Bob McTeer
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The Great Trade Debates and What's at Stake

Remarks before the World Affairs Council and Texas International Trade Alliance
Houston, Texas
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Most of my too-many speeches lately have been about our New Economy or, as we at the Dallas Fed call it, our New-Paradigm Economy. About how a surge in high-tech investment beginning about five years ago has raised productivity and output growth to new highs and reduced unemployment to new lows. About how increased global competition combined with technology to make our stronger growth and lower unemployment less inflationary than in the past. My optimism about our New-Paradigm Economy —bordering on exuberance, rational exuberance—has led some people to call me the Fed's New-Paradigm Optimist.

I plead guilty. I might say, however, that my optimism continues to be rewarded. This economy has been tough on pessimists. Last Friday, for example, we learned that employment growth last month was a vigorous 252,000 and that the unemployment rate declined to 3.9 percent, matching its April low, which was the lowest in about 30 years. Adjusted for changes in the composition of the labor force, 3.9 percent may be the lowest rate ever.

The national decline from 4.1 percent to 3.9 percent in the overall unemployment rate included a full percentage point decline in black unemployment, to 7 percent—the lowest level in history. Latino unemployment is close to historic lows.

Of course, as unemployment declines, other good things happen. Declining unemployment facilitated successful welfare reform and helped reduce crime and improve health.

We just learned last week that household incomes rose 2.7 percent faster than inflation last year to a record high of $40,816. The official poverty rate fell to 11.8 percent, the lowest in 11 years. That's because the average income of the bottom fifth of households rose 4.4 percent last year—the bottom 20 percent.

I don't know whether to quote Buddy Holly saying "Rave On" or Robert Earl Keen saying "The road goes on forever and the party never ends." Or perhaps, Alan Greenspan saying "The economy appears to be benefiting to an unusual but measurable degree from structural adjustments and improvements either set in motion by or resulting to a significant degree from policy adjustments made in an earlier time frame."

I just made that up. That New-Paradigm Economy I described

earlier is Alan Greenspan's economy. God bless Alan Greenspan.

Back to my being a New Paradigm optimist. Naturally, that means that after every speech, about the first question I'm asked is, "What do you worry about? What trouble is on the horizon?" In other words, what is the optimist most pessimistic about?

I don't like to play the forced pessimism or hypothetical-pessimism game because the "hypothetical" part often gets lost in the translation. Let's just say I'm somewhat less optimistic about two things: in the near term, energy prices; in the longer term, losing our nerve on free trade.

My story of faster growth with lower inflation since the mid-1990s has suffered from a little inflation creep over the past year. So far, it's been modest and primarily due to higher oil and gas prices. The overall CPI, which includes energy, has risen 3.4 percent over the past year. The core CPI, which excludes energy and food, has risen only 2.5 percent. The core PPI was up 1.5 percent.

My longer term concern has to do with our apparent loss of nerve —and momentum—on freer trade. Growing sentiment away from freer trade and investment appears to be related to an even broader questioning of the merits of global capitalism by a small but loud minority that appears to be intimidating trade policymakers. Without elaborating on that, let me just remind you of Seattle last year.

It's ironic and mystifying that anticapitalist calls for protectionism and socialism should come so soon after both failed so miserably and visibly and free market capitalism won the battle of the isms. Free enterprise is not only the best creator of wealth but is the only system compatible with individual liberty. But before I get any deeper into this longer term concern, let me return briefly to energy prices.

I know the energy capital of the world may not be the best place to worry out loud about high energy prices, but duty calls and my views have evolved somewhat.

People were conditioned in the 1970s to view sharply rising energy prices in the context of supply cutbacks by OPEC. Such price hikes are inflationary, and they also threaten recession. The dominant impact depends on monetary policy. Easing policy to avoid recession may increase inflation. Tightening policy to avoid inflation increases the risk of recession. That's the bad news on supply-induced price hikes. The good news is that cartels break down because the members have an incentive to cheat when they have excess capacity. OPEC and other major producers finally seem to realize that price hikes can be overdone and moderation has its merits for the longer term.

Recent price hikes don't fit the old pattern well. They had as much to do with demand growth as with supply restrictions. Indeed, supply has continued to grow, although not as fast as in a free market. Demand growth has coincided with a sharp Asian recovery, stronger European growth and still-strong North American growth. Limited refining capacity and low inventories have contributed and make it easier for the cartel to hold together.

Demand-pull energy price increases are more likely to remain higher longer and raise the risk of inflation relative to recession. As the comedian Dennis Miller says, of course, that's just my opinion. I could be wrong.

Futures traders think I'm wrong, and I hope they're right. They have prices declining sooner rather than later.

While I'm on the subject, let me just mention that energy prices constitute one of two differences in the pressures on the U.S. and Texas economies. Higher energy prices are a headwind for most of the country but are still a tailwind for Texas—especially Houston.

Another difference, although less important, has to do with our strong dollar. It's good for all consumers but is a mild headwind for producers and exporters. That's less true for Texas—the headwind part—because Texas exports are heavily weighted toward Mexico, which has a booming economy fueled by high energy prices.

A footnote on Mexico: I was in Mexico City last week, visiting with the governors of their central bank. They're very interested in the U.S. economy because Mexican trade is even more concentrated with us than ours is with them.

Texas is still a net beneficiary of high energy prices, but diversification makes the net benefit less than it once was. Airlines with Texas hubs are hit heavily, as is the petrochemical industry, which uses natural gas as inputs. Poor profits, poor cash flow and excess capacity have discouraged construction of new chemical plants on the coast, contributing to a decline in heavy construction in Texas.

Turning to trade, NAFTA has been a huge success. Trade has increased enormously in both directions, and no sucking sounds have been heard. That makes it doubly a shame that fast-track authority to expand NAFTA to Chile and perhaps other countries was denied. We also seem to have lost steam in our drive to make the Free Trade Area of the Americas (FTAA) initiative happen. The Seattle fiasco not only contributed to the failure to initiate a new round of trade liberalization, but the window breakers spouting nonsense seemed to have had some success.

Meanwhile, while we dawdle, Mexico has reached a free trade agreement with the European Union, which is also courting Mercosur, a customs union in South America. Within Mercosur, there's talk of a South American trading bloc negotiating as a bloc with the United States, NAFTA and the European Union. They are worried about unfair competition from the superpower. If protectionist winds are not blowing in Latin America, there's at least a breeze.

We need universal, worldwide free trade and free trade with the other planets, not free trade within regional blocs. NAFTA is consistent with universal free trade because it reduced trade barriers among its members without raising barriers to others. In contrast, Mercosur, like the European Union, is a customs union with common external barriers and is thus less compatible with

worldwide free trade.

An interesting new development in trade relations is discussed in an article that our Senator Gramm wrote for *The International Economy* magazine, titled "Why Britain Should Join NAFTA." His opening paragraph reads as follows: "Unfortunately, the world is evolving not toward free trade, but toward regional trading blocs that are becoming more protectionist. And nowhere is that more true than in the European Union."

Senator Gramm points out that the most recent members of the European Union had to raise their tariffs to join. His article is written in the context of Britain's future decision on whether to join the Euro zone. He says that "choosing a common currency means joining a country, and choosing a country means choosing values ... a political and economic philosophy."

A critic said the senator's proposal would result in the British Isles becoming a satellite of America at the mercy of American pressure groups and their congressional stooges.

Coming to the senator's defense was one Winston S. Churchill, former member of the British Parliament and grandson of you-know-who. His response to Senator Gramm's critic was as follows. These fears, he wrote, "are belied by reality."

> Is the Mexican legislature subordinate to the Congress of the United States? Is Canada under relentless pressure to join the almighty U.S. dollar? Are these two fiercely independent nations, by fact of their membership of NAFTA—a voluntary treaty, from which they can withdraw at any time, unlike member states of the EU—subjected to a relentless bombardment by regulations from Washington? Of course not. Not only does the United States not dominate its neighbors in these ways, it harbors neither the intention nor the desire to do so.
>
> Sadly, the same cannot be said for the EU, whose high functionaries seem to be inspired by a 1950s Kremlin mentality. No fewer than 26,000 regulations and directives drafted in Brussels—not amendable by our national Parliament—now have the full rigor of British law.
>
> Senator Gramm has performed a valuable service by reminding us that there may indeed be an alternative to the officious, protectionist, union-dominated, anti-democratic, socialist-minded Europe that threatens both our prosperity and our liberties.

That's the end of the quotation from Mr. Churchill.

Not all news is bad news on the trade front. Congressional approval of permanent normal trade relations with China was a hopeful sign. So was the recent expansion of H1-B visas for skilled immigrants needed for our high-tech industries.

I heard a country song recently by Sara Evans, who sang, and I quote, "He changed my mind with three chords and the truth." Naturally, when I heard that line, I thought of the difficulty economists have convincing skeptics of the merits of free trade. They've had the truth ever since Adam Smith published T*he Wealth of Nations* in 1776, but apparently they haven't found the right three chords to change resisting minds.

If economists made a list of the things they agree on, free trade would be at the top of the list. Unfortunately, economists don't talk much about what they agree on. They only debate their disagreements at the margin. That leaves the public and their congressional representatives with the impression that since the professionals don't agree, their instincts are as good as any on the subject.

That's dangerous because of the fallacy of composition, which you get into when you generalize from personal experience. What's true for the individual is rarely true for the nation as a whole. For example, money represents wealth for its individual owner but not for the nation as a whole. That was the point of Smith's *Wealth of Nations*, which was an argument against the mercantilist protectionists of his time and an argument for free trade, both internal and external.

One problem with the arguments for free trade is that its benefits are diffused among the many and its harm is concentrated among the few. Those harmed by freer trade are fewer in number, but they know who they are. The many who are helped are generally helped less, and they don't know what they have at stake. It's an ideal situation for political pandering and demagoguery.

One of the most troublesome fallacies making free trade a hard sell is the fallacy that it causes job losses. It's true that some jobs are lost and that other jobs are created. The jobs lost will be those that existed because of protection in areas of comparative disadvantage. Those gained will be those in areas of comparative advantage. The greater specialization coming from trade will increase total output in both trading nations. If society chose to do so, it could compensate the losers with the gains of the winners and have much left over.

Freeing up trade doesn't change the number of jobs; it changes the mix of jobs, for the better. It's an oversimplification, but assume that increased imports cost jobs in import-competing industries. And assume that increased exports create jobs in export industries. The thing to remember is that exports and imports change together and produce nearly offsetting changes in jobs.

When we import more, other countries have more money to buy our exports. When we export more, we get more money for imports. Exchange rates will adjust to keep those flows approximately the same. If exchange rates are fixed, the governments involved will have to provide compensating finance to maintain the balance.

One problem is that much of international trade theory and much of economics in general is counterintuitive. A wise man once said

that if economics made sense, we wouldn't need economists. Much of it seems not to make sense.

For example, Abraham Lincoln was a very good amateur economist, as I will show later. But he wasn't good enough to get international trade right. Here's what he is supposed to have said about tariffs: "I don't know much about the tariff, but I know this. If I buy a coat in England, I get the coat and England gets the money. If I buy a coat in America, I get the coat and America gets the money."

Every cab driver in the world would agree with that statement, but it's wrong. What Mr. Lincoln failed to consider was that when he bought the coat in England, someone in England would spend the proceeds in America, possibly on Texas cotton to make the coat. The bucks don't stop. You can't have one-way trade. If other countries won't buy from us (or lend us money), we can't buy from them. If we won't buy from them, they can't buy from us.

If we impose tariffs or quotas on steel imports, we may be helping a steelworker, but it will be at the expense of other U.S. workers—possibly farmers—who won't be able to export because the foreign country couldn't sell its steel here.

To protect some workers is to harm others. The problem is those protected know who they are and what they have at stake. The person harmed has no clue. Which one will be writing his congressman?

The most effective rhetoric against protectionism in the history of the world was used by my hero Frédéric Bastiat, who was a self-taught economist and a member of the French Parliament in the 1840s. Bastiat wrote—tongue in cheek—a petition to the chamber of deputies on behalf of the French candle makers wanting relief from the unfair competition of the sun. Listen to this:

> A Petition
>
> From the manufacturers of candles, tapers, lanterns, candlesticks, street lamps, snuffers, and extinguishers, and from the producers of tallow, oil, resin, alcohol, and generally of everything connected with lighting.
>
> To the honorable members of the chamber of deputies
>
> Gentlemen:
>
> You are on the right track. You reject abstract theories and have little regard for abundance and low prices. You concern yourself mainly with the fate of the producer. You wish to free him from foreign competition, that is, to reserve the domestic market for domestic industry.
>
> We come to offer you a wonderful opportunity for applying your...practice....

> We are suffering from the ruinous competition of a foreign rival who apparently works under conditions so far superior to our own for the production of light that he is flooding the domestic market with it at an incredibly low price....

Bastiat is referring, of course, to the sun. He asks for a law requiring the closing of all windows, dormers, skylights, inside and outside shutters, curtains, etc. Virtually all industries in France would benefit. There would be enormous multiplier effects, creating many new jobs and improving the national defense.

When I moved to Texas almost 10 years ago, the superconducting supercollider was just beginning construction. From reading the newspapers, I couldn't figure out what it was supposed to do. All the emphasis was on the number of jobs it was going to create. It may have been a good idea. But if it was, it shouldn't have been sold as a job creator.

My wisdom on jobs is this: If you want more jobs, replace all the bulldozers with shovels. If that doesn't get you enough, replace the shovels with spoons.

No, jobs are too important to waste. You shouldn't count jobs; you should make jobs count.

Actually, economic progress can be measured by job losses. It once took almost 90 percent of our population to grow our food. Now we grow more food with less than 3 percent of the population. Was that progress? Not if you measure progress by the job count. Progress is measured by productivity—output per hour worked—not by how many hours were worked.

What happened to farming yesterday is happening in manufacturing today. U.S. manufacturing today is very healthy. Its productivity is growing by leaps and bounds. That means that job growth in manufacturing is not keeping up with output growth. But that's a good thing. That's productivity growth.

The new jobs not being created in manufacturing are being created in our growing service sectors—in our new information/ knowledge economy.

Back to free trade rhetoric. After Bastiat's, the next-best free trade rhetoric I've found comes from Henry George, who is alleged to have said that protectionists want to do to their country in peacetime what the country's enemies want to do to it in wartime: shut its borders to imports.

The arguments against free trade are similar to arguments against new technology. Both trade and technology offer you more total output. Both involve many winners winning a little and a few losers, each potentially losing more. In both cases, their enemies know who they are, but not their beneficiaries.

Listen to this letter, written by Martin Van Buren, the governor of New York in 1829, and see if it doesn't ring true today:

January 21, 1829

To: President Andrew Jackson

The canal system of this country is being threatened by a new form of transportation known as "railroads." The federal government must preserve the canals for the following reasons:

One. If canal boats are supplanted by "railroads," serious unemployment will result. Captains, cooks, drivers, hostlers, repairmen and lock tenders will be left without means of livelihood, not to mention numerous farmers now employed in growing hay for horses.

Two. Boat builders would suffer and towline, whip and harness makers would be left destitute.

Three. Canal boats are absolutely essential to the defense of the United States. In the event of the expected trouble with England, the Erie Canal would be the only means by which we could ever move the supplies so vital to waging modern war.

As you may well know, Mr. President, "railroad" carriages are pulled at the enormous speed of fifteen miles per hour by "engines" which, in addition to endangering life and limb of passengers, roar and snort their way through the countryside, setting fire to crops, scaring the livestock and frightening our women and children. The Almighty certainly never intended that people should travel at such breakneck speed.

Martin Van Buren
Governor of New York

I said earlier that Abraham Lincoln was a pretty good amateur economist, although not good enough to get trade right. I thought of him when I read about the window breakers in Seattle who wanted, among other things, to help the plight of poor people in poor countries by refusing to trade with them. By not trading with them, we're somehow going to improve their environment and reduce the problem of child labor. Somehow, the problems of the world are caused by large corporations that employ people and by the free enterprise system that has produced unheard of wealth.

Instead they want the system that North Korea chose and left South Korea to languish in free enterprise. They prefer the advantages that East Germany had over West Germany. They want the pristine air and water found in the parts of the world not sullied by raw capitalist development—places like the former Soviet Union and Eastern Europe.

I don't have a clue how to argue with that kind of logic, the logic that has college kids all over the world trying to help child workers by taking their work away and their parents by refusing to buy their goods. I suppose parents in poor countries are not good parents.

They need our moral superiority and guidance. We need to remove their temptation to let their children work by removing the market for the fruits of their labor.

As I said, for some reason I think of the economic wisdom of Abraham Lincoln when I think of the window breakers in Seattle and the trashers of McDonald's in Europe.

I'll close with Honest Abe.

> Economic Principles of Abraham Lincoln
>
> You cannot bring about prosperity by discouraging thrift.
>
> You cannot strengthen the weak by weakening the strong.
>
> You cannot help small men by tearing down big men.
>
> You cannot help the poor by destroying the rich.
>
> You cannot lift the wage earner by pulling down the wage payer.
>
> You cannot keep out of trouble by spending more than your income.
>
> You cannot establish sound security on borrowed money.
>
> You cannot build character and courage by taking away a man's initiative and independence.
>
> You cannot help men permanently by doing for them what they could and should do for themselves.
>
> *Courtesy of the Clint W. Murchison, Sr., Chair of Free Enterprise, University of Texas*

About the Author

McTeer is chancellor of The Texas A&M University System and former president and CEO of the Federal Reserve Bank of Dallas.

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