

Econ 340

Lecture 18 Preferential Trading Arrangements and the NAFTA

Outline: Preferential Trading Arrangements and the NAFTA

- What Are PTAs?
- Examples
 - European Union (EU)
 - North American Free Trade Agreement (NAFTA)
- Effects of PTAs
 - Not the Same as Free Trade
 - Trade Creation
 - Trade Diversion
 - Market Diagram Illustration
- NAFTA
 - History
 - Analysis
 - What Happened?
- NAFTA Renegotiation and USMCA

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What Are PTAs?

- A Preferential Trading Arrangement (PTA) is a **trade policy that favors one country over another**
 - Most obvious cases: Charge a lower, or zero, tariff on imports from one country while charging a higher tariff on imports from another
 - Also called a Regional Trade Agreement (RTA – the term used by the Gerber textbook and by the WTO) when a group of countries in a region do this with each other
 - Term is used even when the countries are not near each other

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What Are PTAs?

- In WTO (and GATT), the MFN principle would prohibit this
 - All members are supposed to be charged a country's MFN (Most Favored Nation) tariff
 - However, some exceptions are explicitly permitted in rules of GATT & WTO

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Examples of Legal PTAs

Permitted by WTO:

- Free Trade Areas (FTAs)
 - Members have zero tariffs against each other on essentially everything (also Customs Unions and Common Markets, which include FTAs)
- GSP = Generalized System of Preferences
 - Developed countries have lower (not usually zero) tariffs on some goods from developing countries

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Examples of Legal PTAs

Permitted by WTO:

- Also
 - Anti Dumping Duties (higher tariff against some than against others)
 - Countervailing Duties (ditto)
 - Note: “safeguards” tariffs are also permitted,
 - But they are **not** normally PTAs; they are supposed to be nondiscriminatory

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Examples of PTAs

• Variations on FTAs

– FTA:

- Two or more countries set zero tariffs on all (or almost all) imports from each other
- Keeping their old (presumably different) tariffs against outside countries
- Must include “rules of origin” (ROOs)
 - ROO = criteria that must be met, regarding location of production, for a good to cross a border tariff-free within the FTA
 - Otherwise, all trade would enter through lowest-tariff country

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Examples of PTAs

• Variations on FTAs

- Customs Union (CU)
 - = FTA + Common External Tariffs (on each good)
 - (no need for ROOs)
- Common Market
 - = CU + free movement of factors (capital and labor) among members

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Examples of PTAs

• European Union (EU)

– A Customs Union

- Originally among 6 countries (France, Germany, Italy, Belgium, Netherlands, Luxembourg)
- Called, then, the “European Economic Community” (EEC)

– Later

- Became a Common Market
- Grew intermittently to 15 countries
 - then, to 25 in 2004, to 27 in 2007
 - and, in 2013, to 28 (adding Croatia)
- Changed name
 - First to “European Community” (EC)
 - Then later to “European Union”

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Examples of PTAs

• North American Free Trade Area (NAFTA)

- US, Canada, Mexico
- Started in 1994
- More on this later

• Mercosur

- Customs union in South America
- Includes Brazil, Argentina, Paraguay, Uruguay, Venezuela



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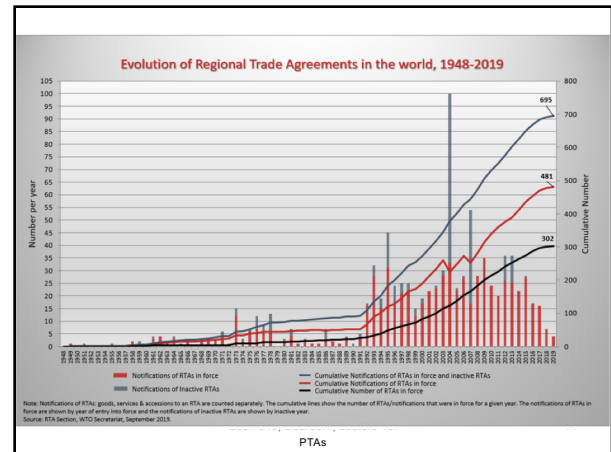
Examples of PTAs

- US also now has smaller FTAs with
 - Israel (since 1985)
 - 2-country FTAs with Australia, Bahrain, Chile, Jordan, Morocco, Oman, Peru, Singapore
 - A contentious FTA was CAFTA (Central American Free Trade Agreement), approved 2005
 - Somewhat recently, 3 more (Colombia, Panama, and S. Korea)
 - Negotiated 2007
 - Approved late 2011
 - Went into effect in 2012
 - US was to be part of TPP under Obama, but no longer.
- There are more than 400 FTAs and similar arrangements that have been notified to the WTO

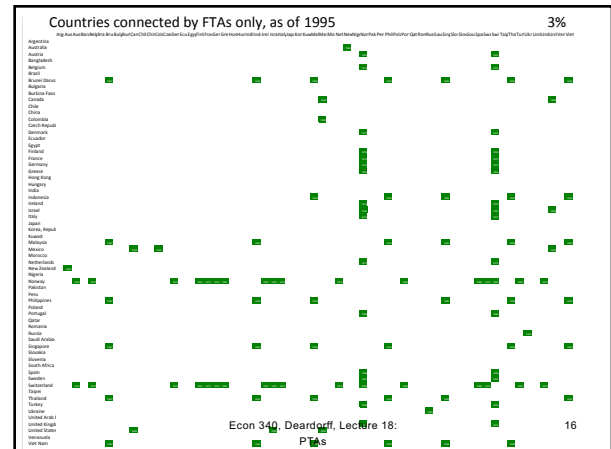
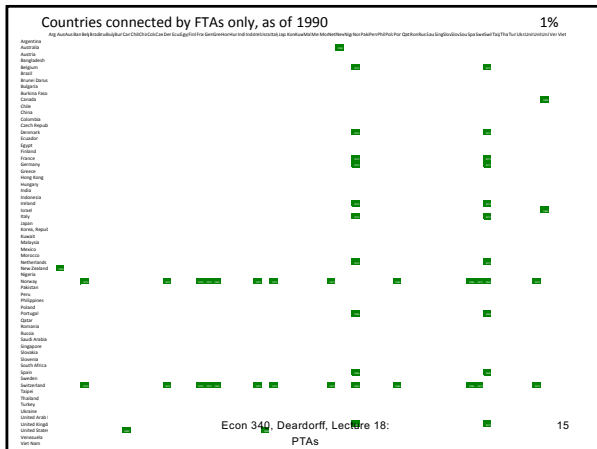
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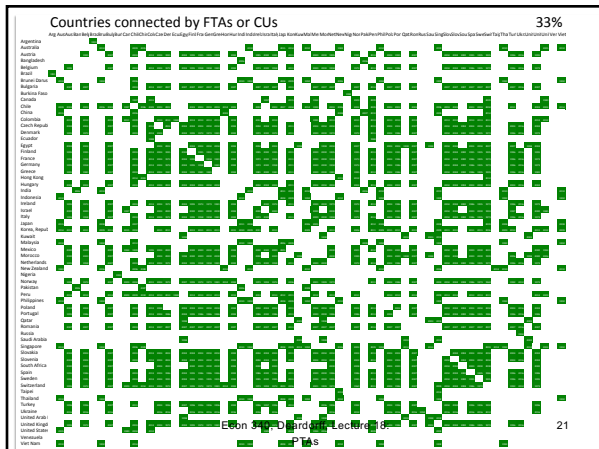
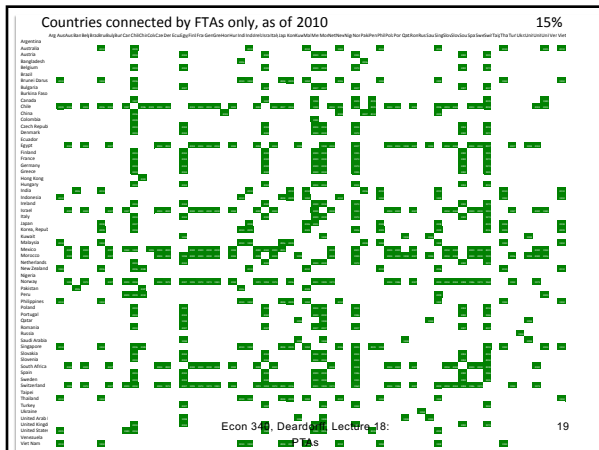
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Effects of PTAs

- They are NOT the same as multilateral free trade, when a country eliminates tariffs against all other countries
 - The name “free trade area” is misleading
 - It is likely that countries outside a PTA will lose from it
 - Even the members of the PTA may lose from it!

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Effects of PTAs

- Two main effects of a PTA
 - Trade Creation
 - = Importing from the partner what you would otherwise produce at home
 - Trade Diversion
 - = Importing from the partner what you would otherwise import from another (“third”) country

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Effects of PTAs

- Welfare effects of one country reducing its tariff on a good from a partner country:
 - Importing country
 - Gains from trade creation
 - Losses from trade diversion (we'll see why shortly)
 - Partner country gains regardless
 - Rest of world
 - Losses from trade diversion
 - Not much affected by trade creation

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Effects of PTAs

- Reasons
 - Trade creation is much like true free trade
 - At zero tariff, import from partner only if its cost is lower
 - Thus resources are used more efficiently
 - Trade diversion is not like true free trade
 - What was imported from 3rd country, not partner, when both paid the same tariff, must have cost more in the partner than in the 3rd country
 - Switching to the partner is a switch to a higher cost source for the good

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Effects of PTAs

- With trade diversion, importing country is paying more for the good
 - The importing person is not paying more, since the person doesn't pay a tariff on imports from the partner
 - But the importing country got to keep the tariff revenue on imports from 3rd countries
 - Thus the price a person paid on import from 3rd country was higher than the price the country paid

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Effects of PTAs

- Example
 - Suppose that, before NAFTA
 - The US imported sugar subject to a 25% tariff
 - The cost of sugar was
 - \$8 in Haiti
 - \$9 in Mexico
 - US sugar importers would pay, with the tariff,
 - ~~1.25 × \$8 = \$10.00~~ from Haiti
 - ~~1.25 × \$9 = \$11.25~~ from Mexico
 - So they buy from Haiti
 - The importers pay \$10.00
 - The US government keeps \$2.00 of that
 - So the US as a country pays only \$8.00

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Effects of PTAs

- Example
 - Now with NAFTA
 - the tariff on sugar from Mexico becomes zero
 - US sugar importers would pay,
 - $1.25 \times 8 = \$10.00$ from Haiti
 - \$9.00 from Mexico
 - So they buy from Mexico
 - The importers pay \$9.00
 - The US government gets nothing
 - So the US as a country pays \$9.00

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Effects of PTAs

EXAMPLE:	Without NAFTA	With NAFTA
a. Price in Haiti	\$8	\$8
b. Price in Mexico	\$9	\$9
c. Tariff on Haiti	25%	25%
d. Tariff on Mexico	25%	0%
e. Price from Haiti [(1+d) × a]	\$10.00	\$10.00
f. Price from Mexico [(1+d) × b]	\$11.25	\$9.00
g. Imports come from	Haiti	Mexico
h. Importers pay	\$10.00	\$9.00
i. Government gets	\$2.00	0
j. Country's net cost [h-i]	\$8.00	\$9.00

Trade Diversion

US Loss from Trade Diversion

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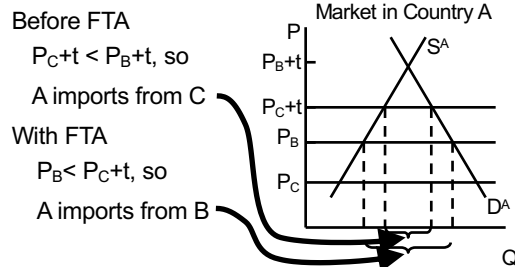
Effects of PTAs

- Market-diagram Illustration
 - Suppose Country A can import a good from either Country B or Country C at prices $P_C < P_B$
 - And Country A has a tariff greater than the price difference: $t > (P_B - P_C)$
 - What happens when Country A forms a PTA with high-cost Country B, lowering its tariff to zero on imports from Country B?

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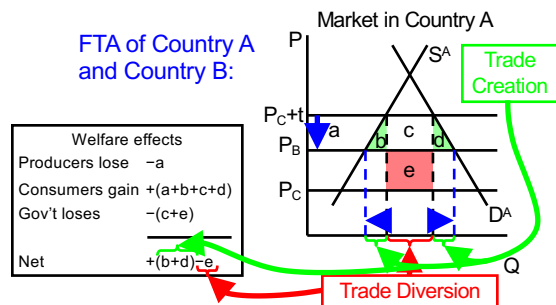
Effects of PTAs



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Effects of PTAs



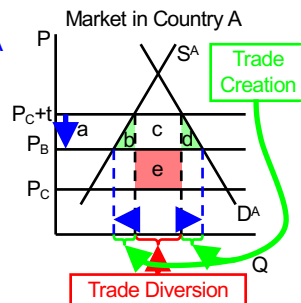
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Effects of PTAs

FTA of Country A and Country B:

Implication:
 Country A can lose from the FTA in this market, if $e > (b+d)$ (as it is in this picture)



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NAFTA - History

- Before NAFTA, US had
 - US-Canada Auto Pact
 - Signed 1965
 - Free trade between US and Canada in cars and car parts
 - US-Canada FTA
 - 1989
 - Prompted by
 - US frustration with multilateral negotiations
 - Canadian frustration with US AD and CVD policies

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NAFTA - History

- Before NAFTA,
 - Mexico had
 - High tariffs, like most developing countries
 - Had begun to reduce them in 1980s
 - Even after reductions, Mexican tariffs were much higher than US tariffs
 - Maquiladora Arrangements with Mexico
 - Low tariffs on US imports from Mexico of goods processed there from US inputs
 - Initially restricted to border region

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NAFTA - History

- NAFTA Negotiations
 - Done by Bush (Sr.) administration, 1991-2
 - Extended US-Canada FTA to include Mexico
 - Covered many issues in addition to trade
 - Investment
 - Intellectual Property
 - Services
 - Agreement was reached under Bush, but was not yet approved by Congress before 1993

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NAFTA - History

- NAFTA Debate (around 1992 US election)
 - Those opposed
 - Labor unions (feared lost jobs and lower wages)
 - Some environmental groups (feared dirty industries)
 - Ross Perot (ran for president)
 - Feared firms would move to Mexico: "Great sucking sound"
 - Some Democrats



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NAFTA - History

- NAFTA Debate (around 1992 US election)
 - Those in favor
 - Bush (Sr.) administration
 - Clinton (Bill) (but with reservations about labor and environment)
 - Most of the business community
 - Most economists (Not all)

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NAFTA - History

- After Clinton won election
 - Clinton negotiated Side Agreements on Labor and Environment
 - NAFTA was approved (very narrowly) by Congress Nov 1993

		Totals		Democrat	Republican	Independent
☐ AYE	234		54%	102	132	0
☐ NO	200		46%	156	43	1
REQUIRED:	Simple Majority			source: house.gov		

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NAFTA - History

- Jan 1, 1994: NAFTA took effect
- What happened?
 - Not much, at first
 - Then, almost a year later, the “Peso Crisis”

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NAFTA - History

- Peso Crisis (also called “Tequila Crisis”)
 - Mexico’s exchange rate had been pegged
 - Resisted depreciation during 1994 due to Mexican presidential election in late ‘94
 - Two assassinations in also 1994 disrupted Mexico
 - Late 1994 (after Mexican election)
 - Crisis hit
 - Peso devalued
 - Devaluation had devastating effects on the Mexican economy

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NAFTA - Analysis

- Before NAFTA
 - Many studies examined likely effects
 - Some, from both sides of the debate, used spurious analysis to support their views
 - Example: All imports from Mexico are viewed as costing jobs
 - On the positive side, advocates of NAFTA did the same with US exports, presumed to rise a lot because of Mexico’s high tariffs
 - Brown reading notes one study that overstated the benefits and understated the costs

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NAFTA - Analysis

- Before NAFTA
 - Best academic studies (including “Michigan Model”) predicted
 - Positive, but very small, benefit to the US
 - Negligible disruption of US labor markets
 - Positive, somewhat larger, benefit to Mexico
 - Significant disruption in some Mexican markets
 - Nobody predicted Peso Crisis

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NAFTA - Analysis

- Reasons for small predicted effects on US
 - US MFN tariffs were already very low
 - Much trade with Mexico was already at even lower tariffs, under Maquiladora system
 - US trade with Mexico was big, but not all that big, compared to size of US economy

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NAFTA - Analysis

- The issue that raised concern
 - Mexican wages were only about 1/10 of US wages
 - Seemed obvious to many (e.g., Ross Perot) that employers would move to Mexico
- Answer
 - Mexican wages were low for a reason: low productivity
 - If this had not been true, jobs would already have moved, given our already low tariffs

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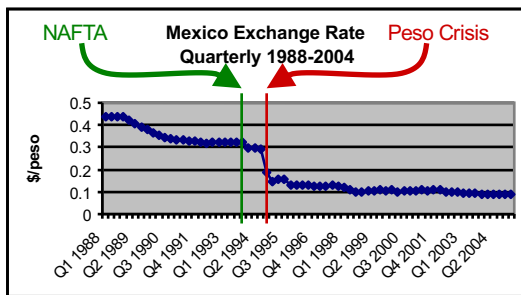
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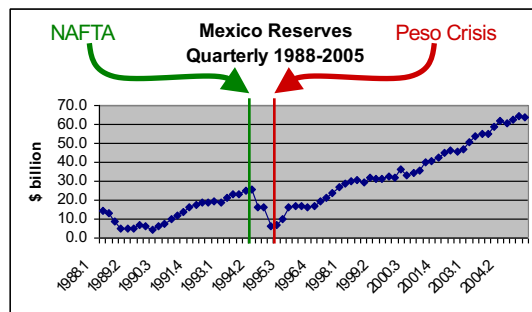
NAFTA – What Happened Peso Dropped One Year After



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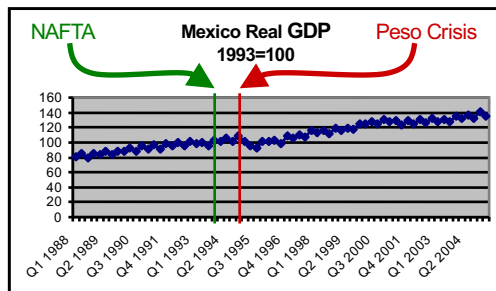
NAFTA: What Happened - Mexico Reserves Dropped at Once



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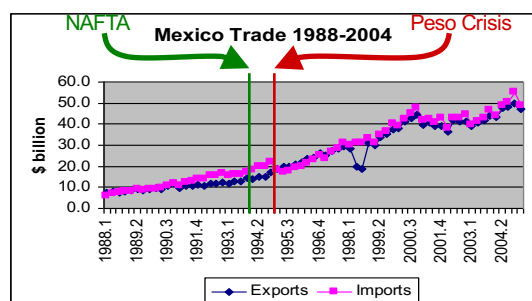
NAFTA: What Happened - Mexico GDP Fell after Peso Crisis



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NAFTA: What Happened - Mexico Imports Fell after Crisis



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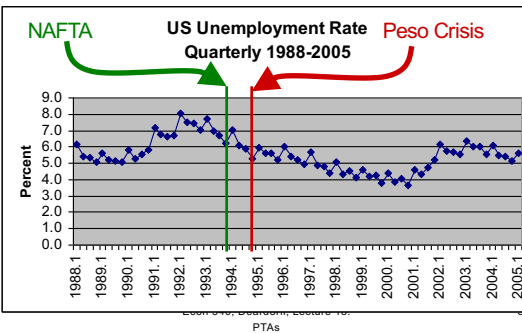
NAFTA: What Happened - Mexico Wages Fell after Crisis



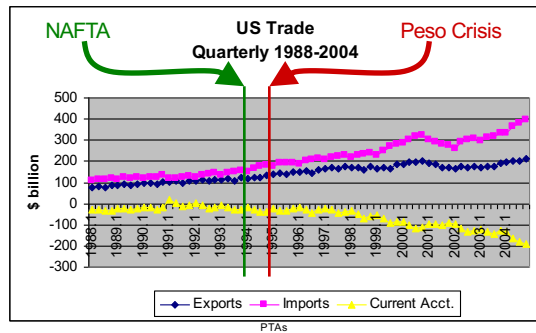
NAFTA: What Happened - Mexico Real Wages Plummeted!



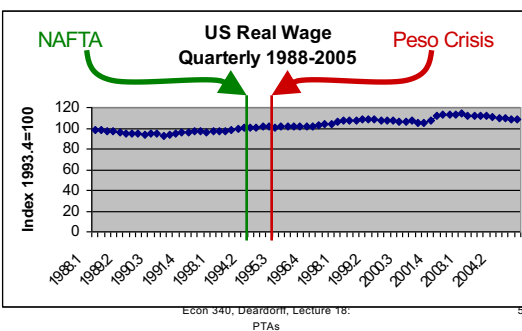
NAFTA: What Happened - US Unemployment: No effect (or fell)



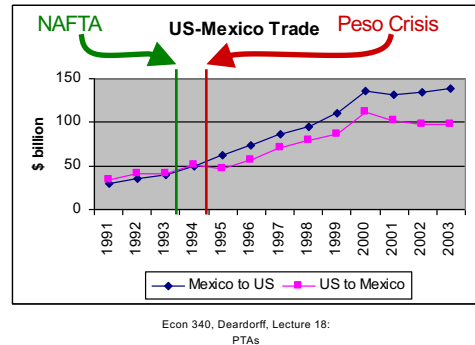
NAFTA: What Happened - US Trade: Continued growth



NAFTA: What Happened - US Real Wage: No Change



NAFTA: What Happened Trade Grew, More To US than From



NAFTA: What Happened

- Posen (see reading) says
 - “For every 100 jobs US manufacturers created in Mexican manufacturing, they added nearly 250 jobs at their larger US home operations”
 - Unemployment in US was actually lower after NAFTA than before (until the 2008 financial crisis)
 - Fears of Mexican farmers crossing border into US haven’t happened:
 - border apprehensions have fallen since 2000,
 - as have most estimates of illegal immigration
 - Critics say NAFTA cost 45,000 jobs a year.
 - That may be true
 - But this is only 0.1% of normal job turnover in the US, where 4m-6m workers leave or lose jobs per month)

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NAFTA: What Happened

- Villarreal & Fergusson (see reading) say
 - “In reality, NAFTA **did not cause the huge job losses** feared by the critics or the large economic gains predicted by supporters.”
 - “The net **overall effect** of NAFTA on the U.S. economy appears to have been relatively modest, primarily because trade with Canada and Mexico accounts for a small percentage of U.S. GDP.”
 - “However, there were **worker and firm adjustment costs** as the three countries adjusted to more open trade and investment among their economies.”

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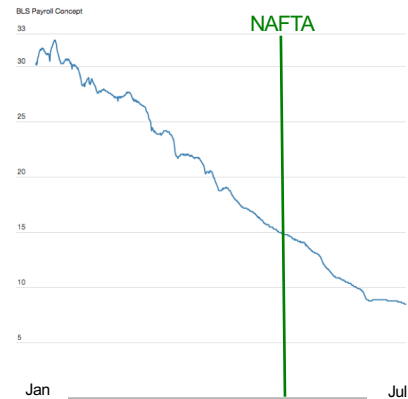
NAFTA: What Happened

- DeLong (see reading) notes that
 - The shift from manufacturing to services is just one of many such shifts that have happened in history
 - From hunter-gatherers to agriculture
 - And then horses, fertilizer, mechanization
 - From agriculture to manufacturing
 - Estimates of any jobs lost (shifted really) due to NAFTA were a tiny fraction of US employment
 - The decline in US manufacturing employment did not start, or even speed up, with NAFTA

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Manufacturing Share of Nonfarm Employment



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NAFTA: What Should Happen?

- During 2008 primary campaign, Obama (& Clinton) argued for “renegotiating NAFTA”
 - Early on, said NAFTA was “devastating” and “a big mistake”
 - Obama later said only that he would “open up a dialogue” with Canada and Mexico
 - Wanted stronger agreements on labor and environmental standards
- After 2008
 - Obama administration did not tamper with NAFTA
 - NAFTA was not an issue in the 2012 campaign
 - Did negotiate TPP=Trans-Pacific Partnership, FTA that included Canada and Mexico

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NAFTA: What Should Happen?

- Faux (see reading) says
 - NAFTA has
 - Caused a larger wage gap between US and Mexico
 - Turned US bilateral trade surplus into deficit
 - Driven 2 million Mexican farmers off the land (due to US subsidies)
 - Caused illegal immigration from Mexico to double
 - Reason: Mexico is “run by a small elite of crony capitalists” who were strengthened by NAFTA
 - Argues for a deal that would
 - Create a “fund for investment in Mexico” (like what EU did for Spain, Portugal, Ireland, Greece)
 - In exchange, require “guarantees for free trade unions, enforceable minimum wages, and an increase in education and other social spending”

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NAFTA: What Should Happen?

- Donald Trump, before election
 - Trump opposed NAFTA as early as 1993
 - “The Mexicans want it, and that doesn't sound good to me.”
 - Called NAFTA “The single worst trade deal ever approved in this country”
- Donald Trump, after election
 - Called for renegotiation of NAFTA, as promised
 - May 18, 2017, Trump formally launched renegotiation
 - Aug 16, 2017, negotiations began

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NAFTA Renegotiation Issues

- Trade imbalances: Trump wants deficits to fall
- Rules of origin: tighten them
- Dispute mechanisms: keep or remove
 - Chapter 11: Investor-State Dispute Settlement (ISDS)
 - Chapter 19: Dumping and CVD
- Dairy and poultry (Canada's policies)
- Sunset clause
- New issues (digital trade, state-owned enterprises, labor standards)

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USMCA

- Outcome of the Renegotiation
 - May 18, 2017: Renegotiation began
 - Aug 27, 2018: Agreement reached between US and Mexico
 - Sep 30, 2018: Agreement reached with Canada to join USMCA
- USMCA = U.S.-Mexico-Canada Trade Agreement

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USMCA

- Features of USMCA
 - Auto rules of origin
 - Required North American content raised from 62.5% to 75%
 - 40-45% content must be from labor paid \$16/hr or more (but does not rise with inflation)

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USMCA

- Features of USMCA
 - New rules (similar to TPP) on
 - Intellectual property
 - Environment
 - Labor
 - Financial services
 - Digital trade

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USMCA

- Features of USMCA
 - Sunset clause? Not exactly
 - Revisit deal after 6 years
 - If happy, extend for 10 more
 - If not, new negotiations

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USMCA

- Features of USMCA
 - Canadian dairy
 - Canada will increase permitted imports of dairy from US, to 3.6% of its market
 - Canada to cease selling some dairy ingredients abroad at low prices and will tax exports over over some threshold

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USMCA

- Features of USMCA
 - Currencies
 - Commitment to “refrain from competitive devaluations and targeting exchange rates”

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USMCA

- Features of USMCA
 - Trade with China
 - Countries must inform US 3 months before beginning trade negotiations with any “non-market economy” (i.e., China)
 - If agreement with such economy is reached, US can terminate USMCA with six months notice.

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USMCA

- Features of USMCA
 - Chapter 19
 - Keeps this dispute settlement system for trade remedies such as anti-dumping
 - Does not apply them to “national-security-based” tariffs

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USMCA

- Features of USMCA
 - Chapter 11 (ISDS)
 - Removes this for disputes between US and Canada
 - Keeps it for disputes with Mexico

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USMCA

- “Side letter” of USMCA
 - Promise to shield Canada Mexico from future “national-security-based” tariffs (i.e., cars) (not enforceable)

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USMCA

- NOT a Feature of USMCA
 - Removal of US recent tariffs on steel and aluminum from Canada and Mexico
 - But these were eventually removed anyway, May 17, 2019

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USMCA

- Prospects for approval
 - Must be approved by all three legislatures
 - Canada: Dairy will resist, but approval assured
 - Mexico: Ratified June 19, 2019
 - US: Contentious, Democrats in House want changes

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USMCA

- Importance of USMCA
 - Trump: “It’s not NAFTA redone, it’s a brand-new deal”
 - NYT: “a consequential set of revisions”
 - Economist: “a modest revision”, “inferior to the agreement it replaces”
 - Bown: deal to “result in less trade, not more”

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Next Time

- International Policies for Economic Development: Trade
 - The Issues
 - Washington Consensus
 - Pros and cons of free trade for developing countries
 - Policy recommendations

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