

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

NAFTA and the Midwest

by Randall W. Eberts and Lydia K. Leovic

In recent months, Midwesterners have consistently told pollsters and politicians that their No. 1 concern is jobs. The economy's tepid growth rate, coupled with the downsizing of several major U.S. corporations, has raised people's anxiety about job security and future employment prospects.

At a time of subpar employment growth in this region and across the nation, workers are now faced with the uncertain effects of another event. On August 12, the United States, Mexico, and Canada announced their decision to create a free-trade zone. The North American Free Trade Agreement (NAFTA), which will come up for a vote in Congress next spring, would eventually eliminate all tariffs on shipments among the three countries, as well as remove limits on international investment, liberalize trade in services, and protect intellectual property rights.

In many respects, the pact is similar to the Free Trade Agreement (FTA) between Canada and the United States, which has been in effect since 1989. Adding Mexico to the trading bloc appears to have caused considerably more consternation among U.S. workers than did FTA, however. This anxiety stems from the fear that much lower wages and less stringent regulations in Mexico will lure American businesses and jobs there. Job loss was not a major concern when FTA was adopted, since wages are no lower in Canada than in the United States, and business regulations are generally stiffer.

The debate over the economic consequences of NAFTA is expected to intensify over the next few months as the U.S., Canadian, and Mexican legislatures consider ratification. Proponents claim that passage would benefit all three nations by increasing commerce within the trading bloc. As they see it, new jobs would be created and wages and standards of living would rise. Critics may agree that overall welfare would be somewhat higher, but they place more emphasis on the expected loss of high-paying jobs in specific industries and regions, as well as on the adjustment costs of retraining displaced workers.

The latest meeting of the Fourth District Economists' Roundtable, held October 2 at the Federal Reserve Bank of Cleveland, offered some reasons for workers to reevaluate their fears about NAFTA. Participants were asked to assess how they see the agreement affecting their businesses, with particular emphasis on autos, steel, and electronics/telecommunications — three industries of great importance to the Midwest economy. In addition, several outside experts were invited to present their insights on the economywide and industry-specific effects of the pact. The group generally agreed that NAFTA would have only a minimal impact on worker displacement. Highlights of the proceedings are reported below.

■ Gains from Trade

According to the traditional view of international trade, an increase in the flow of goods and services across national boundaries boosts the average

The pending ratification of the North American Free Trade Agreement has many American workers concerned about job security and future employment prospects. The fear is that lower wages and benefits in Mexico will entice American businesses to close their doors and head south. The latest meeting of the Fourth District Economists' Roundtable focused on the likely effects of the accord, with particular emphasis on the Midwest economy. The consensus is that NAFTA is merely a codification of the general worldwide trend toward reducing trade barriers, so its impact should be minimal.

standard of living of people on both sides of the border. Gains in efficiency and in real income are derived primarily from nations specializing in those goods and services they can produce relatively cheaply, a phenomenon known as comparative advantage. For example, suppose that U.S. workers are more efficient at producing precision machine tools than electronic components, while Mexican workers have just the opposite relative advantage. Free trade allows workers in each country to concentrate on what they do best, which in this case means that U.S. workers will produce precision machine tools and Mexican workers will manufacture electronic components. Both consumers and workers benefit from this system, with consumers enjoying lower prices and workers engaging in more-productive activities.

NAFTA would expand access to all three countries' markets by phasing out tariffs on most goods over the next 10 years. Trade would not be totally unimpeded, since other barriers are retained in the form of special provisions restricting commerce in a few protected industries. Nonetheless, the pact would provide most businesses with access to a massive combined market of 370 million people and an annual gross domestic product (GDP) of \$6.2 trillion.

Daniel Schwanen of Toronto's C.D. Howe Institute presented several striking examples of how FTA has opened up Canada's trade with the United States. For categories of goods in which tariffs were eliminated, Canadian exports to the United States have increased at a much faster pace than exports to other nations. In fact, the relative gain in sales to our country has occurred even though the U.S. economy has lagged behind that of most of Canada's other trading partners. The stimulative effect of tariff reductions on exports is also suggested by the fact that shipments to the United States have grown for those goods allowed to enter duty free, but have fallen for those still subject to tariffs.

Most analyses of NAFTA predict that real personal income in all three nations will rise as trade increases. Alan Dear-dorff, an economics professor at the University of Michigan, presented results from a study conducted with two of his colleagues. They predict that real income will pick up in all three countries during the 10-year phase-in period, but that the overall increase is likely to be minimal. Even for Mexico, which has the most to gain from the agreement because of its higher tariffs and less developed economy, real income should rise only up to 5 percent of GDP. For both the United States and Canada, the corresponding figures are just a fraction of 1 percent.

■ Mitigating Factors

Roundtable participants cited three reasons for these relatively small gains. First, existing tariffs are not very high. Mexican goods coming across our border are subject to an average tariff of only around 5 percent, while products going in the opposite direction are taxed at only about a 10 percent rate. By comparison, sales-tax differentials between some neighboring U.S. states exceed 5 percentage points.

It is unclear just how responsive trade flows might be to a relatively modest reduction in prices. Currently, U.S. trade with Mexico accounts for roughly 8 percent of our merchandise exports and 6 percent of imports. Comparable figures for Canada are one-half of 1 percent and 2 percent, respectively. Thus, even if trade flows were to double as a result of NAFTA, the impact on the overall national economies would still be small.

Second, much of the trade among the three countries is not subject to tariffs. About 85 percent of Mexican products currently enter the United States duty free, and roughly 80 percent enter Canada duty free.¹ Still, the notion that trade barriers for manufactured goods are already low must be qualified by the recognition that other types of barriers exist. For instance, Mexico imposes import licenses on automobiles, electronics, and pharmaceuticals, while the United

States and Canada enforce quotas on specific goods.

Finally, NAFTA by no means signals the beginning of trade liberalization. Rather, in many respects it simply formalizes a previously established posture among the three countries. The border between Canada and the United States has traditionally been relatively open, and FTA opened the door even further. Mexico dramatically liberalized its economic policy in the mid-1980s by allowing free markets to operate in areas where the government had previously intervened, by deregulating other industries, and by unilaterally lowering tariffs and slashing its import licensing program. In response to these changes, goods and investment funds have poured into Mexico. Thus, it would be a mistake to confuse the effects of NAFTA with the ramifications of previous economic policy shifts.

■ Midwest Jobs:

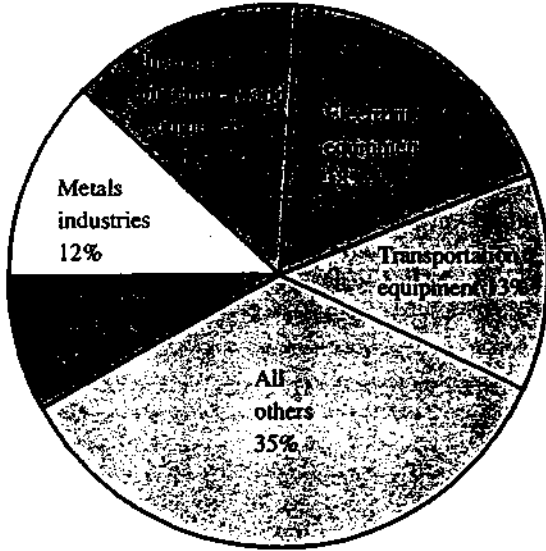
Winners and Losers

Probably the most contentious aspect of NAFTA relates to jobs. Some U.S. labor organizations have insisted that the pact could displace up to half a million American workers. Proponents counter this concern by listing hundreds of thousands of new jobs that could be created as exports expand.

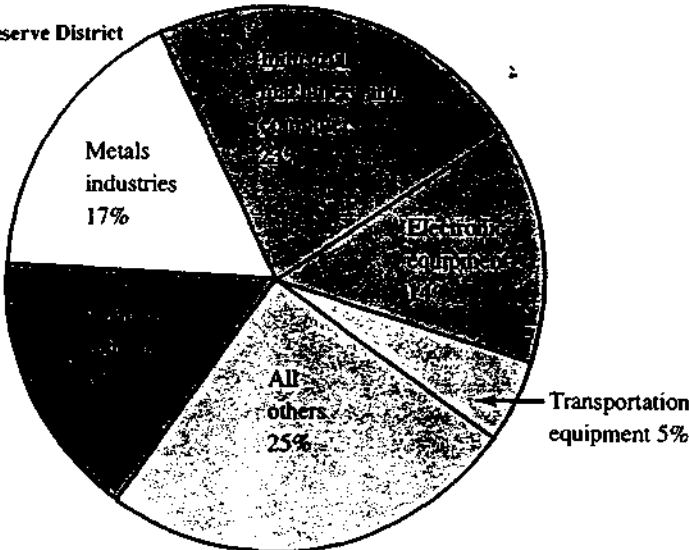
Both of these estimates may be somewhat high, since NAFTA is expected to bolster trade only marginally. A much-cited study by economists Gary Hufbauer and Jeffrey Schott of the Institute for International Economics foresees 110,000 displaced workers from increased imports and 240,000 additional jobs from increased exports, or a net gain of about 130,000.² To put these estimates into perspective, total U.S. employment has declined by 550,000 since the economy peaked in July 1990, while Ohio employment has slipped by 70,000.

FIGURE 1 SHARES OF EXPORTS TO MEXICO

United States



Fourth Federal Reserve District



SOURCE: U.S. Department of Commerce, International Trade Administration, *U.S. Exports to Mexico*, July 1992.

It is not surprising, then, that labor's primary concern is not net job loss, but worker displacement. While jobs will likely be created to replace those lost as a result of increased trade, the workers who are laid off will not necessarily fill these new positions, which may be located in another region or require very different skills. Such structural shifts will enhance the overall competitiveness of the United States, but possibly at the expense of workers in industries that lack a comparative advantage over their Mexican counterparts.

Existing trilateral trade flows offer some indication of the types of businesses that would benefit from liberalized trade, particularly with Mexico. The United States accounts for 70 percent of Mexico's total trade. However, the four states that make up the Fourth Federal Reserve District — Kentucky, Pennsylvania, Ohio, and West Virginia — account for only 4.4 percent of that figure. The goods we do ship to Mexico to a large extent reflect the region's comparative advantage. For example, 32 percent of Ohio's exports to Mexico comprise industrial machinery and computers, 22 percent of Pennsylvania's shipments are primary metal products, most of West Virginia's exports are chemical

products, and Kentucky primarily ships fabricated metals and industrial machinery.³

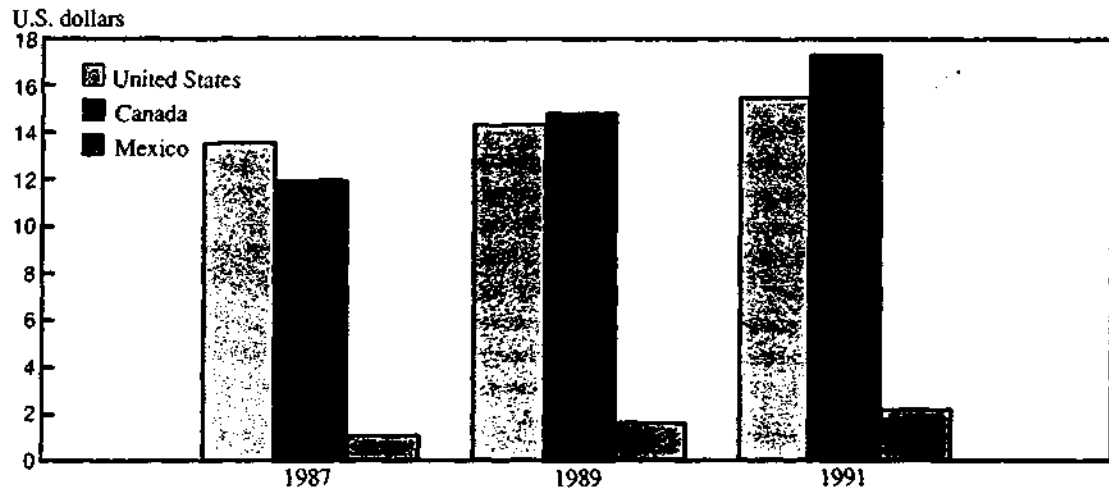
Comparing the share of Fourth District exports to Mexico to the U.S. share reveals that this region excels in primary metals, industrial machinery, and chemical products (see figure 1). Another encouraging sign for Midwesterners is that the District's share of total U.S. exports to Mexico has more than doubled over the last four years in these three key industries.

But jobs may be affected by factors other than a change in the level and composition of trade flows. Perhaps a more pressing concern of Midwest workers — indeed, of all American workers — is that lower wages and benefits in Mexico may encourage U.S. firms to locate their manufacturing facilities there. Hourly manufacturing compensation costs in Mexico are only one-seventh the U.S. rate, and health care costs and pension liabilities are also substantially lower (see figure 2).

It is not clear to what extent American companies will take advantage of this situation, since labor costs are only one of the factors firms consider when locating facilities. The quality of a nation's labor force, access to markets, the condition of highways and other public infrastructure, and the cost of materials also weigh heavily in the decision. Most of the Roundtable participants indicated that their firms have no immediate plans to establish facilities south of the border if NAFTA is ratified, though some noted that Mexico may be an attractive alternative to the Far East because of its proximity and its increasingly stable investment climate.

Professor Deardorff offered estimates of employment changes across industries that would result from both shifts in trade flows and direct U.S. investment in Mexico. Employment in the industrial machinery and chemicals sectors is expected to see the biggest rise if NAFTA is approved, while transportation equipment would be one of the major losers. Even so, his estimate of job losses in the transportation industry

FIGURE 2 HOURLY MANUFACTURING COMPENSATION IN NAFTA COUNTRIES



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, "International Comparisons of Hourly Compensation Costs for Production Workers and Manufacturing," Report No. 825, June 1992.

is quite modest, at only about one-half of 1 percent of existing employment.

In addition to the overview of NAFTA, the Roundtable also heard comments from outside experts about the state of three industries that play a key role in the Midwest economy: autos, steel, and electronics/telecommunications. Below, we present a synopsis of their reports.

■ Autos

Marc Scheinman, from Pace University and The Economist Intelligence Unit, noted that significant investment potential lies south of the border for the U.S. auto industry, which is heavily concentrated in Ohio and Michigan. Approval of NAFTA means that the Mexican government would allow *maquiladoras*, which are classified as foreign businesses, to boost their direct domestic sales immediately. Eventually, all trade barriers would be phased out throughout both the auto and automotive parts industries.

Such liberalization will undoubtedly help Mexico's auto sector, which is cur-

rently operating at capacity, to meet the surging Mexican demand for small cars. Scheinman estimated that Mexico's auto production would have to double by the year 2000 just to accommodate the nation's consumers, with sales expected to skyrocket 140 percent over the decade. Of every three Mexican cars produced, two will likely be consumed domestically. This should help ease American workers' concern that Mexico will flood the U.S. market with inexpensive new cars, particularly since vehicles produced there will not be free of tariffs until well into the twenty-first century.

Another factor that could mitigate the effects of NAFTA is that trade agreements liberalizing foreign content requirements are already in place. Ratification would simply speed up the changes in such requirements and further open opportunities for auto industry expansion, particularly in Mexico's interior. According to Scheinman, both Nissan and Volkswagen have plans to invest heavily in Mexico if NAFTA is signed. Fortunately, this expansion should not affect U.S. jobs. Not only will transportation costs remain high enough to hamper a surge of Mexican exports, but the quality of Mexico's automotive labor force is currently not competitive with that of the United States.

■ Steel

For the steel industry, NAFTA will probably not change the direction of North American trade, according to Donald Barnett, an industry consultant. He reported that domestic producers are in the midst of a major restructuring, the result of new "mini-mills" opening throughout the country. Because of a less labor-intensive production process, these smaller plants are able to produce a limited line of products much more cheaply than can the larger, integrated mills.

On the down side, the quality of the mini-mills' products is still not what it should be, so demand is limited. As this situation improves over time, so will these facilities' competitiveness. Indeed, by the end of the decade, estimates suggest that mini-mills may account for 10 percent of domestic steel capacity. In the interim, we will see a race to reduce costs between the major steel producers and their new rivals on the domestic scene.

Competition from the mini-mills and emerging new technologies have already registered a tremendous impact in reducing labor's share of steel production costs. A good example is labor's share of the cost per ton of flat-rolled steel, which is expected to drop from about 30 percent in 1991 to 25 percent in 2001. As this component of steel costs diminishes, so does the advantage of moving manufacturing facilities to Mexico. What's more, Mexico has no advantage over the United States in the cost of raw materials and other inputs into the steel-making process.

■ Electronics/Telecommunications

The electronics industry supports NAFTA, according to the paper presented by Glyn Finley of the Electronic Industries Association. Tariffs on most trade within this sector would be eliminated by January 1, 1994, and any remaining tariffs would be lifted within five years. This should increase U.S. exports to Mexico by enhancing our competitiveness.

Industry leaders are disappointed that the agreement makes no provision for tariff reductions in the telecommunications area. Nonetheless, it does recognize that the ability to move and manage information freely within and across national borders is necessary for effective trade and economic growth. Though the accord falls short of industry expectations, it takes a step in the right direction by establishing a process to enhance the telecommunication linkages between Mexico and the United States.

■ Conclusion

NAFTA has been heralded as a major step in unleashing the combined competitive powers of the three North American nations. Uniting the economies of Canada, Mexico, and the United States through duty-free trade would form the world's largest trading bloc and would raise the standard of living in all three countries. The benefits will spring from each nation's ability to focus on those goods and services for which they have a comparative advantage. But as workers move from less productive to more productive industries, jobs will inevitably be reshuffled.

In the United States, and particularly in the Midwest, many workers are concerned that NAFTA may be their ticket to the unemployment line. Participants at the latest meeting of the Fourth Federal Reserve District Roundtable see it another way. While they recognize that reducing trade barriers displaces workers, they generally agree that NAFTA's impact on both job loss and overall benefits would be modest. In their view, the agreement is primarily a means of solidifying rather than initiating the process of opening national borders to trade and investment.

The fortunes of particular workers will depend on both the competitiveness of their industries and their ability to meet the skill requirements of the new jobs that will be created. One of the major issues legislators will face as they consider ratification is the adequacy of worker retraining programs intended to prepare workers for this transition. But regardless of NAFTA's fate on Capitol Hill, Midwest businesses and workers will continue to enjoy the benefits—and to face the challenges—of competing in a more open world economy.

■ Footnotes

1. See Steven Globerman and Maureen Bader, "A Perspective on Trilateral Economic Relations," in Steven Globerman, ed., *Continental Accord: North American Economic Integration*. Vancouver: The Fraser Institute, 1991, pp. 153-74.
2. See Gary Huftbauer and Jeffrey Schott, *North American Free Trade: Issues and Recommendations*. Washington, D.C.: Institute for International Economics, 1992.
3. These figures may understate the linkage between Mexico and the Midwest, since goods that are shipped first to border states for processing or storage before going on to Mexico (including autos manufactured in the Midwest) are not reflected in the export data. Texas, for example, ships more goods to Mexico than it actually produces, because the state is a primary staging area for supplying Mexico's *maquiladora* enterprises.

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Chronology of Events Leading up to the North American Free Trade Agreement

- February 1991 The United States, Mexico, and Canada agree to begin negotiations for a free trade agreement.
- June 1991 Formal negotiations begin.
- August 12, 1992 An agreement is reached, and a team of experts and lawyers from all three nations continue to hammer out wording that will ensure effective and smooth implementation of the provision.
- September 18, 1992 President Bush formally notifies Congress of his intent to enter into the agreement.
- October 7, 1992 President Bush, Mexican President Salinas, and Canadian Prime Minister Mulroney meet in San Antonio to discuss plans for implementing NAFTA. Following the meeting, the trade ministers who negotiated the accord initial the document.
- What's Next? The next step in the ratification process will be the formal signing of the agreement by the three heads of state. In the United States, NAFTA falls under the fast-track procedures for congressional review and approval of international trade agreements. The 90-day notification period began on September 18, when the President formally advised Congress of his intent to enter into the agreement. The signing can occur on or after December 17, 1992, but no later than June 1, 1993. At any time thereafter, the President may transmit the implementing legislation to Congress, which must act upon it within 90 session days (this could span up to eight months).

SOURCE: Fact Sheet, "San Antonio Meeting and Initialing of the North American Free Trade Agreement," The White House, October 7, 1992.

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