

The North American Free Trade Agreement: Bad News for non-NAFTA Countries?

Maureen Grewe*

The North American Free Trade Agreement (NAFTA) was signed by Canada, Mexico and the United States in December 1992, and is scheduled to take effect, pending ratification by representative bodies in each of the three signatory countries, on January 1, 1994. Many hailed the recent ratification by the U.S. House of Representatives as a step away from protectionism and toward a freer world trading system.

The NAFTA negotiations generated much discussion, both among the participating countries and non-members. Despite the general support among free traders for opening up trade among the three countries, many parties are concerned over the details of the agreement and anticipate that its effects will not all be positive. Areas of concern include possible job losses, further damage to the environment, and less attention to human rights.

Non-NAFTA nations especially fear losses in trade and investment. [Table 1](#) shows why these excluded nations harbor such fears. The European Community (EC), Japan and the ASEAN nations are particularly concerned. Based on trade volume, the implications of the agreement to their access to U.S. markets is clearly worrying for non-NAFTA members. The Canadian share of trade, for example, is yearly more important to Japan. And the anticipated growth in the Mexican economy will increase that country's future importance for most Asian economies.

NAFTA will create the largest single economic bloc in the world, larger than the European Community (EC) and the European Free Trade Area (EFTA) combined. It will do this both in terms of Gross National Product (GNP) and in populations covered. ASEAN's population, for example, is of comparable size, but its GNP is only a fraction of NAFTA's. Japan has 58 percent of NAFTA's GNP, yet only 35 percent of its population. Though still a developing country, Mexico alone has 90 million citizens, a high annual population growth rate, and a rapidly expanding economy. As an international trading bloc, therefore, NAFTA, in terms of both production and consumption, will unquestionably be a powerful force in world affairs. [Table 2](#) illustrates this inescapable conclusion.

NEGATIVE CONSEQUENCES OF A FREE TRADE AGREEMENT

The aim of a free trade agreement is to promote greater mutual trade and economic harmony among its member countries, while enhancing both efficiency and competitiveness and thereby increasing economic welfare. Proposed benefits for members include more and wider employment, increased exports, lower prices and faster economic growth. Outsiders may view these gains as a threat to their own well-being. They may fear they will end up losers in a zero-sum game, where the members' benefits will come at the expense of non-members. The principal causes of these feared losses are trade and investment diversion and a deterioration in terms of trade.

Trade diversion is the re-orienting of imports within a free trade area from a low cost outside source to a more expensive inside source in response to a change in trade policies. A welfare loss results from the allocation of resources away from the most efficient producer. The extent of trade diversion that can be expected to occur for a given change depends, in part, on how protective the market was prior to change.

A free trade area, for example, may decrease tariffs for its members, thus decreasing the costs of importing products from these trading partners. If the tariffs for all trading partners are low prior to the change, the effect will be minimal as the marginal differences in cost will be small. Additionally, outside trading partners will only be adversely affected to the extent that their goods compete directly with goods produced within the free trade area where tariffs have been lowered. Within NAFTA, both Canada and Mexico have higher trade barriers than the U.S., so exporters to those countries will face more potential trade diversion. The Canadian and Mexican markets, however, are much smaller than that of the United States. Understandably, the U.S. is, therefore, the typical concern of most outsiders.

Despite the general consensus that overall diversionary effects are likely to be small, regional or sectoral effects could be significant for particular industries or countries that compete directly against the NAFTA countries in exports, or where high existing trade barriers will be dramatically lowered for insiders. One study asserts that "NAFTA's sectoral impact will be essentially neutral in Canada and the U.S., but highly significant in opening the Mexican investment regime."¹

The U.S. International Trade Commission estimates that American investment in Mexico—for automobiles and parts, computers, electronics, household appliances and apparel—will increase 16 percent in the long term.² To the extent that this investment, were there no NAFTA, would have been made in countries other than Mexico, it represents a diversionary effect. Aside from automobiles and parts, other sectors identified as likely to experience trade diversion are textiles and apparel, and agriculture.

Diversion of investment capital from both inside and outside NAFTA is of great concern to non-members, especially developing countries for whom foreign investment is crucial for further development. Investment diversion could occur if investors want to capitalize on the ability to export duty-free among the NAFTA nations or ensure market access to the three member countries. Low barriers, however, already exist for most products in the NAFTA region, rendering investment for tariff-jumping purposes unlikely. Tariffs are the lowest for the U.S. market, especially for countries qualifying under the Generalized System of Preferences. Tariffs are the highest in Mexico, making investment diversion for production within the Mexican market the most economically beneficial. Given the present size of its economy, however, it is unlikely that there will be sufficient economies of scale to warrant extensive foreign investment in the near future for Mexican consumption.

Contrary to the fears of many NAFTA opponents, investment decisions are usually most heavily influenced by the economic and political stability of the host country, the existence of well-defined property rights, the stability of the currency, and the ability to repatriate profits, not merely wage costs or tariff evasion.

Jeffrey Schott states that "The trade agreement is only a small part of the package of reforms that is influencing the investment decision" of firms considering relocation to Mexico.³ Given similar costs, NAFTA will presumably give Mexico an edge in attracting investment because it will lock in the economic reforms undertaken during the 1980's in the country and brighten its growth prospects, making Mexico less risky for investors.

It is likely that investment diversion to Mexico will originate from outside of NAFTA, as non-members position investment to take advantage of Mexico's enhanced stability and growth, as well as its improved access to the U.S. and Canada. Nevertheless, the lowered tariffs probably will not in themselves cause large diversionary effects. Mexico's path of economic reform would attract investment even in the absence of NAFTA.

Environmental laxity in Mexico has also been cited as a reason that investment diversion might occur. The theory is that environmental regulations in the industrialized countries involve substantial costs and that firms could lower these costs by relocating to Mexico. Environmental costs, however, represent a small fraction of manufacturers' total costs and can be only part of a "package" of reasons for relocating.

For non-members, NAFTA's investment provisions do provide some cause for concern about its external trade policy. Gestrin and Rugman express reservations about the possible discriminatory effects of the

investment exemptions in the annexes to NAFTA's investment chapter, contending that "they also constitute an emerging North American industrial policy."⁴

The proposed rules of origin for automobiles of 62.5 percent, combined with duty drawback restrictions, will encourage regional sourcing of auto parts and the location of new automobile sector investments in North America. Another example where NAFTA's proposed rules of origin could negatively effect outsiders is in the electronics market. It is anticipated that these rules will promote the use of U.S.-made television tubes at the expense of Asian products.⁵

Despite reservations expressed about investment provisions, they are generally viewed as successful in achieving the goals of clarity, enforceability and transparency. They should also liberalize the Mexican investment regime and provide greater protection for foreign investment in the three NAFTA countries.

Terms of Trade Effects

A possible result of enhanced competitiveness and rationalization of production for NAFTA members is a deterioration in the terms of trade for non-members. This can occur for several reasons. Insiders may experience reduced costs through obtaining duty-free inputs from other members. Rationalization of production among the three countries based on comparative advantage can produce economies of scale that enable members to reduce costs. These two factors would result in a strengthening of the position of an insider who is the existing low-cost producer, or allow a member to newly become the low cost producer. In either case, outsiders will have to cut prices to match the preference given to insiders.

Another possible cause of deterioration in the terms of trade to outsiders is the relaxing of quotas for members. For example, the proposed agreement lifts U.S. import quotas under the Multifiber Arrangement for Mexican textiles, which qualify under the NAFTA rules of origin, and allows no new quotas to be imposed. As a result, increased Mexican textile imports to the U.S. may force down prices and allow the U.S. to recapture quota rents previously earned by outsiders. The outsiders, still constrained by their quotas, would have to drop their prices to remain competitive with the lower prices of Mexican products.

If the NAFTA countries represent a large enough market for a particular product or country, adjustment costs may occur for that industry or country as well. Textile exports, for example, from the Caribbean could decline if the NAFTA member textile industries become more competitive. Yet trade creation and income effects could cause increased exports from the Caribbean to NAFTA members in other sectors. If NAFTA markets represent a large enough portion of a non-member nation's trade, then reallocation of resources could occur in non-member countries as well. This scenario could only credibly occur, however, for a small group of countries for all of whom the U.S. is the dominant import source and export market.

A less directly negative NAFTA consequence could be a shift in U.S. focus to regionalism, thus diminishing its leading role in the General Agreement on Tariffs and Trade (GATT). To date NAFTA's aims have included continuing trade liberalization on the multilateral level. The failure of the Uruguay Round, however, could cause a re-orientation inward. This would be dangerous for outside nations who stand to gain much from continued liberalization under GATT, and for whom a more protectionist U.S. market would be disastrous. Recent discussions by U.S. policy makers have somewhat dispelled this fear by speaking of NAFTA as a step toward a freer and more open world trading system. The close margin of the U.S. House of Representatives' vote on NAFTA, however, underscores the strength of U.S. protectionist interests.

POSSIBLE BENEFICIAL RESULTS

NAFTA may provide some benefits and opportunities for outsiders. The benefits of investment in Mexico for non-members will be increased by enhanced access to NAFTA markets and continued economic reform and stability in Mexico. And higher growth in all of the NAFTA countries is anticipated to cause income effects and trade creation. Thus, the question remains whether trade creation will dominate trade diversion in providing a welfare-enhancing outcome for outsiders as well as for NAFTA members.

Trade creation results when a member of a free trade area imports goods it previously produced itself from a lower cost producer who is also a member of the same free trade area. The welfare of members is increased because resources are reallocated based on comparative advantage. There is a production effect, reflecting the shift from a less to more efficient producer, and a consumption effect, as consumption of the now lower priced good should increase. Expanded production of a good within the free trade area will provide benefits to outsiders if it requires more inputs imported from outside the preference area.

Income growth in the member countries should expand import demand, thus increasing imports from outside nations as well as member countries. This effect should be especially important for Mexico, which will undoubtedly experience increasing demand for consumer goods as its per capita income grows. This growth dividend can result in a positive sum game with overall net welfare enhancing effects if the increased volume of imports exceeds trade diversion.

A positive externality to outsiders can result if an insider is already the lowest cost producer of imports for outsiders, and the price of those goods falls further due to duty free components or economies of scale. If Canada, for example, produces machinery for export to ASEAN manufacturers and can lower its costs because it can *now* obtain parts from the U.S. duty-free, lower prices can be charged. The ASEAN manufacturers, as a result of NAFTA, will therefore gain from improvements in Canada's cost position.

ACCESSION AND EXTERNAL POLICY ISSUES

A question raised by NAFTA is whether it will have differential impacts on industrialized versus developing countries. The answer may vary from country to country, depending on its trade pattern and the complementarity of production with NAFTA members. Generally, with tariff barriers, the agreement is likely to hit developing countries less hard as they currently face lower tariffs than the industrialized countries under the Generalized System of Preferences. Hufbauer and Schott, however, point out that failure to successfully conclude the Uruguay Round will be more damaging to developing countries, insofar as it reduces the multilateral system to competing regional blocs, as many of the industrialized countries now belong to regional organizations like the EC, which exclude the developing nations. ASEAN, as a grouping of rapidly industrializing developing countries, is a clear exception, though the degree of its intra-regional trade is much less than the EC's or NAFTA's, leaving it more exposed to protectionism in other regional blocs.

While the accession clause to the agreement is of special interest to the Caribbean Basin countries and those of Latin America, prospects for the agreement's expansion will also concern other outsiders. The proposed accession clause stipulates that unanimous approval by the NAFTA members is required, yet delineates no geographic limitation.

Hufbauer and Schott note several flaws in the accession provisions.⁶ There are no specified application procedures or criteria, for example. Each NAFTA member can form its own free trade or bilateral agreements with non-member countries, even those rejected for accession to NAFTA. This could create a "hub and spoke" system as described by Wonnacott.⁷ Additionally, there are several industry-specific sectors of the agreement that make no reference to possible extension to outsiders. It may thus require extensive renegotiation to admit additional members.

Wonnacott discusses the implications of NAFTA's expansion for non-members.⁸ He notes that the more the benefits to members, the less they will want to share these benefits by pushing for multilateral liberalization. Beneficial terms, however, increase the incentives for outsiders to end such discrimination and preferential benefits. This adds external pressure for either expansion or increased multilateral liberalization. One caveat is that insiders may soften to multilateral liberalization after a rationalization and restructuring period if they feel they are more prepared to face international competition and will, therefore, not be hurt by lower trade barriers.

The possibility of a hub and spoke system, as described by Wonnacott, exists if member countries pursue separate bilateral agreements rather than the expansion of the free trade area itself.⁹ The U.S., for example, could become a hub with spokes representing NAFTA, the Caribbean Basin, and several South American

nations. Wonnacott argues that this arrangement would be less beneficial to all the participants than an extended free trade area. At first glance, it would seem that the U.S. might benefit as the hub by having preferential access to all of the spokes. Such a system would be administratively costly, however, and could raise accusations that the U.S. is exploiting the Western Hemisphere. This would be detrimental to the U.S.'s role in multilateral circles.

For multilateral requirements, GATT requires that preferential trade areas address all trade among the member countries without raising external barriers as a group. NAFTA complies with this provision. There may be scope, however, for unilateral protectionist action by any of the three countries using non-tariff barriers, including such "gray-area" measures as voluntary export restraints, contingent protection measures (anti-dumping and countervailing duties), and "rules of origin."¹⁰

The likelihood of these measures depends, in part, on the outcome of the Uruguay Round. Failure may provoke a dangerous trend toward protectionism, especially the use of non-tariff barriers not easily dealt with under the existing GATT dispute resolution mechanism. NAFTA's damage to outsiders will be exacerbated by failure to successfully conclude the Uruguay Round as "the sectors in which the potential for trade diversion is the greatest ... are likely to be subject to extensive liberalization in the Uruguay Round."¹¹ Consequently, without any further action, agreement on the measures proposed by the current GATT talks would mitigate NAFTA's impact for non-members.

REVIEW OF EMPIRICAL STUDIES¹²

Many attempts have been made to determine NAFTA's economic implications for the participants. Several models attempt to predict the results for the rest of the world. According to Braga, "the overall impact of NAFTA on the rest of the world should not be significant if the agreement fosters freer trade."¹³ This section will review the results of several such studies and attempt to highlight sensitive assumptions.

A partial equilibrium analysis of NAFTA by Samuel Laird found minimal trade diversion effects of 0.72 percent of total value of exports to the U.S. from non-member Western Hemisphere countries and 0.55 percent decrease from other industrialized countries.¹⁴ This study modeled only tariff removal among the participants. Effects of tighter rules of origin and changes to non-tariff barriers, as well as investment diversion, are thus not captured. Laird also found that if particular anticipated benefits from the Uruguay Round are implemented simultaneously with NAFTA, then trade creation exceeds trade diversion, with Western Hemisphere countries and the industrialized countries experiencing a 1.8 percent and 2.4 percent increase in exports to the U.S., respectively. A partial equilibrium model of a U.S./Mexico FTA by Erzan and Yeats¹⁵ finds a similar result to Laird's NAFTA model. It predicts a total trade diversion of one percent of U.S. imports from all non-NAFTA countries, with 94 percent coming from outside the Western Hemisphere.

Braga found that "the results of computable general equilibrium models... are sensitive to their specifications (particularly, elasticities of supply and demand, market structures, pricing behavior of firms, and assumptions about capital flows)."¹⁶ He reviews three models,¹⁷ each with two or three cases. Each model assumes increasing returns to scale and imperfectly competitive firms that set prices. Without international factor mobility, very small decreases occur in the NAFTA countries' demand for imports and supply of exports to the rest of the world. Cases that allow for international capital mobility, however, result predictably in deterioration of the terms of trade for non-members. These results expose the sensitivity of the model to assumptions about capital flows, which actually have a larger impact than the preferential trade liberalization component.

Referring to a study conducted by Robert McCleery, Michael Plummer and Pearl Imada reviewed the potential impact of NAFTA on the Philippines, Indonesia and Thailand. The study gauged the effects on these non-member countries by pairing their exports with those of NAFTA countries to determine which products would face competition, plus comparing existing tariff levels and non-tariff barriers with a cutoff of US\$5 million. The results predicted little net trade diversion for any of the three countries, while cautioning that particular sectors could be adversely affected, especially agriculture, steel and metal products,

chemicals, and textiles. As to investment diversion, the study found marginal diversion for the Philippines, a negative impact of 2-5 percent of investment annually for Thailand over an eight year period, and a decrease in investment for Indonesia ranging from 0.5 percent in the first year to 2-5 percent in the fourth year. This represents a significant handicap for these nations, as all are trying to expand foreign direct investment to promote technology transfer and continued economic growth.

Looking at income growth, the study found a small positive impact in the Philippines, due to increased exports to the U.S., and a negative impact for Thailand, ranging from a decrease in GDP of 0.35 percent in the first year, rising to 0.6 percent in the third year before falling to one percent in the sixth and seventh years. For Indonesia, the study anticipated a fall in GDP of 0.2 percent a year starting the first year and moving to a one percent annual decline in the fifth year and afterwards. These results occur under assumptions of high trade and investment diversion due to NAFTA. To the extent that reality is less extreme than these assumptions, the impact on these countries would be softened.

There are several sensitive assumptions that can dramatically alter the results of the studies, especially changes in capital flows and non-tariff barriers. Unfortunately, these important factors are difficult to predict and model, leaving room for further research. The results of these empirical studies can be summed up by this statement from Hufbauer and Schott: "On balance, we believe that trade created by growth in the NAFTA region should more than offset the trade diverted in particular sectors."

SUMMARY AND CONCLUSIONS

NAFTA's impact on both member and non-member countries remains a subject for debate, and will increasingly be so as the NAFTA signatories move through the ratification process and toward implementation. With the results dependent on modeling techniques and assumptions, the effects cannot unambiguously be predicted. Competing interest groups will choose the agreement's features that suit their arguments either for or against. The following conclusions can nevertheless be drawn about the impact of NAFTA on non-member countries:

- Most studies conclude that trade creation and income effects will exceed or balance out trade diversion and terms-of-trade effects. Thus NAFTA will have little or no effect on non-member countries. The effect for any particular country will, of course, vary depending on its trade pattern and particular export products.
- Given low pre-NAFTA barriers, investment diversion from the U.S. is likely to be minimal. It may be higher for certain sectors if significant liberalization takes place in Mexico, for example, in financial institutions. For the rest of the world, some countries with less preferential trade relations with the member countries may divert investment to them to increase their market access. Most of the studies do not project a specific investment diversion effect for ASEAN. The ASEAN countries, however, can counter investment diversion by maintaining liberal investment provisions and by promoting infrastructure investment and a stable macroeconomic environment attractive to investors.
- The enhanced competitiveness of NAFTA participants is a double-edged sword for non-members. Some industries will gain from lower costs of existing low cost producers and income effects, while others will lose from direct competition. Sectors likely to lose include textiles and apparel, automobiles and parts, and agriculture.
- Successful completion of the Uruguay Round and continuing multilateral liberalization is the best way for non-member countries to minimize any of NAFTA's possibly adverse impacts.

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