FREE TRADE IN NORTH AMERICA

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ABSTRACT

Many areas in the world are combining into trading groups to take advantage of the benefits of free trade. In North America negotiations are now taking place to unite the markets of the United States, Canada and Mexico. Although there are critics in all countries, such as labor and environmental groups, the uniting of the three markets has relatively few obstacles. Furthermore, many of Mexico's current reforms are addressing many these criticisms, such as environmental concerns and border problems. The relationships between the North American countries are good and should a North American free trade area be agreed upon, its implementation should go smoothly.

There are a wide variety of benefits related to a North American Free Trade Agreement. These benefits include: the static and dynamic gains from trade creation, an increase of industries in North American able to compete in the world market, an increase in employment, agreements on industrial property rights, solutions to border problems and a general increase in investment. All in all, a North American free trade agreement would likely be a great benefit to all three North American countries.

FREE TRADE IN NORTH AMERICA

In the past few decades there has been an increasing emphasis on the importance of free trade. Tariffs and non-tariff barriers have fallen all over the world due to agreements such as GATT, general agreements on tariffs and trade, furthermore large trading blocks have evolved such as the EEC, European Economic Community, which has freed up trade and investment to the point of near economic unity. Currently, a large trading block is taking form which may unite all of North America. This recent development has been spurred not only by the favorable outlook on free trade, but also through the advancement of relations between the North American countries: the United States, Canada and Mexico. Today the United States and Canada have an agreement which creates a free trade area between the two. This agreement, the U.S.-Canada free trade agreement (FTA), has virtually removed all barriers to trade and investment between the two countries. As the FTA was being implemented, the U.S. and Mexico were also exploring an agreement. Presently, the trade talks between the U.S. and Mexico, Mexican reforms and the U.S.-Canada free trade agreement have all initiated the very probable and foreseeably beneficial North American free trade agreement, NAFTA.

FREE TRADE IN THEORY

When opening up borders to free trade, as many in North America hope to accomplish, there are many sources of potential gains. These gains were theorized by early economists such as Adam Smith. Smith was one of the earliest to write about countries improving their standard of living by specializing in the goods that were able to be produced best in the area. The country is said to have an absolute advantage in these goods. In turn the country could trade for the goods they didn't have an absolute advantage in and thus gains from trade are realized through specialization. Later, in 1817, David Ricardo developed the model still used today, the model of comparative advantage[1]. This model describes the gains from trade between countries where one country may even have an absolute advantage in all goods, but through the observation of opportunity cost there are still apparent gains from each country specializing and trading amongst each other. Furthermore when specializing in certain industries economies of scale can better be taken advantage of.

FREE TRADE IN PRACTICE

The EEC, a trading block of 12 European nations nearing full integration in 1992, has taken advantage of the gains from trade and is now the largest free economy in the world, comprising over 320 million consumers and a real GNP of 4.4 trillion dollars[2]. The unity has promoted growth in all of the EEC members. By the incorporation of less developed countries; such as Spain, Greece, Portugal, and Turkey; Ricardo's theory of comparative advantage can be shown, for the integration of these four countries with other EEC members has only improved the growth rate of the European Economic Community. Another large trading area is the bilateral one between the United States and Canada, the U.S.-Canada free trade agreement (FTA). The FTA's benefits are not yet clear, due in part to the current recession, but trade stimulation has occurred, for the U.S. has increased its exports to Canada by over 17%[3]. This agreement is now evolving into the largest trading area yet through a North American free trade agreement. A North American free trade area would combine over 360 million consumers and would result in a real GNP of over 5.9 trillion dollars, outpacing the EEC by approximately 40 million consumers and 25% greater GNP[2].

ARGUMENTS AGAINST A NAFTA

CANADA

Although the FTA has increased trade with the U.S. a NAFTA does not look as appealing to Canada as the FTA did. Unlike the noncompetitive nature of most of the goods produced by the U.S. and Canada, Mexico and Canada compete in many of the same industries such as: telecommunications equipment, electronic equipment and power generation equipment[4]. This is one reason the two countries have never had an exceptional trading relationship with each other. Today, Canada and Mexico trade little and many Canadians blame aspects of the current recession on the FTA and are shying away from an even broader agreement that would include Mexico.

UNITED STATES

There are many in the U.S. voicing some of the same concerns as Canada has about a NAFTA. Although the U.S. and Mexico don't compete in many the same industries, they do compete for some types of jobs. Groups such as the AFL-CIO fear that cheap Mexican labor will take American jobs, and send the U.S. into a deep recession. Environmentalists are concerned about the aspects of Mexico's pollution standards and how U.S. firms may relocate just to take advantage of the lower standards, thus hurting the environment.

MEXICO

Perhaps the country that is pushing for a NAFTA the most is Mexico. But even Mexico has its critics. Many Mexican industries are wary about removing all barriers and being subject to some of the most competitive firms in the world, those of the U.S. and Canada. Small Mexican farmers probably have the most to lose. As they will, in all likelihood, be driven out of business by big U.S. agricultural firms, specifically those involved in wheat and maize[5]. Mexico has also been historically firm on keeping its nationalism and many fear the integration with the United States may cause Mexico to lose its national identity.

MEXICAN REFORMS

Although there are some critics in Mexico the president, Carlos Salinas de Gortari, has been hard at work changing the Mexican economy and a NAFTA is one of his many goals. A big reason the U.S. is able to accept the negotiation between itself and Mexico has been upon Mexico's new surge of economic growth and the reforms put in place. This new surge of reform is not only to help Mexico compete in the external world market, but also perhaps to wring out some of the corruption saturating the government. President Salinas has changed the climate for foreign business; last September Michael Jordan, chairman of PepsiCo's international snack and beverage businesses, was trying to get approval to allow PepsiCo to buy a large Mexican cookie maker, Gamesia. Jordan was expecting heavy donations to many corrupt politicians in Mexico but instead, under the Salinas administration, Jordan reported no trouble and the deal went through five days later[2].

The Mexican reforms have also helped Mexico go from a sluggish economic growth rate to a growth rate of 3% in 1991[13]. Recent Mexican reforms include: 1) reducing the budget deficit from 16% of GNP in 1986 to about 6.3% in 1989; 2) the implementation of price and wage restraint (this coupled with the decrease in government spending reduced inflation from 160% in 1987 to 20% in 1989); 3) reducing foreign debt from 100 billion to 94.5 billion; 4) inducing a program of privatization and deregulation (having recently sold over 1200 state owned enterprises); 5) an increase on the reliance of non-oil exports; 6) improving patent protection and the enforcement of intellectual property rights; and 7) opening up its economy to the rest of the world (Mexico recently joined GATT in 1986 and has eliminated most non-tariff barriers)[6].

Mexico's reforms have also been in areas concerning the environment, border cooperation, narcotics, electoral reforms and human rights.

PRESENT NORTH AMERICAN RELATIONSHIPS

U.S. & MEXICO

The recent reforms in Mexico have drawn U.S. eyes to a country which may be a perfect trading partner with the United States. The U.S. does not compete with many Mexican goods, thus few U.S. industries are endangered of any change in competition. In fact U.S. industries can greatly increase their own competitive edge by using Mexican labor instead of expensive U.S. labor in production. Furthermore the integration with Mexico will not be an extreme one, for right now trade barriers are already low between the two nations. Mexico has lowered its tariffs from an average of 16.4% in 1982 to an average of 10% with the U.S.[3] and has further encouraged investment by allowing foreign investors to have full ownership of Mexican firms[2]. The Mexican investment from the U.S. is not new, for years Mexico has opened up along its borders Maquiladors, places where U.S. firms can own plants in Mexico. Cooperation such as this has already put the U.S. as Mexico's #1 trading partner as well as its #1 investor[3]. As for Mexico's establishment in the United States, the U.S. has even lower tariffs for Mexico, an average of four percent[7], making Mexico the United States third largest trading partner[8]. Altogether the U.S. and Mexico share an extremely good relationship.

U.S. & CANADA

Another good trading relationship, so good it dwarfs the U.S.-Mexico relationship, is that of the U.S. and Canada. These two countries share the largest bilateral trading relationship in the world, trading over 195 billion in 1990[3]. Historically these two have been close neighbors. On January 1, 1989 the FTA went into effect, a comprehensive agreement to alleviate the already low barriers to trade they had[9]. Both before and after the FTA, Canada has been and is still the United States #1 trading partner[3]. Canada has also been a leading investor in the U.S., the United States fourth largest, as the U.S. has been and remains Canada's largest trader and investor by quit a margin accounting for approximately two-thirds of Canada's trade[3]. Right now there are very few barriers to trade between the two and the few remaining are to be implemented out within ten years, when the FTA takes full effect[9].

CANADA & MEXICO

On the other hand, Canada doesn't share such a fruitful relationship with Mexico as it does with the United States. Canada and Mexico have been very indifferent to each other in the past, not sharing a great deal of trade, only 1.4 billion in 1990[8]. The only interest that Canada seems to have in a NAFTA is that it protects its borders from trade deflection. If Canada allowed Mexico and the U.S. to form an agreement amongst themselves then Canadian consumers could bypass Canadian trade barriers by buying Mexican goods through the U.S. market, likewise Canada could bypass Mexican trade barriers. In this event the U.S. acts as a middleman buying nontariffed goods from one, either Mexico or Canada, and selling them to the other for more than bought for, but just enough to undercut tariffs. Thus the U.S. benefits and Canada's and Mexico's markets would be penetrated anyway. So Canada is led to join the negotiations by way of protecting the FTA instead of seeking a stronger relationship with Mexico.

POTENTIAL BENEFITS OF NAFTA

STATIC GAINS FROM TRADE

Based on the trading relationships between the North

American countries, significant static and dynamic gains from trade would be discovered with the formation of a North American free trade area. Dynamic gains, such as increased competition, stimulation of technical change, stimulation of investment, and economies of scale, are likely to be the most important source of gain but are most difficult to estimate. In contrast, static gains are relatively easy to estimate. The static gains from trade, that the three countries will likely benefit from, are those associated with trade creation. Trade creation is trade created from the lowering of trade barriers and the efficiency gained from doing so.

When a barrier is put on a good, the barrier in effect reallocates consumer and producer surplus related to that good. The surplus is reallocated to, firstly, the government imposing a tariff, in the form of tariff revenue, and secondly, in the form of dead weight loss. The dead weight loss is the efficiency loss resulting from the distortionary effects of a barrier. A barrier to a good from a country which produces the good efficiently may raise the price of the good sufficient enough so as it may be purchased elsewhere for a lower price, thus the means of producing the good shifts from an efficient producer to a less efficient producer. The efficiency loss, dead weight loss, is illustrated by the shaded triangles in figure 1.

This dead weight loss is alleviated by the abolishment of trade barriers so as production moves back to the most efficient means. In a specific trade area, the abolishment of barriers may not completely eliminate all efficiency loss. Efficiency loss may still be incurred through trade diversion. Trade diversion takes place when a low barrier trading partner relationship exists and higher barriers are established or maintained against the rest of the world. The diversion occurs if a certain good might be produced more efficiently elsewhere and imported, but instead is imported from a trading partner because of the low barrier price. The amount of trade diversion is the revenue lost from a tariff that could be imposed on the efficient producer that would set the price equal to the nonbarrier trading partners price of the good (see figure 2).

In a NAFTA very little trade diversion would take place, for one, the goods produced in North America are very competitive in the world market due to the high technology and the vast resources. Secondly, due to the geographic proximity of the three countries, when considering transportation costs, goods are rarely available at a lower price.

In the case of trade creation, North America has much to gain. With the acceptance of Mexico into a free trade area, much like the U.S. and Canada already share, all three countries stand to gain through increased efficiency related to trade creation. Since Canada and

Mexico trade little at present, $1.4 billion[8], the gains to be had are minimal, but the gains presented to the U.S. and Mexico are substantial. The U.S. imports $30.8 billion dollars[10] in goods from Mexico under an average of a four percent tariff[7]. With this amount of imports, the reduction of tariffs will result in an annual efficiency gain of over $24 million (see figure 3). The efficiency gains that would result from Mexico lowering its tariffs are even higher, due to Mexico's higher tariffs. As the result of Mexico lowering tariffs to U.S., efficiency gains would amount to over $140 million annually (see figure 4).

BENEFITS TO THE U.S.

Today U.S. exports to the rest of North America are increasing rapidly, thus the potential static gains of a NAFTA are increasing. Many U.S. firms see a chance to increase exports into an expanding Mexican economy, and take advantage of Mexican consumers buyer loyalty to U.S. products. Exports have been increasingly important to U.S. growth; since 1986 exports have accounted for more than 40 percent of U.S. economic growth[3]. Merchandise exports expanded from $246 billion in 1986 to $424 billion in 1990, an increase of 72 percent[3]. With concern to Mexico and Canada, U.S. exports have grown 56 percent faster than exports to the rest of the world[3].

The importance of exports to American jobs and well being is a prime factor in the United States pursuance of a NAFTA.

The U.S. also hopes to form agreements on industrial property rights, so as to protect U.S. firms investment in research and development. Further more, if the NAFTA goes through the U.S. would have a chance to reduce the trade deficit with Mexico, for now the Mexican tariffs with which the U.S. has to compete are much higher than the tariffs Mexico faces exporting to the United States. In the global market the mixture of U.S. technology and inexpensive Mexican labor could yield the most competitive goods in the world. Comparatively, the average industrial wage in Mexico is $2.20 per hour, while in the U.S. it is $14.30 per hour[11]. The use of Mexican labor may threaten jobs in some areas of the U.S. but in most cases the integration will save jobs by making the industries more competitive world wide, thus saving the industries themselves. A NAFTA may also very well solve the border problem the U.S. has with Mexico, the problem of illegal aliens coming over the border. For now the U.S. has an unworkable and ineffective border policy and allowing U.S. and Canadian firms into Mexico to create jobs could greatly reduce the number of Mexican immigrants crossing the border thus solving the uncontrollable border problem. Along with the border problem many other problems such as: environmental control, human rights, and corruption, could better be dealt with if more investment was induced into Mexico. A wealthy Mexico could control its problems better than the poor Mexico of today. Since the U.S. is Mexico's neighbor many Mexican problems become U.S. problems and solving Mexican problems can solve related U.S. problems.

BENEFITS TO MEXICO

Perhaps the one with the most to gain from a NAFTA is the southern-most North American, Mexico. Mexico is in great need of investment to take advantage of its abundance of natural resources. Investment from U.S. and Canada in Mexico would accelerate greatly with a NAFTA, furthermore Mexico would be able to take advantage of the technology transferred over by U.S. and Canadian firms locating in Mexico. The U.S. is also looking at helping Mexico build a suitable transportation system in the result of a NAFTA, so as to ease up the flow of goods. One of Mexico's longest ongoing problems may also be solved with a NAFTA, that of Mexico's unemployment rate. Currently Mexico has an unemployment rate of 18 percent[3], this rate could be drastically reduced by U.S. and Canadian firms locating in Mexico and taking advantage of its cheap labor. Mexico stands to gain all this plus having free access to the large U.S. market.

BENEFITS TO CANADA

Mexico may indeed benefit the most and Canada perhaps the least, but even so Canada does stand to gain from a NAFTA. Canada will have a much larger market to export to, for a North American free trade area would have over 360 million consumers[2]. This is much larger than Canada's population, Canada being the smallest of the three with only slightly over 26 million consumers[8]. Also Canada will want to get in on the expanding Mexican economy while keeping the U.S. market open, this can all be done through a North American free trade agreement.

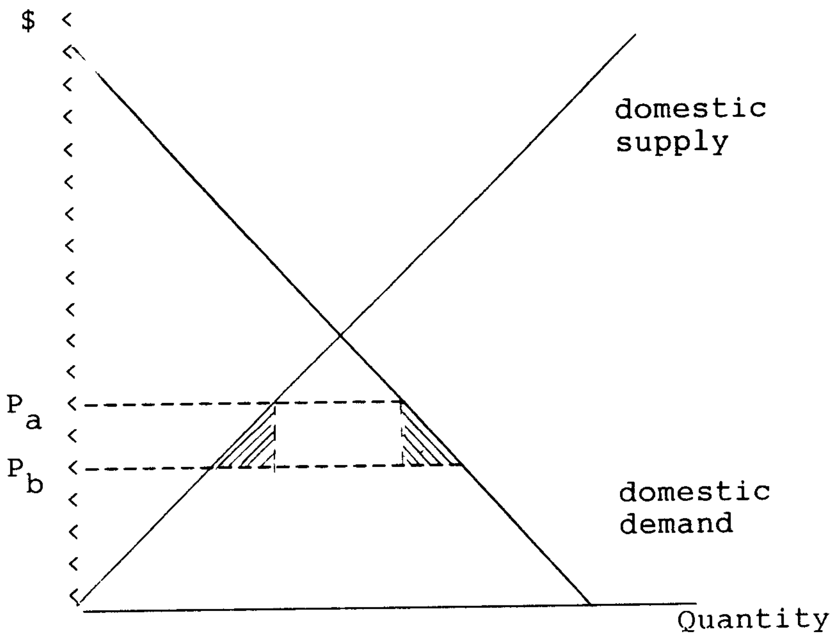
NORTH AMERICA & THE WORLD

Perhaps the biggest reason for all three to unit with a NAFTA is to compete in the world economy. Global competition keeps getting tougher as technology grows and as areas merge together such as the EEC. Even Japan is making moves to integrate the pacific rim[12]. A NAFTA would put the 3 countries in the largest trading block in the world with over 360 million of the most highly skilled and educated workers and consumers anywhere, and a GNP of over 5.9 trillion, 25% larger than the EEC[2]. An area this large would also serve as a bargaining chip in world trade talks, for areas such as the EEC realize the importance of North America as a destination for exported goods. A NAFTA would also put all three in a good position to merge with the rest of America, South America, through President Bush's enterprise for the Americas initiative which would create a trading block bigger in GNP than any potential European or Pacific area.

CONCLUSION

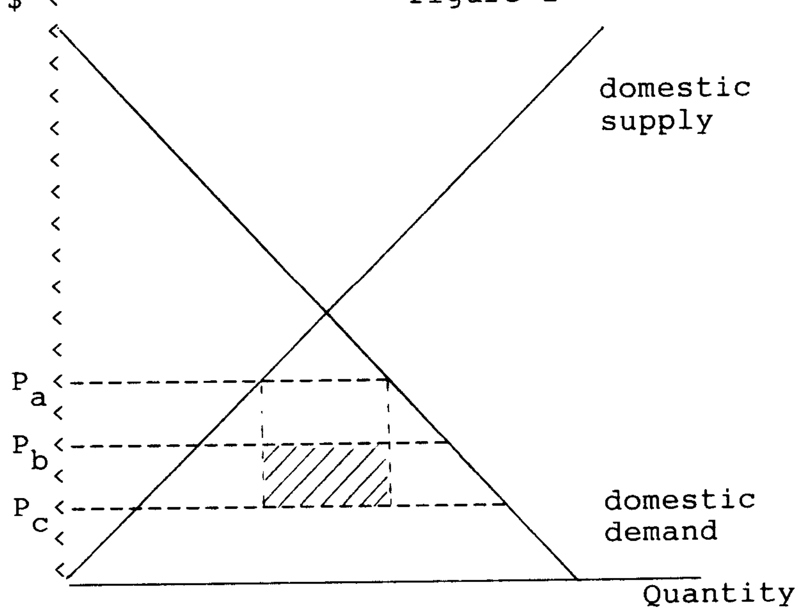
The combination of countries uniting in large trading communities and of multilateral moves to free up trade such as GATT, together work to bring the world into united economies. The gains are able to be had it is just a matter of implementing reductions in trade barriers. This may very well be happening in North America soon as Mexico, Canada and the U.S. realize the gains from opening up their borders through a North American free trade agreement.

figure 1



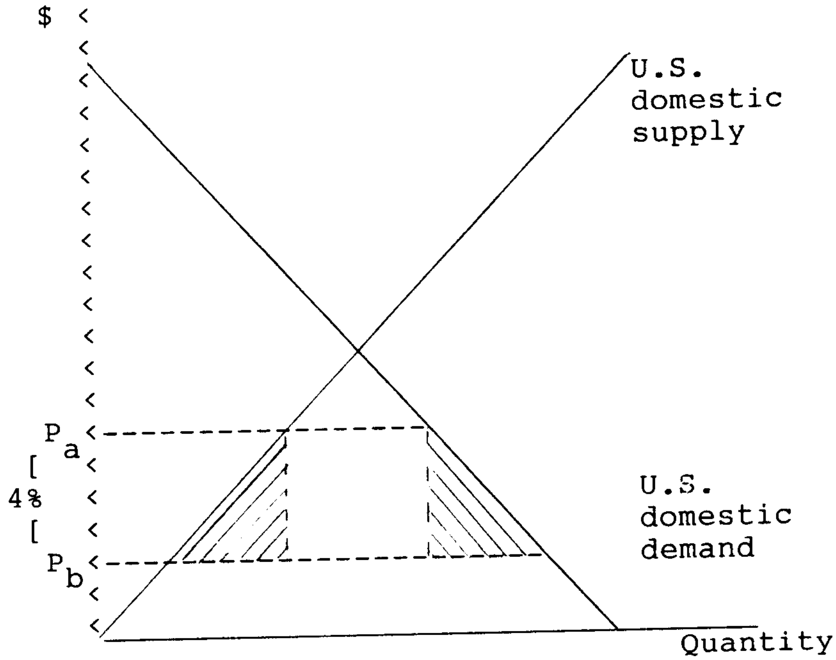
P_a: price with a tariff
P_b: price under free trade

figure 2



P_a: price of efficient producer with tariff
P_b: price of trading partner under free trade
P_c: price of efficient producer under free trade

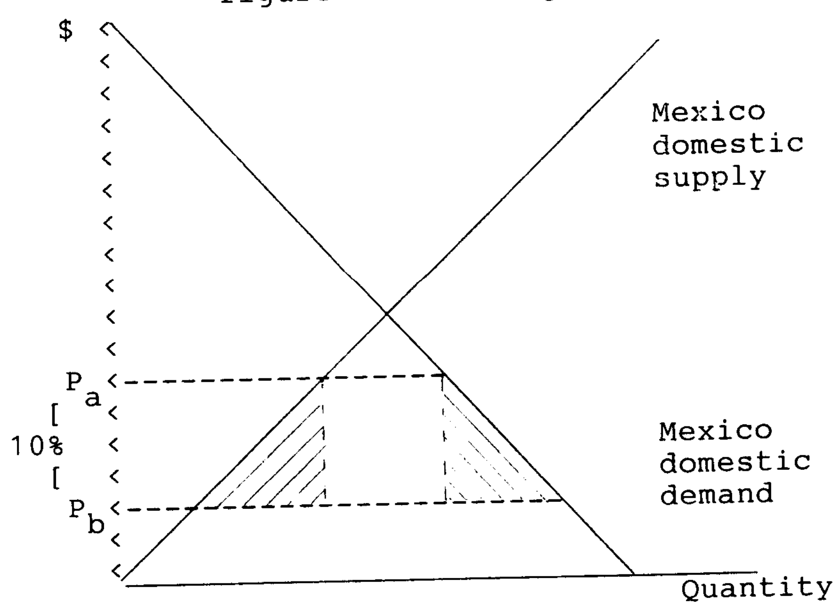
figure 3: Mexican exports to the U.S.



P_a: price with U.S. tariff
P_b: price under free trade

Under U.S. tariffs averaging 4% on U.S. goods and assuming the demand for imports is unit elastic, the area of the shaded areas approximates 24.64 million (with Mexico exporting 30.8 billion to the U.S.).

figure 4: U.S. exports to Mexico



P_a: price with Mexican tariff
P_b: price under free trade

Under Mexican tariffs on U.S. goods averaging 10% and assuming the demand for imports is unit elastic, the area of the shaded areas approximates 142 million (with 28.4 billion in U.S. exports to Mexico).

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