SCHOOL OF LAW
CASE WESTERN RESERVE UNIVERSITY

Canada-United States Law Journal

Volume 23 | Issue

Article 36

January 1997

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When Henry contacted me first about six months ago to do this task, I leapt at the chance. NAFTA and the U.S./Canada FTA were a big part of my career when I was in the Senate. I was an official advisor to the negotiators, and I spent a lot of time writing about it when I first left the Senate. For the last two years, though, I have really been involved with Chinese economic and trade issues and general issues with nonmarket economies, so I have gotten away from NAFTA. This is a good chance to get back and review the issue. Also, since last week, I have done two panels on China, and I am about to leave for a lecture tour in China, so it is a good chance to get a break from the monotony of talking about those issues.

In trying to draft my remarks in the last couple days, I realized that the questions of where we are and where are we going are broad enough to cover just about anything I might want to talk about. That is good and bad. On the good side, of course, nothing is left out, and I can go wherever I want to go. On the bad side, though, almost invariably if I do an interesting presentation, I will probably trample on some other speakers, so forgive me if those things happen.

Also, before I begin my remarks, I should mention that I am an economist, not a lawyer, which has a couple of implications. First of all, I will speak on these issues from a different perspective than many of you. Secondly, I occasionally lapse into a language that is not quite like English, and so if I lose you, just stop me and I will break out of the jargon.

The first question is, where do we stand? Before addressing that question, it is important to make a couple of points. As an economist, I view trade agreements as long-term policy ventures. It is impossible to evaluate how an agreement is working after one or two or even three

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years because often the economic effects of tariff cuts and trade concessions are literally swamped by other larger economic changes such as growth rates and different exchange rates which have a much larger short-term effect than trade agreements. That said, though, I am sure most economists would agree that an agreement to lower trade barriers generally benefits all countries involved. That is one of the few points, in fact, which has consensus in the economic community.

The unfortunate reality when you try to marry the economics of trade agreements with the politics of considering trade agreements is that politics demand a short-term focus and short-term benefits, but economics really cannot give short-term answers on trade agreements. The result of this is that you see a lot of economic analysis and a lot of job estimates tossed out that, while certainly not dishonest, are incomplete. There is a tendency to try to work too fast, and thus the numbers you have seen thrown about on the NAFTA, particularly in the debate in the United States, are questionable because the time period involved is so short.

I also think that the debate on the NAFTA in the U.S. Congress, of which I was a part, really set a new low in economic discussions in the public policy forum. Both sides did not just resort to exaggeration, but exaggeration was the main weapon, which meant that the public had a very distorted view of the NAFTA and its possible economic costs or benefits. The reality for the United States and Mexico, in particular, is that economic integration is a geographical reality. The fact is, if you live along the border with Mexico, trade and commerce occur regardless of the trade agreements in place. It happened before the NAFTA, and it is happening after the NAFTA. The United States, Mexico, and Canada are all economically dependent on each other regardless of the state of trade agreements. Trade agreements can set the rules for integration and set the pace for integration, but they cannot stop it. That is an important point to keep in mind when you talk about the job and economic effects generally.

I think you have the monograph I did a couple years ago on the economic effects on the United States and Canada. I will not be talking much today about the economic issues with Mexico's inclusion for a couple of reasons. First of all, I really do not think enough time has passed to do a good economic analysis of what the Mexican inclusion in the NAFTA has meant to the economies of the United States and Canada, particularly because the peso crisis has disrupted Mexican growth and has literally swamped the economic effect of the NAFTA. So most of the economic analysis that I will talk about today focuses on the U.S./Canada Free Trade Agreement, because the agreement has been in place for a long enough time to have some credible numbers generated in terms of economic and job effects.

Let me just make two points in answering the question of where we are now. First of all, the NAFTA, from an economic perspective, has been good for the United States and for Canada. Almost certainly it will be good for Mexico in the longer run. There is good data available now that the United States and Canada have both benefitted substantially from the increased market access to the other market. I will not bury you with a dizzying array of numbers here, but essentially the economy of scale benefits of an agreement like the U.S./Canada FTA are almost undeniable. By economy of scale I mean that the producers in both countries can have access to a larger market over which they can distribute their costs, which results almost invariably in economic benefits over time.

In the U.S./Canada case, three things emerge. First, trade expanded much more rapidly between the United States and Canada after the FTA. There was a total increase of $47.2 billion by 1994. Of that, Canadian exports increased $14.1 billion more than they would have been projected to without the FTA. It is important to note that trade between the United States and Canada was increasing anyway, so trade would have increased presumably if there was no U.S./Canada FTA. But what these findings show is that trade increased above and beyond what would have been expected. So the U.S./Canada FTA had a positive effect on trade. For Canada, that was a $14.1 billion gain in exports; for the United States it was a $33.1 billion gain over the period. Those figures are for the period up to 1994. Since 1994, you have two full years of data available. I looked at some numbers yesterday, and it appears to me that those same figures would about double now. Both the United States and Canada have seen significant economic gains.

The second point is that, as a result of the FTA, both the United States and Canada increase the propensity to import from each other more rapidly than from other countries. This means that, above and beyond existing economic trends, the fact that the U.S./Canada FTA was in place made each country more likely to trade with the other. It made those countries' exports more competitive with domestic production. That is not terribly surprising, but it is still important to demonstrate, given the political debate on free trade.

The third point, which I think is probably the most important in a political context, is that the U.S./Canada FTA has benefitted both parties. There is a lot of debate now in the U.S. Congress about the U.S. trade deficit and the effect of free trade agreements on that deficit. The United States has a trade deficit now with Canada; a continuing imbalance. As a result of the work that we did in 1995, the imbalance would actually have been larger if there was no FTA in place. I think that is probably the most important point, so I will repeat it again. If there was no FTA, the U.S. trade deficit with Canada would likely be larger than it is today. That makes good economic sense, given that the Canadian barriers before the FTA were higher on average than the U.S. barriers, so this is a predictable result. But the fact is that numbers seem to confirm the expectation.

We can also guess that, once the NAFTA results with Mexico are fully in, the same result will occur, but the peso price will probably disrupt any kind of a short-term measurement of those economic effects. Over time, though, we can clearly expect similar results with Mexico. Again, our experience has been that the U.S./Canada FTA confirms what we already suspected, that free trade has been a positive influence. The FTA has been positive for increasing development and encouraging trade to the benefit of all countries involved.

One issue with Mexico which I will pick up again is that differences in development of the legal systems can have an effect on the size of the economic benefits you might expect from a trade agreement like an FTA. The primary reason that countries engage in trade agreements is to establish a rule of law for commerce, so it does not come down to the law of the jungle, where the biggest party can dictate terms. Some of us who have been involved on both sides in the U.S./Canada FTA will probably be a little disappointed in this regard. The hope might have been that we would end all the bilateral scuffling. Theoretically, there is now a legal system in place that should resolve all disputes automatically. The reality has been, however, that this is not the case. In agriculture, we have disputes between the United States and Canada on wheat. With Mexico, there have been disputes involving tomatoes. There is a cultural industries issue, which we talked about in the last panel, a dispute settlement on softwood lumber, which is a long-running U.S./Canada dispute, and which has not been satisfactorily resolved. In fact, the United States and Canada have seen the need to negotiate a temporary understanding outside the scope of the U.S./Canada FTA to address the political problems raised by the *Softwood Lumber* case.

I will not dwell on this point much, although we might pick it up in discussion, but it seems to me that there are limits on what can realistically be expected in terms of establishing a rule of law in trade agreements. The fact is, you cannot magically wish away some of the political tensions and issues that surround trade matters, particularly between large trading partners like the United States, Canada, and Mexico. There are going to be, from time to time, matters that cannot easily be resolved by dispute settlement mechanisms in the agreement. For the system to survive, all parties have to be willing to judiciously consider extra-agreement approaches to solving particular trade problems, as with the cases of wheat and softwood lumber between the United States and Canada. Similar issues will spring up in the future. They are a reality. Even if we can cover ninety-five percent of trade in a rule-of-law-based system, there will be exceptions. That is a political reality, not an economic one.

So where do we go from here? Well, most of my discussion will focus on possible bilateral and pluralateral agreements for extending NAFTA in various directions. I want to mention three issues. The first is that of extending the NAFTA south. Chile is, of course, the most obvious candidate for joining in the NAFTA. Most of the arguments that you heard in the United States already, most economics arguments, are grossly distorted in economic terms for reasons I have already pointed out. The fact is, we can expect a Chilean FTA to have a small positive benefit for the U.S. economy over time, and probably a much larger benefit for Chile over time. But you are hearing the battle cries of the NAFTA beginning to start in Congress, and I think the distorted and exaggerated debate has already started. That is unfortunate, but it probably is a reality of U.S. politics at this point.

Let me just make a couple points about Chile that I think are useful. As an economist, I have always found it interesting that most of the debate about extending the NAFTA south is focused on issues like environment and labor standards, though they are important issues. Not nearly as much consideration has been given to setting up some economic readiness indicators, which I think is a very good idea. One of the lessons of the Mexican peso experience is that economic stability would be a wise criteria for determining who should be our next NAFTA partner. Such issues as exchange rate controls, as well as fiscal and monetary policy, might be the most important policies to examine in deciding who should be the next NAFTA partner. It seems to me Chile does very well on all these criteria, but I find it surprising that this is not more centrally injected into the congressional debate on the NAFTA, because this seems like a good place to put sound economics to work in setting up trade policy.

I am somewhat of a voice in the wilderness on this idea, because I do not hear much response on this notion in Congress. What you do hear in Congress now is a focus on environment and labor standards on both sides as a potential barrier, a potential issue in the Fast Track discussion. I think all of you are probably familiar with what the Fast Track is, so I will not go into a long discussion about that, but the issue of trying to set environmental and labor standards in the trade negotiating context has already become the most important issue in the decision by the U.S. Congress on extending Fast Track for NAFTA expansion.

As someone who is involved in the NAFTA, I think the discussion of side agreements on the environment and labor that are in the NAFTA has been distorted. Both those side agreements are modest steps to try to integrate, in a very initial way, issues of environment and labor into trade agreements. I should also confess that when I worked in Congress I was involved with the folks who worked to get those side agreements concluded, so historically, I have been an advocate to this kind of approach, or at least an employee of those who were advocates of this kind of approach. I have had a chance to think more about this since I left the government, and let me just share a few thoughts with you.

It seems to me that over time, economic integration between the NAFTA partners as a result of the geographic proximity and their increasing economic integration will require more coordination on issues like labor and environmental standards. Probably the same is true on competition policy. I think that is an inevitable result of the economies getting more closely integrated. Once you eliminate some of the more obvious trade barriers, tariffs, and so forth, your attention naturally shifts to another level of problems, and at some point that shifting of attention will focus on labor and environmental standards, competition standards, and other issues. That is a natural, inevitable, and probably desirable result of the NAFTA.

That said, there is also something to be said for not trying to take too much in one bite. In other words, it would be detrimental to all parties involved if the environmental and labor issues were allowed to slow the extension of NAFTA. I say that for two reasons. First of all, common environmental and labor policies are an inevitable result, something that cannot be stopped, and whether it is on the agenda now or not, it will be on the agenda in another decade. Secondly, I believe there is very strong evidence that trade and economic growth in general enhances the cause of environmental standards and improved respect for labor rights. So, probably the most effective way to advance both goals is to include trade agreements and expand growth in the hemisphere. The unfortunate reality may be in the U.S. Congress that this good economic argument might not be enough.

Actually, I was very optimistic that our Congress would extend Fast Track up until a month ago. Now I am much less certain. I am not sure that either the Administration, which has been the advocate of environmental and labor standards in this context, or the Republican Congress have enough negotiating room or enough flexibility to conclude a good Fast Track agreement. So I guess I would end on a pessimistic note here. I am not sure Fast Track will be extended this year.

I want to mention two other issues that deserve attention. The first one is looking to Europe. In the study on the U.S./Canada FTA that I mentioned, we found that trade between the United States and Canada expanded smoothly. As expected, there were real benefits to free trade, real solid economic benefits that can be easily demonstrated. David Ricardo [a well-known economist] probably would suggest that the best place to have trade agreements is between developed and developing nations because those countries have very different comparative advantages, with developing nations focusing on labor-intensive goods; developed nations focusing on capital-intensive goods. That is true on the surface, but I think what Ricardo would have missed is that there are some other issues in trade that need consideration, such as legal systems, political systems, and economics structures that are in place for things like currency control, and fiscal and monetary policy. All of these things figure into the benefits of trade, particularly in the short-term.

As a result, the benefits of free trade are inevitable if an FTA can come into being between either developed or developing countries. As a political matter, the benefits are likely to be more certain in the short-term in an FTA between two developed countries, rather than between developed and developing countries. Differences in legal systems, poor fiscal and monetary policy, and differences in exchange rates can all disrupt trade between developing and developed countries more easily than between developed countries. This would suggest that perhaps the United States and Canada should be looking not to developing countries as FTA partners, but to more developed countries.

The most obvious market in the world with a similar level of development and similar legal and political institutions would be in Europe. For that reason, you could expect that a Transatlantic Free Trade Area, perhaps involving NAFTA partners and the European Union, would generate the same kind of predictable economic benefits without major disruptions. Many people will wonder about how we would deal with some of the sensitive sectors. The United States and Europe have had a number of trade disputes over the years, particularly hot issues right now are in agriculture and aerospace.

Because of time constraints I will not try to go through every possible issue to be resolved, but let me suggest, on both of those two hot spots, there are ways the issues could be addressed that would allow an FTA to go forward. Agriculture is probably the most difficult issue, but we have made some progress there. There has already been substantial liberalization in the agricultural sector, and there is an ongoing process in place in the WTO. So we have breached the wall already when it comes to agriculture.

And the problems left are really not insurmountable. The European Union and the United States have both agreed to amend their agricultural programs in light of international trade realities. As we found in a study we did last year with the Council on Foreign Relations, there are some concrete steps that could be taken without sparking a political uproar that we might expect from agricultural negotiations. Let me just say here again, we have already made some progress. It is an issue that needs to be addressed, but it is not an issue that would necessarily halt an FTA.

Let me just wrap up with a few remarks on what I think is a larger trade issue. If you follow the trade literature at all, one of the issues in debate for the last ten years is the clash of economic systems. Most of the original focus was on Japan, the notion being that Japan had established a command capitalist structure which is fundamentally different from the free market-based system that the United States and Europe follow to greater and lesser degrees. In Japan, there is a role for the government, which is setting the agenda, setting industrial policy, and driving industrial policy forward. Many were concerned for years that perhaps that sort of capitalization was incompatible with the market-based system that the United States and Europe were pursuing. Some of the problems with Japan have lessened over the years. Japan has seemed to move more toward a Western-based system, and so the two models of capitalism are not as different as they were even a few years ago.

At the same time, however, there have been some changes in the world that I think the NAFTA partners need to take note of. Western capitalism seems to expand well in NAFTA and in Europe, and, as a result of the end of the Cold War, a series of former nonmarket economists have entered into the economic system and have become bigger players in the world of economy. They bring with them some notions of nonmarket economics and a desire to develop rapidly. As they look around the world for economic models to follow, many have adopted the notions that Japan had, and they have merged them with their own nonmarket economics. That is a troubling result for the United States, Europe, and for the NAFTA partners in general. First of all, the former nonmarket economies are not practicing market economics as we know it, which results in problems for all of the NAFTA and the European countries. These are not rule-based economies, and they are not easily integrated into a rule-based, market-based system.

I think one of the challenges that all of the NAFTA partners and

Europe face in the next two decades is trying to find a way to get those economies into a market-based system. It is critical from a political perspective that all countries put aside some differences and work together, because setting the terms of trade is probably the most important economic issue on the agenda. Working together, the NAFTA partners and Europe are far more likely to have an effect than working separately, or not working at all. Maybe the most important agenda for the future of the NAFTA is spreading the economic philosophy that the NAFTA partners share to the rest of the world.