NAFTA's Effects on North American Economic Development: A United States Perspective

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I would like to thank the organizers of this conference, and the Canada Institute of the Woodrow Wilson Center for International Scholars, for inviting me to participate. I have long admired both the University of Toronto and York University and the scholarship that emanates from them. It is a pleasure to be here, in this beautiful setting, to participate in these discussions of important topics.

I was asked to give a perspective from the United States on the impact of the North American free trade agreement (NAFTA) on North American economic development. Accurately assessing the effects of NAFTA on North American economic development is an exceedingly difficult task. The agreement was negotiated and implemented during a time of rapid technological change that was, in itself, driving global economic integration. At the same time Mexico was engaged in a profound reform of economic policies, and for a variety of reasons experienced a severe financial crisis just after NAFTA went into effect. Sorting out precisely the effects of the NAFTA agreement in the midst of other influences is beyond the capabilities of economic science at this time. Consequently, the evidence is mixed and conflicting opinions and assessments abound. But some interesting empirical work done recently sheds important light on the subject. I should at this point give a disclaimer that my perspective on this issue will be painted with very broad strokes, and is seen through the somewhat restricted lens of one whose professional training is in economics.

It may be good to begin with some discussion of what each of the three countries hoped to gain from North American economic integration--that is, what were the objectives of each of the three players? For the United States, this must be seen within the broader context of the trade and foreign policy goals of the United States. From the formation of the GATT in 1947 until the early 1980s, the United States had been a staunch proponent of the multilateral trade regime and had forgone bilateral or regional trade agreements. However, after the completion of the Tokyo Round in 1979 progress within the multilateral arena seemed to have stalled. The United States wished to take advantage of its strengths in agricultural production, high-technology industries, and services, but attempts to liberalize trade in these sectors had met with little success. The US Trade Representative at the time, William Brock, decided that progress on these issues might be possible in bilateral or regional agreements, and that progress in those venues might provide a breakthrough in the multilateral arena.[1]

Brock first approached Middle Eastern countries with the idea, but only Israel responded favorably. He then turned to the countries of North America. Canada, in the face of considerable opposition from some groups within the country, responded favorably to the suggestion of a free trade agreement with the United States, but Mexico demurred. It was several years later that the government of Mexico decided that it was in the best interests of that country to also have a free trade agreement with the United States.

Viewed from the standpoint of the original objective of the United States--that is, to provide a template for progress on new issues within the multilateral trading system, this strategy would have to be judged a success. The Uruguay Round agreement brought services trade within the disciplines of the multilateral regime for the first time, yielded important reductions in agricultural distortions, and included innovations regarding

[1] Personal conversations with Ambassador Brock during January 2004.

investment regulations, intellectual property, and dispute settlement. Many of these changes were patterned on provisions of the US-Canada FTA and its successor, NAFTA.

While the US-Canada FTA had hardly appeared on the radar screen of most Americans during its negotiation, since NAFTA involved economic integration with a much less developed country, it was highly controversial in the United States. Organized labor and presidential candidate Ross Perot predicted mass unemployment in the United States as capital was lured by the lower wages (and lower environmental standards) of Mexico. Pat Buchanan railed against the loss of US sovereignty that he and others foresaw as resulting from NAFTA.

As it turned out, very little movement of production from the United States to Mexico actually occurred. In the years during which NAFTA took effect the United States economy was in a boom phase, so millions of jobs were created and the unemployment rate fell. The special adjustment assistance measures put in place for NAFTA-affected workers were hardly used. About the only US industry seriously affected by NAFTA was the very labor-intensive apparel industry. (Klein, et.al., 2005) The share US foreign direct investment going to Mexico increased from only about 3% to around 4%, a minuscule flow of capital when compared to total annual investment of the United States.[2] None of the dire events predicted by NAFTA opponents in the United States actually came to pass.

Canada

Canada's primary objective in seeking a free trade agreement with the United States was secure access to the market that accounted for almost three-fourths of its foreign trade. During the 1980s, the combination of stringent monetary policy and expansionary fiscal policy had driven interest rates in the United States to historically unprecedented levels, which in turn strengthened the value of the US dollar. The resulting difficulties of both export firms and import competing firms in the United States had ratcheted up protectionist pressures in the Congress. While the target of most of the protectionist rhetoric was obviously Japan, Canada was understandably made nervous by it. The prospect of guarantees against new trade barriers through a free trade agreement was appealing. Canada also hoped to depoliticize trade disputes, particularly those involving antidumping and countervailing duties.

Canada was not successful in either harmonizing trade remedy laws or exempting itself from their application. However, it did gain a more effective dispute settlement mechanism. Certain trade disputes, such as the softwood lumber dispute, which are politically charged and complicated by differences in the economic systems of the United States and Canada, have thus far proved to be intractable.[3] But, in general, the dispute settlement mechanism has functioned reasonably well and has provided some additional security of access to the United States market.

A secondary objective of Canada in seeking free trade with the United States was the rationalization of Canadian industries. Some of these industries were protected by relatively high trade barriers, and given the geographically fragmented Canadian market, they were shielded from competitive pressures and unable to realize the benefits of

[2] U.S. foreign direct investment in Mexico in recent years has been equivalent to only about 0.2% of gross private domestic fixed investment of the United States.
[3]For a more detailed discussion of the softwood lumber case, see (McKinney, 2004)

economies of scale. Increasing trade with the United States would expose such industries to increased competition, and would provide opportunities for expanded production that the domestic market could not provide.

From the time that the US-Canada FTA went into effect, Canada has become much more dependent on international trade, and an increasing share of that trade is with the United States. Canada's exports of goods and services as a percentage of GDP expanded remarkably from 25% in 1989 to 43% in 2002, with exports to the United States increasing from 18.6% to 37.6% of GDP during the same period. Imports of goods and services to Canada as a percentage of GDP grew from 25.8% to 38.1%, with the United States share increasing only marginally, from 68.3% to 71.1%. In contrast, between 1989 and 2002, inter-provincial exports in Canada fell from 22.5% of GDP to 19.7%. In 2001, nine of ten Canadian provinces exported more to the United States than to other provinces, as compared to only two provinces that did so in 1989. (Courchene, 2005) Canada's economy has definitely become more integrated with areas of the United States and relatively less integrated across provinces.

However, it is not at all clear that the free trade agreements in North America have been mainly responsible for the increases in trade between the United States and Canada. International transactions during this period were increasing rapidly around the world, not just within North America. Between 1988 (the year before the US-Canada free trade agreement went into effect) and 2002, Canada’s share of United States merchandise exports increased only slightly, from 21.4% to 22.6%. Canada’s share of United States merchandise imports actually declined slightly, from 18.6% to 18.1%. The share of the United States in Canada’s merchandise imports has also declined, from 64.5% in 1990 to 62.7% in 2002.[4].

The most significant change has been in the United States share of Canada’s exports, which increased from 74.9% in 1990 to 87.2% in 2002. (DFAIT, 2003) Empirical studies indicate that this expansion was caused primarily by the rapidly growing United States economy during the 1990s combined with the trade effects of a depreciating Canadian dollar (caused primarily by depressed natural resource prices). After reviewing the existing empirical work on this subject, James Lee (2002) has estimated that the free trade agreements accounted for only about 9% of the increase of Canadian exports to the United States.

Nevertheless, because Canada previously had relatively high trade barriers, and since trade with the United States was such a large proportion of its total trade and its national income, the Canadian economy has felt a significant impact from the US-Canada free trade agreement, and subsequently from NAFTA. Some of the more sophisticated work estimating the specific effects of the trade agreements on Canada has been carried out by Daniel Trefler (2001). He found clear evidence of significant long-run productivity gains resulting from trade liberalization, but also that short run displacement of workers had been substantial. Specifically, Trefler found that the FTA caused significant skill upgrading in the Canadian work force and narrowed wage differences in the economy slightly; that in the most trade-impacted industries employment had been reduced by about 15% and output by 11%; that labor productivity had increased in the manufacturing sector by 4.7%, and in the most trade-impacted industries by 16.6%. In Trefler’s words, "Dramatically higher productivity in low-end manufactures and resource

[4] Calculated by the author from trade statistics reported by U.S. Department of Commerce

re-allocation to high-end manufactures are the key gains from the FTA." (Trefler, 2001) It appears that the FTA and NAFTA have had the anticipated and hoped-for effect of improving the efficiency of Canadian industry—productivity gains that over time improve a nation's standard of living.

Canadian opponents of the FTA and NAFTA worried that free trade would cause Canadian industries to be taken over by US firms, and that many firms would move to the lower labor cost areas of the US and Mexico. As it has turned out, Canada and the United States have become relatively less important to each other as foreign investment partners during recent years. Canada's share of foreign direct investment in the United States fell by almost half, from 18.4% in 1988 to10.2% in 2000. (Rugman, 2003) Likewise, the United States share of inward foreign direct investment in Canada declined from 72% in 1986 to 67% in 2001. (Globerman and Storer, 2003)

Free trade opponents also were concerned that the competitive pressures from free trade would erode support for social programs, such as Canada's cherished national health care system. I am not aware of any adverse effects from the FTA or NAFTA on the Canadian health care system. Any convergence of the US and Canadian systems is more likely to involve the US system taking on characteristics of the Canadian system, rather than vice versa. Canada has maintained during the NAFTA era a distinctively higher level of expenditure on social programs than either the US or Mexico.

Some Canadians worried that free trade might cause Canadian culture to be overwhelmed by that of the United States. Having spent a semester in Ottawa recently, I can attest that Canadian culture is alive and well, and faces no imminent threat from NAFTA.

Mexico

Mexico's primary objective in requesting a free trade agreement with the United States was to attract foreign investment by sending a signal to international capital markets that the economic reforms implemented in Mexico were permanent. As a developing economy, Mexico needed both the capital and the technology that would come from increased foreign investment. Gaining improved and more secure access to the United States market was also important to Mexico, but fundamentally the free trade agreement was more about investment than trade. After all, Mexico already had relatively free access to the United States market.

Assessing the impact of NAFTA on the Mexican economy is much more complicated than estimating the effects of the FTA on Canada's economy, because it is almost impossible to separate out lagged and current effects of ongoing economic reform measures, as well as the effects of currency crises. Consequently, estimates can vary widely depending on methodologies and estimation techniques employed.

As in the case of Canada, the external trade of Mexico has grown rapidly. Mexico's non-oil exports increased by more than ten-fold between 1985 and 2000, from \$12 billion to \$150 billion, and trade as a percentage of GDP increased from 26% to 64% (Tornell, et.al., 2004). Trade with the United States and Canada has increased faster than Mexico's trade with the rest of the world. Almost 90% of Mexico's exports are sold to the United States, and about three-fourths of its imports came from the United States. (Hanson, 2003)

However, one cannot assume that this increased trade is attributable primarily to NAFTA. Mexico already had relatively free access to the US market, and had unilaterally removed most of its trade barriers before NAFTA was negotiated. Mexico's proximity to the United States virtually ensured that as its foreign trade increased most of that trade would be with the United States. Garces-Diaz , after studying Mexico’s trade performance, concluded that "…the behavior of Mexican exports has not been affected in any meaningful way by the accord…", but rather that "…the really important institutional change was the abandonment of erratic trade policy in favor of the opening up of the economy following the adherence of Mexico to the GATT." (Garces-Diaz, 2004)

Whatever the reasons for it, the rapid increase in Mexico's external trade has not translated into favorable overall economic performance. Mexico's growth rate since NAFTA came into effect has been below expectations, and job creation and wage trends have been disappointing, to say the least.

It was widely expected that removal of trade restrictions between labor abundant Mexico and the more capital abundant US and Canada would expand labor-intensive production in Mexico and cause wages to rise there. What was not fully taken into account, however, was the fact that prior to NAFTA the most highly protected industries in Mexico were very labor intensive industries such as maize production. As protection of these industries has been removed, large amounts of labor have been released to be absorbed in other parts of the economy. Often the displaced workers lack the skills to find employment in the expanding sectors of the economy. Investments by US firms in Mexican manufacturing have been in industries that, while less skill-intensive than the average of US industry are considerably more skill-intensive than the average of Mexican industry. (Hanson, 2003) The fact that most of these investments have been made in states adjacent to the US border has also widened regional wage disparities in Mexico.

Downward pressure on Mexican wages in recent years is also related to the fact that the Mexican labor force increased during the 1990s from about 32 million workers to just over 40 million. This was the result of persons born during the period of rapid population growth of the 1970s reaching working age during the 1990s, and a higher labor force participation rate by females. Also, the Mexican government has apparently held down minimum wages in an ill-conceived attempt to improve competitiveness. (Polaski, 2004, 2005)

The creation of new jobs has also been hindered by serious distortions in Mexico’s financial sector. Distortions in that sector hinder the movement of resources from less efficient activities to those with more upside potential. Edward Prescott, recent Nobel prize-winner in economics, has estimated that Mexico is operating at 30% below its potential due to deficiencies in its financial sector. (Prescott, 2002) A recent paper by Tornell et. al. (2004) explains the failure of financial intermediation as follows: in the wake of the financial crisis of the mid-1990s, many Mexican banks became insolvent because their assets were denominated in pesos and their liabilities in dollars. The banks were bailed out by being allowed to exchange non-performing loans for government bonds that provided a stream of interest but could not be traded. Moreover, because it is very difficult in Mexico to foreclose on the assets of borrowers that default on their loans, banks have been reluctant make loans to new businesses, and have instead been content to earn income from the interest on government bonds. While the tradable goods sector of the Mexican economy has been able to prosper by accessing international capital markets, the nontradable goods sector has been deprived of investment funds so that both employment and production in that sector have suffered. (Tornell, et. al., 2004)

In the face of mediocre income growth in Mexico since NAFTA, and very poor wage performance, the question arises as to whether these things can be blamed on NAFTA. Indications are that they cannot be. A recent study by Ianchovichina, et. al. (2002) of how tariff reductions affected household welfare in Mexico found that, while holding other variables constant, tariff liberalization seemed to raise disposable income in both rich and poor households, implying a reduction of the number of households in poverty by 3%. Gordon Hanson, in a very recent study found that, holding other variables constant, during the 1990s labor incomes in Mexican states with low exposure to globalization "fell relative to high-exposure states by 10% and the incidence of wage poverty…in low-exposure states increased relative to high-exposure states by 7%." (Hanson, 2005)

Therefore, while NAFTA itself does not appear to be culpable in Mexico's less than desirable economic performance, Mexico certainly has not realized the expected benefits from the trade agreement. In order to benefit more fully from North American integration, Mexico will need improvements in its taxation system in order to raise the revenues required for upgrading its infrastructure and strengthening its educational systems. Reform of its legal system to reduce corruption and improve contract enforceability will also be essential.

Institutional Development and other Improvements

The effects of North American economic integration on the economic development of all the countries involved could also be enhanced by further institutional development in North America. The institutions of NAFTA are by design minimalist institutions, because each of the three member countries is jealous of its own sovereignty and protective of it.[5] However, a higher level of cooperation in North America will be required as economic integration deepens, as it is bound to do through the silent working of markets even if no further liberalization measures are undertaken by governments. A strengthened institutional structure could facilitate this cooperation. A more formal Free Trade Commission with a fixed location and staff would be able to give more careful attention to issues peculiar to North American integration. A North American Trade and Investment Court could deal more effectively with seemingly intractable trade disputes, and provide protections needed for efficient investment in North America while correcting for the excesses inherent in NAFTA's investment chapter. Increased funding for the North American Commission on Environmental Cooperation and the North American Commission on Labor Cooperation would enable them to more effectively address the environmental and labor issues that will arise as the three economies of North America become increasingly intertwined. Finally, the North American Development Bank should be converted into a genuine development bank, adequately capitalized to provide assistance for Mexico to upgrade its infrastructure so that it can more fully benefit from North American economic integration.

[5] For a more complete discussion of NAFTA's related institutions, see (McKinney, 2000).

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