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## **Thomas M. Hoenig**

President, Federal Reserve Bank of  
Kansas City

Dr. Hoenig took office October 1, 1991, as the eighth chief executive of the Tenth District Federal Reserve Bank, at Kansas City. Dr. Hoenig is currently serving a full term that began March 1, 1996.

Dr. Hoenig was born September 6, 1946, at Fort Madison, Iowa. He earned a B.A. in economics and mathematics from Benedictine College, Atchison, Kansas, and M.A. and Ph.D. degrees in economics from Iowa State University.

Dr. Hoenig joined the Federal Reserve Bank of Kansas City in 1973 as an economist in the banking supervision area. He was named a vice president in 1981 and senior vice president in 1986.

He has served as an instructor of economics at the University of Missouri-Kansas City and lectured on the U.S. banking and regulatory system for the People's Bank of China. Dr. Hoenig is a member of the Boards of Trustees of Midwest Research Institute and Benedictine College. He is a member of the banking advisory boards at the University of Missouri-Kansas City and at the University of Missouri-Columbia.

**The Benefits of an Open Economy**

Thomas M. Hoenig  
President  
Federal Reserve Bank of Kansas City

Opening Remarks  
Public Hearing of the U.S. Trade Deficit Review Commission  
Kansas City, Missouri

April 26, 2000

Welcome to the Federal Reserve Bank of Kansas City. We're honored to be your host today. I am Thomas Hoenig, President of the Bank, and I'd like to thank you for asking me to make a few opening remarks.

We are in the midst of a vibrant, some even say booming, U.S. economy. Last year, real GDP again grew at a rate above 4 percent. This is an exciting outcome and I would suggest that it can be traced to three elements of a sound economic policy environment.

- First, responsible fiscal policy enabled us to run a federal budget surplus in both 1998 and 1999, the first time we've achieved surpluses since the 1960s.
- Second, monetary policy provided an environment of low and stable inflation.
- And third, our trade policy recognized the importance of free and open trade.

By adhering to these fundamentally sound policies, we have enjoyed a resurgence in productivity growth and rising living standards.

It is interesting to me that while there seems to be agreement that replacing fiscal deficits with surpluses and moving toward a stable price environment have contributed importantly to a stronger U.S. economy, that there is increasing debate and less confidence regarding the benefits of our recent trade policies.

### **The opposition to free and open trade is unfounded**

There are any number of reasons for this erosion of confidence in our trade policy. As witnessed by this commission, for example, many people are concerned about the large and growing current account deficit. By the end of last year, it had risen to 3.7 percent of GDP, almost \$350 billion. As recently as the end of 1997, it was a more modest 2 percent of GDP. Thus, a large and growing current account deficit has caused some within the U.S. to begin questioning the wisdom of those policies that encourage open trade. The claim is that having

opened U.S. markets to the rest of the world, we are undermining our economic growth and paying for other countries' prosperity with American jobs.

While understandable, I believe these objections are misplaced. I too am concerned with the U.S. having a large and growing current account deficit, but I do not consider the remedy of trade restrictions to be useful. Certainly, a large and growing current account deficit poses a risk to the economic outlook and raises important questions. For example, can the United States continue to act as the "consumer of last resort" for the rest of the world? Will foreign investors be willing to continue lending to us? More generally, is the large and growing current account deficit even sustainable? But these questions and the very fact of a current account deficit are issues of macroeconomics, not of trade policy directly.

Other legitimate concerns focus on labor rights and working conditions, or the effects of industrial development on the world's environment. These are important issues, without question. But restricting trade hardly strikes me as the best means of solving them. Take the issue of labor conditions, for example. In studying the relationship between trade and labor standards, the Organization for Economic Cooperation and Development (1996) found that trade reforms, if sustained, lead to improvements in labor standards. That is, rising labor standards are the *result* of economic growth-not the cause-and that free trade is one of the main ways to bring about this result. Perhaps these kinds of findings apply to other of the issues as well. We need to find this out before we draw our conclusions.

**The case for free and open trade is strong**

Throughout history, even before Adam Smith wrote his famous *The Wealth of Nations* some 200 years ago, economic thinkers have repeatedly shown that open trade helps countries systematically raise their levels of wealth and income. Issues of job displacement and transition represent legitimate concerns. But as world trade has expanded we have dealt successfully with these issues, and in the end, added to both wealth and jobs.

Let's take a moment to consider some key facts.

In 1947, one of the first postwar trade agreements was the General Agreement on Tariffs and Trade, or GATT, the predecessor of today's World Trade Organization. GATT reflected the leadership of the United States in an expanding system of world trade. Since then, the average tariff in the United States has shrunk from about 20 percent to just 5 percent. Most of these gains have been passed on to consumers, raising our standard of living.

Since the first GATT agreement, the growth of real GDP in the United States has averaged nearly 3.5 percent per year. Meanwhile, our real per capita GDP has surged from under \$10,000 in 1947 to nearly \$30,000 today. For more than 180 other countries of the United Nations, average real GDP growth since 1947 has even exceeded that of the United States.

In 1995, economist Jeffrey Sachs and his colleague Andrew Warner studied the effects of trade policies in dozens of countries. Among the countries reviewed, he and Warner found that developed nations with open economies grew about 2 ¼ percent annually from 1970 to 1990, while developed nations with closed economies grew a meager 0.7 percent. The contrast among developing nations is even starker. Developing nations with open economies grew about 4 ½ percent, while developing nations with closed economies

grew less than 1 percent. Countries that switched from closed to open economies saw their growth rates climb on average by more than a full percentage point a year.

In addition to these facts, consider that despite their recent financial woes, South Korea, Singapore, and Hong Kong—countries that have opened their doors to trade—are far wealthier than countries with closed economies. It is no coincidence that these three countries have grown two to four times faster than India, Brazil, and Mexico—countries that have been slower to open their doors to trade.

In Hong Kong, real per capita GDP has soared from a U.S. equivalent of \$3,000 in 1970 to \$18,000 today. In China, that same measure of wealth has grown from \$100 to \$800—and most of that increase has come in the past ten years, as China has finally begun to pry open its doors.

In other words, what this information and history show is that trade is good for each participating country. The U.S. current account reflects, in part, just how much Americans have benefited from the world's willingness to meet our demand for goods, to hold our debt, and to invest in our projects. I am confident that our standard of living in the United States would be far lower, and our inflation rate far higher, if we were operating in a trade vacuum. The current account deficit also reflects how the rest of the world has benefited from our willingness to buy foreign-made goods. Indeed, events of the past couple of years have shown how trading partnerships helped developing nations pull out of financial trouble, thus averting a worldwide economic crisis that would have harmed us all.

Of course, I am not suggesting that enhancing wealth is the only goal of a society in building international relationships. Obviously, as I discussed earlier, there are many other

legitimate issues-such as labor rights, working conditions, and the environment- in building international relationships. But, as I have tried to suggest, while they are most important issues, they are not directly trade policy issues and should be addressed in another context.

I also am not suggesting that the act of removing trade barriers, by itself, assures a nation of prosperity. Any society that wishes to improve its economic wellbeing must first embrace a host of other economic and legal principles beyond open trade. A country must have a legal and market infrastructure in place to handle economic transactions. It must have the rule of law and contracts. Its people must be educated. And its fiscal and monetary mechanisms must work.

In other words, a country must develop certain internal systems. Only then can prosperity flow from negotiating fair agreements with other countries to open markets to new competition. The country then must develop ways of building products, and employing and redeploying resources most productively. And, of course, prosperity requires a system that provides incentives to work, to save, and to invest.

### **Free and open trade in the Tenth Federal Reserve District**

I think the agenda for today's meeting is quite important. Some people seem surprised when I tell them that international trade is important to the Tenth Federal Reserve District-a region in the heartland. But, as you have heard from Harry Cleborg this morning and will hear from Alan Barkema of our Bank this afternoon, free and open trade is becoming increasingly important for agriculture. And I can tell you that it is also important for small businesses.

In fact, let me leave you with a few observations about the impact of free and open trade on our District.

- The district ships a wide variety of products to foreign markets, including high-tech computer hardware and software, commercial jetliners, and food products.
- A substantial portion of the district's agricultural bounty is sold abroad, including more than 40 percent of the district's wheat crop and about 10 percent of district beef production.
- And finally, Canada is the leading market for district exports of manufactured products and the third largest for agricultural products, after Japan and Western Europe. District exports to Canada have grown rapidly in recent years. Manufactured exports are up nearly two-thirds since the North American Free Trade Agreement was enacted in 1994, and farm exports are up more than a third.

## Conclusion

In the future, the United States, as well as nations around the world, will face changes and challenges to our economic well-being. This is a simple fact of life.

But our successes will depend on how we **choose** to react to those events. If we react with barriers to trade, if we engage in a "beggar thy neighbor" policy, we will surely falter. Our incomes will shrink. And our prosperity will suffer, as will that of our neighbors. On the other hand, if we react with confidence in our market mechanisms, with patience and foresight, we will prosper-both now and in the long run, as we have in the past.

Finally, if I leave you with no other point this afternoon, let it be that any country that has worked hard to build and maintain its prosperity, or has gone from an underdeveloped

nation to a developed one, that country's economy and society have been outward looking. How sad it would be if we let our success convince us that we can afford to abandon our commitment to open trade. How sad it would be also to try and solve our concerns over the current account deficit by shrinking our economy through trade restrictions that harm far more Americans than it can possibly help.