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195

The NAFTA: Another Futile Trade Area (AFTA) or a Serious Approach Towards Regionalism?

by Rolf J. Langhammer

430370 *

CONTENTS

- The North American Free Trade Agreement (NAFTA) negotiated between the US, Mexico, and Canada in August 1992 is targeted at removing all barriers to trade in goods and services between these countries. However, it contains a number of exclusions, safeguards, and restrictions on trade, thus limiting the effects on trade, welfare, and factor income. As in each free trade agreement (FTA), rules of origin play a prominent role in the restrictions. Furhermore, to some extent the trade effects have already been forestalled as result of the unilateral Mexican trade liberalization since 1985, special offshore assembly provisions of the US (maquiladora industries), and the bilateral Canadian-US FTA (CUSTA).
- All studies on NAFTA's effects unanimously support the so-called "win-win" strategy saying that each partner state will be better off because of the NAFTA. As tariffs are already low within the NAFTA area, the major effects of the agreement are assessed to result from the dismantling of non-tariff barriers and particularly the removing of Mexican restrictions on foreign direct investment. The dynamic effects of foreign capital inflows into Mexico are expected to exceed the static trade effects by far. Thus, Mexico is said to achieve the highest gains. Fears of US trade unions that wages will fall in the US because of Mexico's free access to the US market are not supported by the studies.
- The rest of the world will lose small market shares in North America. This view, however, seems overly optimistic with respect to those small economies that direct the largest share of their exports to North America. These countries are, for instance, various Caribbean and Asian countries. Their tariff preferences will be eroded and they might also suffer from the trade-diverting effects of more restrictive rules of origin. In addition to losing their market shares, third countries fear that NAFTA will become so attractive to foreign investors that future capital flows will tend to flow to Mexico instead. The experience the Mediterranean countries made after their accession to the EC shows that such concerns are not unfounded for the short run.
- There are major differences between NAFTA and FTAs of the EC with Central and Eastern European countries as far as the trade effects are concerned. These are still to come in Europe, while they have already been largely realized within NAFTA as a result of structural adjustments in Mexico. The signal effect that NAFTA exerts on other American countries to establish further FTAs seems similar to the signal effect that the FTAs between the EC and the CSFR, Poland, and Hungary exert on the rest of Eastern Europe. However, in the short run the prospective American FTAs are expected to have a higher trade-diverting potential than the prospective European FTAs because the supply capacity of the countries at the eastern border of Europe is very limited. The same conclusion holds for the investment-diverting potential. A proliferation of FTAs towards the South of the Americas is expected to attract more foreign investment than a proliferation of FTAs towards the East of Europe.

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I. LAFTA, PAFTA, AFTA, and Now NAFTA: The Unbroken Attractiveness of Regional Free Trade Areas

Unlike customs unions for which over decades the EEC has remained the only successfully operating scheme, regional free trade arrangements have always been a pet issue of trade politicians. While boom periods during which such arrangements mushroomed were followed by periods of disenchantment and even disintegration, the attractiveness of "going regional" remains by and large unbroken. Such boom periods were the early sixties when the Latin American Free Trade Association (LAFTA) and the European Free Trade Association (EFTA) were launched and when the Pacific Free Trade Area (PAFTA) failed to move beyond the stage of paperwork [Haberler, 1974, p. 20].

Obviously, the early nineties mark the beginning of a new boom period. The European Economic Space negotiated in 1991 is a free trade area between EFTA and the EEC, and shortly afterwards the Association of Southeast Asian Nations (ASEAN) committed itself to achieve an ASEAN Free Trade Area (AFTA) by the year 2007. The latest scheme is the North American Free Trade Area (NAFTA) negotiated between the United States, Canada and Mexico in 1991/92, and heralded by the White House on 12 August 1992 as a "massive open market — over 360 million people and over $6.000.000 million in annual output" [US, 1992b].

Both the theory of political economy and the empirical evidence suggest mere economic size to be less conducive for the sustainability of regional trade integration than a small number of member states and the conformity in the fundamentals of macroeconomic policies. Economic size in terms of shares in world trade has more important implications for third countries if the integration scheme includes such large trading partners as NAFTA does. In 1990, the NAFTA region accounted for 19.7 per cent (16.4 per cent) of world merchandise imports (exports) and 19.7 per cent (15.9 per cent) of world manufactured imports (exports) [GATT, 1992, Tables I.4, IV.2, IV.3].[1] Thus, NAFTA is likely to impact on the import side as one of the most absorptive markets as well as on the export side where a free trade area could lead to a reallocation of resources and to an expansion of exports. In short, third countries may fear to lose markets within NAFTA (trade diversion) as well as to be exposed to more competition on domestic and third markets.

But beyond this, there are at least two additional factors which require that more attention be paid to NAFTA than to the other so-called free trade agreements (FTAs). First, for the second time (after the Europe Agreements of the EC with the CSFR, Poland, and Hungary) industrialized and developing economies with striking differences in resource endowment, per capita income, level of external protection, and institutional setting have agreed to merge to a free trade area. It is exactly this type of heterogeneity which has given rise to concerns that trade diversion effects could be sizeable [Bhagwati, 1991, p. 77; Langhammer, 1992b, p. 224].

Secondly, NAFTA is not confined to removing internal border measures like tariffs and quantitative restrictions. As will be shown below, trade-related investment measures as well as technical and environmental standards are also going to be subject to the principle of national treatment within North America. This has triggered fears that investment flows could also be diverted in favour of intra-NAFTA flows and to the detriment of third countries. At a time when worldwide competition for external savings has sharply intensified because of increasing demand (Eastern Europe) and diminishing supply from former capital surplus

Helpful comments by Ulrich Hiemenz on an earlier draft are gratefully acknowledged.

[1] In terms of expansion of world manufactured imports in the eighties, the NAFTA contribution is even more impressive. It accounted for 22.5 per cent of incremental world manufactured imports between 1980 and 1990. Next to the formation of the European Economic Space, the implementation of NAFTA can therefore be expected to have the largest impact on third countries of all regional free trade areas ever launched.

regions (Western Europe, Middle East), the dynamics of investment diversion seemingly count more than the static "once and for all effects" of trade diversion.

This paper tries first to cast some light on the point of departure, that is, on the one hand, the domestic homework done by Mexico and, on the other hand, the Canadian-US Free Trade Agreement (CUSTA) both being indispensable prerequisites for NAFTA (Chapter II). Furthermore, the main elements of the NAFTA agreement are presented as far as they have been already agreed upon (Chapter III) followed by the discussion of the likely effects on trade, growth and welfare as they have been derived from a number of general equilibrium models (Chapter IV). The question of GATT consistency is raised in Chapter V followed by a comparison of NAFTA to the Europe Agreements, the other important regional trading arrangement between developed market economies and developing (or quasi-developing) economies (Chapter VI). Chapter VII concludes on the main findings.

II. Structural Adjustment in Mexico and the CUSTA: Paving the Road to NAFTA

The US have always been the "natural" trading partner of Mexico and Canada as a purchaser and seller. Geographical proximity, the absorptive capacity of the US market, the complementarity of the resource endowments, cross-border ethnic links, and — in the case of Mexico — the existence of special offshore assembly provisions for the Mexican border industries producing for the US market have been the main determinants of a traditionally high US share in Mexican and Canadian trade. As concerns Mexico, changes in trade shares during the eighties were mainly due to declining oil prices on the Mexican export side and the increasing importance of US offshore assembly provisions on the Mexican import side.[2]

However, such close neighbourhood relations are widely independent of the institutional affiliation such as FTAs or customs unions (CUs). They are in place anyway, because for Mexico and Canada there is no equivalent alternative to the US market. What FTAs and CUs influence instead, is on the one side the degree of outward orientation, that is the share of exports in GNP, and on the other side the share of imports in domestic supply (domestic production plus imports minus exports). Both are expected to rise if the FTA works well.

From the very beginning of discussions on NAFTA, it has been clear that without considerable domestic adjustment in Mexico the debt-ridden and defaulting country would not have been able to benefit from easier access to the US market, and to meet the challenges of intensified competition on the domestic market. In other words, without doing substantial homework to cope with the negative consequences of domestic distortions, an FTA with the US would have immediately fallen into the same trap of widening regional imbalances, distributional conflicts, and stale-mate as many FTAs in the Third World.

[2] As far as exports (imports) are concerned, the US share increased by more than 10 percentage points to about 72 per cent (71 per cent) between 1980 and 1990. Declining oil prices allowed exports of manufactures to grow more rapidly while the US offshore assembly provisions were instrumental to stimulate US intermediate exports to Mexico. These exports are assembled in Mexico and reexported into the US. As a result, a large part of Mexican imports — the US-made components incorporated in Mexican products and the Mexican goods processed from US-origin metal — returns free of duty to the US under offshore assembly provisions (so-called subheadings 9802.00.60 and 9802.00.80 of the US Tariff Schedule). In 1989, US imports under these subheadings accounted for 45 per cent of total US imports from Mexico, up from 29 per cent in 1985. Most of the assembly takes place in Mexican "in-bond" or maquiladora industries. In addition, 9.3 per cent of US imports from Mexico entered the US markets duty-free under the generalized system of preferences (GSP), up from 6.5. per cent in 1985 [USITC,1991, p. 107, Table 1.1.]. Thus, in 1989 almost 55 per cent of US imports from Mexico was exempted from duties, in addition to fuels and raw materials (about 18 per cent) which are non-dutiable anyway.

Mexico started its domestic adjustment programme in the second half of the eighties. In 1985, the import licensing system was replaced by a generalized tariff system. Public expenditures were cut and an austerity programme was maintained. In 1986, the Mexican government signed the GATT treaty, and thus disciplined itself externally as far as discretionary trade policy manoeuvring was concerned [Hiemenz, Nunnenkamp et al., 1991, pp. 124–129]. In the following years, tariffs were bound at a ceiling rate of 50 per cent, the tariff range was narrowed to 0–20 per cent in 1988, and average tariffs were lowered to 13 per cent in 1990 [OECD, 1991, Table 1].

In 1987, the government provided new incentives for private investment by launching a framework agreement with the US on expanding bilateral trade relations which — together with successive peso devaluations — fuelled investment in "maquiladora" industries. Finally, a growth-oriented adjustment programme (1986/87) substantially reduced uncertainty and qualified the country as the first major debtor to benefit from the Brady Initiative of reducing debt and debt services (July 1989).

The results of structural adjustment were impressive:

—Private investment as a share of GDP increased by 18.4 per cent in 1985–1990 which was above the average increase in forty major developing countries (15.9 per cent) while the share of private investment in total investment rose by 19.7 per cent (average: 3.9 per cent) [Pfeffermann, Madarassy, 1992, Tables 6 and 7, pp. 24–25].

—Economic growth regained momentum. Real GDP grew by 2.6 per cent on average in 1986–1990 after having virtually stagnated in 1983–1986 (0.7 per cent). The decline in real per capita income (–1.7 per cent in 1983–1986) came to a standstill (0.4 per cent in 1986–1990) [UNCTAD, 1992, pp. 438–439].

—Public expenditures were contained and tax collection improved so that the budget deficit turned into a surplus in 1990.

—Three-digit inflation rates which had prevailed until 1988 could be lowered to a level of 27 per cent in 1990.

—Merchandise exports (including exports of border industries) grew by 15–16 per cent in 1989 and 1990 compared to 9 per cent for the entire decade. At the same time, Mexico stopped its policy of import compression [GATT, 1992, Table III.21].

—Finally, Mexico regained the confidence of foreign investors. Accumulated foreign investment in physical assets more than doubled from US$4.6 billion in 1985 to US$30.3 billion in 1990 (US$3.9 billion in 1991) [Deutsch-Mexikanische Industrie- und Handelskammer, 1992, p. 2]. Among the ten leading foreign investors in Mexico, the US had a share of two thirds in 1990.

Contrary to Mexico which had to do its homework first before entering into negotiations with the US, Canada's fitness course following CUSTA widely overlaps the course that will be caused by NAFTA. The main provisions of CUSTA will come into force by the mid-nineties when also NAFTA provisions are expected to be implemented. For instance, in 1994 at the earliest, 50 per cent of Canada's dutiable exports to the US are scheduled for entering the US market duty-free. Sensitive items like logs, many agricultural products and textiles, steel and steel pipes will not be covered before 1998, not to speak of controversial issues like government procurement, financial services and trade-related investment measures. Given the overlap between CUSTA and NAFTA and the similarities in the conventional areas like tariffs and other trade measures [Whalley, 1992, p. 138], the former agreement will ultimately become merged into NAFTA.

Therefore, it does not come as a surprise that NAFTA initially meant much less for Canada than CUSTA, which generated a nationwide debate in Canada, and shaped the 1988 Parliamentary election into a quasi-referendum on the FTA. Even the maintenance of the status quo was considered, i.e. two bilateral FTAs with

the US as the hub, and Mexico and Canada as the two spokes. Such an early lack of interest mirrors insignificant direct economic interactions between Canada and Mexico. Only 1.3 per cent of Canadian imports originated from Mexico in 1989 and 80 per cent of this trade entered the Canadian market duty-free. The Canadian export side shows even smaller interactions. In 1989, no more than 0.5 per cent of Canadian exports were directed to Mexico [USITC, 1991, p. 117; Hart, 1990, p. 68].

However, the Canadian public soon became aware of the fact that there are important indirect implications of NAFTA on Canada, such as Canadian exports to the US markets facing an erosion of their benefits of the CUSTA or even replacement by Mexican exports. Beyond static trade effects, there was the fear of "investment diversion" to the detriment of investment in Canada which heightened Canada's interest in NAFTA when US-Mexico negotiations proceeded. Furthermore, issues of interest to Canada like the strong exposure of Canadian banks to Mexican debt [Hart, 1990, p. 124], rules of origin for automobiles, textiles and clothing, intellectual property rights in pharmaceuticals, and trade in energy products could not have been influenced by the Canadian government without actively participating in the negotiations.

III. NAFTA in August 1992: An Unfinished Job of Balancing Vested Interests

The August 1992 draft proposals of NAFTA as they were released by the Bush administration [US, 1992b] and the Canadian government [Government of Canada, 1992b] witness the unfinished character of NAFTA. The legal text was paraphed on 7 October 1992 but the legislative hurdles have not yet been passed. A new US administration could take a different stance towards NAFTA, and the US Congress is able to modify (not to say water down) many of the controversial issues.[3] To what extent vested interests impact upon the assessment of the draft proposal can be gauged by confronting the comments of the three governments with each other.

1. The US Government View[4]

Tariffs

About 65 per cent of all US industrial and agricultural exports to Mexico will be eligible for duty-free treatment either immediately after the agreement has come into force or within five years. Mexican tariffs on cars and light trucks are cut in half immediately. Within five years, tariffs on 75 per cent of US exports of car components will fully be removed. Current Mexican requirements of local content and "trade balancing" for these goods will be phased out over ten years.

[3] In fact, the necessary legal steps to bring NAFTA into operation are numerous and sophisticated, at least on the US side: once the legal text is completed, the president notifies Congress of the agreement. Following notification, the president must wait for at least 90 calender days before signing the agreement. During this period, the Congress may attempt to seek changes in the agreement. For the agreement to be considered using "fast track procedure" which means the agreement would be exempt from amendment and subject to a straight up-or-down vote in Congress, the agreement must be signed by the president by 1 June 1993. After the agreement is signed, legislation must be prepared to implement it, including any necessary changes to US law. Under the "fast track", NAFTA will not go into effect until the Congress has approved the implementing legislation on a up-or-down vote. That means that legislation must pass both the Senate and House by majority vote. The approval process must occur within a specified time, that is 90 "session" days of Congress [Schaffer,1992; US, 1992a].

[4] For documentation, see US [1992b].

Rules of Origin

Only vehicles with substantial North American parts and labour content will benefit from tariff cuts. NAFTA requires vehicles to contain 62.5 per cent North American content (in two stages over eight years) which is more than the 50 per cent required by CUSTA. NAFTA contains so-called tracing requirements so that individual parts can be identified according to their origin.

Restrictive rules of origin prevail also for textiles and apparel and US computer exports to Mexico. For most textile products, for instance, the rule of origin is "yarn forward" which means that textile and apparel goods must be produced from yarn made in a NAFTA country. A "fiber forward" rule is provided for certain products like cotton and man-made fiber yarns. In this case, goods must be produced from fiber made in a NAFTA country.[5]

Trade in Agriculture

NAFTA will immediately eliminate Mexican import licenses which covered 25 per cent of US agricultural exports last year, and will phase out remaining Mexican tariffs within 10–15 years.

Trade in Services

Mexican financial services markets will be opened, and US banks and securities firms will be allowed to establish wholly owned subsidiaries. Transitional restrictions will be phased out by the year 2000. Mexican insurance markets will be opened. US firms with existing joint ventures will be permitted to obtain 100 per cent ownership by 1996. New entrants can obtain a majority stake in Mexican firms by 1998. By the year 2000, all equity and market share restrictions will be eliminated.

NAFTA will permit US trucking companies to carry international cargo to the Mexican states contiguous to the US by 1995, and gives them cross-border access to all of Mexico by the end of 1999. US railroads will be able to provide services in Mexico, and US companies can invest in land-side port services and operate them.

Trade-Related Investment Measures (TRIMs)

Mexican "domestic content" rules will be eliminated permitting additional sourcing of US inputs. US firms operating in Mexico are granted "national treatment". Export performance requirements will be dropped.

Trade-Related Intellectual Property Rights (TRIPs)

NAFTA will provide a higher level of protection of TRIPs than under bilateral or multilateral agreements. The agreement will also limit compulsory licensing which was a major concern with Canada.

Environment

NAFTA allows the US to maintain its stringent environmental, health and safety standards. It encourages "upward harmonization" of national standards and regulations. An integrated border plan for addressing soil, air, water, and hazardous waste problems in the US-Mexico border area will be implemented in its first stage in 1992–1994.

Safeguards

Specific safeguards exist for import-sensitive industries enjoying a transition period of up to 15 years before tariffs are phased out. General safeguards allow the US to reimpose tariffs in the case of "injurious" import surges.

[5] Apparel cut and sewn from certain imported fabrics can qualify for preferential treatment when the NAFTA countries agree that the fabrics (such as silk, linen, and certain shirting fabrics) are in short supply.

2. The Canadian View[6]

The Canadian government sees NAFTA as a "CUSTA-Plus". Detailed assessments (other than those cited by the Bush administration) cover the following issues.

Tariffs
Mexico will immediately provide duty-free access for many of the Canadian key export items. For sensitive items, Mexican tariffs as well as Canadian tariffs will be phased out over a maximum of ten years. Canada will be allowed to continue to impose special tariffs to prevent import surges of goods like fruits, flowers, and vegetables.

The Car Industry
Canadian car manufacturers will get immediate access to Mexico for medium and heavy-duty trucks and buses. A duty drawback scheme (refunding of import tariffs on car components which are reexported), which was negotiated within CUSTA, is extended for two years beyond its expire in 1994. A new duty refund system will be introduced thereafter which will reduce input costs for Canadian manufacturers. These schemes are seen to balance the disadvantages of higher local content levels compared to CUSTA.[7]

Trade in Agriculture
Within NAFTA, Canada and Mexico will handle trade in agricultural items bilaterally, as CUSTA continues to govern trade between the US and Canada. Canada will maintain its import quotas for dairy products, poultry, eggs and sugar — the same does Mexico —, while those on grain, beef, and margarine will be dropped. Special and general safeguards will continue to exist.

Trade in Textiles and Apparel
Canada sees the negative impact of tighter origin rules as being offset by increased "tariff rate quotas" providing Canadian producers with preferential access to the US market. Unlike in CUSTA where the quotas were either fixed or only insignificantly extended, the increase of NAFTA quotas covers most textile and apparel categories.

Energy
Canadian gas exporters will enjoy better access to the US market than under CUSTA, and suppliers of petrochemicals are expected to benefit from more discipline imposed upon the Mexican use of restrictive trade practices including export taxes and discriminatory border restrictions. While Mexico did neither agree to lift constraints on private ownership in its energy sector nor to guarantee the security of supply provisions it did neither obtain security of supply for its imports nor security of access for its exports.

Services
Canada and Mexico agreed to maintain their relatively open international maritime shipping market. NAFTA offers better market access for the Canadian trucking industry and special air services (aerial mapping and surveying). Domestic carriers in each NAFTA country, however, still retain the exclusive right to haul cargo within their own country. Like in CUSTA, NAFTA excludes free competition in basic telecommunications but includes enhanced telecommunications services (advanced data-processing services).

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[6] For documentation, see Government of Canada [1992a].

[7] Higher local content requirements are said to be a barrier for Honda cars produced in Ontario to qualify for NAFTA tariff treatment.

Government Procurement
The scope and coverage of procurement contract opportunities available to Canadian companies under the NAFTA provisions are improved compared to GATT and CUSTA.

The assessments concerning financial services (better market access in Mexico), trade-related intellectual property rights (rights are comprehensively protected), investment (Mexico reduces investment restrictions), and environmental standards (no underbidding of NAFTA partner's standards in order to attract foreign investment, no lowering of national standards, freedom to choose the standards which it finds appropriate) are similar to that of the US administration.

3. The Mexican View

The Mexican view as given by the Mexican president shortly after the end of the negotiations focuses on

- —the "hinge" function which Mexico hopes to play between the North American market on the one hand and Colombia, Venezuela and the Central American economies on the other hand;
- —better access to the Canadian market which up to now was much less open to Mexican exports than the US market;
- —attracting more foreign investment without being forced to adjust environmental and social standards up to the level of the NAFTA partner countries;
- —successfully fighting inflation by tightening external monetary discipline;
- —enjoying an improved transfer of technology through facilitating capital goods imports into Mexico;
- —positive employment effects outside the border areas in order to bridge regional disparities.

4. A Synoptical View: Taking a Dispassionate Look at NAFTA

As a result of Mexico's homework during the second half of the eighties tariffs in general have ceased to be major barriers. Mexican average tariffs amount to 10 per cent, that is two-and-a-half times the US tariff. To a large extent, the relatively low Canadian and US MFN tariffs do not even apply to Mexico today because of the GSP and the offshore assembly provisions.[8] This suggests that the trade effects of NAFTA will be small if they are estimated on the basis of preferential tariffs rather than GATT-bound tariffs. Where tariffs still play a role like in textiles and cars, rules of origin have been tightened mainly for two reasons. First, they are intended to discourage tariff saving of companies which invest in activities with low NAFTA value added. In this respect, they basically protect US companies against duty-free imports from Mexico in pure assembly industries. Secondly, they are targeted against so-called "trade deflection", that is extra-NAFTA imports channelled into a high-tariff member state, that is Mexico in the NAFTA case, via the low-tariff member states Canada and the US. Trade deflection would result in tariff revenues foregone by Mexico.

[8] Brown, Deardorff, and Stern (BDS) [1992a, Table 2 and pp. 16 and 20] use effective ad valorem tariff rates for US imports from Mexico ranging between 6.2 per cent for clothing at the maximum and 0.1 per cent for rubber products and petroleum products. These rates are averages of the nominal tariff rate and a tariff-equivalent rate for non-tariff barriers (NTB) using the NTB coverage rate to weight the NTB tariff equivalent. Nominal rates are scaled by a factor that reflects the value added applied to US exports to maquiladora plants in Mexico. Notwithstanding the difficulties in estimating price equivalents of NTBs, these estimates indeed suggest effective tariffs against Mexican exports to be relatively low. There is a much wider spread in Mexican effective tariffs against the US and Canadian goods. Maximum tariffs in the BDS estimates are almost 20 per cent [ibid., Table 4].

Rules of origin are cornerstones of any FTA, and only in integration schemes where national tariffs are similar and/or intra-FTA trade flows are negligible (as in EFTA), they do not impede trade. Actually, the 62.5 per cent rule for cars and the "yarn forward" or "fiber forward" rules for textiles penalize manufacturers buying from the cheapest source in the world. This means that such manufacturers face MFN treatment if they do not meet the rules. Under such circumstances, the NAFTA provisions would become totally ineffective. It is argued that, for instance, the Canadian clothing industry could become a victim of the "yarn forward" rule as it imports yarn from East Asia [Neue Zürcher Zeitung, 1992].

Apart from rules of origin, there are a number of other provisions diluting the FTA:

—There are special safeguards in sensitive items with long periods of transition up to 15 years until free trade is accomplished. Agriculture, cars, energy, and textiles are affected primarily by special safeguards.

—General safeguards against "import surges" and for protecting human, animal, and plant life or health, and the environment are implemented. Given the recent GATT-recorded disputes between the US and Mexico on the extra-territorial application of national environmental standards, such safeguards are a leverage of US environmentalists to urge for the denial of NAFTA preferences to Mexican goods if these goods allegedly do not comply with US standards.

—Some items and sectors are excluded from NAFTA provisions. On this exclusion list, sectors figure prominently which are reserved to the Mexican state and Mexican nationals by the Mexican constitution (for instance, mineral oils). Furthermore, some services like basic telecommunications, the maritime industry, and most air services are not part of the NAFTA provisions. Nor are important agricultural items included in the provisions, like sugar exported under the US sugar re-export programmes or dairy products, poultry, eggs, and sugar in trade between Canada and Mexico.

—NAFTA preferences can be denied if services are supplied by companies which are controlled or owned by non-NAFTA residents unless this company has already substantive business activities within NAFTA. This provision can become a discretionary instrument against new investors from outside NAFTA.

To summarize, in its draft stage NAFTA has still been as far from a perfect FTA as CUSTA [Whalley, 1992, p. 133].

IV. Expected Effects of NAFTA

Since 1990, a number of empirical studies have been undertaken in the US to gauge the likely effects of NAFTA. In addition, all issues relevant to NAFTA have been embodied into a general analysis and assessment of US trade policy [Hufbauer, Schott, 1992].

The empirical studies use computable general equilibrium models calibrated for different sectors and regions. All studies focus on the removal of trade barriers which is the only measure for which there is sufficient and reliable information. NTBs are taken into account through estimates of price equivalents and assumptions on the extent of quota dismantling.

Four of the models are static [BDS, 1992a; USITC, 1991; KPMG Peat Marwick, 1991; Hinojosa-Ojeda, Robinson, 1991 (Berkeley study)]. They do not endogenize the effects of the US-Mexican FTA (the core of NAFTA) on the capital stock and the sectoral structure of the economies. Nor do they analyze the impact of changes in investment flows on trade patterns. Yet, in addition to the removal of tariffs and NTBs, they

assume "once and for all" changes in investment in different scenarios. Three studies[9] use dynamic models. Two of them (CIEMEX/WEFA, ESI) project the impact of the FTA until the year 2000 (for a detailed discussion of shortcomings and strengths of the various models see Prestowitz Jr., Cohen [1991, pp. 36-49]).

1. Effects on Trade

The trade effects of the models estimated under different scenarios for the core of NAFTA, that is the US-Mexico FTA, are summarized in Table 1. The major findings are the following:

(i) Irrespective of whether or not changes in investment are assumed, the static models produce small effects on intra-NAFTA trade. This is not surprising given the low level of tariff protection against Mexican exports to the US and the dismantling of Mexican tariffs in the pre-NAFTA period. Three studies (USITC, BDS, and the international accounting firm KPMG Peat Marwick) estimate that US exports to Mexico would rise by about 8–12 per cent of the 1989 level while Mexican exports to the US would rise by 13–17 per cent. The higher increase of Mexican exports in spite of already low tariffs can be attributed to the removal of NTBs.[10]

(ii) The effects on the rest of the world (ROW) are estimated to be low as well. While ROW exports are found to decline in the BDS model, this impact is negligibly small. Hence, concerns of third countries, especially from East and Southeast Asia, that trade could be diverted from extra-NAFTA trade to intra-NAFTA trade, do not find support in this study. The USITC study [1991, p. 166] argues along the same lines but is more serious about fears of small third countries like the Caribbean economies that such losses could nevertheless be large in relation to the size of their economies, and the importance of individual products affected.

(iii) The Almon study produces an "outlier" result of much higher FTA-induced export increases of the US to Mexico (more than one third). Apart from differences in the type of model used this might be due to the fact that the Almon study models the Mexican propensity to import by using data from countries that did not restrict imports during the eighties [Prestowitz Jr., Cohen, 1991, p. 39].

(iv) The impact on Canada's trade is found to be small as well although some of the preferences enjoyed by Canada through CUSTA are going to be eroded. There is probably a base effect underlying this result because the Canadian trade with Mexico both on the export and import side is far from being sizeable.

(v) The studies covering the period until the year 2000 are not comparable to those dealing with "once and for all" effects. Their results rely basically on investment effects and their impact on trade flows. The CIEMEX/WEFA model, for instance, assuming a US$40 billion investment inflow into Mexico and an export share of 50 per cent in the newly installed foreign-run capacity, estimates a large demand for intermediate products imported from the US starting at 70 per cent of Mexican inputs in 1992 and falling to 50–60 per cent by the year 2000 [Prestowitz Jr., Cohen, 1991, p. 41]. Such a demand hike produces a trade deficit of Mexico of US$19 billion although Mexican textile and clothing exports as well as metal exports are assumed to triple between 1992 and 1994, and to double between 1994 and

[9] Almon [1990], Adams et al. [1991] (CIEMEX/WEFA study), and Cohen [1991] (ESI study), all cited in: Prestowitz Jr., Cohen [1991, pp. 37–40, 41–42, and 45–49].

[10] In contrast to KPMG Peat Marwick, the BDS model shows a much larger increase in trade volumes if Mexico relaxes its capital import controls thus allowing for a 10 per cent increase in the Mexican capital stock due to foreign direct investment inflows [BDS, 1992a, Table 5, Scenario d]. Then, Mexican exports are expected to rise by US$12.3 billion instead of US$2.9 billion probably because foreign direct investment (FDI) substantially improves the supply capacity of Mexico due to higher factor productivity. BDS also suggest that the capital inflow into Mexico may come primarily from outside NAFTA and not from the US so that the fear of US trade unions that US companies would relocate production to Mexico may be largely unfounded [ibid., p. 29].

1996. As the Mexican car market will be opened to the US, this industry is expected to contribute largely to additional US exports. The ESI study using a similar model as CIEMEX/WEFA assumes a higher export share for the capital stock newly installed by foreign investment in Mexico. This assumption and the one that the marginal capital productivity of this capital stock would be higher than that of the old Mexican capital stock lead to much higher Mexican exports to the US than in the CIEMEX/WEFA model. As a result, different scenarios in the ESI model end up in Mexican exports to the US of up to US$84 billion compared to US$70 billion US exports to Mexico.

Table 1—Trade Effects of the US-Mexico FTA (US$ bil.)

	USITC	Almon	BDS[a]	Memo: actual trade
	Removal of tariffs and NTBs[b]			
	1988	1988	1989	1989
Balance of trade				
US	0.0	7.8	–0.2	–
Mexico	0.0	–2.9	0.0	–
US exports to				
Mexico	2.03	9.1	2.9	25.0
ROW	0.15	1.0	–	338.9
Mexican exports to				
US	2.17	2.9	2.9	16.1
ROW	0.15	1.0	–	6.9
Canadian				
exports	n.a.	n.a.	0.0	120.7
imports	n.a.	n.a.	0.0	117.4
ROW				
exports	n.a.	n.a.	–0.1	1620.0
imports	n.a.	n.a.	–0.3	1602.2
	KPMG Peat Marwick	CIEMEX/WEFA	ESI	Berkeley[c]
	Investment in Mexico			
	of US$25 bil. in 1988 only	of US$40 bil. in 1991–2000	of US$25 bil. in 1992–2000	of US$12.5 bil.
Balance of trade				
US	0.0	n.a.	8 to –13	–4.7
Mexico	0.0	–19	n.a.	7.7
US exports to				
Mexico	2.83	54	70	5.31
ROW	0.51	n.a.	n.a.	1.14
Mexican exports to				
US	2.76	50	63 to 84	1.71
ROW	0.80	n.a.	n.a.	–1.47

[a] Scenario (c) in BDS assumes in addition a 25 per cent expansion of US import quotas imposed on Mexican exports of agriculture, food, textiles, and clothing. — [b] The base years of the three models are given in the next line. — [c] This study assumes in addition the removal of tariffs. — ROW = rest of the world. — n.a. = not available.

Source: USITC [1991]; BDS [1992a, Table 5]; Almon [1990], KPMG Peat Marwick [1991], Adams et al. [1991] for CIEMEX/WEFA, and Cohen [1991] for ESI, as cited in: Prestowitz Jr., Cohen [1991, pp. 36–39, and pp. 45–49]; Hinojosa-Ojeda, Robinson [1991] for Berkeley; for actual trade, see IMF [1991].

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2. Effects on Real Income

Table 2 summarizes the main findings of NAFTA studies with respect to gains in real income:

(i) All partner countries would enjoy welfare gains. Hence, there is no zero-sum-game as many politicians fear from FTAs between countries at different levels of income.

(ii) The static Armington type models with constant returns to scale and national product differentiation report real income gains of 0.3 per cent for Mexico and negligible effects for the US, if constant FDI is assumed and if NAFTA relies on tariff dismantling only. Removing the remaining tariffs, therefore, does not induce large welfare gains in North America. Given the much larger importance of the US market for Mexico than vice versa, it is not surprising that the welfare gains are higher for Mexico than for the US.

Table 2 — Effects of NAFTA on Real Income (percentage change)[a]

Effects on	Static Models: Perfect Competition and CRS[b] Technology							
	KPMG Peat Marwick		Berkeley		Roland-Holst et al.[c]		Trela, Whalley	
	(1)	(2)	(1)	(2)	(1)	(2)	(3a)	(3b)
Mexico	0.3	4.6	0.3	6.4	2.3	n.a.	1.2	1.6
Canada	n.a.	n.a.	n.a.	n.a.	4.9	n.a.	n.a.	n.a.
US	0.02	0.04	0	0.1	1.7	n.a.	0.01	0.01

Effects on	Static Models: Imperfect Competition and IRS[d] Technology					
	Cox, Harris	Sobarzo	Roland-Holst et al.		BDS	
	(1)	(1)	(4a)	(4b)	(1)	(2)
Mexico	n.a.	2.0	2.5	3.3	1.6	5.0
Canada	3.11	n.a.	4.1	6.8	0.7	0.7
US	n.a.	n.a.	1.6	2.6	0.1	0.3

[a] Specific assumptions on liberalization measures are denoted as follows: (1) = removal of tariffs; (2) = (1) plus expansion of import quotas plus liberalization of FDI flows; (3) = removal of import quotas for textiles (variant a) or steel (variant b); (4) = removal of NAFTA tariffs and NTBs under Cournot competition (variant a) or contestable markets (variant b). — [b] CRS = constant returns to scale. — [c] FDI kept constant. — [d] IRS = increasing returns to scale.

Source: For KPMG Pear Marwick, Berkeley, and BDS see Table 1; Roland-Holst et al. [1992], as cited in: BDS [1992b]; Trela, Whalley [1992]; Cox, Harris [1992]; Sobarzo [1992].

(iii) Dismantling import quotas and attracting additional FDI through liberalizing capital inflows into Mexico raises welfare substantially more than tariff cuts. Again, there is relatively little change for US welfare but much to gain for Mexico (between 4.6 and 6.4 per cent).

(iv) Trela and Whalley [1992] identify US import quotas on steel and textiles as particularly welfare-impeding for Mexico. A large part of the positive effects on Mexican welfare is derived from dismantling import quotas in these two industries. An aggregate welfare gain of 2.8 per cent for Mexico with almost no implications for the rest of the world and very small gains for the US could be achieved if these quotas were completely lifted [ibid., p. 56].

(v) Models which incorporate the possibility of increasing returns to scale and imperfect competition produce larger welfare gains from NAFTA than the other static models. This even holds for removing

only tariffs, as Sobarzo [1992, p. 93] shows with his 2.0 per cent Mexican welfare increase. Much more can be gained if NTBs are lowered and especially if free movement of foreign risk capital is allowed. BDS [1992a, p. 22] report a 5 per cent welfare gain for Mexico under these assumptions compared to only 1.6 per cent if tariffs were removed and NTBs partly lifted.

3. Effects on Wages and Employment

The Heckscher-Ohlin-Samuelson theorem suggests that in a free trade arrangement between countries with different resource endowments prices for labour will fall in the capital-abundant country as a result of rising intra-area imports of labour-intensive goods while prices for capital would fall in the labour-abundant country because of the increase in imported capital in terms of capital-intensive goods. This effect would be strong if imports of labour-intensive goods into the capital-abundant country were strongly discouraged, thus keeping the domestic price of labour artificially high (so-called factor protection). Translated into NAFTA conditions, workers in the US, especially those being unskilled, would have reasons to fear a downward pressure on their wages. Whether wages would rise in the labour-abundant country, that is Mexico, and thus contribute to narrowing the wage gap between the two economies, as the theorem predicts, is not certain, however, if the full employment assumption does not hold. In fact, Mexico has a largely untapped reservoir of unskilled labour which may satisfy the rising NAFTA-induced demand for labour without giving rise to an upward pressure on wages. Yet, if labour markets are segmented either artificially through barriers of entry or because of different skill requirements, the impact of NAFTA on the labour market may be very different in various labour categories.

As NAFTA includes the relaxation of barriers to capital inflows, such inflows can be expected to slow down in Mexico if the return to capital decreases following the Heckscher-Ohlin-Samuelson theorem.

What would happen to wages in the US and Mexico as a result of NAFTA, has been one of the most controversial issues of public debate in the US. Trade unions have strongly expressed their fears of relocation of capital in labour-intensive industries to Mexico, and of a respective import surge of labour-intensive goods into the US. It is because of this heated debate that all NAFTA studies devoted a large part of their analyses to the effects on factor prices and employment.

The main findings are summarized in Table 3 as far as wages are concerned:[11]

(i) All studies have in common that they do not expect US wages to fall. Instead, wages will rise in Mexico and the US but more rapidly in Mexico so that the wage gap will become smaller.

(ii) The Berkeley model of Hinojosa-Ojeda and Robinson [1991] is the only one which disaggregates wages in the US and Mexico into four segments (skilled, unskilled, rural and white collar). It yields remarkable differences in the speed of changes in wages.[12] For instance, under the scenario of tariff removal and relaxation of NTBs, wages of rural and urban unskilled workers in Mexico are estimated to fall by 0.2 per cent while they are estimated to rise by 1.0 for each of the two other groups. However, if the scenario is run with FDI inflows, first, wage increases will be much stronger in Mexico with rural and unskilled workers enjoying higher wage increases (9.2 per cent) than skilled and white collar workers (7.4 and 8.8 per cent, respectively). The wage increase in the US is explained by the improvement of the terms of trade of the US which maintain the lowest import barriers within NAFTA.

[11] To economize on space, the effects on rents are dropped in Table 3. The overall result for the rental rate is that it would rise more strongly in Mexico than in the US but that the growth rate falls behind that of wages.

[12] Changes in wages for rural, urban unskilled and white collar workers are not recorded in Table 3. See for a full presentation of the estimates Hinojosa-Ojeda and Robinson [1991, p. 28].

Table 3 — Effects of NAFTA on Wages and Employment (percentage change)[a]

Effects on	Static Models: Perfect Competition and CRS[b] Technology					
	KPMG Peat Marwick		Berkeley[c]		Roland-Holst et al.	
	(1)	(2)	(1)	(2)	(3)	(1)
Mexico						
Wages	n.a.	n.a.	1.0	7.4	n.a.	n.a.
Employment	0.9	6.6	n.a.	n.a.	0.3	1.5
Canada						
Wages	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Employment	n.a.	n.a.	n.a.	n.a.	0.6	9.0
US						
Wages	0.02	0.03	0.0	0.1	n.a.	n.a.
Employment	n.a.	n.a.	n.a.	n.a.	0.1	1.9

Effects on	Static Models: Imperfect Competition and IRS[d] Technology				
	Cox, Harris	Sobarzo	Roland-Holst et al.[e]	BDS	
	(3)	(3)	(1)	(1)	(2)
Mexico					
Wages	5.9	n.a.	n.a.	0.7	9.3
Employment	n.a.	5.1	1.7	n.a.	n.a.
Canada					
Wages	5.9	n.a.	7.3	0.4	0.5
Employment	n.a.	n.a.	n.a.	n.a.	n.a.
US					
Wages	n.a.	n.a.	1.8	0.2	0.2
Employment	n.a.	n.a.	n.a.	n.a.	n.a.

[a] Specific assumptions on liberalization measures are denoted as follows: (1) = removal of tariffs and expansion of import quotas; (2) = (1) plus FDI liberalization; (3) = removal of tariffs only. — [b]CRS = constant returns to scale. — [c] For skilled labour only. — [d] IRS = increasing returns to scale. — [e] Cournot competition assumed. — n.a. = not available.

Source: See Table 2.

The prices of US-originating goods on world markets will then rise while those of imports will fall. In the Armington type models assuming full employment, US export price increases are translated into a pulling up of the value of each factor's marginal product in terms of imported goods, irrespective of whether or not the marginal product falls [BDS, 1992b, p. 7].

(iii) In the models with imperfect competition, the returns to both factors rise, too. This is derived from the behaviour of monopolistically competitive firms. If trade is liberalized within NAFTA, firms face a more elastic demand curve in a more competitive environment, thus cutting the price-cost margin and moving down the average total cost curve to a higher level of output. Wages paid to the relatively scarce factor measured in terms of the domestic good will rise if the demand curve perceived by the firm will become more elastic [ibid.].

(iv) The employment effect which is found to be positive in all three member states but in particular in Mexico is closely linked to the inflow of capital, either directly through FDI or indirectly through

liberalized capital goods imports. This inflow not only raises the productive capacity of the labour-abundant country, and thus stimulates more employment. It also boosts investor's confidence in the host country policies, lowers the risk premium on capital, and thus stimulates more capital inflows. As exchange rate effects are not considered in the models, the dampening effect of rising prices of non-tradables relative to tradables (real exchange rate appreciation) on capital inflows cannot be captured.

All estimates on factor price effects of NAFTA critically hinge upon assumptions on labour market conditions in Mexico, that is full employment and market segmentation, as well as on the capital-labour ratios prevailing in the newly installed capital stock. Under full employment and/or market segmentation plus capital-labour ratios similar to those prevailing in US industries, the findings appear plausible. It goes beyond the scope of this survey to investigate whether these assumptions are heroic or not.

In any case, all models show that NAFTA primarily matters for Mexico. Changes in the three relevant criteria (trade, welfare, factor prices) are always much higher for Mexico than for the US. Results for Canada are biased by base effects because economic relations between Canada and Mexico are much less intensive. Furthermore, the liberalization of FDI in Mexico entails greater positive effects than the removal of tariffs and NTBs. This suggests that Mexico will benefit from NAFTA in three ways. First, it gains freer access to US and Canadian markets than it could achieve through US and Canadian unilateral concessions with "gift" character (GSP) or through US offshore assembly provisions (maquiladora). Second, its attractiveness as a host of foreign investors, both from NAFTA sources and non-NAFTA sources, is improved.[13] So are the prerequisites for a transfer of technology and know-how. Third, NAFTA is an external anchor of policy discipline for Mexico. It prevents new governments from intervening discretionarily, improves the overall investment climate, and thus lowers the risk premium to investment. In short, it promises sustainability of Mexico's liberalization .

V. NAFTA and Third Countries: No Reason for Concern?

Negative effects for third countries did not figure prominently in the studies discussed above. They were not denied but rated as relatively small [for instance, USITC, 1991, p. 116; BDS, 1992a, p. 29]. Such results support the rule-oriented perspective taken by the NAFTA governments. They underline that because of explicit reference to basic GATT principles such as national treatment in merchandise trade and most-favoured nation treatment in services, NAFTA would be consistent with the GATT. In particular, they would comply with the provisions of Art. XXIV which specifies the preconditions for legal discrimination due to FTAs and CUs.[14]

[13]The likely effects on investment flows have been discussed for countries competing for investment with Mexico, for instance in East and Southeast Asia, Australia and New Zealand. The catch word articulating fears in these countries is "investment diversion" [Kreinin, Plummer, 1992b]. Yet, while the rapid inflow of foreign capital into Spain and Portugal after their accession to the EC seems to support such fears, they are nevertheless misleading as they reflect a zero-sum-game view. What is likely instead, is a change in the regional pattern of future investment flows but not a redirection of past investment. The Mediterranean experience also suggests that rising investment flows are a transitional phenomenon and will normalize when exchange rate effects (rising relative prices of non-tradables in the host countries = real appreciation) become stronger.

[14]Yet, each of the statements on the legal consistency of NAFTA with GATT can be challenged with respect to whether or not they are fulfilled. To mention but a few of them, under special circumstances, the ten years period can be extended to fifteen years which could be questioned as unduly long according to Art. XXIV:5(c) GATT. The reference to national treatment is only related to intra-NAFTA trade, and the most-favoured nation clause only states that each

Fears of third countries focus on two issues, trade and investment. With respect to trade, it is argued that some provisions in the NAFTA agreement could result in higher trade barriers in absolute terms against non-NAFTA suppliers compared to the pre-NAFTA status quo. Furthermore, in relative terms, an erosion of tariff preferences which developing countries enjoy could also stimulate a diversion of trade from non-NAFTA suppliers to NAFTA suppliers. As concerns investment, NAFTA could attract more foreign investment than in the past, thus changing the direction of future investment flows to the detriment of non-NAFTA hosts.

A leverage for third countries' complaints on rising trade barriers could be the 62.5 per cent local content requirement for cars. This requirement is a typical case of balancing vested interests: on the one hand, the initial US demand for 70 per cent local content (in order to exclude those Japanese subsidiaries from duty-free treatment which import more than 30 per cent components from Japan), and on the other hand, the initial Mexican demand of 50 per cent to encourage FDI. The Mexican demand was supported by the Canadians. Japanese car manufacturers operating in Canada already under the CUSTA-negotiated 50 per cent rule have raised doubts on the GATT consistency of this measure immediately after the publication of the draft proposals [Frankfurter Allgemeine Zeitung, 1992]. Other local content requirements (textiles) or other provisions unduly favouring NAFTA residents (services) could provoke similar reactions.

However, the major empirical evidence for a discrimination effect is not the increase in the absolute levels of trade barriers against non-NAFTA suppliers but the advantages of NAFTA suppliers due to the lowering of trade barriers against them. Especially small economies depending on the NAFTA market like the Caribbean or Asian countries see either their preferences being eroded (Caribbean Basin Initiative, GSP) or fear market losses because of a strong overlap between their export supply and those of NAFTA competitors. Kreinin and Plummer [1992a] find such overlaps to be high for Australia and New Zealand which basically export agricultural products and other raw material-intensive goods to NAFTA countries. They translate tariff preferences into terms of trade losses for both countries, which are expected to maintain their share in NAFTA markets and thus reduce their export prices by two-thirds of the original NAFTA countries' tariff preferences. The aggregate losses in export revenues amount to slightly less than 5 per cent of their total trade with the NAFTA region. Notwithstanding the shortcomings of this approach,[15] it disregards income and exchange rate effects which can easily outweigh or compensate small static trade diversion effects [Langhammer, 1990].

Overall, how large a discrimination effect will be at the end of the day depends on the final shape of the NAFTA provisions for quota-restricted goods, rules of origin, and trade-related investment measures. Given the fact that Mexican tariff barriers are higher than those of the US, suppliers from the OECD might have more reasons to fear losses in trade shares on NAFTA markets than developing countries. This could be expected as preference margins of US-originating capital goods competing with other OECD countries' capital goods on the Mexican markets are higher than those margins which Mexican suppliers of relatively labour-intensive goods will enjoy over competitors from other developing countries on the US market. Quota-restricted items, such as textiles and clothing, could be an exception to this assessment.

New regional patterns of FDI are not unlikely if Mexico scraps its restrictions on FDI and thus contributes to raising the marginal productivity of capital relative to investment in other areas of the world. This could cause a drain of financial resources to Mexico until an appreciation of the real exchange rate erodes this effect.

NAFTA country should treat suppliers of services of other NAFTA countries no less favourably than it treats third country suppliers in like circumstances. Thus, third country suppliers can still be treated and will be treated less favourably than NAFTA suppliers. Otherwise an FTA would not make sense.

[15]For non-homogeneous products, the first-best approach is to calculate elasticities of substitution between NAFTA products and third country products. If such elasticities are low as some studies show, trade diversion effects will be low as well. Furthermore, tariff savings as a result of NAFTA may be captured by importers rather than passed through to the consumer thus sterilizing trade diversion.

Where the funds come from is politically relevant. The studies are inconclusive in this respect. Although BDS [1992a, p. 29] suggest that the inflow of capital into Mexico may come primarily from outside NAFTA, the origin of capital inflows is not explicitly discussed in their model. In other studies, this issue is even simply defined out. The KPMG Peat Marwick study, for instance, is criticized as it assumes that investment in Mexico will not come at the expense of any investment in America [Prestowitz Jr., Cohen, 1991, p. 40].

What can be argued is that the US have already been the forerunner in investment in Mexico and that other OECD countries plus the newly industrializing economies (with higher average savings rates than the US) are lagging behind. This is a similar situation as after the accession of Spain and Portugal to the EC when the bulk of capital inflows came from other EC member countries first. Should such a sequence also hold for NAFTA, non-NAFTA capital exporters could be expected to become more important investors than in the past.

VI. The Europe Agreements and NAFTA: Similar Approaches to Regionalism?

Policy-induced regionalism within North America cannot be compared to market-driven regionalization in Asia-Pacific. Free trade areas do not yet exist in the latter area and are unlikely to emerge unless a failure of the Uruguay Round triggered defensive reactions and/or relations between the US and Japan became more amicable [Fishlow, Haggard, 1992]. Therefore, policy-induced negative effects of regionalism for third countries are unlikely to emerge in Asia-Pacific.

However, the 1991 Europe Agreements (EAs) of the EC and the CSFR, Poland, and Hungary on the one hand and NAFTA on the other hand can be compared as far as their potential third country effects are concerned because both types of agreements are targeted to grant partner countries preferential market access on a reciprocal basis. Beyond that, there are other *similarities*:

First, both arrangements combine economies with large disparities in resource endowment and per capita income level. Actually, in terms of income disparities, the spread between the richest and poorest member state was exactly the same in both areas in 1990 if it is measured by purchasing power parity per capita income (the so-called international comparisons programme (ICP) estimates of income).[16]

Second, unlike in EFTA, the level of initial tariff protection (and probably NTBs too) is uneven between the former socialist countries and the EC as well as between Mexico and the US. Such unevenness is the main reason why third countries are concerned of trade diversion and why rules of origin could become a protectionist instrument.

Third, in both areas there is a leading economy, the EC and US, providing cross-border services with public goods character to the region, that is large absorptive markets, superior technological know-how, and an anchor currency.

Fourth, economic relations between the poorer and richer parts of the two areas are characterized by what is called a "natural trading partnership".[17]

[16] In 1990 figures, Mexico's ICP per capita income was 28 per cent of the US level, and the same spread holds for Poland in terms of the West German income (disregarding the special case of Luxembourg) [World Bank,1992, Table 30].

[17] In the literature, authors propose either the volume criterion (high intra-regional trade shares in total trade) or pattern criterion (statistically significant positive correlation between revealed comparative advantages in intra-regional trade and world trade). See Krugman [1991] for the volume criterion, and Kreinin and Plummer [1992b] for the pattern criterion.

Fifth, political pressure to contain negative cross-border externalities such as migration pressure, debt default and environmental pollution has been a strong incentive for the rich partner states to "internalize" such externalities through an FTA.

Similarities also exist in the institutional framework of implementing the FTA, for instance, timing (ten years period to finalize the FTA), sequencing (dismantling of tariffs first, NTBs later), coverage (excluding labour mobility and including trade in non-factor services), and safeguards (special as well as general escape clauses), and special protection of sensitive sectors in the poorer member states (natural resources, real estate). However, the following *dissimilarities* matter more.

First, the EAs were negotiated against the background of fundamental economic transformation, not simply economic adjustment and policy reforms. Compared to what Mexico had already achieved by 1990, Eastern Europe has not yet even started. Basic preconditions like privatization and deregulation, the operation of efficient capital markets, and the legal framework of property rights have not yet been fulfilled when the EAs were negotiated.

Second, given the nature of the transformation process, the EAs are not only a stabilizing external anchor for trade policies. They are basically a trade-cum-aid programme integrated into a transfer scheme (PHARE) and equipped with strong elements of technical assistance [Langhammer, 1992a]. In short, the similarities to a reciprocal Lomé type of arrangement with African, Caribbean, and Pacific countries are closer than to a pure FTA which NAFTA is.

Third, preferential elements are much stronger in the EAs than in NAFTA. This is witnessed by different starting points to liberalize. While in the EAs the EC starts first and Eastern Europe is allowed to postpone sensitive issues, Mexico and the US liberalize simultaneously.

Fourth, trade effects in the EAs are likely to depend more on the success of the internal transformation process than on trade barriers while within NAFTA the reverse may hold. In other words, supply constraints appear more binding in the EAs than in NAFTA.

Finally, it seems that the trade diversion potential is more relevant in Europe than in NAFTA. This can be expected for three reasons. First, the level of external protection in Eastern Europe and the EC is higher than in Mexico and the US. Second, the export potential of Eastern Europe will probably more concentrate on goods facing relatively high import barriers in the EC such as agriculture, textiles and clothing, steel, and coal than the Mexican supply which is technologically more advanced. Such concentration will open a potential for trade diversion provided that supply constraints in Eastern Europe are removed. Third, many of the trade effects have already been realized within North America due to the GSP and offshore assembly provisions while they are yet to come in Europe.

One qualification, however, is at stake. A success of NAFTA will probably induce other Latin American countries to negotiate similar FTAs with the US, while the EC will negotiate other EAs with countries like Bulgaria, Romania, the Baltic states, perhaps finally also with members of the Commonwealth of Independent States. Given that industrial capacity is much more advanced in the Latin American countries than in the Eastern European countries, trade diversion effects from the extension of the FTAs towards Latin America could be expected to be higher than those from the new EAs. This may also hold because trade barriers in the Latin American countries are higher than in NAFTA which could fuel trade diversion anyway. In short, the signal effect of NAFTA towards the South may be more harmful for third country trade than the same effect in Europe towards the East. A similar assessment could be justified for investment diversion as long as foreign investors remain reluctant to move into Eastern Europe during the early stages of transformation and at the same time are attracted by ongoing regionalism in the Americas.

VII. Conclusions: Doing What Comes Naturally in North America?

All studies on NAFTA unanimously reject "zero-sum game" fears and instead support" win-win" hopes: Mexico will gain most, but also the US and Canada will gain. Whether the rest of the world will gain or not does not play a large role in the North American political arena, to say the least.

Yet, this message has not cushioned vested interests in the US. They do not only lobby for the protection of factor income in "sensitive" sectors like textiles, clothing, and cars. They also close ranks with compatriots in some consumer circles which care more about the consistency of Mexican exports with US environmental standards than about their income gains. As a result, the paraphed NAFTA text of October 1992 is very unlikely to be identical with what will come out at the end. The "fast track" procedure does not mean that the US administration will not have to compromise with the US Congress in order to prevent a down vote against implementing legislation. Such compromises are very likely to result in watering down those proposals which really mean almost free trade within North America.

Yet, one might ask whether it makes much difference to have NAFTA or not. Mexico has very much liberalized unilaterally, and worldwide applause for being a Latin American success story has stimulated its government to continue this policy. The merits of NAFTA would be to accelerate this ongoing process, to make it binding and thus to delink it from the vagaries of Mexican policy-making and changes in government. As concerns the US, their tariff barriers against Mexican exports have already been virtually removed while many NTBs will remain hidden (and effective) also within the NAFTA framework. This is what the EC experience has taught. North American-based companies will continue to exploit the potential of "natural trading partnership" by furthermore integrating Mexico into their globalization process of worldwide sourcing. Canada cares more about its FTA with the US than about its small trade with Mexico.

So why doing something institutionally what would come naturally through the market, through cultural and economic proximity, and through unilateral policies?[18] There are a number of answers.

First, the weaker partner Mexico wants to bind the larger partner US because such binding lowers the risk premium to investment in Mexico. Low access barriers to Mexican exports are good but secured conditions for market access are better. Furthermore, an alliance with the other smaller partner Canada shifts dispute settlement from the bilateral level traditionally preferred by the US to a trilateral level.

Second, NAFTA gives the US a leverage to contain the flow of negative cross-border externalities like environmental pollution or migration across the Rio Grande. In addition, within NAFTA the US can better control the protection of intellectual property rights.

Third, NAFTA could become a centrepiece for what is called by Fishlow and Haggard [1992, p. 25] a "hemispheric initiative" of negotiating first hub-and-spoke types of bilateral agreements with other Latin American countries and later on inviting other countries to join NAFTA. Hub-and-spoke patterns have already been initiated by the US as well as by Mexico. In each case, Chile has been the prime candidate. Unlike few years ago, the Latin American response today is positive. With the exception of Chile, there is no other Latin American country, however, which has already done its homework in the same way as Mexico had undergone structural adjustment. Without such homework any new FTA with a Latin American country could therefore become more trade-diverting than the US-Mexico deal.

Fourth, most importantly, NAFTA has been motivated by the frustrating lack of progress in the Uruguay Round. In a strategic game with the EC, NAFTA and its provisions have therefore become a bargaining chip to push the Uruguay Round forward. This has triggered the fear that by killing the disease, the patient, that is the

[18] I owe this phrase to Riedel's discussion of economic development and state intervention in East Asia [see Riedel, 1988].

multilateral trading order, may be killed, too. In fact, if NAFTA were finally implemented with stronger preferences given to NAFTA residents and NAFTA-originating goods than in the draft proposal, and if the US demand for more GATT discipline and progress remained unsatisfied, the multilateral trading order would suffer. This is likely to hold mainly because it would "produce the negative perception that regionalism is antithetical to the GATT and that proliferation of Article XXIV-sanctioned free trade areas is somehow the nemesis of the GATT" [Bhagwati, 1991, p. 74]. Such perception could become a self-fulfilling prophecy if the stalemate situation in the Uruguay Round could not be overcome.

It is mainly because of the last two aspects why NAFTA is not another "déjà vu" example of those futile trade areas proliferating in international bureaucracies. Instead, it is an attempt which should be taken very seriously by those who want to support the GATT as the only institution overseeing world trade policies.

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