TELECONFERENCE ON MEXICO AND THE U.S. LOOK TO THE FUTURE, BUILDING A FOUNDATION FOR TRADE AND CULTURAL EXCHANGE WAYNE STATE UNIVERSITY

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The Economy and Expanded Trade

I'm honored to participate in your workshop. The topic of building a foundation for trade between Mexico and the United States is of particular interest to me.

I had the opportunity to meet with President Fox last year when he spoke at the Economic Club of Chicago, and we discussed this issue in detail. And earlier this year, the Chicago Fed hosted cabinet member Juan Hernandez at our remittance conference on cross-border money transfer. Then just last month, Governor Ortiz and I met together at a conference for central bankers. Governor, it's good to see you again. So our two countries are bound by common issues, and, thanks to innovative technology such as we're using today, much less limited by distance.

As President Reid mentioned, I'm an economist by training and served as a deputy trade representative in the first Bush administration. So I appreciate your invitation to share my perspective on the economy and, in addition, to have the opportunity to discuss something I feel very strongly about — and that's the importance of expanded trade to economic prosperity.

I would note here that there are important linkages across countries. We at the Fed closely monitor developments abroad and assess their impact on the United States. At the same time, we recognize that the health of the U.S. economy influences economies beyond our borders.

Mexico, in particular, is very important to us. It is our second largest trading partner after Canada. And, of course, we are important to Mexico. Around 80 percent of Mexico's exports — more than 20 percent of Mexico's GDP — goes to the United States.

As a result, the relatively mild downturn in the United States — which led to much weaker U.S. imports — contributed to a downturn in Mexico, as well.

Hence, developments in the overall U.S. economy will have a major impact on the near-term economic outlook for Mexico and Mexican-U.S. trade.

Background on Federal Reserve

Before I discuss the economy in detail, I'd like to give a little background on the Federal Reserve and its role in the economy.

The Federal Reserve System comprises 12 regional reserve banks that, together with the Board of Governors in Washington, D.C., serve as the nation's central bank. The Chicago District covers a five-state area that includes all of Iowa and most of Indiana, Illinois, Michigan and Wisconsin.

I should acknowledge here that President Reid serves as a director of the Detroit branch of the Chicago Fed, and we greatly value his contribution to our organization. The board plays a key role in gathering information about the economy and in providing guidance and oversight for our activities.

As president of the Federal Reserve Bank of Chicago, I serve on the Fed's key policymaking group, the Federal Open Market Committee, or FOMC. This is the group chaired by Alan Greenspan that is responsible for determining monetary policy.

At each meeting, we report on regional economic conditions and share our outlook and policy recommendation for the national economy. After our discussion of the outlook, the FOMC makes a decision on where to set its target for the federal funds rate. Our goal is to foster the monetary conditions that are most conducive to the economy achieving maximum sustainable growth and price stability.

Clearly, this is a tough job. With regard to our current situation, while overall output has recovered from the recession we suffered last year, the economy is still experiencing uncertain times.

At our September FOMC meeting, the Committee left the federal funds rate target at 1¾ percent, the accommodative level it has maintained since last December.

The Committee also kept the accompanying "balance of risks" statement unchanged. From March until August, that statement had said that risks were balanced between economic weakness and inflation.

But during the August meeting, we changed the statement to say that we see the risks as being "weighted mainly toward conditions that may generate economic weakness." And we reiterated that statement at last week's FOMC meeting.

The committee noted that, "over time, the current accommodative stance of monetary policy, coupled with still robust underlying growth in productivity, should be sufficient to foster an improving business climate." But it added that "considerable uncertainty persists about the extent and timing of the expected pickup in production and employment owing in part to the emergence of heightened geopolitical risks."

Looking back, since the declines of last year, real GDP has risen for three consecutive quarters. Overall, growth since last year's third quarter has averaged 3 percent at an annual rate. Much of the support has come from the household sector. In addition, businesses are in the process of moving from liquidating inventories to restocking them. But even though a recovery in overall output has already occurred, the path of GDP growth has been — and could well continue to be — somewhat uneven.

Factors supporting economic recovery

We expect that the economic expansion now underway will continue. But what will keep the economy growing?

Aggressive inventory control means that stock levels are now very lean. Thus, some further lift from inventory investment can be expected. But this can only give a temporary boost to growth. To solidify the expansion, final demand needs to gain a firmer footing. Important to this will be the degree to which business fixed investment turns around. Furthermore, household spending needs to keep moving forward.

While a large number of factors will influence business and household spending over the near term, the key to the longer-run prospects for both of them is productivity, or output per unit of input. Ultimately, productivity growth is the key to improvements in our standard of living. On this front, we have reason to be optimistic. Improvements in technology and the skills of workers, as well as more flexible labor markets, led to an acceleration of productivity beginning in the mid-1990s that was more than double the rate of growth of the previous 25 years.

Moreover, productivity was unusually well maintained during last year's downturn, and, on average, productivity has increased at a remarkably robust pace over the past three quarters. This is a positive sign for the U.S. economy. The rapid gains we've seen in productivity support the growth in incomes needed to maintain the economy's forward momentum.

In our current situation, monetary and fiscal policies also have supported aggregate demand. Recognizing weaknesses in the national economy, the Fed began a process in January 2001 that reduced the federal funds rate target by 300 basis points over the course of the next eight months. After 9-11, the Fed cut rates by another 175 basis points in the last four months of 2001, and since then we have maintained the funds rate at the low level of 1¾ percent.

This accommodative stance bolsters demand throughout the economy. Fiscal policy moves, including last year's tax legislation and bills signed into law after 9-11 and early this year, also have been stimulative.

Finally, inflation remains relatively low and reasonably well contained.

Challenges to economy

I have just cited a number of factors supporting the economy. Yet challenges lie ahead. We now are all aware of the risk of potential terrorist attack. Even without another incident, the emphasis on heightened security has impacted, and will continue to impact, the economy. The cost of doing business is now higher, both through increased insurance premiums and the costs of providing heighten security and back-up contingencies.

Furthermore, businesses purchased a great deal of capital equipment during the late 1990s, greatly boosting their productive capacity. However, in some cases the increases in capacity exceeded what, in retrospect, was needed to meet demand. The resulting reductions in capital spending were a major factor in the recent downturn. Much of the overhang that led to the decline has been worked off. But even now in some sectors, such as telecommunications, substantial idle capacity remains. Thus it may be some time before the level of capital spending returns to where it was prior to the recession.

The economy is facing another important challenge today — How do we deal with the recent revelations of accounting improprieties and failures in corporate governance?

One of the cornerstones of capitalism is a transparent system of laws and regulations that are enforced in a fair manner. So if we find evidence of criminal behavior or fraud in the executive suite, we must root it out and prosecute. Those found guilty must be punished...which in some cases should include jail time.

These revelations have added a great deal of skittishness to an already uncertain business climate. They also have undoubtedly raised the cost of financing new investment — as evident from both the increased risk spreads on corporate borrowing, particularly for lower-grade issues, and the lower prices that would be coming to any new equity issues. And if lower stock prices were maintained, the resulting dent in households' balance sheets would be a negative factor for future household spending.

To be sure, to the extent that the news on misreported earnings and other accounting irregularities reveals that markets had been mis-evaluating risks and returns, then investors should be demanding higher premiums. The concern, however, is that they may go overboard in this regard.

Indeed, capitalism cannot thrive without entrepreneurial risk taking. If we are too risk-averse, we will stifle innovation and, with it, our ability to generate continual increases in our standard of living.

So the proper pricing — and regulation — of risk is a key element in shaping the future of our economy.

We're also operating in a world of increased geopolitical risk, with heightened concerns about developments in the Middle East. The geopolitical context and the shock of accounting and corporate governance failures, so soon after last year's downturn, certainly have added to the uneasiness about the course of the economy. So we are dealing with a good deal of uncertainty. Putting together the various positive and negative factors, we at the Chicago Fed anticipate that — though we could experience some periods of softness — on balance, moderate economic expansion will continue.

Open markets and expanded trade

Let me turn now to a subject that I believe is vitally important to our long-term prospects. And that's open markets and expanded trade.

We have seen dramatic growth in trade and investment across North American borders. This trend towards integration preceded the North American Free Trade Agreement, or NAFTA, but was certainly accelerated by it. Increased integration has been marked by substantial flows of people as well as goods and capital. In 2000, some 300 million people crossed back and forth over the U.S.-Mexican border. I understand that the border town of Laredo, Texas has the highest grossing Wal-Mart in the United States — thanks to the active cross-border commerce.

When NAFTA was being debated in the U.S. prior to enactment, the arguments focused on the benefits or costs in terms of jobs created or lost. That was almost certainly the wrong emphasis. Basic economic theory tells us that job creation depends primarily on the state of the macroeconomy, with a relatively small and mainly transitory effect from trade. Because of the strength of the U.S. economy, millions of jobs have been created in the U.S. since NAFTA was enacted.

In my view, the United States has benefited tremendously from its increasing ties with Mexico and the rest of the world. But it is not my purpose here to discuss the specific effects of NAFTA on either the United States or Mexico — whether effects on the overall economy or on particular industries. Instead, I want to talk more generally about the benefits of free trade...

Free trade a top news story

In recent months, free trade has been much in the news.

This past spring, the United States increased tariffs for steel and lumber. The European Union, Canada and Japan threatened to increase tariffs on a variety of products, including steel, citrus fruit, textiles and paper.

The World Trade Organization recently ruled that the European Union can impose up to $4 billion in penalties on the U.S. because its reduced tax rate on exports amounts to an illegal subsidy under international law.

In August, U.S. lawmakers recognized the importance of giving the President greater flexibility to negotiate, by passing the Trade Promotion Authority bill, also known as "Fast Track." This will enable the U.S. to participate fully in the current round of WTO multilateral negotiations.

And recently the Bush administration provided exemptions to its steel tariffs by excluding additional products, while the U.S. International Trade Commission ruled not to impose additional antidumping duties on cold-rolled steel.

In viewing these different actions, some commentators have questioned which way the world trading system is moving. Is it towards more openness or less? The issues are extraordinarily complex. But as part of the dialog, it is appropriate to take a step back and consider in broad terms who benefits and who loses from open markets and expanded trade. Let me turn to that subject.

Open markets foster prosperity

Despite recent economic uncertainty, the United States and much of the rest of the world have never before been as affluent as they are today. For example, in both the United States and Mexico, real output per capita has more than doubled since the mid-1960s and more than tripled since 1950.

We also have seen a dramatic rise in economic openness among nations. Since 1970, for example, total trade (measured as exports plus imports) by the United States has increased from 11 percent of GDP to nearly 25 percent today. In Mexico, the figures are even more dramatic, increasing from 16 percent to more than 64 percent today.

The parallel rise in openness and affluence is no coincidence. Economic studies have repeatedly found that openness promotes prosperity. Looking across the countries of the world, you find that the economies most open to trade and investment are those with higher per capita income. That is because cross-border investment fosters an efficient reallocation of resources that leads to productivity improvements, higher economic growth and, most important, a higher standard of living.

Moreover, freer trade makes economies more efficient. When firms can purchase the highest quality and lowest cost materials from anywhere in the world, their production costs fall. These lower costs lead to lower prices and better choices, which spread broadly throughout entire societies.

It's important to note that the benefits of lower prices are largest for those with low and moderate incomes. Because free trade lowers the price of everything from food and clothing to automobiles, those who spend the largest fraction of their income on these goods reap the largest gains.

Dealing with arguments against open markets

Despite these benefits, there are a number of groups, both here and abroad, who oppose free trade and open markets. Especially in cases regarding displaced workers, their concerns are serious and deserve our attention.

As trade barriers fall, some industries and their workers inevitably find themselves facing sharp competition from imports. While competitive pressures may cause some firms to contract their businesses and reduce their work forces, other firms will see input costs fall, allowing them to expand production and increase hiring. Moreover, net exporters, in particular, will see expanded opportunities as other countries lower their barriers to our goods.

In most cases, lowering barriers to trade promotes an efficient allocation of resources. But in some industries, like steel, many governments around the world have chosen to subsidize firms in order to keep high-cost factories in operation. The result has been persistent overcapacity in the global steel industry, high levels of production and low prices.

So producers in the U.S., Mexico or abroad may find themselves facing sharp competition from firms that are not necessarily more efficient than they are, but instead, receive subsidies. It's important to recognize that the problem there is not freer trade. The problem is government subsidy policies that work to keep inefficient plants open. We should encourage multilateral efforts that, over time, will reduce government subsidies that cause these problems. The new Trade Promotion Authority granted by Congress should make it easier to negotiate such agreements for the U.S.

Regardless of whether the patterns of trade reflect economic fundamentals or, instead, government subsidies, the shifts can be extremely difficult for workers and firms in the industries that compete most directly with imports. Overall, economic studies generally suggest that worker dislocation caused by trade accounts for no more than 10 percent of all displaced workers in the U.S.

Furthermore, during the 10-year expansion that ended in 2001, trade relative to U.S. GDP grew steadily, and at the same time jobs increased by more than 24 million. Thus from a broader perspective, society at large benefits when we open our borders. Nonetheless, we cannot ignore those who are displaced by trade. Indeed, the overall benefits to society of freer trade are large enough that we can afford to help those who are displaced by changes in tariff and non-tariff barriers.

The issues surrounding greater openness between nations extend beyond displaced workers and subsidies. As we move towards openness, debates focus on income inequality, the environment, health care and working conditions, to name just a few.

Despite the noise level surrounding this issue, I firmly believe that firms, workers and nations benefit from producing and selling goods globally. I believed it 10 years ago when I negotiated trade agreements. I still believe it today. In addition, I believe countries on both sides of the transaction stand to gain — particularly developing countries.

Because of NAFTA, North America now has one of the largest and most dynamic trading relationships in the world. The success of NAFTA in raising living standards throughout North America underscores the importance of expanding free trade globally. Indeed, NAFTA provides a clear example that trade agreements between developed and developing countries can work to the benefit of both.

Conclusion

Let me conclude with some final thoughts on the U.S. economy and free trade…

During the last 20 years or so, we've deregulated financial markets, developed more flexible labor markets and made major advances in technology. We're also committed to free trade, and have worked to strengthen our partnerships with countries around the world — including our neighbor, Mexico. These efforts help foster solid noninflationary economic growth at home and contribute to greater openness and prosperity abroad.

Looking ahead, while we are faced with some uncertainties in the near term, the long-term prospects for the U.S. economy are good. This bodes well for the U.S. and for the continued expansion of our successful trade relationship with Mexico.