Geo Factsheet

Number 117

The North American Free Trade Agreement (NAFTA)

Introduction : What is a Trade Bloc?
A trade bloc is a group of countries that share trade agreements between each other. Since the Second World War, there have been many examples of groups of countries joining together to stimulate trade between themselves and to obtain other benefits from economic co-operation.

Table 1. Increasing economic integration between countries

- ***Free trade areas*** *– members abolish tariffs and quotas on trade between themselves but maintain independent restrictions on imports from non-member countries. NAFTA is an example of a free trade area.*
- ***Customs unions*** *– besides free trade between member nations, all members are obliged to operate a common external tariff on imports from non-member countries.* ***Mercosur****, established on 1st January 1995, is a customs union joining Brazil, Paraguay, Uruguay and Argentina in a single market of over 200 million people.*
- ***Common markets*** *– these are customs unions which, in addition to free trade in goods and services, also allow the free movement of labour and capital.*
- ***Economic unions*** *– these organisations have all the characteristics of a common market but also require members to adopt common economic policies on such matters as agriculture, transport, industry and regional policy. The EU is an example of an economic union, although it must be remembered that its present high level of economic integration was achieved in a number of stages. When Britain joined in 1973 the organisation could best be described as a common market. The increasing level of integration has been marked by changes in the name of the organisation. Initially known as the European Economic Community (EEC), it later became the European Community and finally, from November 1993, the European Union (EU).*

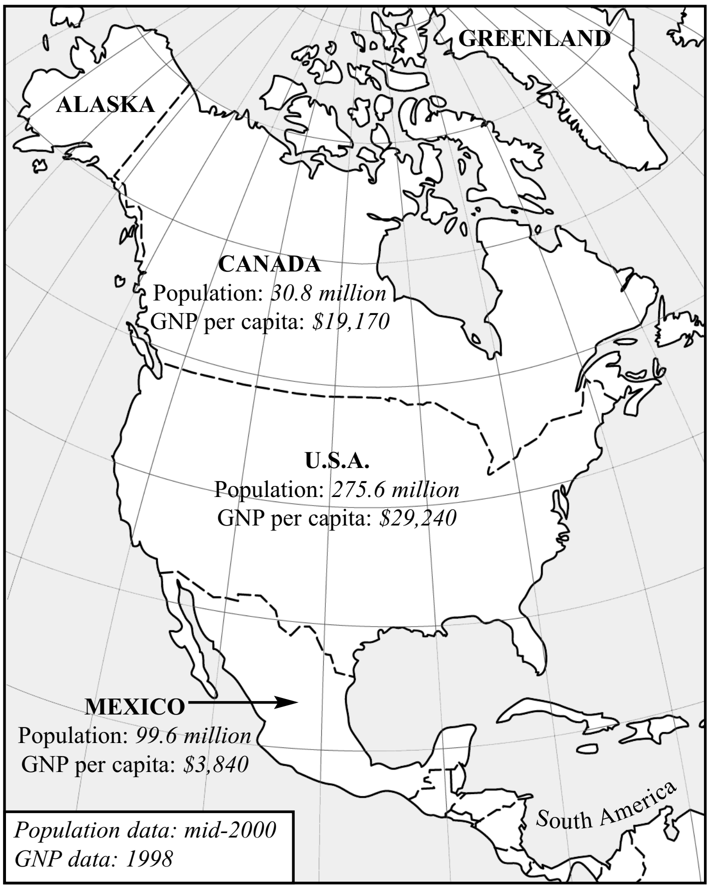
Increasing integration

Most countries now belong to some form of trade bloc. For example, in Africa, only Somalia and Western Sahara remain outside the continent's nine economic blocs.

NAFTA
NAFTA came into effect on January 1st 1994 with the objective of eliminating most tariffs and other restrictions on free trade and investment between the United States, Canada and Mexico *(Fig 1)* by the year 2003; remaining tariffs will be removed by 2008.

The formation of NAFTA in the 1990s was hastened by three factors:
- *the ever-increasing economic challenge from Western Europe and Asia*
- *the completion of the internal market of the European Union (EU)and the establishment of the European Economic Area (EEA) in 1993*
- *growing concern that nations left outside trade blocs would be commercially disadvantaged*

Fig. 1 NAFTA member countries: population and GNP per capita



Stages of Development
The first significant move towards a North American trade bloc was the signing of the Canada-United States Automotive Products Trade Agreement (Auto Pact). In 1988 the two countries extended their relationship with the establishment of the comprehensive Canada-United States Free Trade Agreement (FTA or CUSTA).

In 1990 Mexico formally requested a free trade relationship with its northern neighbours. After four years of intense negotiation, NAFTA was approved by the governments of all three countries. In effect, the terms of the 1988 FTA were extended to include Mexico, whose economy was then less than five per cent the size of those of the United States and Canada combined. This established a unique relationship between a relatively poor Third World nation and two of the world's richest countries. Never before had a trade bloc included members of both the developed and developing worlds.

When NAFTA was established in 1994, its 390 million consumers (with a combined GDP of over $7.6 trillion) vied with the EEA (the EU and Iceland, Norway and Liechtenstein) to become the world's largest trade bloc. NAFTA was seen as an important step in the gradual move towards global free trade which is being directed by the World Trade Organisation (WTO). Over 130 countries belong to the latter organisation.

The NAFTA Agreement
The 1994 agreement planned for:
- *all tariffs on goods qualifying as North American to be phased out within ten years, although special rules applied to key sectors such as energy, agriculture, textiles and clothing.*
- *trade in services would also be facilitated*
- *other provisions would give relief or protection to 'sensitive industries' (e.g. some agricultural products like US sugar were given protection for 15 years) and outline technical and environmental standards.*

To lessen the USA's concerns about Mexico, certain safeguards were written into NAFTA:
- *An annual review of any suspected examples of dumping of cheap products by one member into another's country. A penalty could be imposed, e.g. in 2001 the USA suspected British Columbia (Canada) was subsidising its timber industry and therefore slapped a 19% duty on imports to protect its own timber industry. Pre-NAFTA tariffs could also be reintroduced for 3 years.*
- *A three country commission monitors the enforcement of NAFTA - related regulations such as environmental standards, minimum wages, child labour and health safety at work. Any two nations can instigate an investigation of suspected breaches and fines of up to $20 million can be imposed.*

Differences between NAFTA and the EU
The objectives of NAFTA differ from the EU's Maastricht Treaty (1993) in a number of significant ways. The NAFTA agreement is limited to trade only and thus does not:
- *permit free movement of labour*
- *attempt to redistribute wealth to poorer regions within its boundaries*
- *seek to establish a common currency*
- *seek political union*
- *aim to establish a customs union with common external tariffs*
- *affect existing border controls*

Discussion point: Why do you think this was so?

However, like the EU, NAFTA may allow other countries to join providing all current members agree. The objective of NAFTA's supporters is that the whole of Latin America will follow Mexico's example and eventually join. The establishment of Mercosur on January 1st 1995 was a major stage in this process. The members of this customs union are Brazil, Argentina, Paraguay and Uruguay. Mercosur is negotiating with the Andean Pact countries (Bolivia, Peru, Ecuador, Colombia and Venezuela) and Chile for the creation of a South American Free Trade Area as an important building block towards the establishment of the American Free Trade Area (AFTA) incorporating all the countries of North, Central and South America by the year 2005, as agreed during the 'Americas Summit' in Miami in December 1994. This idea of a trade bloc covering all of the Americas was reaffirmed by the Quebec Declaration in April 2001.

In recent years Chile has been poised to join NAFTA but was rebuffed in 2000, mainly because of a lack of interest in the US. Chile is now seeking full membership of Mercosur instead, of which it is currently an associate member.

The Impact of NAFTA on its members:

1. On the USA
The arguments for and against NAFTA have been debated most fiercely in the US.
- Within the USA the strongest supporters of NAFTA have been multinational corporations, economists and key political figures such as ex-President Clinton. The classical economic argument (following Ricardo's Theory of Comparative Advantage) is that all three countries would be better off with free trade as they would specialise increasingly in what they are best at. Former US Commerce Secretary Mickey Kantor called NAFTA a "win-win situation" for all concerned.
- Trade unions and environmental groups have led the argument against NAFTA. The major debate in the USA focuses on the issue of trade with Mexico. Trade unions have long feared that free trade with Mexico would result in wage and benefit reductions if US firms were to remain competitive against cheap Mexican labour. They also foresaw US companies moving to Mexico to take direct advantage of lower wage rates as well as being attracted south of the border by less demanding environmental legislation. In 1999 the average factory worker in the US earned more than eight times as much as his Mexican counterpart.
- Many environmental groups such as the powerful Sierra Club have been strong critics of NAFTA. They envisaged more severe environmental degradation in Mexico, where environmental laws are lax and often not enforced. The Sierra Club also predicted that US environmental legislation would be watered down in the name of staying competitive with Mexico.
- Multinational corporations that have moved operations to Mexico have, as expected, reaped higher profits. However, the US visible trade deficit with Mexico has increased, with no signs of the situation being reversed. But the predictions of an almost immediate adverse impact on the US economy as a whole did not materialise, as growth remained strong in the USA throughout the 1990s. Nevertheless a significant number of American workers are less well off now than before the advent of NAFTA. Although the overall unemployment rate remained low into the new century, there is clear evidence that many higher paid workers have been forced into lower paid jobs as US companies have transferred manufacturing operations south of the border. Some companies have also used threats to move to Mexico when negotiating pay levels with workers.

Critics of NAFTA within the US frequently cite the growth of the visible (merchandise) trade deficit as evidence for their point of view *(Fig 2)*. However, NAFTA trade only accounts for 16% of the overall visible trade deficit *(Fig 3)*.

Fig. 2. US Visible Trade Deficits

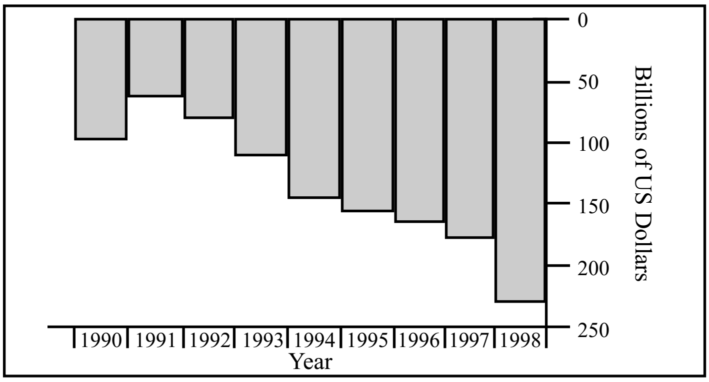
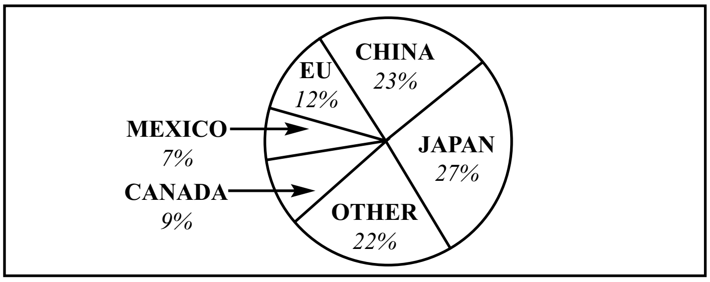


Fig. 3. Percentage of US Visible Trade Deficit in 1998



Public Citizen, a pressure group opposed to NAFTA, has attacked the organisation over a wide range of issues, calling it a "trade agreement from hell". A recent publication (February 6th 2001) entitled "Grave Danger Posed by Unsafe Mexican Trucks" argued that the US should maintain limited access to its highways. A NAFTA tribunal is expected to reject US concerns about truck safety and order the US to permit Mexican trucks to have full access to American highways. Currently, Mexican trucks are confined to a narrow 20-mile commercial zone near the border. Among the concerns voiced by the US were:
- *Mexico does not limit the time drivers spend behind the wheel.*
- *Mexico's hazardous materials control system is much more lax than the US system.*
- *In 2000 Mexican truck carriers were found to be three times more likely to have safety deficiencies than US carriers.*

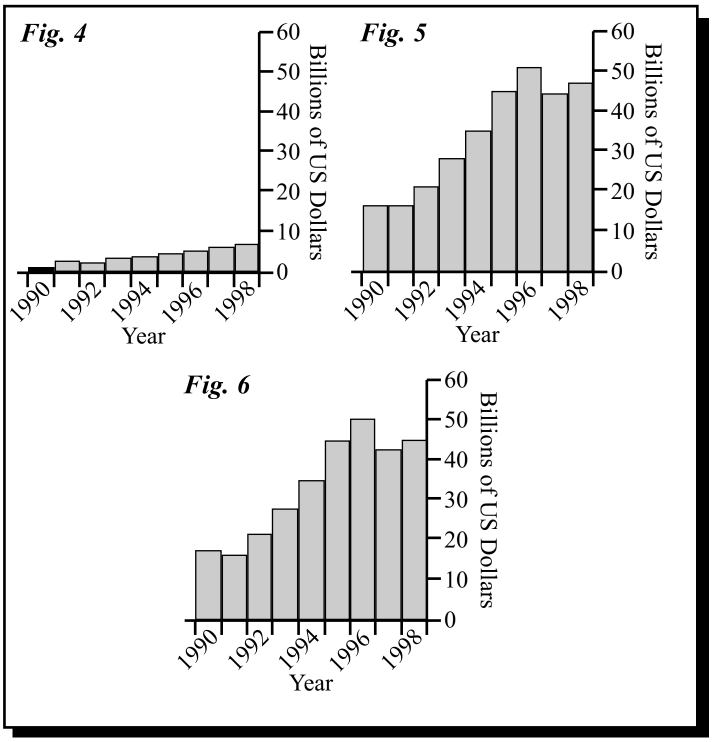
2. On Canada

Although there are significant exceptions, most organisations and individuals in Canada hold favourable views about NAFTA because the benefits of the agreement seem very clear cut. Visible trade with the US increased 80% in the first five years of NAFTA, reaching $475 billion in 1998. During the same period, visible trade with Mexico doubled to reach $9 billion.

- Canadian exports to the US and Mexico increased 80% and 65% respectively in the first five years of NAFTA, reaching $271.5 billion and $1.4 billion.
- US investment in Canada reached $147.3 billion in 1998, up 63% from 1993. Investment from Mexico reached $464 million in 1998, tripling from 1993.
- More than one million new jobs have been created in Canada since the start of 1994.
- In 1998, 68% of foreign direct investment into Canada came from the US and Mexico.

Canada's trade with its NAFTA partners has been growing much faster than its trade with other countries. Although Mexico's trade surplus with Canada rose considerably through the 1990s, Canada's surplus with the US is on a much larger scale *(Figs 4,5 and 6)*.

Fig. 4 The Mexican trade surplus with Canada
Fig. 5 Canada's trade surplus with the US
Fig. 6 Canada's overall NAFTA trade balance



Canada has always been conscious of the limited size of its domestic market and saw huge benefits of having open access to the US and Mexico. As Canada is distant from Mexico, it has not experienced some of the difficulties that have arisen between the US and Mexico because of their common border. However, environmental groups in Canada have voiced similar concerns to those raised in the US.

3. On Mexico

Supporters of NAFTA in Mexico say the new market is forcing Mexican companies to adopt higher foreign standards and business practices. Such a process will gradually improve the competitiveness of Mexican business. As the Mexican economy is locked into the economies of the US and Canada, it makes it impossible for the country to go back to the disastrous protectionist policies of the past. Now, in fact, Mexico has numerous trade agreements with countries other than its northern neighbours.

Mexico trades at reduced or zero tariff with over 60% of the world. It is the only country other than Israel that has free-trade agreements with both the US and the European Union. Of all the Latin American nations, Mexico holds the greatest promise of development as a consumer market. Sound economic policies implemented by the Zedillo government over the past five years have brought the country from profound economic crisis to a relatively solid economic footing.

However, not all Mexicans are so convinced about the merits of NAFTA. They argue that Mexico has swapped one kind of trade dependence for another. In the early 1980s, oil dominated the country's economy, accounting for two-thirds of exports. Although the economy is more diversified now, over 88% of exports go to the US *(Fig7)*, up from 78% at the beginning of the 1990s. However, while total US imports grew by 110.3% during the 1990s, Mexican exports to the US grew by 252.5%, implying an increase in Mexico's share of US imports from 6.45% to 10.75 % *(Fig. 8)* and it is still rising. The gain in market share during this period is equivalent to $44 billion in exports. Mexican exports have increased not only because of US demand but also because of Mexican penetration of the US market. This reflects: (a) the decline in barriers to trade and (b) the improved quality of Mexican goods. Mexico has achieved significant market penetration in food and live animals, beverages and tobacco, machinery and transport equipment, and miscellaneous manufactured articles.

Mexico's main trading partners

Exports to:	*% of total*	*Imports from:*	*% of total*
United States	*88.4*	*United States*	*74.3*
Canada	*1.7*	*Germany*	*3.5*
Germany	*1.5*	*Japan*	*3.3*
Spain	*0.7*	*South Korea*	*1.9*
Japan	*0.6*	*Canada*	*1.9*

Trade balance

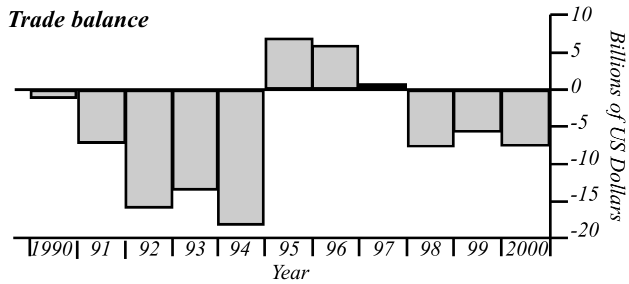
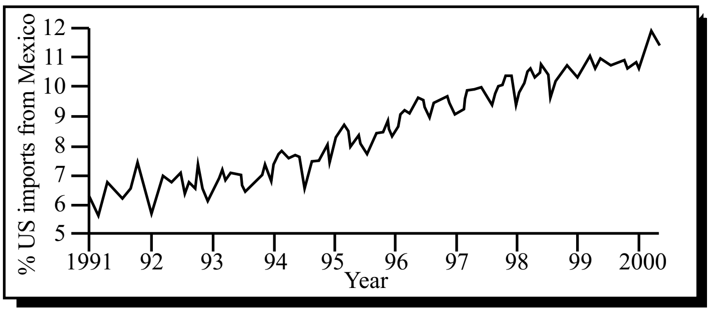


Fig. 7 Mexico's trade situation in 1999



Bilateral trade between the US and Mexico, which stood at $82 billion in 1992, rose to about $200 billion in 1999. However, while in many ways Mexico's success in the US market is good news, any downturn in the US economy is bound to have an adverse knock-on effect south of the border. A common expression in Mexican business circles is "When the United States catches a cold, Mexico gets pneumonia".

Another criticism is that the Mexican government did too little to prepare the country for such a significant change. Mexican farmers have been particularly hard hit. The vast majority of farm plots are less than ten hectares and operate with very modest equipment. Before NAFTA they were protected by import tariffs and government-guaranteed prices. Now they have to compete with large-scale high technology American and Canadian agribusiness. The impact on the landscape of the north-western state of Sonora has been startling. The state used to be known as Mexico's breadbasket because wheat dominated agricultural production here. Now, due to the impact of cheaper wheat from the United States and Canada, farmers have turned to nuts, peaches, asparagus, chickpeas, olives, cucumber, watermelon and jalapeno chilli. Most production of the new crops is for export. Although change was already underway before 1994, the advent of NAFTA speeded up the process considerably. However, corn growers have been hit hard because the government has allowed more corn to enter the country duty-free than NAFTA specifies. Corn is Mexico's staple crop, covering about half the cultivated area.

At present Mexico has to import more than 50% of its milk supply. Most comes from the US, along with many other agricultural products. However, other Latin American countries are also gaining a foothold in Mexico's food market by means of free trade agreements.

Industry has also had its problems. Critics of the government claim that Mexico does not have an industrial policy apart from promoting maquiladoras. These are factories that import materials or parts to make goods for re-export. Maquiladoras existed long before 1994 but they have increased greatly in number since NAFTA came into effect. Although the jobs they provide are important to the economy, less than 3% of the maqiuladoras' input is produced locally. Thus, while rising exports have been helpful in reducing the trade deficit, they have not done much for the rest of the economy. While exports have been growing by an average of 10.9% a year in the 1980s and 1990s, output for the domestic market has risen by an average of only 3.5%.

The export boom has had a very uneven impact in Mexico. Employment in the maquiladoras is now 1.3 million compared with 546,000 when NAFTA began. The vast majority of these factories are close to the border with the USA, the main destination of the finished products.

An ever-increasing number of Asian and European companies have established plants in Mexico in order to gain access to Mexico's NAFTA trade partners. Mexico is being used as a springboard to the US and Canada in the same way that many foreign companies base operations in the UK to gain open access to the whole of the EU. At the same time, many US companies manufacture products in Mexico that are destined for the latter's trade partners throughout Latin America.

A clear-cut assessment of NAFTA membership on Mexico is difficult because many of Mexico's trade liberalisation policies were in effect before NAFTA began, prompted by Mexico's membership of GATT (the General Agreement on Tariffs and Trade) and its ongoing domestic reforms.

Tension between the EU and NAFTA

The world's two largest trade blocs have clashed a number of times in recent years. Two main areas of contention were trade in beef and bananas. The disputes strained cross-Atlantic relations and put World Trade Organisation dispute mechanisms to the test.

Conclusion

Opinion about NAFTA remains divided, particularly in the US. Some analysts say it is too early to judge NAFTA's impact, partly because many of its provisions have yet to take effect. Also, trade agreements are directly influenced by economic changes in individual countries and globally, such as changes in income and exchange rates. A reasonable statement about NAFTA would be that neither the critics' worst fears nor the supporters' rosiest forecasts have materialised.

Definitions:

Tariff *is a duty or tax imposed by one country on the imports from other countries to protect its own home-based industries from foreign competition of cheaper products.*

Quota *is the introduction of a set figure for the amount of imports from a particular source - to protect a country's home-based industries.*

Visible trade *is concerned with the import and export of goods. The difference between visible exports and imports is called the trade balance.*

Invisible trade *consists of the import and export of services such as finance, as well as tourism, shipping etc.*

Bilateral trade *involves the development of a trade between two countries for their mutual benefit.*

Maquiladora *are branch factories located in Mexico on the US-Mexican border. They are owned by foreign companies (usually TNCs) and are the result of foreign direct investment (FDI) into Mexico which takes advantage of lower labour costs, less stringent environmental controls and easy access to the US market.*

Examination Question

(a) What is a trade bloc? (5 marks)

(b) With reference to a trade bloc you have studied, explain why the organisation has its supporters and its opponents. (20 marks)

Guidelines for answers

(a) A trade bloc is a group of countries that share trade agreements with each other. The degree of economic integration increases from (1) free trade areas to (2) customs unions to (3) common markets to (4) economic unions. You could briefly explain the characteristics of each type of organisation and give an example.

(b) In NAFTA the balance between support and opposition has varied significantly between the US, Canada and Mexico. You should be able to elaborate on the arguments for and against in each country. The most intense debate has been in the US. Big business, economists and many major politicians have sung NAFTA's praises. The opposition to NAFTA has been led by trade unions and environmental groups. You should outline the main arguments put forward by both groups.

In Mexico it is the agricultural sector which has experienced most difficulty due to the small-scale nature of much of Mexican farming. In some areas the type of farming has changed dramatically in the face of US and Canadian agribusiness. Mexican industry has made increasing inroads into US markets. The service sector has expanded as the economy overall has done well in recent years. Many Mexicans criticised their government for failing to prepare the country properly for such a significant change. The main concern today is Mexico's high dependence on the state of the US economy.

Support for NAFTA has been very strong in Canada, although environmental groups have voiced the same concerns as those raised in the US. Canada has long been concerned about the relatively small size of its domestic market.

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