the second quarter of 2001, economic growth has averaged a decent 2.8%.

Yet the recovery could have been a lot stronger, given the amount of stimulus pumped into the economy. Consumers and businesses aren't fools: They used their extra money to buy cheap imports rather than more expensive American-made goods and services. Between 2001 and today, imports rose by three percentage points as a share of GDP, one of the main reasons that job growth was so slow. By comparison, the import share rose by only one percentage point or so in the recoveries of the early 1980s and the early 1990s.

In an open economy, Policy Classic loses its punch. The inability to create jobs after a recession is bad enough. What really should concern us all, though, is what might happen in the next recession. Foreign investors have been extraordinarily willing to put their money into the U.S. But let's suppose, just for the sake of argument, that a recession here makes other countries look like a better bet. Then foreign investors pull out their money, pushing interest rates way up and the dollar way down. The higher rates slow the economy, and the lower dollar makes imports more expensive, triggering higher inflation.

Poof! Instant stagflation. And what's worse, Bernanke and the Fed will be forced to keep interest rates high to fight inflation.

But enough of cataclysmic scenarios that might or might not happen. The question to ask is this: How does globalization affect the long-term policies for growth, both liberal and conservative, rolled out by the U.S. in recent decades? Probably the best known is supply-side economics, which originated in the 1970s and achieved prominence under President Ronald Reagan in the 1980s. Like all Big Ideas, the logic behind supply-side economics is clear: Lower tax rates give workers an incentive to put in more hours, encourage savings and investment by increasing the after-tax rate of return, and spur entrepreneurs to expand their businesses by allowing them to keep more of the profits.

According to Kevin A. Hassett, director of economic policy studies at the American Enterprise Institute, globalization actually increases the pressure to cut taxes. If tax rates are too high, "corporate income is so mobile that the money just leaves," says Hassett. "There's an international tax competition, and everyone is playing."

Yet economists are hard-pressed to find evidence that tax cuts have a big effect on growth. Last summer, the Treasury Dept. released a study that looked at the long-term impact of extending President Bush's tax cuts, which are due to expire at the end of 2010. The study concluded that extending the tax cuts indefinitely would boost GDP by only 0.7% over the long run. That's less than a rounding error.

It's also clear that having a low tax rate is only one factor among many determining international competitiveness. It's equally important to have an honest government, or an efficient health-care system, or an educated workforce. "There isn't a single blueprint for a successful economy," says Robert E. Hall, a Stanford University economist who was one of the main advocates of a flat tax in the 1980s.

On to the next Big Idea: deficit reduction, a mirror image of supply-side economics that the Democrats have made the centerpiece of their political and economic agenda. "Fiscal responsibility is important for the long term," says Bruce Reed, president of the Democratic Leadership Council. "The overall economy is going to pay a price if the country is going broke."

The case for deficit reduction as a long-term growth strategy is also straightforward. Smaller budget deficits are supposed to boost national savings, which leads to lower interest rates, smaller trade deficits, increased investment by businesses, and more job creation. And certainly that's the way it worked in the 1990s, when Rubin was running economic policy under President Clinton--hence the name Rubinomics.

But this line of reasoning doesn't hold up so well in an economy that is far more exposed to global forces than it was in 1993, when Clinton took office. The financial markets have become far more seamlessly global, making the U.S. budget deficit a much smaller influence on interest rates. Today's roughly $250 billion deficit would use up about 14% of U.S. national savings. That's a big deal, but it's only 2% of global savings.

The ease with which capital flows across national borders helps justify the Bush Administration's relative lack of concern about budget deficits or even personal savings. "What starts to break down is the simple link between encouraging savings and encouraging investment," says James S. Poterba, a Massachusetts Institute of Technology economist appointed by Bush to his tax reform commission in 2005. "If Joe in Pittsburgh saves, we can't say that we benefit this factory in Harrisburg. The jobs we generate might be jobs somewhere else"--like overseas.

So if globalization weakens the usefulness of tax cuts and deficit reduction as policy tools, what's left? The New Economy boom of the 1990s was driven by technological change and innovation. The logical way to rekindle the magic, then, is to boost government spending for R&D and education. Just listen to Daron Acemoglu of MIT, the most recent winner of the John Bates Clark Medal, given to the best economist under the age of 40. "The U.S. is a frontier country," says Acemoglu, meaning that its competitive advantage comes from being at the forefront of new technology. As a result, he says "if any policy is going to have a beneficial effect, it has to help the innovation sector."

This Big Idea was first suggested by Paul Romer, now at Stanford University, in the 1980s, and named New Growth Theory. That term fell out of favor after the tech crash--perhaps because it sounded too much like the New Economy--and the Big Idea now goes by the prosaic name "innovation policy."

The problem is that it's tough to make a direct connection between federal R&D spending and the creation of high-tech jobs. Despite the U.S. prominence in medical research, the pharmaceutical, biotech, and medical devices industries have added only 19,000 workers in the past five years.

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THE TRUTH IS, CHINA and India are increasingly attractive places for companies to do research and development (using ideas, perhaps, that were originally developed using U.S. tax dollars). Money is following as well, with U.S. venture capitalists investing more than $400 million in Chinese and Indian companies in the third quarter alone, according to the National Venture Capital Assn. There's a growing sense that at a time of scarce resources, the U.S. may not be getting enough bang for its buck from R&D spending. "The question about funding basic R&D for health care is the same as for funding other basic R&D," says Robert B. Reich, Labor Secretary under Clinton and now at the University of California at Berkeley. "How long can and should the U.S. continue to subsidize the rest of the world?"

This question becomes especially pressing if the newly resurgent Democrats carry through on their promise to put in place a "pay-as-you-go" budget system whereby new spending cannot be financed by increased borrowing. Who is going to vote an increase for science if it means raising taxes or cutting spending for children? The last bout of meaningful deficit reduction, during Clinton's first term, did serious damage to R&D spending, which dropped by 3.9% in real terms.

Education poses a different set of issues. Clearly, education is key to competitiveness. "If an educated population is the engine of change, then we're doing a really, really lousy job," says Claudia Goldin, a Harvard economist who is co-authoring a book about education and technology. "We have been un-subsidizing higher education for some time."

There are two problems. First, real wages for young Americans with a bachelor's degree have declined by almost 8% over the past three years. Nobody knows the reason for sure, but some economists suspect that global competition has something to do with it.

The other problem is that education is closely tied, in tricky ways, to the hot-button issue of immigration. Despite post-September 11 restrictions, foreign students with temporary visas still account for almost 40% of new graduate students in science and engineering. We still need to spend more on education, but in an era of labor mobility the decision about where to put our resources is not a slam-dunk.

With the Big Ideas under assault by globalization, economists have responded by focusing on smaller goals. "Are there places where we can make sensible improvements that don't require big philosophical changes in what we are doing?" asks Poterba of MIT. For example, the new pension bill encourages companies to automatically enroll new hires in 401(k) plans unless they opt out. Economists believe that will greatly increase savings by workers. Not as big a deal, perhaps, as full-scale tax reform, but a gain.

Beyond that, the idea of a national economic policy may be fundamentally out of date in a world of global markets. Washington is no longer the center of the economic universe. That's a basic fact that Democrats and Republicans alike will need to get their heads around.

GRAPH: WHY THE ECONOMY IS SO HARD TO CONTROL: Spending on imports is a bigger share of the economy...

GRAPH: WHY THE ECONOMY IS SO HARD TO CONTROL: ...and catching up to federal revenues...

GRAPH: WHY THE ECONOMY IS SO HARD TO CONTROL: ...while U.S dependence on foreign money is rising

PHOTO (COLOR): RANGEL: Clout in Congress, but a limited ability to affect the economy

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By Michael Mandel

With Richard S. Dunham, in Washington

THE FOUR BIG IDEAS OF ECONOMIC POLICY

Policy Classic
ALIAS: Keynesian economics.
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MAIN PROPONENTS: Almost everyone.

HOW IT WORKS: Increase government spending, cut taxes, and slice interest rates to fight recessions.

WHY GLOBALIZATION AFFECTS IT: Fiscal and monetary stimulus now increases the current account deficit rather than creating jobs at home. Interest rate cuts will have little effect against an economic crisis caused by a falling dollar.

Supply Side

ALIAS: Dynamic scoring.

MAIN PROPONENTS: Ronald Reagan, George W. Bush.

HOW IT WORKS: Cut tax rates to boost work effort, savings, and entrepreneurial energy.

WHY GLOBALIZATION AFFECTS IT: Tax rates are just one out of many factors that matter for global competition. There's only weak evidence that tax cuts really have a big impact on growth.

Deficit Cutting

ALIAS: Rubinomics.

MAIN PROPONENTS: Mainstream Democrats and Republicans.

HOW IT WORKS: Shrink the budget deficit to promote savings and investment.

WHY GLOBALIZATION AFFECTS IT: In a global economy, the U.S. budget deficit has little effect on interest rates or on the trade deficit. A focus on fiscal restraint also holds back essential investments.

Innovation Policy

ALIAS: New Growth Theory.

MAIN PROPONENTS: Technology heavyweights such as John Chambers and John Doerr.

HOW IT WORKS: Boost government spending on education and research and development in order to stoke growth and competitiveness, and improve living standards.

WHY GLOBALIZATION AFFECTS IT: Global competition is helping push down real wages for young Americans with bachelor's degrees. R&D is moving to India and China.