



fedgazette

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Timothy J. Kehoe on the regional impact of international trade

Editor's note: Congress is currently debating the merits of free trade agreements with countries around the world, including the controversial Central American Free Trade Agreement, or CAFTA. Timothy J. Kehoe is a professor of economics and Distinguished McKnight Professor at the University of Minnesota and an adviser to the Federal Reserve Bank of Minneapolis. He has



conducted research and written extensively on matters of international trade, including a [study](#) last fall on the impact of CAFTA's counterpart, the North American Free Trade Agreement (NAFTA).

fedgazette: Your NAFTA research focused on the effects of that trade liberalization specifically for Minnesota and Wisconsin. What did you find?

Kehoe: First, let's step back and think about what happened with NAFTA. When countries change their trading patterns, how do they change them? We have seen a big change in U.S. trading patterns over the last 15 years, with trade becoming much more concentrated with Canada and Mexico, which are by far the United States' most important trade partners, although China is on its way.

There are two ways that a country can change its trading pattern when it starts to trade more. Let's concentrate on the United States and Mexico. Either we export more of the same goods to Mexico as before, or we start exporting goods that we were not trading before.

Which of the two ways is more important? Well, Kim Ruhl (a former research assistant at the Fed, now an assistant professor at the University of Texas-Austin) and I started looking at this question at the national level about three years ago, and what surprised us is the bulk of the trade increase in North America was not from exporting the same goods as 10, 15 years ago just more intensely. Rather, we were starting to export goods that were never exported before.

So then we looked at Minnesota, and we saw that Minnesota's trade pattern was out of whack with the pattern of the rest of the United States. Minnesota exports very little to Mexico compared to, say, its exports to Europe and Japan. (Canada is Minnesota's top trading partner.) At the same time we found that Minnesota, compared to the United States as a whole, was not expanding exports in new goods.

So then we wanted to do a comparison. And what better state to compare ourselves with than our neighbor to the east? And we found some interesting things. Wisconsin has been much more successful at expanding its exports than Minnesota. Why? We found that a huge amount was accounted for by expanded exports to Mexico.

fedgazette: So what accounted for the difference?

Kehoe: One of the stories that people tell is that big firms in Minnesota—3M, Honeywell, Medtronic—are Europe-oriented. They are not looking for export opportunities in Latin America. Wisconsin had a huge trade increase, and we found it was all driven by Canada and Mexico. Chemicals, and allied products, rubber and plastic products, textile products, apparel, clothing, furniture and fixtures—these are all sectors where Wisconsin was experiencing something like 500 percent growth in its exports to Mexico.

In Minnesota we see some big successes, particularly in paper and allied products. But overall, Minnesota did not get this

kind of big expansion in the products it had not been exporting before, the same way the United States as a whole or Wisconsin had.

fedgazette: Is there something that Minnesota was maybe doing wrong or not doing that would have changed the picture?

Kehoe: It's hard to know the exact cause. Could it be the educational system that is not making young people as aware of things like the Spanish language and Mexico and what the importance of Latin America is? I don't know.

One other story is that the firms in Minnesota that, for one reason or another, do not see the opportunities in places like Mexico are not big firms; they are small firms. In Wisconsin, the state government claims that a lot of export expansion is by small firms that had never exported, and that increase is being driven by the Wisconsin state trade office in Mexico City.

That needs to be investigated more. Now, we can ask whether a foreign trade office is a sensible use of state funds. If you are a small or medium-sized firm and you are thinking about exporting, there are lots of costs you have to pay to obtain information and establish contacts. To the extent a state trade office can do that for you, it certainly can promote and direct your exports in the direction that the state trade office wants. Is it a sensible thing to do? The state trade office can do things—obtain information, set up contacts—that are good for one firm, but it can also provide the same services for other firms at a very low cost. But the Wisconsin trade office doesn't provide these services to Minnesota firms, only to Wisconsin firms, and it provides these services at a very low cost compared to the cost that the firms themselves would have to pay.

So we have to look at other state trade offices overseas. There have been academic studies, but they are not particularly conclusive, and the particular kind of methodology and models that they were using were not concentrating on the essential thing—whether state trade offices cause exports to expand, to grow, particularly among small companies.

fedgazette: There's also a debate about free trade agreements and regional trading blocs versus multilateral trade. What do we know about the benefit of regional trade blocs, and how does it differ from globally open borders?

Kehoe: This is a very deep and important question for U.S. trade policy in general. Even just within Latin America, we are now signing a lot of trade agreements with little countries because we are having trouble pushing forward with the Free Trade Agreement of the Americas (a trade pact among all countries in the Western Hemisphere), to which we committed in principle 10 years ago. The stumbling blocks are Brazil and Argentina. They want something different than the United States wants, so the Bush administration has decided to follow a piecemeal approach.

What about multilateral trade liberalization? Trade is becoming more concentrated in North America, and trade is becoming more concentrated in Europe, instead of increasing across the two sets of countries. I think there are big potential gains in getting away from that. It's just politically difficult. We saw that in the last round of WTO (World Trade Organization) negotiations. The big stumbling block there was agriculture. I think for the United States as a whole there are going to be big advantages in obtaining freer trade in agriculture.

That's why the United States is cautiously on the side of the developing countries in pushing for freer trade in agriculture.

But if we think about our own region, we have to be honest. When Europeans are accused of being protectionist in agriculture, one of the prime examples they want to bring up of protectionism in the United States is the U.S. sugar policy. And when we talk about U.S. sugar policy we need to talk about western Minnesota and eastern North Dakota, where a lot of people's livelihoods depend on protectionism in sugar.

fedgazette: Jim Horvath, from American Crystal Sugar, said that the sugar industry is not protectionist—they're in favor of multilateral trade negotiations, and they don't like these regional trading blocs; the American sugar industry would be competitive if everyone gave up their subsidies. (*Editor's note: The May 2005 fedgazette features an [article](#) on the sugar beet industry and CAFTA.*)

Kehoe: That is the kind of issue that needs some economic analysis. It is entirely possible that Horvath is right when he talks about what would be the equilibrium price of sugar with no barriers to sugar trade. On one hand, the U.S. sugar industry would face lots of competition from the Caribbean and Central America, but, on the other hand, our ability to sell to countries in Europe would expand so much that it would make up for it. That is entirely possible. But what is wrong is to say that U.S. sugar policy is not protectionist. The U.S. sugar policy is heavily protectionist.

fedgazette: Looking forward, what will trade growth look like over the next 10 years or so?

Kehoe: There is a huge potential for expanding our trade in Latin America. Right now, Mexico does a lot more trade than the rest of Latin America combined, even though the rest of Latin America combined is far bigger than Mexico. So, if countries in Latin America, especially Brazil and Argentina, open up to U.S. trade to the same extent Mexico has, it would give us a huge opportunity for expanding our exports.

What does that mean for the future? Well, the United States is currently in the process of negotiating or has just negotiated free trade agreements with a large number of countries in Latin America. The kinds of models that Kim (Ruhl) and I look at suggest that you pay a certain kind of fixed cost to set up export opportunities. To the extent that firms that have learned to export to Mexico have already paid a lot of the fixed costs that would be involved in exporting to Latin America, you would think that is going to give the average Wisconsin or U.S. firm an edge that Minnesota firms don't have. Instead, Minnesota firms concentrate on exporting to Canada, Europe and Japan, where it does not look like we are going to have huge expansion in exports, at least in the near future.

Right now, when we talk about world trade, the wild card is China. China has become tremendously important in world export markets, but it's not clear where China is going. China is producing and exporting a lot of manufactured goods, like textiles and electronics. And it dominates the world toy market. China is importing raw materials, but its trade surpluses are enormous. That will not continue forever.

China is so big—1.4 billion people, twice the size of Latin America. China is the country that has kind of come out of nowhere in the last 10 years as far as world trading patterns. We are going to have to see what will happen there.

fedgazette: In the early 1990s, you were involved in trying to predict what the impact of NAFTA would be when that agreement was being hammered out. And then more recently, you've kind of reflected on that experience and the accuracy of different models that were used. Can you give us a summary of what we've learned looking back?

Kehoe: What those models missed was the mechanism for increasing trade, and it was not traditional comparative advantage that economists study. We thought, if a firm was already good at exporting a certain product, then, if you lower barriers the same firm will export more of that product. And that does happen, but that is not where the big growth in exports comes from.

The big growth comes from the export of goods that were not exported before—a phenomenon that is inherently more difficult to predict. What it really boils down to is that firms export, not countries or states. A firm sees changing export opportunities, and it has to make the decision whether to pay the costs to get into that market or not. What the evidence shows is that Wisconsin firms made that decision to get into the Mexican market, and Minnesota firms did not. If we can really figure out why that happened, then we can build better models to predict what is going to happen in the future. We are still at the stage where we are trying to figure out why.

fedgazette: What about policies that stifle trade?

Kehoe: Well, let me tell you one thing that Kim (Ruhl) and I have found that was surprising. Right now the United States is going through a period where the value of the dollar is very low. Traditional economic theory tells us that we should be expanding our exports very quickly to those countries that have much stronger currencies, such as the euro, whose real exchange rates have appreciated a lot compared to the dollar. Well, that is not happening.

What is the reason? Firms look at that favorable real exchange rate and they think about exporting to Europe, and they are not sure how favorable that real exchange rate is going to be in a couple of years. Real exchange rates fluctuate a lot; five years ago, the euro was very much depreciated in real terms versus the dollar.

But, when there are changes in policy, like NAFTA or multilateral trade liberalization under the WTO, firms respond because they know that if trade barriers are lowered by, say, 10 percent, they are lowered by 10 percent permanently. It's not quite the same as real exchange rate fluctuations, which are transitory. The evidence we have been looking at shows that firms respond to changes in trade policy. It's easy to say, looking at an economics textbook, "Ah, the weak dollar leads to expanded export opportunities for U.S. firms." But we are not seeing it much in the data. What really expands export opportunities are changes in policy that guarantee a payback on a fixed investment of getting into a market, setting up a distribution network and so on.

And that will make us change our thinking not just about economic theory, which it is already doing. It's going to make us change our analysis of trade policy. I think it is going to prove the importance of trade liberalization.

fedgazette: Are you suggesting that the dollar's slide has had a small effect on trade?

Kehoe: Well, what is for sure is that the dollar has slid and U.S. trade deficits are still huge. And U.S. exports to Europe are not very responsive to the dollar/euro real exchange rate. We see the fall in the value of the dollar and we do not see a big expansion in exports, but we see changes in trade policy and we see a huge expansion. That is because firms are choosing to pay the fixed costs of moving into new markets when trade policy changes but not when real exchange rates change.

fedgazette: Thank you, Professor Kehoe.

—Joe Mahon

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