

U.S. data show that moving jobs overseas hasn't hurt the economy. Here's why those stats are wrong.

Whenever critics of globalization complain about the loss of American jobs to low-cost countries such as China and India, supporters point to the powerful performance of the U.S. economy. And with good reason. Despite the latest slow quarter, official statistics show that America's economic output has grown at a solid 3.3% annual rate since 2003, a period when imports from low-cost countries have soared. Similarly, domestic manufacturing output has expanded at a decent pace. On the face of it, offshoring doesn't seem to be having much of an effect at all.

But new evidence suggests that shifting production overseas has inflicted worse damage on the U.S. economy than the numbers show. *BusinessWeek* has learned of a gaping flaw in the way statistics treat offshoring, with serious economic and political implications. Top government statisticians now acknowledge that the problem exists, and say it could prove to be significant.

The short explanation is that the growth of domestic manufacturing has been substantially overstated in recent years. That means productivity gains and overall economic growth have been overstated as well. And that raises questions about U.S. competitiveness and "helps explain why wage growth for most American workers has been weak," says Susan N. Houseman, an economist at the W.E. Upjohn Institute for Employment Research who identifies the distorting effects of offshoring in a soon-to-be-published paper.

FLY IN THE OINTMENT

The underlying problem is located in an obscure statistic: the import price data published monthly by the Bureau of Labor Statistics (BLS). Because of it, many of the cost cuts and product innovations being made overseas by global companies and foreign suppliers aren't being counted properly. And that spells trouble because, surprisingly, the government uses the erroneous import price data directly and indirectly as part of its calculation for many other major economic statistics, including productivity, the output of the manufacturing sector, and real gross domestic product (GDP), which is supposed to be the inflation-adjusted value of all the goods and services produced inside the U.S. (For a detailed explanation of how import price data are calculated and why the methodology is suspect, see page 34.)

The result? *BusinessWeek's* analysis of the import price data reveals offshoring to low-cost countries is in fact creating "phantom GDP"--reported gains in GDP that don't correspond to any actual domestic production. The only question is the magnitude of the disconnect. "There's something real here, but we don't know how much," says J. Steven Landefeld, director of the Bureau of Economic Analysis (BEA), which puts together the GDP figures. Adds Matthew J. Slaughter, an economist at the Amos Tuck School of Business at Dartmouth College who until last February was on President George W. Bush's Council of Economic Advisers: "There are potentially big implications. I worry about how pervasive this is."

By *BusinessWeek's* admittedly rough estimate, offshoring may have created about \$66 billion in phantom GDP gains since 2003 (page 31). That would lower real GDP today by about half of 1%, which is substantial but not huge. But put another way, \$66 billion would wipe out as much as 40% of the gains in manufacturing output over the same period.

It's important to emphasize the tenuousness of this calculation. In particular, it required *BusinessWeek* to make assumptions about the size of the cost savings from offshoring, information the government doesn't even collect.

GETTING WORSE

As a result, the actual size of phantom GDP could be a lot larger, or perhaps smaller. This estimate mainly focuses on the shift of manufacturing overseas. But phantom GDP can be created by the introduction of innovative new imported products or by the offshoring of research and development, design, and services as well--and there aren't enough data in those areas to take a stab at a calculation. "As these [low-cost] countries move up the value chain, the problem becomes worse and worse," says Jerry A. Hausman, a top economist at Massachusetts Institute of Technology. "You've put your finger on a real problem."

Alternatively, as Landefeld notes, the size of the overstatement could be smaller. One possible offset: Machinery and high-tech equipment shipped directly to businesses from foreign suppliers may generate less phantom GDP, just because of the way the numbers are constructed.

Depending on your attitude toward offshoring, the existence of phantom GDP is either testimony to the power of globalization or confirmation of long-held fears. The U.S. economy no longer stops at the water's edge. Global corporations often provide their foreign suppliers and overseas subsidiaries with business knowledge, management practices, training, and all sorts of other intangible exports not picked up in the government data. In return, they get back cheap products.

But the new numbers also require a reassessment of productivity and wages that could add fire to the national debate over the true performance of the economy in President Bush's second term. The official statistics show that productivity, or output per hour, grew at a 1.8% rate over the past three years. But taking the phantom GDP effect into account, the actual rate of productivity growth might be closer to 1.6%--about what it was in the 1980s.

More broadly, it becomes clear that "gains from trade are being measured instead of productivity," according to Robert C. Feenstra, an economist at the University of California at Davis and the director of the international trade and investment program at the National Bureau of Economic Research. "This has been missed."

Pat Byrne, the global managing partner of Accenture Ltd.'s ([ACN](#)) supply-chain management practice, goes even further, suggesting that "at least half of U.S. productivity [growth] has been because of globalization." But quantifying this is tough, he notes, because most companies don't look at how much of their productivity growth is onshore and how much is offshore. "I don't know of any companies or industries that have tried to measure this. Maybe they don't even want to know."

Phantom GDP helps explain why U.S. workers aren't benefiting more as their companies grow ever more efficient. The cost savings that companies are reaping "don't represent increased productivity of American workers producing goods and services in the U.S.," says Houseman. In contrast, compensation of senior executives is typically tied to profits, which have soared alongside offshoring.

IMPORTING EARNINGS

But where are those vigorous corporate profits coming from? The strong earnings growth of U.S.-based corporations is still real, but it may be that fewer of the gains are coming from improvements in domestic productivity. In fact, holding down costs by moving key tasks overseas could be having a greater impact on corporate earnings than anyone guessed--or measured.

There are investing implications, too, although those are harder to quantify. Companies with their primary focus in the U.S. might suddenly seem less attractive, since underlying economic growth is slower here than the numbers show. But if the statistical systems of other developed countries suffer from the same problem--and they might--then growth in Europe and Japan might be overstated, too.

When Houseman first uncovered the problem with the numbers that is created by offshoring, she was primarily focused on manufacturing productivity, where the official stats show a 32% increase since 2000. But while some of the gains may be real, they also include unlikely productivity jumps in heavily outsourced industries (see [BusinessWeek.com](#), 6/2/07, "[Overseas Sweatshops Are a U.S. Responsibility](#)") such as furniture and audio and video equipment such as televisions. "In some sectors, productivity growth may be an indicator not of how competitive American workers are in international markets," says Houseman, "but rather of how cost-uncompetitive they are." For example, furniture manufacturing has been transformed by offshoring in recent years. Imports have surged from \$17.2 billion in 2000 to \$30.3 billion in 2006, with virtually all of that increase coming from low-cost China. And the industry has lost 21% of its jobs during the same period.

Yet Washington's official statistics show that productivity per hour in the furniture industry went up by 23% and output by 3% between 2000 and 2005. Those numbers baffle longtime industry consultant Arthur Raymond of Raleigh, N.C., who has watched factory after factory close. "And we haven't pumped any money into the remaining plants," says Raymond. "How anybody can say that domestic production has stayed level is beyond me."

WRENCHING PROCESS

Paul B. Toms Jr., CEO of publicly traded Hooker Furniture Corp., ([HOFT](#)) recently closed his company's last remaining domestic wood-furniture manufacturing plant, in Martinsville, Va. It was the culmination of a wrenching process that started in 2000, when Hooker still made the vast majority of its products in the U.S. Toms didn't want to go overseas, he says, but he couldn't pass up the 20% to 25% savings to be gleaned from manufacturing there.

The lure of offshoring works the same way for large companies. Byrne of Accenture is working with a "major transportation equipment company" that's planning to offshore more than half of its parts procurement over the next few years. Most of it will go to China. "We're talking about 30% to 40% cost reductions," says Byrne.

Yet no matter how hard you look, you can't find any trace of the cost savings from offshoring in the import price statistics. The furniture industry's experience is particularly telling. Despite the surge of low-priced chairs, tables, and similar products from China, the BLS is reporting that the import price of furniture has actually risen 6.7% since 2003.

The numbers for Chinese imports as a whole are equally out of step with reality. Over the past three years, total imports have climbed by 89%, as U.S.-based companies have rushed to take advantage of the enormous cost advantages. Yet over the same period, the import price index for goods coming out of China has declined a mere 2.3%.

FACADE OF GROWTH

The import price index also misses the cost cut when production of an item, such as blue jeans, is switched from a country such as Mexico to a cheaper country like China. That's especially likely to happen if the item goes through a different importer when it comes from a new country, because government statisticians have no way of linking the blue jeans made in China with the same pair that had been made in Mexico.

Phantom GDP can also be created in import-dependent industries with fast product cycles, because the import price statistics can't keep up with the rapid pace of change. And it can happen when foreign suppliers take on tasks such as product design without raising the price. That's an effective cost cut for the American purchaser, but the folks at the BLS have no way of picking it up.

The effects of phantom GDP seem to be mostly concentrated in the past three years, when offshoring has accelerated. Indeed, the first time the term appeared in *BusinessWeek* was in 2003. Before then, China and India in particular were much smaller exporters to the U.S.

The one area where phantom GDP may have made an earlier appearance is information technology. Outsourcing of production to Asia really took hold in the late 1990s, after the Information Technology Agreement of 1997 sharply cut the duties on IT equipment. "At least a portion of the productivity improvement in the late 1990s ought to be attributed to falling import prices," says Feenstra of UC Davis, who along with Slaughter and two other co-authors has been examining this question.

What does phantom GDP mean for policymakers? For one thing, it calls into question the economic statistics that the Federal Reserve uses to guide monetary policy. If domestic productivity growth has been overstated for the past few years, that suggests the nation's long-term sustainable growth rate may be lower than thought, and the Fed may have less leeway to cut rates.

In terms of trade policy, the new perspective suggests the U.S. may have a worse competitiveness problem than most people realized. It was easy to downplay the huge trade deficit as long as it seemed as though domestic growth was strong. But if the import boom is actually creating only a facade of growth, that's a different story. This lends more credence to corporate leaders such as CEO John Chambers of Cisco Systems Inc. ([CSCO](#)) who have publicly worried about U.S. competitiveness--and who perhaps coincidentally have been the ones leading the charge offshore.

In a broader sense, though, the problem with the statistics reveals that the conventional nation-centric view of the U.S. economy is completely obsolete. Nowadays we live in a world where tightly integrated supply chains are a reality.

For that reason, Landefeld of the BEA suggests perhaps part of the cost cuts from offshoring are being appropriately picked up in GDP. In some cases, intangible activities such as R&D and design of a new product or service take place in the U.S. even though the production work is done overseas. Then it may make sense for the gains in productivity in the supply chain to be booked to this country. Says Landefeld: "The companies do own those profits." Still, counters Houseman, "it doesn't represent a more efficient production of things made in this country."

What Landefeld and Houseman can agree on is that the rush of globalization has brought about a fundamental change in the U.S. economy. This is why the methods for measuring the economy need to change, too.