Notes for remarks before the U.S. Trade Deficit Review Commission by Bob McTeer, President and CEO, Federal Reserve Bank of Dallas

Welcome to the Dallas Fed. We're honored to be your host, and I'm honored you invited me to speak. I'll speak only for myself, of course, and not the Federal Reserve. Chairman Greenspan asked me to make that perfectly clear.

My first thought after receiving your invitation was my vacation in Scotland last year. I agreed to go on two conditions: that I not have to drive on the wrong side of the road and that we visit Adam Smith's grave. We found it. I saluted and even pulled a few weeds.

Perhaps I should just say I agree with Adam Smith on trade and let it go at that. As you know, his Wealth of Nations was an argument for free trade, internally and externally, and an argument against the fallacies of mercantilism. His absolute advantage arguments were later refined by others into the doctrine of comparative advantage, which has stood the test of time. But the case for free trade, accepted almost universally by economists, has always been a hard sell with the public.

One reason is the misleading terminology left over from mercantilism. Imports are a minus--or a negative--in balance of payments accounting, while exports are a positive. An excess of imports over exports is pejoratively called a "deficit," even though imports are what we get from trade and exports are what we give up.

Another problem is a common failure to consider secondary effects, as well as primary effects. For example, on the crucial issue of

jobs, it's commonly believed that exports create domestic jobs and imports destroy them. That's largely--but not entirely--true, as far as it goes. But that's only half the story. The other half is that exports and imports generally move up and down together, on a cause and effect basis. More imports lead to more exports and vice versa. As both grow, it changes the job mix but not the total number of jobs in any predictable way. If imports grow faster than exports, they will be financed by a capital inflow which will stimulate jobs indirectly. Any residual negative impact on jobs will be offset by a monetary policy dedicated to maximum sustainable growth. In short, trade affects the mix of jobs but not their total number.

This conclusion is, of course, connterintuitive and is viewed by many with suspicion. One reason is that jobs lost because of imports or plant relocations are easily identified and highly visible. Understandably, the people adversely affected make a lot of noise. Jobs gained through exports or capital inflows are not easily identified. That's because the gains from international trade are widespread and diffused. A lot of people are helped a little. The losses from trade are lower, but more visible and concentrated. A few people are hurt a lot. That makes trade protection tempting to politicians. The beneficiaries of protectionist measures know who they are and what they have at stake. Those harmed aren't as aware and individually have less at stake. Comparative advantage, however, ensures that the net result is positive in each trading country. Therefore, if society chooses to compensate the losers, it should be in some way other than trade restrictions.

I understand that the topic today is our trade deficit, rather than the benefits of free trade in general. I appreciate your indulgence. The

problem is that the evils of a trade deficit are frequently exaggerated and used as an excuse for protectionism. Please don't let that happen this time.

Turning to my take on *our* present situation, I need to provide just a bit more background, at the risk of some repetition. As you know, trade is carried out by people and companies, not by countries. There is no reason to expect millions of transactions with people of foreign countries to result in equal values of imports and exports, on the one hand, and equal capital inflows and outflows, on the other hand. Each would approximate separate balance if capital transactions were limited to those that finance trade. But with massive, independently motivated capital flows in the mix, our exchange rate will tend to clear the market for total transactions--not trade and capital transactions separately. Consequently, trade surpluses will be matched by capital outflows and deficits will be matched by capital inflows.

We have had a current deficit matched by capital inflows for several years now, and it increased during the Asian crisis. But this pattern of international payments is, in my opinion, a result of our economic strength rather than weakness. We've grown faster than our trading partners in recent years, stimulating our demand for imports relative to foreign demand for our exports. At the same time, our technology-driven economy, with its accelerating productivity, also attracts capital from the rest of the world. The United States has been the best place to sell goods and invest capital, resulting in our current pattern of international payments. Our strong dollar is additional evidence that the capital inflow--not the trade deficit--is the main driver. Viewed in this light, our international payments position reflects our relative prosperity--a sign of our economic strength and vitality.

Another way of looking at our international position is, however, somewhat less sanguine. We are not saving enough domestically to finance our domestic investment. We depend more and more on foreign savings which adds to our international debt. (Of course, not all international investment here is debt that needs servicing.) That need not create a burden if the investment is productive and generates the growth necessary to service the foreign debt. Nevertheless, our reliance *on* foreign debt has probably contributed to the decline in our saving rate. The decline in our personal saving rate has been partially offset by our fiscal budget's reversal from deficit to surplus, but our domestic saving needs to be boosted. Measures to stimulate domestic saving that are justified on their own merits will effectively reduce our current account deficit and our reliance on foreign savings.

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NAFTA has clearly succeeded in stimulating two-way trade with Mexico. U.S. job growth has been the envy of the world since the beginning of NAFTA, and our unemployment rate has fallen to 30-year lows. Trade with Mexico is roughly four times more important for Texas than it is for the United States as a whole. Texas employment growth has exceeded U.S. employment growth every year since NAFTA's inception. Unemployment on the Texas side of the border has declined significantly. U.S.-Mexican trade has benefited our border towns, although the border infrastructure needs improvement. Laredo has become a virtual boomtown, but the impact on El Paso has been mixed. My colleague from El Paso will say more about the border, especially the maquiladoras.

NAFTA's precise impact on trade is difficult to sort out because of the peso crisis and sharp Mexican recession in early 1995. Econometric work done at the Dallas Fed, however, concludes that the effect has been positive. We can make an updated version of that study available to you if you wish.

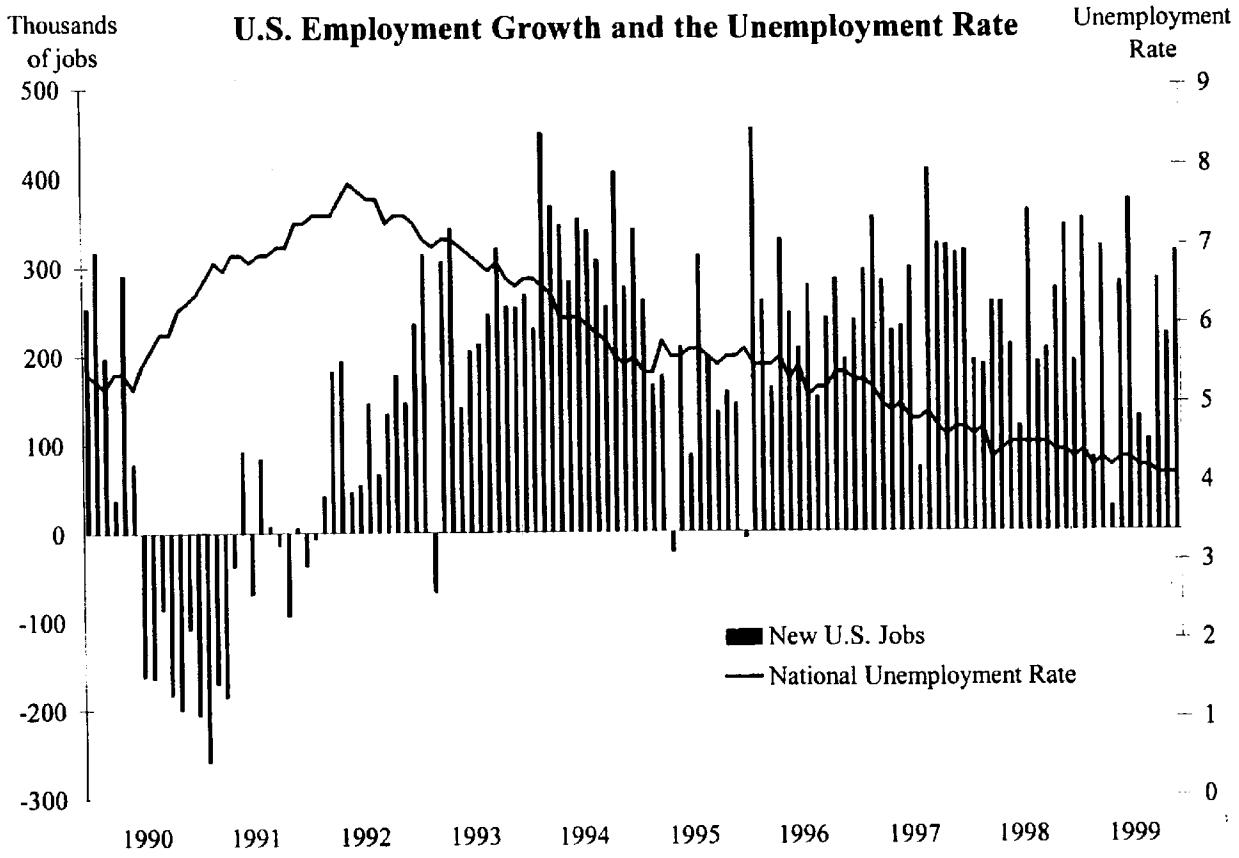
Let me close with my major conclusions. Our trade deficit--large as it is--is not currently a major problem. The trade deficit and the offsetting capital inflows are--both separately and combined--signs of economic strength rather than weakness. They have not slowed job growth nor increased our unemployment rate. The period since NAFTA has seen acceleration in U.S. productivity and output growth. Inflation and unemployment have declined substantially. I'm not saying NAFTA is the sole factor in our recent prosperity, but it has been a major factor.

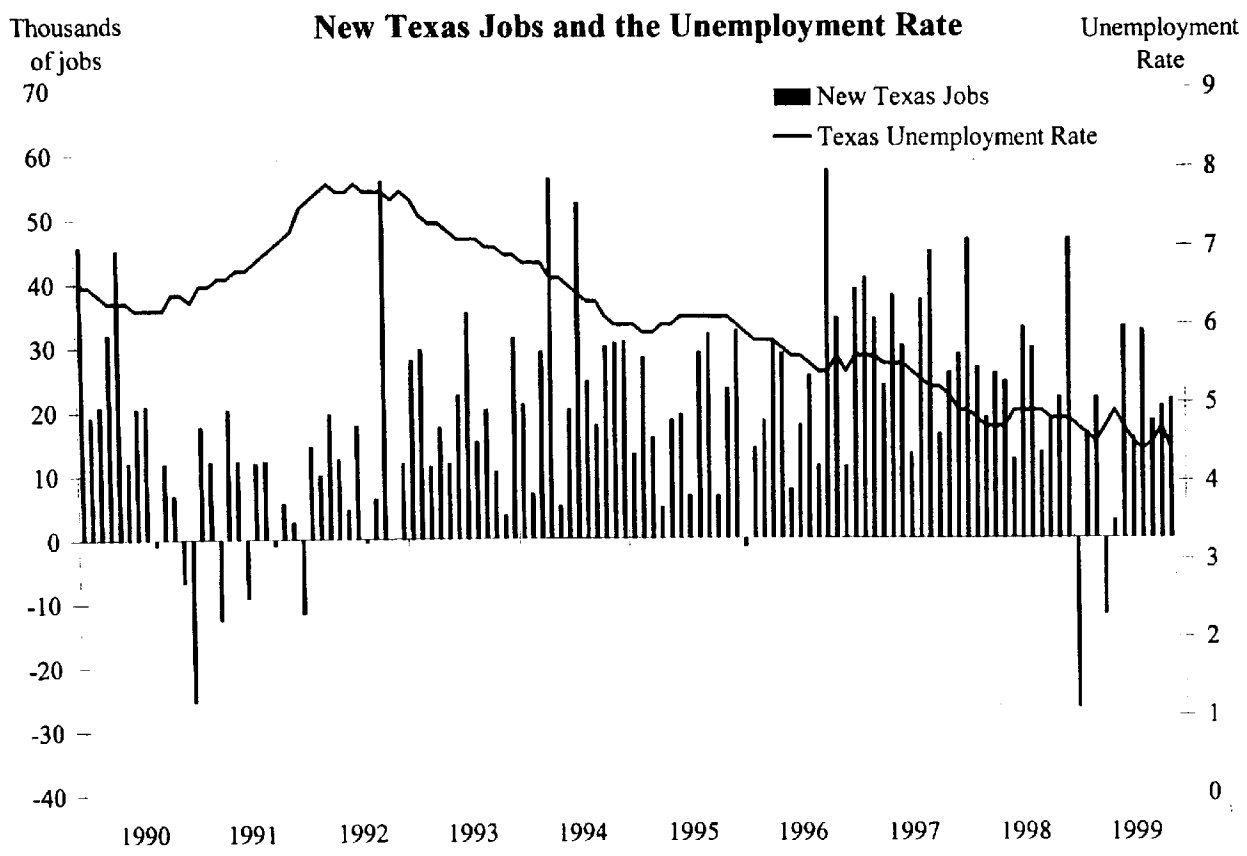
Free trade is more important than balanced trade. Measures to

reduce the trade deficit should not include restrictions on trade. Focus should remain on opening foreign markets to U.S. exports, not limiting imports.

The financing of continued large current account deficits may be a potential future problem if markets come to view it as unsustainable. The best way to deal with that is to promote domestic policies that encourage saving. Increases in national saving would tend to substitute for foreign saving and lead to a better balance in our international payments.

In addition to opening export markets and encouraging domestic saving without restricting imports or erecting new trade barriers, thought might be given to efforts to increase public understanding and reduce trade paranoia. In particular, demystify the World Trade Organization. The first step might be to change its name.


U.S. Employment Growth and the Unemployment Rate
Thousands of jobs
Unemployment Rate
500
400
300
200
100
0
-100
-200
-300
9
8
7
6
5
4
3
2
1
0
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
New U.S. Jobs
National Unemployment Rate


New Texas Jobs and the Unemployment Rate
Thousands of jobs
Unemployment Rate
New Texas Jobs
Texas Unemployment Rate
70
60
50
40
30
20
10
0
-10
-20
-30
-40
9
8
7
6
5
4
3
2
1
0
1990
1991
1992
1993
1994
1995
1996
1997
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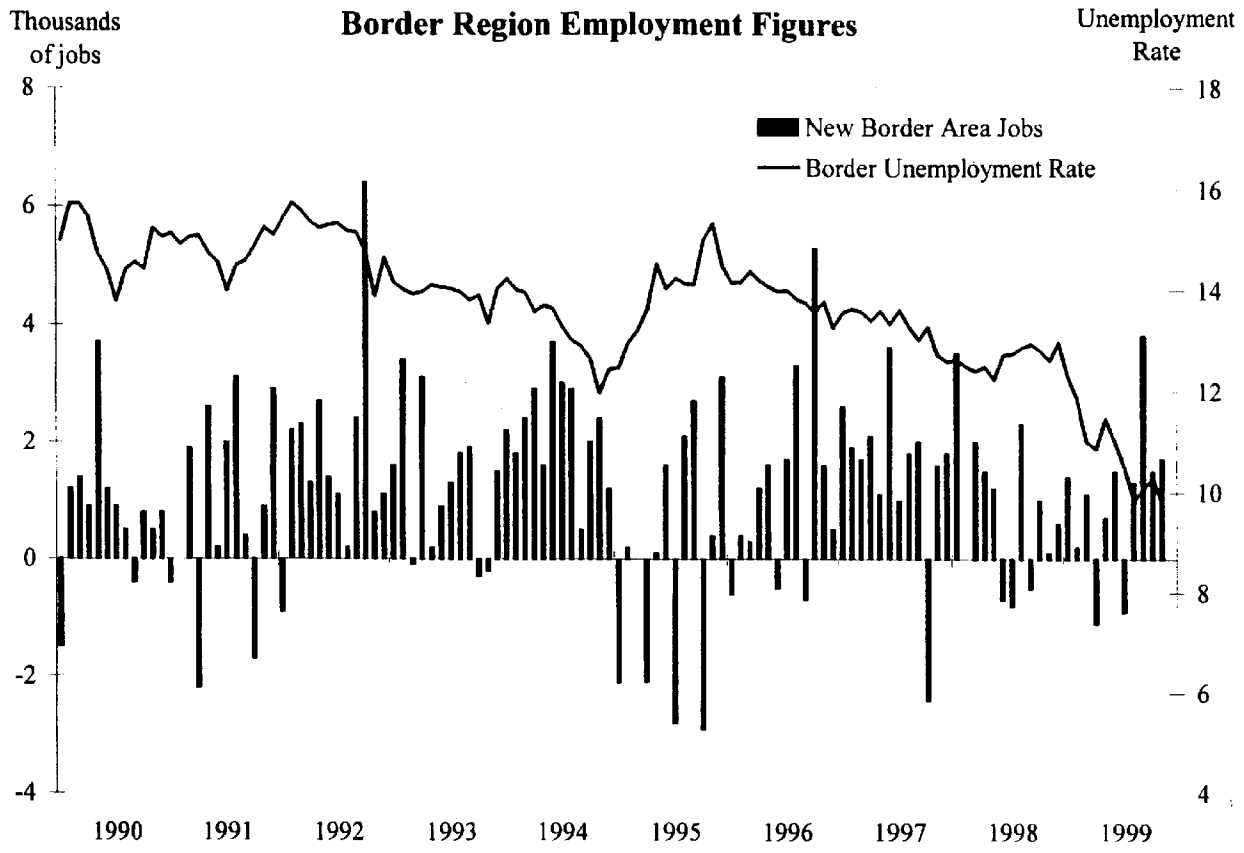
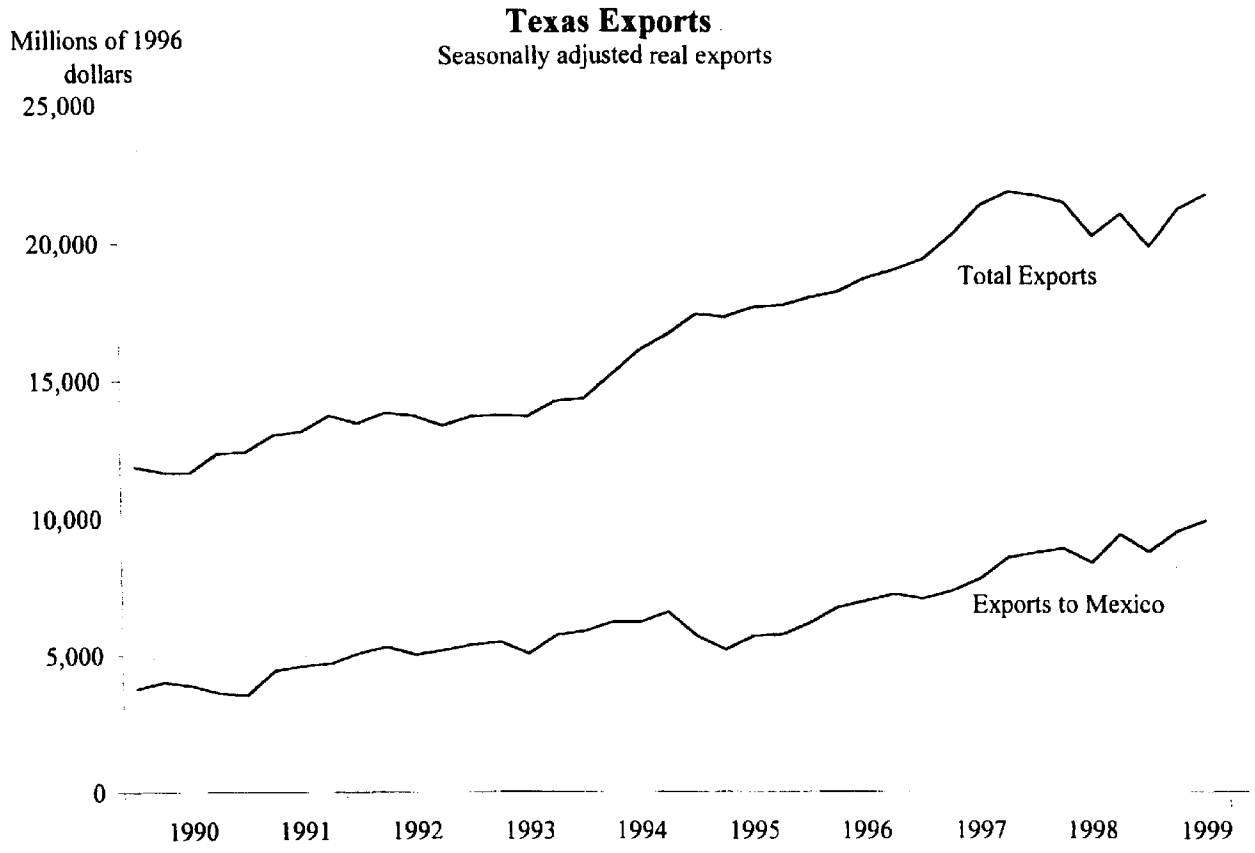
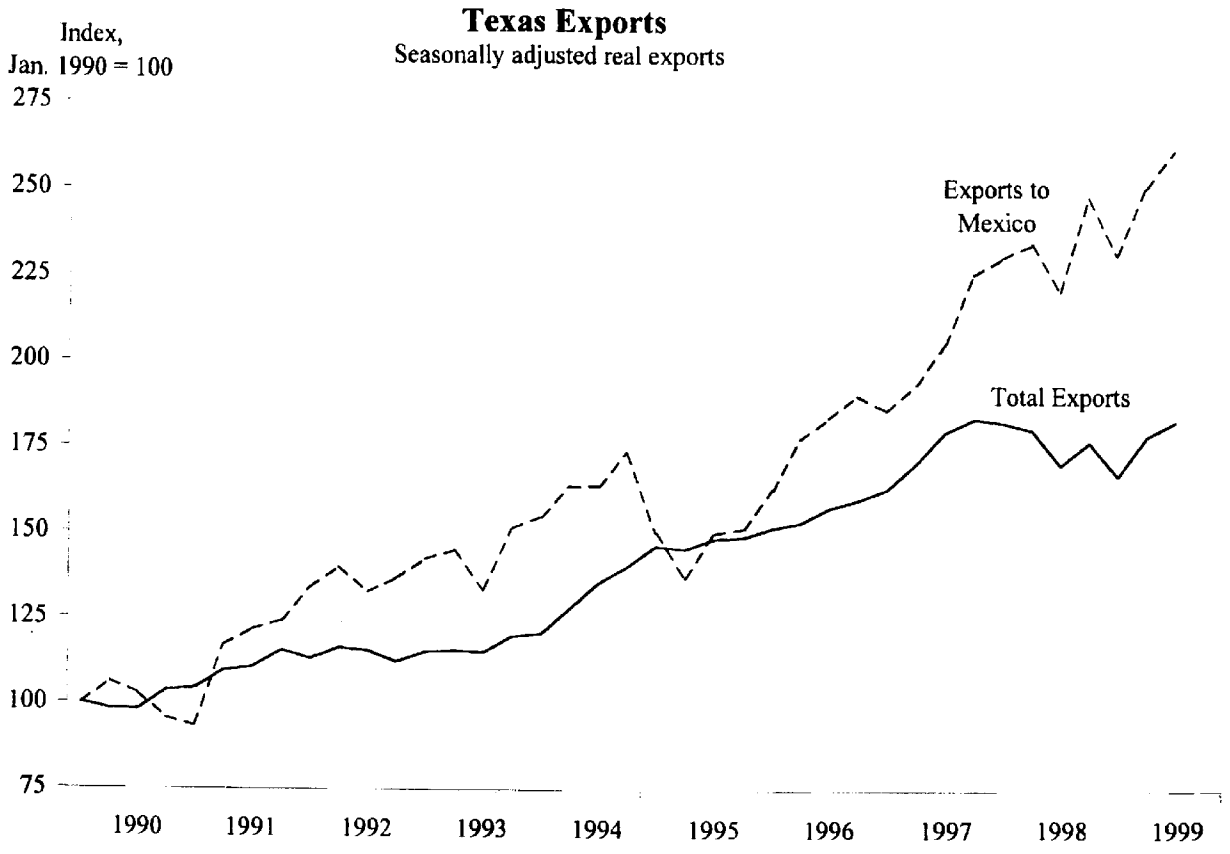
1999


Thousands of jobs
Border Region Employment Figures
Unemployment Rate
New Border Area Jobs
Border Unemployment Rate
8
6
4
2
0
-2
-4
18
16
14
12
10
8
6
4
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999


Texas Exports
Seasonally adjusted real exports
Millions of 1996 dollars
25,000
20,000
15,000
10,000
5,000
0
Total Exports
Exports to Mexico
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999


Texas Exports
Seasonally adjusted real exports
Index,
Jan. 1990 = 100
275
250
225
200
175
150
125
100
75
Exports to
Mexico
Total Exports
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999