Economic Commentary

by
William C. Gruben
Senior Economist and Policy Advisor
Federal Reserve Bank of Dallas

Can U.S.–Mexico Free Trade Last?

Analysts widely agree that the North American Free Trade Agreement (NAFTA) will enhance trade and investment opportunities for all countries involved, but views of how the effects of the agreement will progress over time differ somewhat. Some economists focus on the process of compound growth. They believe that trade expansion in one industry may foster more trade in another. Other economists suspect that the effects of the agreement could weaken over time in some industries. Because the NAFTA will affect many industries, both sides could be correct. But if the beneficiaries of free trade fail to monitor what takes place in Washington after the NAFTA is ratified, economists who are concerned about possible erosion may realize their worst fears.

Compound Growth and the NAFTA

The arguments for the view that one industry's trade growth builds on another's are very compelling. Suppose you are a Mexican producer whose product could not easily sell in the United States before the NAFTA. With the agreement, you not only sell more, but you buy more inputs from other producers in Mexico. Those producers are not yet efficient enough to sell in the United States, but low shipping costs still make them your cheapest suppliers. Economies of scale may be involved. As their sales grow, these suppliers can develop efficiencies that also make them competitive in the United States. Because of these dynamic effects, the long-term effects of the agreement cannot be appreciated from a short-term perspective.

Erosion of the NAFTA's Effects

One factor that may offset some of the compound growth effects of NAFTA is known among political economists as the *compensation effect*; that is, if a group's economic fortunes decline, the group will turn to politics for relief. If an effect of the NAFTA for your industry is increased competition from foreigners, then the possible rate of return on your lobbying or political efforts to stop the competition go up. So, you devote more energy and money to such efforts. As compound growth occurs in Mexico, affected groups in the United States will seek redress by increasing lobbying efforts.

These groups may also invent new ways to stop the competition that is benefiting U.S. consumers. The invention of new ways to stop competition has been called the *voter information paradox*. As voters become more sophisticated in their opposition to trade protectionism, political groups invent new kinds of protectionism that are increasingly difficult to detect. The history of trade liberalization is a history of the voter information paradox.

For example, as U.S. tariffs declined in the decades following World War II and voters got the idea that trade was freer, special interest groups and their friends in politics devised so-called "voluntary export restraints." Encouraged by innovative special interest groups, U.S. officials approached foreign producers and threatened trade retaliation if these producers did not "voluntarily" set limits on their shipments to the United States. U.S. politicians could then tell their voters that they were keeping costs of goods low, even though, in fact, they were using nontariff barriers to keep the prices of foreign goods high by restricting supply.

The United States' history of innovative protectionist schemes through the voter information paradox and the history of increasing special interest pressure generated over time through the compensation effect suggest that the effects of the NAFTA may erode over time, even in the face of the compound growth effect. Rather than violating specific terms of the NAFTA, special interest groups may devise ways to weaken it.

These notions are not simply abstract concepts. They are already at work in the framework of the Canada–U.S. free trade agreement. Indeed, special interest groups have been so quick to abridge free trade between these two countries that a recent *Wall Street Journal* article asked, "Free Trade Agreement? What Free Trade Agreement?" and noted that both Canada and the United States have been "busily sabotaging the spirit of the free trade agreement they signed three years ago." Without a great deal of care, the same problems may appear when free trade is extended to Mexico.