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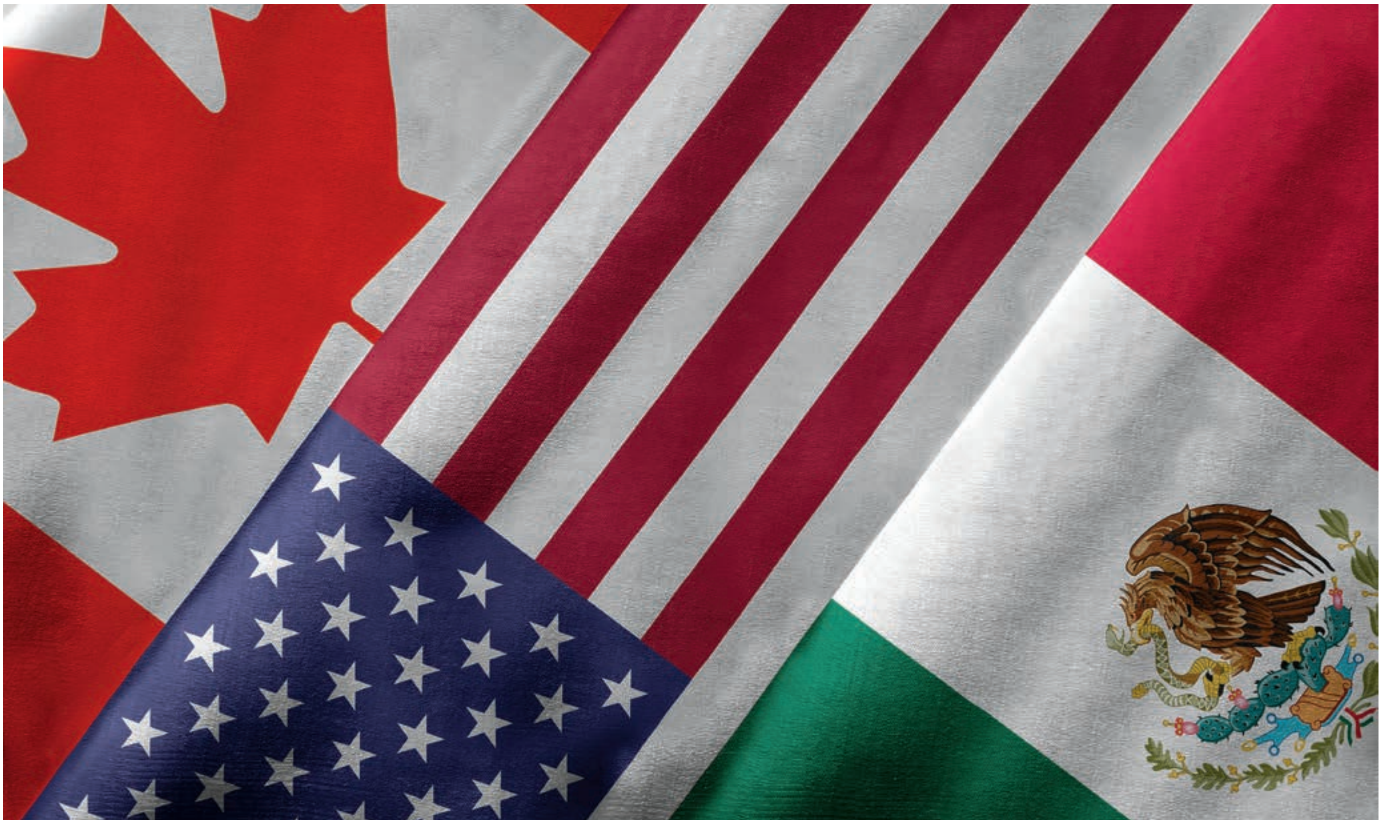


NAFTA, Globalization and Free Trade: Can the U.S. Maintain Leadership in the World Economy?

Elmore R. Alexander

During election season in 2002, in an MBA course on global management I was teaching at Philadelphia University, I identified competitive U.S. congressional races where the issue of globalization was relevant. The students then focused on these races to develop comprehensive analyses of the candidates' positions and understanding of globalization. The results were telling: the candidates who were judged by the students to understand globalization best lost *every single* race.

This is the quandary of globalization—it involves complex issues that neither political leaders nor the general public completely understand. While 70 percent of Americans think it is important to buy US products, 37 percent would refuse to pay more for a U.S. product.[1] In reality, international trade has been a positive force since World War II. Trade has expanded, global living standards have improved dramatically, and millions world-wide have escaped poverty.[2] Nevertheless, international trade is constantly attacked—every candidate (Republican and Democratic) in the recent presidential election questioned trade policies. The most vociferous attacks came from now President Donald Trump, who labeled the North American Free Trade Agreement (NAFTA) the worst trade agreement ever negotiated.

Can we reconcile the positive effects of trade since World War II with current sentiments in America? More importantly, are we headed toward a sort of protectionism comparable to that experienced during the Great Depression?

The Rise of Anti-Globalization

Nationalist sentiment is on the rise. The shock of the United Kingdom's June 2016 "Brexit" vote was followed by Donald Trump's election on a populist-nationalist agenda. The trend continued across Europe from the Czech Republic to Hungary, Poland and Rumania. While there have been recalibrations with Emmanuel

Macron's May 2017 defeat of right-wing populist Marine Le Pen in France and the victory of Angela Merkel's centrist Christian Democratic Union in Germany, Merkel is still struggling to form a stable government, and nationalistic rhetoric has not disappeared. It is important to understand the underlying dynamics of the movement as well as the experience of workers in the current economy.

> U.S. agriculture depends heavily on agricultural exports to Mexico ($18B) and Canada ($23B). If NAFTA were to expire, tariffs on agricultural products (currently at zero) would jump dramatically and bring devastation to midwestern farmers.

Underlying Dynamics

There are three underlying dynamics that must be considered. The first of these involves recent ***declines in population growth rates***. The post-World War II period saw dramatic population growth creating a young demographic. Recently, growth rates have declined in the developed world, resulting in an older demographic. Japan and China face the toughest challenges, but nine of the 56 largest countries are already dangerously older.[3] The second dynamic is equally important: there has been ***stagnation in worker productivity***. Productivity growth surged during the "dot com" bubble. However, since 2007, productivity growth has been just one-half of that experienced since 1945. In 2016, the United States experienced its first productivity decline since 1982, which has created an economic recovery without wage growth.[4] The final dynamic to consider is the ***decline in global trade***. Global trade hit its apex in 2008. U.S. trade actually declined $500 billion in 2016.[5] Growth is occurring only in restricted industrial and geographic sectors. In 1975, 109 firms accounted for one-half of U.S. profits. By 2015, that number had fallen to 30. In 2015, 75 percent of U.S. venture capital went to just four metropolitan areas—New York City, Boston, Los Angeles and San Francisco.[6] Today, American companies seem to be more risk averse, choosing to redistribute capital to shareholders rather than investing in growth.

The Experience of the Workforce

In addition, the American workforce is undergoing significant change. Manufacturing employment fell by between six and seven million jobs in the 2000s. The average income for the bottom 90 percent of families has been stagnant since 1980, and wage growth has been one-half the rate of productivity growth.[7] Much of this has been blamed on international trade. Clearly, there are winners and losers from trade.[8] Businesses and members of the skilled workforce have typically benefited; in contrast, lower-skilled workers have typically been hurt. In reality, a substantial proportion of the job losses are attributable to automation as opposed to trade. Nevertheless, only 35 percent of workers think that the U.S. has benefited from globalization while 55 percent believe that we have lost.[9] Given these trends and the experience of the workforce, the rise of nationalist sentiment is not surprising.

The Current State of U.S. Trade Policy

Upon taking office, President Trump withdrew from the Trans-Pacific Partnership (TPP) negotiations, a proposed trade agreement that would have linked the U.S. economy to 12 countries in the Asia-Pacific region and North America. Next, he began renegotiating NAFTA and threatening action on numerous bilateral fronts from Korea to China. The President's rhetoric has been loud and aggressive, especially as it has concerned NAFTA.

Indeed, NAFTA has been controversial in North America, ever since it was signed with Canada and Mexico in 1993. The agreement consists of six basic provisions: a) the elimination of duties and tariffs for goods traded between the three countries; b) the protection of the foreign direct investment of the three countries; c) the protection of intellectual property; d) ensuring ease of movement for business travelers; e) mechanisms for independent resolution of trade disputes; and f) freer access to government procurement for suppliers from each country.[10] The details are complicated and controversial. With the exception of the provisions for dispute resolution and the definition of what constitutes a NAFTA-compliant product, however, the disputes that have emerged among the partners since 1993 have focused more on outcomes than on the specific provisions of the agreement.

Why is NAFTA so significant? NAFTA combined two developed economies with a developing one (a first in modern trade history). More concretely, it encompasses fully one quarter of global trade.[11] Interestingly, most NAFTA trade is focused on "intermediate goods" (components that make up parts of finished goods). For example, automotive components cross U.S.-Canadian and U.S.-Mexican borders approximately eight times before a completed car reaches a U.S. showroom.[12] This illustrates the economic

concept of "comparative advantage." Each country specializes in what it does best, yielding a higher-quality and less-expensive product and raising the Gross Domestic Products of all. The resulting integrated North American economy is primed to compete in Asia, Europe and the rest of the world.

In the past 25 years, trade among the three NAFTA countries has increased threefold—from approximately $300 billion in 1993 to $1.1 trillion in 2016.[13] The integration of the three economies is dramatic. Forty-five percent of the value of U.S. imports from Mexico is attributable to U.S. components. Similarly, 25 percent of the average import from Canada is comprised of U.S. components. In contrast, integration with the Chinese economy is only four percent.[14] Fourteen million U.S. jobs depend on NAFTA trade. Possibly 100,000 manufacturing jobs have been lost to NAFTA trade—0.1 percent of the U.S. labor force, a miniscule number when compared to recent *monthly* job growth of approximately 150,000 jobs. Furthermore, U.S. states with a higher proportion of NAFTA trade have a higher involvement in advanced manufacturing, and the jobs created by NAFTA pay 15 to 20 percent more than the jobs that were lost.[15]

Has NAFTA increased trade deficits? First, there is not a deficit with Canada. The exact number varies from slightly positive to slightly negative from year

to year. With Mexico, trade has moved from a surplus of $1.7 billion before the agreement took effect to a deficit of $61.2 billion in 2016.[16] The intermediate trade effect (percentage of imported products with U.S. components), however, means that that the deficit is closer to $30 billion. While that number may seem worrisome, consider the larger context keeping in mind that it is only about 5 percent of our overall trade deficit. Trade deficits do not result from trade agreements. They are macroeconomic phenomena caused by low U.S. consumer savings and the attractiveness of the U.S. as a stable location for investment.[17] Unless U.S. consumers spend less and save more, and the U.S. becomes a more risky location for foreign investment, trade deficits will remain. Forcing a decrease in the U.S.-Mexico trade imbalance through some artificial means will merely shift the deficit to another country or region of the world.

NAFTA: The Negotiations

The initial NAFTA renegotiation process in the spring and summer of 2017 was very positive. Congressional hearings were held soliciting input from a wide variety of interest groups. Seasoned trade professionals who had been a part of the original NAFTA negotiations were appointed to handle the talks. The announced objectives were thoughtful and moderate, and reflected the interests of both Republicans and Democrats.[18] They

focus on four goals: a) higher-paying U.S. jobs; b) growing the U.S. economy; c) reducing the trade deficit; and d) trade rule enforcement reform. The first negotiation rounds resulted in agreement on many issues including those involving the environment, telecommunications, digital trade, small- and medium-sized businesses, and services.[19] Even the rhetoric surrounding the negotiations was positive.

Then things became complicated. In late fall 2017, the U.S. began making untenable demands on the Canadians and Mexicans. Repeatedly, President Trump threatened to pull out of the talks.[20] Intense lobbying to preserve NAFTA by U.S. businesses and both Republican and Democratic Congressional representatives ensued. The administration's rhetoric intensified.

From a technical perspective, three issues remain. The first concerns reducing the trade deficit with Mexico. Since the deficit cannot be addressed directly, the push from U.S. negotiators has been to alter the "rules of origin" (what qualifies a product as "NAFTA-compliant" and thus renders it eligible for free trade) to require a minimum of 50 percent U.S. content.[21] The Mexicans and Canadians have said that this is unacceptable, and there have been some indications that the U.S. would settle for 35 percent U.S. content.[22] Since the discussion of this issue has become a numbers question, there is conceivably room for compromise involving lower levels of U.S. content and other concessions.

The second issue involves the overall "rules of origin." Currently, the requirement for a product to be NAFTA-compliant is that 62.5 percent of the product must be attributable to North American production.[23] The U.S. is now demanding that the limit be raised to 85 percent.[24] It is likely that a compromise is possible in the low 70s.[25] Recently, Canadian negotiators proposed creative new strategies that may yield an agreement.[26]

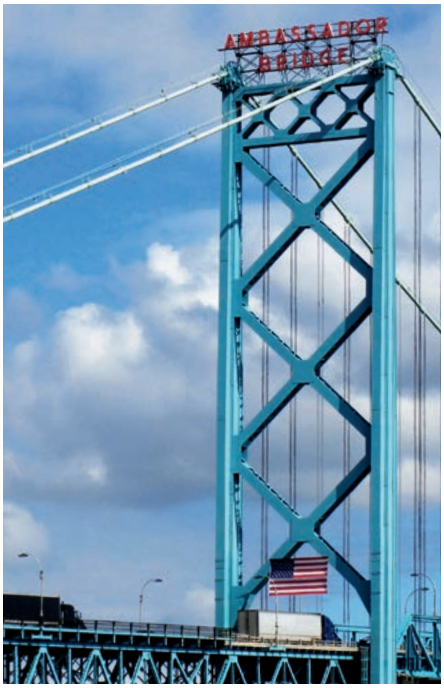
The final issue involves arbitration panels. One of the successes of NAFTA from the perspective of promoting trade has been the requirement that trade disputes among the three countries be handled by independent arbitration panels. The U.S. wants to eliminate these panels allowing resolution to happen in the court systems of the three countries. Canada is strongly committed to retaining the panels and actually walked out of the original negotiations over this issue.[27] This issue is clouded by the issue of sovereignty.[28] It is hard to predict whether or not a compromise is possible.

Recently, the U.S. has added a "sunset" demand abrogating the agreement after five years.[29] This is unacceptable by both Mexico and Canada, and U.S. businesses indicate that it renders the agreement meaningless. This has been accompanied by increasingly confrontational U.S. rhetoric.

NAFTA: The Aftermath

Although a survey of North American economists predicts a successful renegotiation,[30] the outcome of the NAFTA negotiations is unclear. U.S. businesses from advanced manufacturing to agriculture strongly support an updated NAFTA, but it is not clear that the administration wishes to proceed. This led a vice president of the U.S. Chamber of Commerce to characterize the administration's position as a policy without a constituency.[31] That said, President Trump did moderate his rhetoric in his January 2018 speech to the World Economic Forum in Davos.[32]

It is difficult to imagine a North American economy without NAFTA. The disruption of supply chains that would result from expiration of the agreement would be monumental. Automotive manufacturing disruption would be significant with increases in manufacturing costs of as much as $27 billion and, one Bloomberg report held, an average increase in the price of automobiles of $1,000.[33] "Just-In-Time" processes could fail, compromising the effectiveness of advanced manufacturing—a hallmark of U.S. competitiveness. U.S. agriculture depends heavily on agricultural exports to Mexico ($18B) and Canada ($23B). If NAFTA were to expire, tariffs on agricultural products (currently at zero) would jump dramatically and bring devastation to midwestern farmers.[34]



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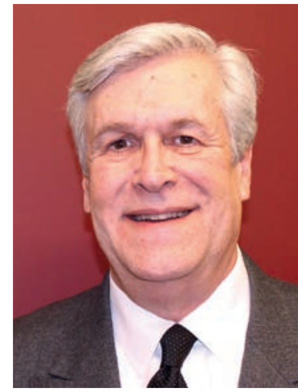
While the economic impact of withdrawal from NAFTA would be significant, a more important question concerns the position of the U.S. in the world economy. The posture taken by the Trump administration contrasts with that of every administration since World War II, each of which favored free trade and engagement in economies around the world. To the extent that there is an interest in negotiating trade agreements within the Trump administration, it is in bilateral as opposed to multilateral agreements. While bilateral agreements certainly have their place in the world economy, world trade is increasingly complex. Supply chains seldom involve just one border and potential conflict caused by bilateral agreements can negate any advantages. What's more, the "America First" perspective is clearly seen by the rest of the world as the U.S. abdicating its long-held leadership role. The remainder of the TPP group (including Canada, Mexico, Japan and Australia) has reached an agreement without the U.S.[35] Canada has negotiated a new agreement with the European Union yielding almost zero duties.[36] Mexico has moved to increase its imports of corn from Brazil and Argentina.[37] The U.S. is in danger of being left behind.

Are we headed to a last-minute agreement to modernize NAFTA; or is its demise imminent? As I write this in February, it is impossible to know. What is clear is that NAFTA has enhanced the state of our workforce and the competitiveness of our economy. However, we have not developed a "safety net" to protect workers harmed by international trade. Without such protections, we should not be surprised by current populist nationalist sentiments.

Everyone agrees that NAFTA is in need of modernization. The world grows more complex and intertwined every day. We need to address those changes, not ignore them.



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