

The Southwest ECONOMY

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Commentary

NAFTA: Capstone and Cornerstone

The North American Free Trade Agreement is both the capstone of 50 years of U.S. foreign economic policy and cornerstone of future multilateral trade negotiations. NAFTA achieves in our hemisphere the major goals of international trade that U.S. governments have pursued since the end of World War II. NAFTA's passage is vital to achieving these goals in the rest of the world. Failure to ratify the agreement would undermine U.S. credibility in future trade negotiations.

U.S. Policy Goals in Perspective

Throughout the postwar period, the principal goal of U.S. foreign economic policy has been opening world markets to the free movement of goods. The policy developed out of the realization that the protectionist and beggar-thy-neighbor policies of the interwar period had been major contributors to the breakdown of world order, with all its catastrophic consequences.

The core insight of the U.S. free

trade policy is that, if goods do not move freely across borders, armies might. No nation can be self-sufficient, and when denied access to crucial markets, countries all too often resort to war. Crafted initially with Europe in mind, U.S. policy came to be applied to all free-world countries, with varying degrees of success.

In pursuing free trade, successive U.S. administrations have hoped to foster world economic growth. In doing so, they have combined sound economic policy with pragmatic foreign policy. Seldom has a marriage of good economics and politics worked so well. Not only U.S. trade but that of our principal allies flourished. Not only was Western Europe reconstructed after its devastation, it was also spared any new armed conflict. In Europe and elsewhere, nations with serious political disagreements on specific issues have continued to permit their citizens to trade. Their economies have grown, and the interest in free trade that unites them has

helped countries overcome the differences that sometimes divide them.

Attaining free trade is a process, not an event. Throughout the postwar period, the U.S. government and those of its allies have promoted world trade through a number of organizations, the most important of which has been GATT—the General Agreement on Tariffs and Trade. Within GATT, the greatest success has occurred in lowering tariffs on manufactured goods, especially for developed countries. In many cases, barriers to trade in agricultural commodities have proved intractable. While U.S. exports of services are booming, they too encounter many barriers. These barriers are critical for U.S. exporters of services, whose large trade surplus substantially offsets the merchandise trade deficit (*Chart 1*).

As tariff barriers have fallen, governments have

I N S I D E

**Have Texas
Banks Fully
Recovered?**

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Chart 1
Surplus in Trade in Services

Billions of dollars



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

often substituted nontariff barriers. Equivalent in effect to a tariff, a nontariff barrier is easier to disguise and more difficult to remove through negotiation. Examples of nontariff barriers include idiosyncratic national standards of weight and measurement, domestic content rules and quantitative restrictions on goods admitted. Frequently, governments impose such trade barriers on the pretext of protecting their citizens' health or safety and, increasingly today, their environment.¹

In recent years, U.S. trade negotiators have understandably focused their efforts on removing nontariff barriers, especially those to services. Promoting trade in agricultural commodities has also become an important item on the U.S. trade agenda. These interests underscore NAFTA's importance in broader U.S. trade policy.

NAFTA: What Is at Stake

NAFTA represents an unprecedented opening of a developing country to U.S. exports. True, Mexico has already unilaterally opened itself to U.S. merchandise exports by reducing its average tariff from about 25 percent to 12 percent. NAFTA goes far beyond this, how-

ever, in the key areas of agricultural trade and trade in services. In many cases, the opening is accomplished by reducing or eliminating nontariff barriers to trade. In negotiating NAFTA, the United States has substantially achieved in North America its trade agenda of the past 50 years.

Understanding what NAFTA represents requires understanding what failure to ratify it undoes. Failure to ratify sends a signal to all Latin American countries. In response to initiatives of the Bush administration for hemispheric trade, many Latin American countries dramatically opened their economies to U.S. exports. Additionally, these countries liberalized their economies, breaking down internal trade barriers, privatizing state enterprises and enhancing private property rights. U.S. failure to ratify NAFTA would signal our neighbors to the south that our promises of reciprocity in trade are not credible.

U.S. credibility would not be lost solely with Latin America, however. The U.S. government is urgently trying to complete the Uruguay Round of GATT negotiations. As with NAFTA, promoting agricultural trade and removing nontariff barriers to trade, especially in services, are important agenda items. If the U.S.

Congress rejects NAFTA, it would be rejecting a treaty containing what we have tried to achieve in the broader GATT negotiations. Rejecting NAFTA would tell the world that U.S. negotiating positions are not to be taken seriously. In such circumstances, why would anyone negotiate trade policy with us in the future?²

In light of what is at stake, it is no exaggeration to say that failure to ratify NAFTA would constitute the greatest economic policy mistake of the second half of the 20th century.

NAFTA Demystified

A great deal of misinformation about NAFTA has been disseminated. It is commonly but erroneously believed that NAFTA opens the United States to a flood of cheap Mexican goods. The fact is that the United States is already wide open to Mexican exports. U.S. tariffs on Mexican goods average only 4 percent, roughly the same as those on our other major trading partners.

Some have claimed that U.S. workers cannot compete against goods produced by low-wage labor. U.S. workers already compete with their Mexican counterparts, however, and the figures speak for

themselves. In 1992, U.S. firms ran a \$5 billion surplus in trade with Mexico (*Chart 2*). Again, U.S. firms accomplished this with little if any tariff protection.

U.S. firms compete successfully in Mexican trade for a number of salient reasons. U.S. workers are highly skilled and the most productive in the world. They can avail themselves of capital and technology available to Mexicans only at higher cost, or not at all. The pattern of our exports reflects these advantages: machine tools, electrical machinery, high-tech business equipment and capital goods generally.

Wages are only one component of total production costs (and an ever-diminishing share for many U.S. firms). In Mexico, other costs can be far higher than in the United States. Financing costs are three times higher than in the United States. Communication costs are also far higher than those north of the border. Infrastructure—including roads and other forms of transportation—is generally far inferior to that in the United States.

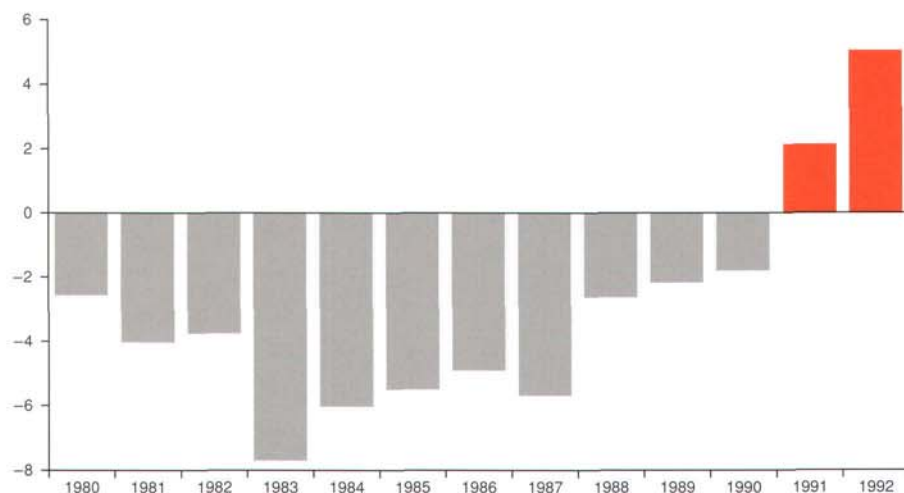
When all costs are included, U.S. firms enjoy and will continue to enjoy cost advantages in many areas. Mexican firms will become more productive over time, but U.S.

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Chart 2
Merchandise Trade Surplus/Deficit with Mexico

Billions of dollars



SOURCE: *El Mercado de Valores*.

"If someone asks what U.S. citizens will obtain from NAFTA, the answer is simple: a higher standard of living."

firms will also continue to improve productivity. To believe that somehow the United States will be outstripped in productivity by Mexico, a task no country—not Japan, not Germany, not anyone—has succeeded in accomplishing, evidences a lack of confidence in the ability of the most innovative and successful economy in the history of the world. One can only marvel at such defeatism.

NAFTA: Policy Concerns

The prospect of free trade in North America has raised legitimate concerns, with environmental issues topping the list for many. Few issues have so occupied negotiators of the three signatory countries. Negotiators from Canada, Mexico and the United States continue to work on the environmental accords. In any case, some misconceptions can be cleared up.

First, Mexico has tough environmental laws, as stringent as those in our own country. Second, the Mexican government enforces its laws—dramatically in some cases (such as shutting down refineries and polluting plants in Mexico City). Third, there has been and continues to be substantial cooperation on solving environmental problems among the governments. This includes not only the federal governments, but state and local governments on both sides of the U.S.–Mexico border.

By U.S. standards, Mexico is a relatively poor country, and poor countries have fewer resources to devote to protecting the environment. The best, indeed the only way to solve Mexico's environmental problems is to achieve more rapid growth in per capita Mexican income. Increased international trade with the United States is a practical means of attaining this goal.

Richer countries have the means to protect and improve the environment. Indeed, statistical evidence suggests that Mexican per capita income is at the threshold where, in

other countries, green issues brook larger in public policy debates. Anyone visiting Mexico, especially the capital, knows there already is a strong and growing constituency for sound environmental policy.

Other concerns about NAFTA also tend to go back to the basic question of means. For instance, working conditions in Mexico are often below those in the United States today, as were U.S. working conditions when our country was in its early economic development. Again, trade and per capita income growth will alleviate the problems.

NAFTA: The Bottom Line

Lest we lose sight of the goals of free trade, we conclude by returning to basics. In fostering global trade, U.S. governments have pursued the goal of enhancing growth in real per capita incomes and thus fostering job growth—in all countries. Free and open trade between two countries is mutually beneficial, causing real income to be higher in both countries than would have otherwise been the case. The most obvious benefits are the lower prices paid by consumers. If someone asks what U.S. citizens will obtain from NAFTA, the answer is simple: a higher standard of living.

—Gerald P. O'Driscoll, Jr.
William C. Gruben
John H. Welch

¹ See Gerald P. O'Driscoll, Jr., "What About Free Trade Within the United States?" Federal Reserve Bank of Dallas *Southwest Economy*, January/February 1992; and Gerald P. O'Driscoll, Jr. and Fiona Sigalla, "Bring Free Trade Home," *Regulation*, Winter 1993, 61–67.

² See William C. Gruben and John H. Welch, "Is NAFTA More Than a Free Trade Agreement?" Federal Reserve Bank of Dallas *Economic Review*, forthcoming.