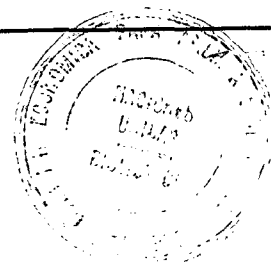


IDB - ECLAC

**WORKING PAPERS
ON TRADE IN THE
WESTERN HEMISPHERE**

WP-TWH-28
March 1993



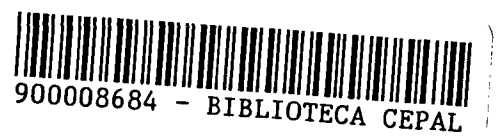
**On Beyond NAFTA:
Employment, Growth, and Income
Distribution Effects of a Western
Hemisphere Free Trade Area**

Robert A. Blecker
William E. Spriggs

17 DEC 1993

INTER-AMERICAN DEVELOPMENT BANK

UNITED NATIONS ECONOMIC COMMISSION FOR LATIN AMERICA
AND THE CARIBBEAN



900008684 - BIBLIOTECA CEPAL

ON BEYOND NAFTA:
EMPLOYMENT, GROWTH, AND INCOME DISTRIBUTION EFFECTS
OF A WESTERN HEMISPHERE FREE TRADE AREA

By

Robert A. Blecker
Department of Economics
The American University
Washington, DC 20016 USA
Phone (202) 885-3767
FAX (202) 885-3790

and

William E. Spriggs
Economic Policy Institute
1730 Rhode Island Ave., N.W., Suite 200
Washington, DC 20036 USA
Phone (202) 775-8810
FAX (202) 775-0819

Final Draft
March 1993

Revised version of paper prepared for the Inter-American Development Bank and U.N. Economic Commission for Latin America and the Caribbean Project, Support to the Process of Hemispheric Trade Liberalization, Fifth Colloquium on "The Negotiating Agenda and Perspectives," Washington, DC, September 28-29, 1992. The authors wish to acknowledge helpful comments from Hans Singer, Ron Sprout, and other participants in the Fifth Colloquium. The opinions expressed here are those of the authors alone, and are not to be attributed to either of the sponsoring organizations or to the authors' institutions.

ON BEYOND NAFTA:
EMPLOYMENT, GROWTH, AND INCOME DISTRIBUTION EFFECTS
OF A WESTERN HEMISPHERE FREE TRADE AREA

1. Introduction

Negotiations for a North American Free Trade Area (NAFTA) linking the United States, Mexico, and Canada had not even begun when proposals for establishing a broader, western hemisphere-wide free trade area began to be advocated. Former U.S. President George Bush quickly endorsed this idea with his "Enterprise for the Americas Initiative" (EAI). In practice, however, hemisphere-wide integration has taken a back seat as the negotiation of the NAFTA took precedence. And new U.S. President Bill Clinton has promised to negotiate "parallel agreements" on labor and environmental standards before implementing the NAFTA agreement.

In the meantime, there has been a far-reaching debate over the likely consequences of the NAFTA for the three member countries. In the course of this debate, it has frequently been observed that the NAFTA as presently conceived will largely extend and deepen a process of U.S.-Mexican economic integration which is already ongoing. Mexico has made a phenomenal opening to foreign trade and investment in the last five years, reversing 70 years of efforts to develop autonomously. As we shall show, in these five years Mexico has already acquired

an unprecedented importance in U.S. foreign investment and in the manufacturing employment generated by U.S. firms.

For this reason, even though precise predictions are hard to make (or to believe), it is possible to infer how the NAFTA is likely to affect the U.S. and Mexican economies, by extrapolating from the effects of the ongoing integration process between them.¹ Of course, it would be naive simply to project existing trends into the future, especially when both economies are undergoing profound structural changes. Nevertheless, we believe that any serious discussion of the NAFTA must begin with an appreciation of how U.S.-Mexican integration has already affected both nations' economies, rather than by making forecasts derived from theoretical models of trade liberalization.²

From this perspective, the best way to look at the NAFTA (at least for the U.S. and Mexico) is as *an opportunity to regulate and manage a process which is already going on*, and which is probably impossible to stop altogether. The issue is not whether the U.S. and Mexico will become more tied together economically, but how they will be connected, and how the costs and benefits of the integration process will be distributed between different groups in those two countries and, by extension, in Canada as well. Up to the present, the mobility of capital has already far outstripped the ability of labor organizations, local communities, or national governments to respond to the challenges which that mobility poses for them. It is clear from the text of the NAFTA agreement (as negotiated by President Bush, Mexican President Carlos Salinas de Gortari, and Canadian Prime Minister Brian Mulroney) that its main intention is to extend the *status*

quo by giving greater protections for and incentives to foreign investment in Mexico, with minimal protections for the environment and no protections for labor rights or standards. Unless and until President Clinton implements his campaign promises, the opportunity to regulate and manage the process of economic integration in order to broaden the social benefits, prevent massive dislocations, and ameliorate painful adjustments has so far been passed up.

In this paper, the authors will draw largely on what they have learned from the debate in the United States, and to a lesser extent from the discussions in Mexico and Canada, about the probable effects of a NAFTA, in order to offer some hypotheses about the probable effects of a Western Hemisphere Free Trade Area (WHFTA). While analysis of the NAFTA can proceed on the basis of ongoing trends, analysis of a WHFTA is impeded by the much lower degree of existing economic integration between the U.S. (or North America as a whole) and most of South America. Only in certain parts of Central America and the Caribbean does the existing level of economic integration with the U.S. resemble that found in the case of Mexico, and these regions are already part of a preferential trading arrangement with the U.S. under the Caribbean Basin Initiative (CBI).

To be sure, almost all the nations of Latin America and the Caribbean have increased their integration into the world trading system in the past decade. Most Latin American nations have, to a greater or lesser extent, reduced their trade and investment barriers since the debt crisis of the early 1980s. Trade and investment liberalization measures have been adopted as part of the "structural adjustment policies" promoted by the U.S. government along with the IMF, World

Bank, and other international organizations, in response to the perceived failure of past nationalistic economic policies. But most of these liberalization measures have trade and capital flows with all nations — not just the United States. (Mexico's trade and investment liberalization in the late 1980s was also multilateral, but Mexico's proximity to the U.S. market led to a concentration of the new trade and investment flows in that direction.) In this respect, moving toward a WHFTA would be less of an extension of ongoing liberalization measures, and more of a shift from multilateral liberalization to preferential trade arrangements, for the nations of South America, as compared with Mexico (or the Caribbean and Central American nations covered by the CBI).³ With regard to South America especially, therefore, it is necessary to adopt a comparative perspective in order to gain insights into the degree to which it would or would not follow the Mexican model after the formation of a WHFTA.

The rest of this paper will use the recent trends in U.S.-Mexican trade, employment, and investment relations as a stepping stone toward a comparative analysis of hemisphere-wide integration. We shall proceed in three steps, essentially moving from goods markets to labor markets to capital markets. In section 2, we discuss trends in economic development and trade relations among the different countries and regions of the western hemisphere. In section 3, we analyze the effects which the opening up of trade has had on employment, wages, and income distribution. And in section 4, we look at capital flows and macroeconomic relationships, both within the western hemisphere and between it and other regions of the world economy. In each case, we start from the more familiar

territory of U.S.-Mexican relations and move on to assess how well our conclusions about those relations can be generalized to other parts of the hemisphere. Finally, in section 5, we draw conclusions about policies for managing the process of hemispheric integration based on the concerns elaborated in the rest of the paper. Our intention throughout is not to reach definitive conclusions, but to raise questions that need to be dealt with by all who are seriously concerned about this process.

2. Goods Markets: Developmental Differences and Trade Flows

Basic Development Indicators

This section begins by examining some standard "development indicators" for the United States, Canada, and Mexico, as well as totals for Latin America (including Mexico as well as the Caribbean) which are shown in Table 1. Most striking are the differences between how these countries compare in terms of population versus income measures. Mexico has about one-third the population of the U.S. today (based on 1990 figures), and is projected to have nearly half the U.S. population by 2025; Latin America as a whole has three-quarters more people than the U.S. today and is expected to have more than double the U.S. population by 2025. Yet Mexico has barely 4.4% of the GDP of the U.S., and all of Latin America combined has less than one-fifth of the U.S. GDP. The per capita income (GNP) of all Latin America is just one-tenth of the U.S. level, while that of Mexico is about one-ninth of the U.S.

| Table 1 Basic Development Indicators for the United States, Canada, Mexico, and Latin America | | | | |
|---|--------|--------|--------|---------------|
| | U.S. | Canada | Mexico | Latin America |
| Population, in millions | | | | |
| Total, 1990 | 250 | 27 | 86 | 433 |
| Total, 2025 (projected) | 307 | 32 | 142 | 699 |
| Population growth, average annual percentage rate | | | | |
| Actual, 1980-1990 | 0.9% | 1.0% | 2.0% | 2.1% |
| Projected, 1989-2000 | 0.8% | 0.8% | 1.8% | 1.8% |
| Working-age population (15-64 years), in millions | | | | |
| Actual, 1990 | 165 | 18 | 51 | 275 |
| Projected, 2025 | 188 | 19 | 97 | 441 |
| Gross national product per capita, 1990, in U.S. dollars | 21,790 | 20,470 | 2,490 | 2,180 |
| Gross domestic product (GDP), 1990, in billions of U.S. dollars | 5,392 | 570 | 238 | 1,015 |
| Growth of GDP, average annual percentage rate | | | | |
| 1965-1980 | 2.7% | 4.8% | 6.5% | 6.0% |
| 1980-1990 | 3.4% | 3.4% | 1.0% | 1.6% |

Source: World Bank, *World Development Report 1992*, World Development Indicators (Tables 1, 2, 3, 5, and 26), and authors' calculations.

Note: Data for Latin America include Mexico.

These figures should prompt some skepticism about the allegedly enormous market that the NAFTA or WHFTA would create for U.S. business. For example, it is often claimed that the NAFTA will create a \$6 trillion economy. But 96% of that economy already exists in the U.S.-Canada FTA, and 87% of it is in the U.S. alone; only 4% is gained by adding on Mexico. With Mexico included, the three NAFTA countries had a total GDP of \$6.2 trillion in 1990; without adding on Mexico, the U.S. and Canada together already had a combined GDP of \$6.0 trillion. And most of the Mexican consumers who will be added on are much poorer than those of the U.S. and Canada. With a per capita income one-ninth of the U.S. level, and greater inequality, the ability of the average Mexican family to purchase exported U.S. consumer goods must be quite minimal. The picture changes only slightly if we shift the focus to a WHFTA. The U.S. alone would constitute 77% of a WHFTA, and the U.S. and Canada together would make up 85%. The other 15% percent would be composed of Latin Americans who, while more numerous, are also much poorer on average than their North American cousins (and even, on average, poorer than most Mexicans).

It is difficult to see *a priori* how adding on such a relatively small and impoverished market by itself could give the U.S. significant aggregate gains from trade, either static or dynamic, regardless of whether one assumes a model based on constant or increasing returns to scale. Of course, there could be large gains in specific sectors which have major exports to Latin America (which we would expect to be mainly producer goods sectors), as well as large losses in specific sectors which compete with imports from Latin America.

At first glance, there appear to be enormous potential gains for Latin American countries from gaining improved access to the vast U.S.-Canadian consumer market. But the potential for such gains to be realized depends on many other factors. For one thing, Latin America's potential for export gains will depend heavily on the extent to which the U.S. market grows in the next decade. Although U.S. growth was fairly rapid in the 1980s, it was largely fueled by unsustainable deficit spending and rising debt — much like the rapid growth of Latin America in the 1970s. The 1990s seem likely to be a decade of slower growth in the U.S. economy, given the sluggish recovery from the 1990-91 recession, and the contractionary effects of President Clinton's initiatives for reducing the federal government budget deficit. We shall return to the question of the prospects for U.S. market growth in section 4, below. It is worth mentioning here, however, that if the U.S. market does not grow rapidly, Latin American countries will gain only to the extent they can take market shares away from more efficient East Asian competitors. While the trade preferences under a WHFTA would help, this would still be a difficult task for many Latin American countries to achieve, especially those which have not already distinguished themselves as competitive exporters of manufactured products.

While the total products and per capita incomes are the most relevant indicators of the likely gains from trade, the population and demographic data are more important indicators of the opportunities for direct foreign investment (DFI) by multinational corporations (MNCs). Note especially that Mexico's working-age population (15-64 years) is projected nearly to double in the next 35 years (from

1990 to 2025), with an increase of 46 million workers over the existing level of 51 million. This is an increase of more than 1 million workers per year, and it would make the Mexican work force leap from less than one-third of the U.S. work force today to over half in just one generation.

Even the highest estimates of the employment-creation effects of the NAFTA for Mexico show that it would not suffice to absorb more than a small fraction of this projected increase in the Mexican labor force.⁴ For the foreseeable future, then, the assumption of an infinitely elastic supply of labor at a relatively constant real wage is a reasonable first approximation for Mexico. It is this vast and ever-expanding source of cheap labor, and not the limited Mexican consumer market, that excites American corporate capital about the prospects for a NAFTA. Basic economic reasoning suggests that giving American firms greater access to such a large and growing supply of labor cannot help but depress wages for American workers.⁵ The numbers also suggest that, even if some Mexican workers get manufacturing jobs at the expense of U.S. workers, average Mexican real wages are unlikely to rise substantially for a long time to come — especially if Mexican workers have to compete with even lower-wage workers from other Latin American countries in a WHFTA. And finally, these numbers suggest that the NAFTA will hardly make a dent in the prospective influx of Mexican (or other Latin American) migrants to the U.S. in the next few decades. Taking account of these demographic trends, as well as the disruptions to peasant agriculture caused by the liberalization of agricultural trade,⁶ the migration problem may well worsen rather than improve following the adoption of the NAFTA if it is not

accompanied by domestic policies to deal with rising structural unemployment in Mexico.

Trade Trends

Next we consider trends in the international trade of the U.S., Canada, Mexico, and other parts of the western hemisphere. Table 2 gives data on the value, growth, and composition of merchandise trade for these countries. The total value of Latin America's trade (exports plus imports) is approximately equal to that of Canada, a country with one-sixteenth the population of Latin America (and just over one-half the GDP). Mexico's total trade is only about one-fifth of Canada's. U.S. trade, totalling nearly \$900 billion, dwarfs that of the other countries.

In terms of growth rates, the most notable difference is that between the rapid growth of U.S. and Canadian imports in the 1980s and the *negative* growth of imports in both Mexico and Latin America as a whole during that decade. When we consider that these are growth rates of *nominal* import values, these negative growth rates are even more striking. The depression of Latin American demand in the 1980s, as a result of rising interest rates, falling terms of trade, the debt crisis, and contractionary stabilization policies, clearly took its toll in reducing the continent's ability to import needed goods, both primary and manufactured.

| Table 2 Value, Growth, and Composition of Merchandise Trade for the United States, Canada, Mexico, and Latin America | | | | |
|--|-------|--------|--------|---------------|
| | U.S. | Canada | Mexico | Latin America |
| Value of trade, 1990 (in billions of U.S. dollars) | | | | |
| Exports | 371.5 | 125.1 | 26.7 | 123.2 |
| Imports | 515.6 | 115.9 | 28.1 | 101.1 |
| Average annual growth rates, 1980-1990 (in percent) | | | | |
| Exports | 3.3 | 5.9 | 3.4 | 3.0 |
| Imports | 7.6 | 8.4 | -1.1 | -2.1 |
| Composition of exports, 1990 (in percent) | | | | |
| Machinery and transport equipment | 47 | 37 | 25 | 11 |
| Other manufactures | 31 | 26 | 19 | 21 |
| Primary products | 22 | 37 | 56 | 67 |
| Composition of imports, 1990 (in percent) | | | | |
| Machinery and transport equipment | 40 | 50 | 36 | 31 |
| Other manufactures | 36 | 33 | 37 | 35 |
| Primary Products | 24 | 17 | 27 | 34 |

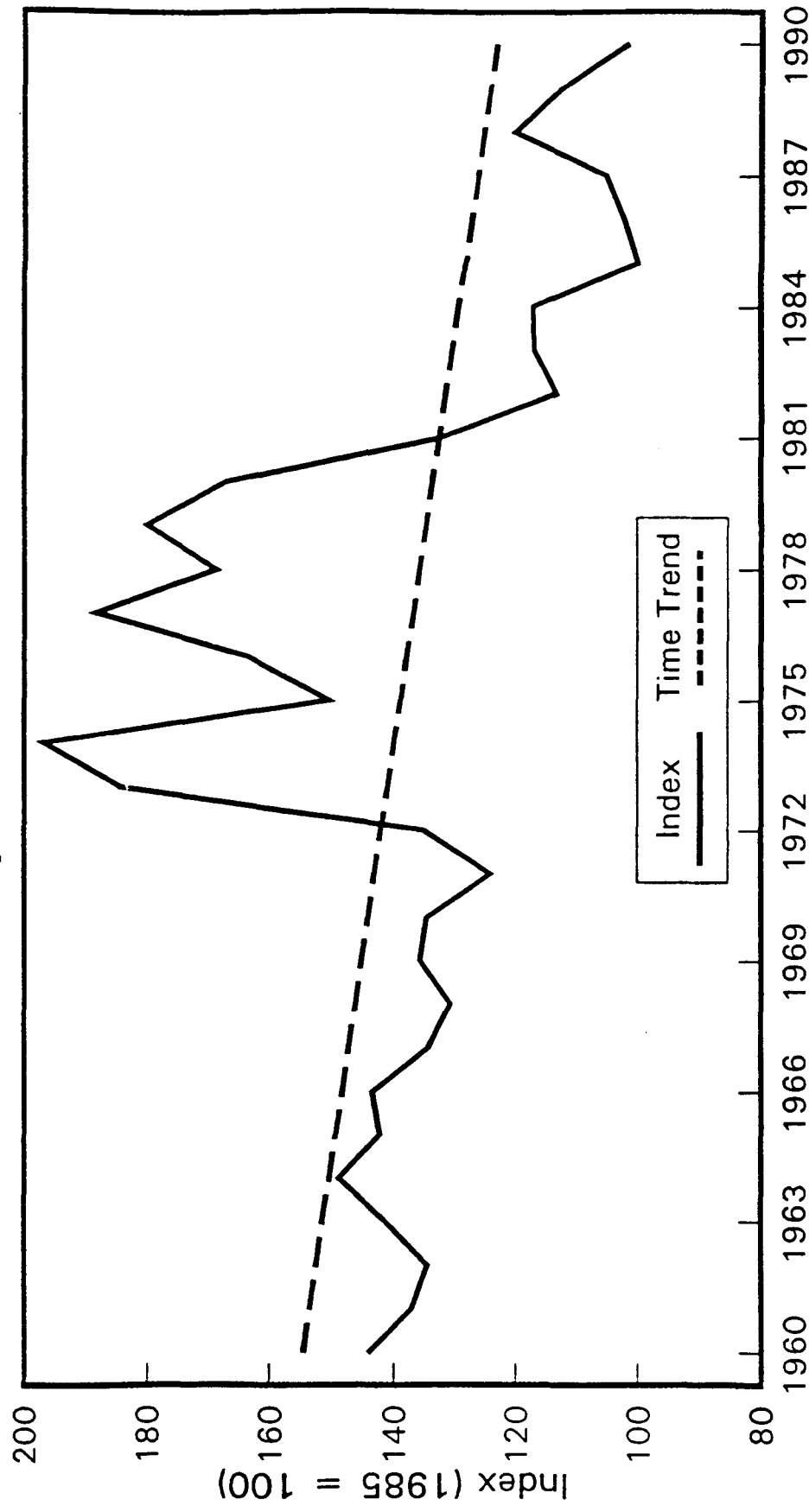
Source: World Bank, *World Development Report 1992*, World Development Indicators (Tables 14 and 15), and authors' calculations.

Note: Data for Latin America include Mexico.

With regard to the composition of trade in the western hemisphere, it is striking that both Mexico and Latin America as a whole continue to rely on primary products for the majority of their export revenue. For all of Latin America, primary products account for two-thirds (67%) of the value of exports, and excluding Mexico the primary product share of other Latin American countries is even higher (70%). While these figures for primary products include oil, the falling oil prices of the post-1982 period have demonstrated that oil is no exception to the traditional problems of volatile and sometimes falling terms of trade for primary commodity exports. Figure 1 shows that the terms of trade for non-oil commodity exports of developing countries had a declining trend over the past three decades, in spite of the temporary commodity price boom of the 1970s, and fell very sharply in the 1980s.⁷ These declining terms of trade have hamstrung the development efforts of countries relying on such exports to relieve tight foreign exchange constraints, to service their debts, and to help finance their economic growth.

Most Latin American nations are hoping that a WHFTA would open up the doors for them to develop more exports of manufactures on the East Asian model. But given the existing pattern of trade and the compelling logic of comparative advantage, a WHFTA might instead reinforce the traditional specialization of some Latin American countries in primary products. Most likely, those nations which already have relatively well-developed and efficient manufacturing sectors (e.g., Mexico, Brazil, Costa Rica, and the Dominican Republic) will be induced to move further in that direction, while the other nations will find themselves

Figure 1
Terms of Trade for Developing Country Exports
of Non-Fuel Primary Commodities, 1960-1990



Source: IMF, International Financial Statistics, 1990 and 1991 Yearbooks, and authors' calculations.

Note: The nominal commodity price index was deflated by the wholesale price index for all industrialized countries.

squeezed out of manufacturing markets and relegated to greater dependency on agricultural and mineral exports.

Trends in U.S. Bilateral Trade

The next three tables give some perspective on the United States' bilateral trade relations with the nations of the western hemisphere in comparison with its trade with the rest of the world. Table 3 shows U.S. bilateral trade balances for 1980, 1985, and 1990.⁸ From 1980 to 1990, the U.S. trade deficit with the entire world widened from \$36.2 billion to \$123.9 billion.⁹ Most of that increase was accounted for by larger deficits with Japan and other Asian countries (principally South Korea, Taiwan, and China), as well as by a reduced surplus with the European Economic Community (EEC). However, the U.S. trade balance with the western hemisphere also worsened by about \$17 billion — \$4 billion with Canada, and \$13 billion with Latin America.¹⁰ The worsening of the U.S. trade balance with Latin America from 1980 to 1990 was more than accounted for by a \$15 billion decline with South America, and a \$5 billion negative swing with Mexico (which has since been reversed¹¹), while the balance with Central America and the Caribbean improved by about \$6 billion (about half of which improvement is due to cheaper oil imports from Trinidad and Tobago and the Netherlands Antilles).

Table 3
U.S. Bilateral Merchandise Trade Balances
With Latin America and Other Countries,
1980, 1985, 1990
(in millions of U.S. dollars)

| <u>Country</u> | <u>1980</u> | <u>1985</u> | <u>1990</u> |
|-------------------------------|-------------|-------------|-------------|
| World | -36,178 | -148,474 | -123,914 |
| EEC | 18,873 | -22,623 | 2,541 |
| Japan | -12,183 | -49,749 | -44,485 |
| Other Asia | -4,476 | -32,580 | -43,424 |
| Canada | -6,604 | -22,176 | -10,821 |
| Other western hemisphere | -170 | -18,076 | -13,223 |
| Mexico | 2,311 | -5,757 | -2,422 |
| South America | 2,127 | -11,505 | -13,063 |
| Argentina | 1,838 | -446 | -485 |
| Bolivia | -17 | 19 | -72 |
| Brazil | 352 | -5,007 | -3,524 |
| Chile | 795 | -176 | 101 |
| Colombia | 409 | 12 | -1,371 |
| Ecuador | -89 | -1,384 | -867 |
| Paraguay | 24 | 74 | 251 |
| Peru | -271 | -656 | -74 |
| Uruguay | 80 | -510 | -191 |
| Venezuela | -994 | -3,431 | -6,831 |
| Central America and Caribbean | -4,608 | -814 | 2,262 |
| Costa Rica | 93 | -148 | -113 |
| Dominican Rep. | -33 | -289 | -169 |
| El Salvador | -171 | 33 | 301 |
| Guatemala | 88 | -43 | -114 |
| Haiti | 47 | -10 | 122 |
| Honduras | -99 | -125 | 2 |
| Jamaica | -114 | 112 | 333 |
| Neth. Antilles | -2,231 | -408 | 89 |
| Nicaragua | 23 | -8 | 53 |
| Panama | 346 | 208 | 616 |
| Trinidad & Tobago | -1,774 | -800 | -646 |

Source: International Monetary Fund, *Direction of Trade Statistics*, various years, and authors' calculations.

Notes: Data for other Asia for 1980 include an estimate for Taiwan. Other western hemisphere includes all countries in the hemisphere except U.S. and Canada. Regional totals include countries not shown separately. South America excludes the Guyanas, which are included in Central America and Caribbean.

Table 4 shows the corresponding trends in the value of U.S. merchandise exports (in current or nominal dollars). The total value of U.S. exports *fell* by 3.5% from 1980 to 1985,¹² but then shot up by 84.4% from 1985 to 1990 for a gain of 78.1% over the entire decade. U.S. exports to Japan and the rest of Asia grew at notably above-average rates, while exports to Europe grew at less than average rates. In the western hemisphere, exports to Canada also grew at a significantly above-average rate. Exports to Mexico grew at only a slightly above average rate over the whole decade, but in the 1985-90 period grew almost as fast as exports to Japan and the rest of Asia.¹³ Exports to all of Latin America (Latin America is shown as other western hemisphere including Mexico) grew by a scant 39% over the whole decade, and exports to South America (excluding the Guyanas) actually *fell* by nearly 12% between 1980 and 1990.

The relatively slow growth of U.S. exports to most of Latin America also shows up in a reduced Latin American share of U.S. exports (last three columns of Table 4). The total Latin American share fell from 17.6% in 1980 to 13.7% in 1990. While the Mexican share (including components for assembly operations) rose slightly, from 6.9% to 7.2%, the share of South America was more than cut in half, from 7.8% to 3.8%. Meanwhile, the shares of Canada, Japan, and other Asian countries rose sharply.

Table 4
U.S. Merchandise Exports to Latin America and Other Countries, 1980, 1985, and 1990

| Country | Value (in millions of U.S. dollars) | | Growth Rates (percentage increases) | | Shares of U.S. Total (in percent) | | | | |
|----------------------------------|--|---------|--|---------|--------------------------------------|---------|---------|---------|---------|
| | 1980 | 1985 | 1990 | 1980-85 | 1985-90 | 1980-90 | 1980 | 1985 | 1990 |
| World | 220,781 | 213,146 | 393,106 | -3.5% | 84.4% | 78.1% | 100.00% | 100.00% | 100.00% |
| EEC | 58,861 | 48,994 | 98,032 | -16.8% | 100.1% | 66.5% | 26.66% | 22.99% | 24.94% |
| Japan | 20,790 | 22,631 | 48,585 | 8.9% | 114.7% | 133.7% | 9.42% | 10.62% | 12.36% |
| Other Asia | 28,781 | 28,639 | 60,774 | -0.5% | 112.2% | 111.2% | 13.04% | 13.44% | 15.46% |
| Canada | 35,395 | 47,251 | 82,959 | 33.5% | 75.6% | 134.4% | 16.03% | 22.17% | 21.10% |
| Other western hemisphere | 38,745 | 31,020 | 53,960 | -19.9% | 74.0% | 39.3% | 17.55% | 14.55% | 13.73% |
| Mexico | 15,146 | 13,635 | 28,375 | -10.0% | 108.1% | 87.3% | 6.86% | 6.40% | 7.22% |
| South America | 17,149 | 10,780 | 15,106 | -37.1% | 40.1% | -11.9% | 7.77% | 5.06% | 3.84% |
| Argentina | 2,630 | 721 | 1,179 | -72.6% | 63.5% | -55.2% | 1.19% | 0.34% | 0.30% |
| Bolivia | 172 | 120 | 138 | -30.2% | 15.0% | -19.8% | 0.08% | 0.06% | 0.04% |
| Brazil | 4,352 | 3,140 | 5,062 | -27.8% | 61.2% | 16.3% | 1.97% | 1.47% | 1.29% |
| Chile | 1,354 | 682 | 1,672 | -49.6% | 145.2% | 23.5% | 0.61% | 0.32% | 0.43% |
| Colombia | 1,736 | 1,468 | 2,038 | -15.4% | 38.8% | 17.4% | 0.79% | 0.69% | 0.52% |
| Ecuador | 864 | 591 | 680 | -31.6% | 15.1% | -21.3% | 0.39% | 0.28% | 0.17% |
| Paraguay | 109 | 99 | 307 | -9.2% | 210.1% | 181.7% | 0.05% | 0.05% | 0.08% |
| Peru | 1,172 | 496 | 778 | -57.7% | 56.9% | -33.6% | 0.53% | 0.23% | 0.20% |
| Uruguay | 183 | 64 | 145 | -65.0% | 126.6% | -20.8% | 0.08% | 0.03% | 0.04% |
| Venezuela | 4,577 | 3,399 | 3,107 | -25.7% | -8.6% | -32.1% | 2.07% | 1.59% | 0.79% |
| Central America and Caribbean | 6,450 | 6,605 | 10,479 | 2.4% | 58.7% | 62.5% | 2.92% | 3.10% | 2.67% |
| Costa Rica | 498 | 422 | 992 | -15.3% | 135.1% | 99.2% | 0.23% | 0.20% | 0.25% |
| Dominican Rep. | 795 | 742 | 1,658 | -6.7% | 123.5% | 108.6% | 0.36% | 0.35% | 0.42% |
| El Salvador | 273 | 446 | 556 | 63.4% | 24.7% | 103.7% | 0.12% | 0.21% | 0.14% |
| Guatemala | 553 | 405 | 759 | -26.8% | 87.4% | 37.3% | 0.25% | 0.19% | 0.19% |
| Haiti | 311 | 396 | 478 | 27.3% | 20.7% | 53.7% | 0.14% | 0.19% | 0.12% |
| Honduras | 376 | 308 | 563 | -18.1% | 82.8% | 49.7% | 0.17% | 0.14% | 0.14% |
| Jamaica | 305 | 404 | 944 | 32.5% | 133.7% | 209.5% | 0.14% | 0.19% | 0.24% |
| Neth. Antilles | 449 | 428 | 542 | -4.7% | 26.6% | 20.7% | 0.20% | 0.20% | 0.14% |
| Nicaragua | 250 | 42 | 68 | -83.2% | 61.9% | -72.8% | 0.11% | 0.02% | 0.02% |
| Panama | 699 | 675 | 867 | -3.4% | 28.4% | 24.0% | 0.32% | 0.32% | 0.22% |
| Trinidad | 680 | 504 | 430 | -25.9% | -14.7% | -36.8% | 0.31% | 0.24% | 0.11% |

Source: International Monetary Fund, Direction of Trade Statistics, various years, and authors' calculations.
Notes: See Table 3 for notes on country definitions.

Table 5
U.S. Merchandise Imports from Latin America and Other Countries, 1980, 1985, and 1990

| Country | Value (in millions of U.S. dollars) | | | Growth Rates (percentage increases) | | | Shares of U.S. Total (in percent) | | |
|-------------------------------|-------------------------------------|---------|---------|-------------------------------------|---------|---------|-----------------------------------|---------|---------|
| | 1980 | 1985 | 1990 | 1980-85 | 1985-90 | 1980-90 | 1980 | 1985 | 1990 |
| | | | | | | | | | |
| World | 256,959 | 361,620 | 517,020 | 40.7% | 43.0% | 101.2% | 100.00% | 100.00% | 100.00% |
| EEC | 39,988 | 71,617 | 95,491 | 79.1% | 33.3% | 138.8% | 15.56% | 19.80% | 18.47% |
| Japan | 32,973 | 72,380 | 93,070 | 119.5% | 28.6% | 182.3% | 12.83% | 20.02% | 18.00% |
| Other Asia | 33,257 | 61,219 | 104,198 | 84.1% | 70.2% | 213.3% | 12.94% | 16.93% | 20.15% |
| Canada | 41,999 | 69,427 | 93,780 | 65.3% | 35.1% | 123.3% | 16.34% | 19.20% | 18.14% |
| Other western hemisphere | 38,915 | 49,096 | 67,183 | 26.2% | 36.8% | 72.6% | 15.14% | 13.58% | 12.99% |
| Mexico | 12,835 | 19,392 | 30,797 | 51.1% | 58.8% | 139.9% | 4.99% | 5.36% | 5.96% |
| South America | 15,022 | 22,285 | 28,169 | 48.3% | 26.4% | 87.5% | 5.85% | 6.16% | 5.45% |
| Argentina | 792 | 1,167 | 1,664 | 47.3% | 42.6% | 110.1% | 0.31% | 0.32% | 0.32% |
| Bolivia | 189 | 101 | 210 | -46.6% | 107.9% | 11.1% | 0.07% | 0.03% | 0.04% |
| Brazil | 4,000 | 8,147 | 8,586 | 103.7% | 5.4% | 114.7% | 1.56% | 2.25% | 1.66% |
| Chile | 559 | 858 | 1,571 | 53.5% | 83.1% | 181.0% | 0.22% | 0.24% | 0.30% |
| Colombia | 1,327 | 1,456 | 3,409 | 9.7% | 134.1% | 156.9% | 0.52% | 0.40% | 0.66% |
| Ecuador | 953 | 1,975 | 1,547 | 107.2% | -21.7% | 62.3% | 0.37% | 0.55% | 0.30% |
| Paraguay | 85 | 25 | 56 | -70.6% | 124.0% | -34.1% | 0.03% | 0.01% | 0.01% |
| Peru | 1,443 | 1,152 | 852 | -20.2% | -26.0% | -41.0% | 0.56% | 0.32% | 0.16% |
| Uruguay | 103 | 574 | 336 | 457.3% | -41.5% | 226.2% | 0.04% | 0.16% | 0.06% |
| Venezuela | 5,571 | 6,830 | 9,938 | 22.6% | 45.5% | 78.4% | 2.17% | 1.89% | 1.92% |
| Central America and Caribbean | 11,058 | 7,419 | 8,217 | -32.9% | 10.8% | -25.7% | 4.30% | 2.05% | 1.59% |
| Costa Rica | 405 | 570 | 1,105 | 40.7% | 93.9% | 172.8% | 0.16% | 0.16% | 0.21% |
| Dominican Rep. | 828 | 1,031 | 1,827 | 24.5% | 77.2% | 120.7% | 0.32% | 0.29% | 0.35% |
| El Salvador | 444 | 413 | 255 | -7.0% | -38.3% | -42.6% | 0.17% | 0.11% | 0.05% |
| Guatemala | 465 | 448 | 873 | -3.7% | 94.9% | 87.7% | 0.18% | 0.12% | 0.17% |
| Haiti | 264 | 406 | 356 | 53.8% | -12.3% | 34.8% | 0.10% | 0.11% | 0.07% |
| Honduras | 475 | 433 | 561 | -8.8% | 29.6% | 18.1% | 0.18% | 0.12% | 0.11% |
| Jamaica | 419 | 292 | 611 | -30.3% | 109.2% | 45.8% | 0.16% | 0.08% | 0.12% |
| Neth. Antilles | 2,680 | 836 | 453 | -68.8% | -45.8% | -83.1% | 1.04% | 0.23% | 0.09% |
| Nicaragua | 227 | 50 | 15 | -78.0% | -70.0% | -93.4% | 0.09% | 0.01% | 0.00% |
| Panama | 353 | 467 | 251 | 32.3% | -46.3% | -28.9% | 0.14% | 0.13% | 0.05% |
| Trinidad | 2,454 | 1,304 | 1,076 | -46.9% | -17.5% | -56.2% | 0.96% | 0.36% | 0.21% |

Source: International Monetary Fund, Direction of Trade Statistics, various years, and authors' calculations.
Notes: See Table 3 for notes on country definitions.

Table 5 shows how U.S. imports changed between 1980 and 1990. The total value of U.S. imports from the entire world just about doubled, increasing by 101.2%. Imports from Asia roughly tripled, however, with increases of 182.3% from Japan and 213.3% from the rest of Asia. Aside from Uruguay, whose exports to the U.S. were minuscule to begin with, the only Latin American country whose sales to the U.S. increased at an Asian-like rate was Chile. U.S. imports from Chile grew by 181.0%, almost the same rate as from Japan. Other Latin American nations with relatively rapid growth of sales in the U.S. included Costa Rica (172.8% growth), Colombia (156.9%), and Mexico (139.9%), with Argentina and Brazil just behind. U.S. imports from Latin America as a whole grew by less than three-quarters of the average rate for all countries (72.6%). These figures make it clear why many Latin American nations might view a FTA as essential for increasing their access to the U.S. market. Only by a preferential trading arrangement can most Latin American countries hope even to restore the shares of U.S. imports which they had a decade ago.

From a U.S. perspective, these figures show that there is also a tremendous range in the degree to which Latin American countries are poised to take advantage of such an opportunity to penetrate the U.S. market. Beyond Mexico, only a few nations in Latin America (especially Chile, Colombia, and Costa Rica) have had truly outstanding success in exporting to the U.S. in the past decade.

Trends in Multilateral Trade

Next we turn to a broader, multilateral perspective on the trade of western hemisphere countries with each other and with the rest of the world. Table 6

shows the shares of the exports of the U.S., Canada, Mexico, and the rest of Latin America going to various countries and regions of the world as of 1990. The data in this table show striking differences in the regional composition of the trade of different parts of the western hemisphere. Both Canada and Mexico send about 73% of their exports (by value) to the United States. Their interest in free access to the U.S. market is clear. But the other Latin American countries excluding Mexico sell only about 31% of their exports on average to the United States. The EEC share is almost as great (26%).

Of course, these average percentages conceal important differences among the other Latin American countries, especially between the nations of Central America and the Caribbean, which do export a lot to the United States, and many South American countries (notably Argentina, Brazil, Peru, and Chile) whose exports are more oriented toward Europe. Clearly, the current trade orientation of many of these Latin American countries does not suggest a high priority for them in forming a trading bloc with the United States and Canada. For many of these countries, the WHFTA option would seem to be of interest mainly because other avenues which might be superior — especially greater access to all industrial country markets via multilateral GATT negotiations or more South-South trade through regional Latin American FTAs — seem to be blocked. There is also the fear of losing out as a result of trade and investment diversion in Europe, through the strengthening of the European Community (EC), and in North America, due to the NAFTA.

Table 6
Shares of Merchandise Exports from the United States, Canada,
Latin America, and Mexico to Selected Destination Countries, 1990
(in percent)

| Exports To: | Exports From: | | | | |
|---|---------------|--------|----------------------------|--------|----------------------------------|
| | United States | Canada | Latin America ^a | Mexico | Other Latin America ^b |
| World | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| Industrial Countries ^c | 63.89 | 87.81 | 73.48 | 91.75 | 68.00 |
| USA | 0.00 | 72.66 | 40.44 | 73.12 | 30.64 |
| Canada | 21.10 | 0.00 | 2.18 | 2.42 | 2.11 |
| Japan | 12.36 | 5.44 | 5.89 | 5.37 | 6.05 |
| EEC | 24.94 | 7.59 | 22.64 | 10.16 | 26.38 |
| Developing Countries | 35.05 | 7.63 | 24.14 | 7.56 | 29.11 |
| Latin America ^a | 13.73 | 1.57 | 14.51 | 5.40 | 17.24 |
| Mexico | 7.22 | 0.37 | 0.81 | 0.00 | 1.06 |
| Other Latin America ^b | 6.51 | 1.20 | 13.70 | 5.40 | 16.18 |
| Other Developing Countries ^d | 21.32 | 6.06 | 9.63 | 2.16 | 11.87 |
| Total Western Hemisphere ^e | 34.83 | 74.24 | 57.13 | 80.94 | 49.99 |
| Total for Countries Shown ^f | 98.94 | 95.44 | 97.62 | 99.31 | 97.11 |

Source: International Monetary Fund, *Direction of Trade Statistics*, 1991 Yearbook; and authors' calculations.

Notes:

^aIncludes all countries in the western hemisphere except United States and Canada.

^bIncludes all countries in the western hemisphere except United States, Canada, and Mexico.

^cIncludes countries not shown separately.

^dDeveloping countries excluding Latin America (as defined in note a).

^eTotal for the hemisphere, including United States, Canada, Mexico, and all of Latin America.

^fDoes not add to 100.00 percent due to the exclusion of the former U.S.S.R. and certain other ex-Communist countries.

Regarding the prospects for South-South economic integration in Latin America, Table 6 shows that intra-Latin American trade is only a small percentage of the regions's total trade. Trade between Mexico and the rest of Latin America is almost negligible, accounting for just 5% of Mexican exports and barely 1% of other Latin American exports. Excluding Mexico, the other nations of Latin America conduct only 16% of their trade with each other on average, although they do send an average of 50% of their exports to the entire western hemisphere. And Latin America is far from the most important export market for the United States, accounting for just under 14% of U.S. exports — about evenly divided between Mexico and the rest of Latin America. In contrast, Canada accounts for 21%, and the EEC for about 25%.

Thus the picture of intra- and inter-regional trade flows which emerges from these data is one of tremendous unevenness and asymmetries. In particular, Canada, Mexico, and the rest of Latin America are all far more dependent on trade with the United States than vice-versa. While this demonstrates the economic importance that FTAs with the U.S. can have for those countries, it should also give some pause to Canadians, Mexicans, and other Latin Americans as to how much political bargaining leverage they can expect to have within a NAFTA or WHFTA. This should be of special concern to the smaller Latin American and Caribbean nations, who do not have even the leverage of a Mexico, Chile, or Brazil.¹⁴

Conclusion on Trade and Development Issues

Considering the tremendous asymmetries and divergences in both levels of development and in trade flows, the purely commercial rationale for a WHFTA seems to be quite weak for many countries in the hemisphere, especially in South America. Extending the NAFTA framework to embrace the rest of the western hemisphere would bring together a group of countries with disparate domestic structures and diverse patterns of trade. Some of the most important South American countries (such as Argentina, Brazil, Chile, and Peru) conduct most of their export trade with nations outside the western hemisphere,¹⁵ and sell more of their exports to the EC than to the U.S. Many Caribbean and Central American countries have proportionally more of their trade with the United States, but they already have preferential access to the U.S. market via the CBI. These anomalies raises the question of why there is so much interest in moving toward a generalized WHFTA.

Part of the answer lies more in the political than in the economic realm. The EC seems to be turning more inward, not only in regard to trade, but also in terms of investment flows which are going increasingly to low-wage regions within Europe. The GATT process has been stalled, due to the seemingly irreconcilable differences between the U.S. and the Europeans and Japanese over issues such as agriculture and subsidies. Rather than promote compromises in the multilateral framework of the GATT, where the U.S. bargaining position is relatively weak, the Bush administration showed more interest in pursuing preferential trading arrangements such as the NAFTA and EAI with poorer nations than the United States can still dominate politically. When presented with the prospective failure

of the Uruguay Round of the GATT, and given the ascendancy of "free market" ideologies in countries where statism has been discredited by past policy failures, Latin American countries (outside of Mexico and perhaps Chile) may be hoping for more from a WHFTA than it is actually likely to offer them. Efforts by the new Clinton administration to revive the Uruguay Round, especially if successful in opening up all industrial country markets more to developing country exports, could potentially lessen some of the current interest in a regional trade pact such as a WHFTA.

What would be the consequences for trade flows if a WHFTA were actually formed later in this decade? While it is hard to be certain, a few hypotheses may be ventured. One is that the growth of export-oriented manufactures will continue to be concentrated in limited parts of Latin America, especially Mexico, certain Central American and Caribbean countries, and some of the more industrially advanced South American nations such as Brazil and Argentina. Many of the poorest Latin American nations, especially in Central America and the Andean region, will only find their high degree of specialization in primary product exports reinforced. Latin Americans who hope to follow the path of the prosperous East Asian NICs should remember that Korea, Taiwan, et al. achieved their stunning successes in export-oriented industrial development with significant government intervention and the strategic use of trade protection, not through deregulated "free markets" or complete trade liberalization (Amsden, 1989; Smith, 1991; Wade, 1990).

While all the nations of Latin America could potentially attract more foreign investment in low-wage, labor-intensive manufactures, not all are likely to

succeed. The economies of scale and scope which arise from investing in a small number of countries will tend to keep such investment concentrated largely where it is currently going. Moreover, Mexico and the Caribbean countries have natural advantages in access to the U.S. market as a result of geographical proximity and relatively low transportation costs. All of these are obstacles which nations such as Ecuador, Bolivia, or Paraguay will find difficult to overcome. In any event, competing on the basis of who can offer the lowest wages and least protection of workers' rights and environmental safeguards is not a beneficial game to play.

Foreign investment in the countries which are specialized in primary products would undoubtedly increase under a WHFTA, but it would most likely flow to traditional mineral and agricultural areas. At best, some of the poorer Andean countries could hope to emulate Chile by moving into nontraditional primary products such as winter fruits and vegetables for the U.S. market — but even there they will face stiff competition from Mexico as well as Chile. More countries trying to sell the same products in the same market at the same time is a sure way to depress the commodity terms of trade rather than to boost economic development.

There is one positive commercial scenario that seems possible for the parts of Latin America that have relatively little to gain from access to North American markets. Although the initial attraction of the WHFTA concept is mainly to secure freer access to the U.S. market, a WHFTA would result in "plurilateral" trade liberalization across Latin America. Nations which are disappointed in how their exports to the U.S. grow under a WHFTA could try to reorient their trade toward other Latin American countries. There are pitfalls here too, due to (1) the

fact that most of the poorer Latin American countries tend to export products which are substitutes rather than complements (especially agricultural commodities), and (2) the risk that the smaller Latin American nations will be overwhelmed with manufactured exports from the larger nations such as Brazil, thus stifling domestic manufacturing development. These are the same difficulties which have contributed to the failure of most past efforts at forming effective trading blocs within Latin America or sub-regions thereof.

3. Labor and Income Distribution Issues

Current discussions on the potential impact of the NAFTA and WHFTA have concentrated on trade flows. As the previous discussion has shown, a WHFTA would have ambiguous effects on hemispheric trade patterns, but there are clear incentives for industrial capital to relocate investment in countries with abundant labor and low wages provided that productivity and quality can be maintained. These considerations suggest a shift in attention to investment flows and their effects on labor.

Most recent analyses of the effects of the NAFTA on labor have not been grounded in empirical studies of the North American labor market, and have deemphasized the role of investment flows within the continent.¹⁶ Despite the evidence from the U.S.-Canada FTA, and from the recent opening of the Mexican market and its change in investment laws, economic modelers' guesses about the future have dominated debates over the effects of the NAFTA, and insufficient

attention has been paid to the empirical evidence on the actual trends during the current integration of the North American market.

In part, the economic theorists excuse themselves from discussing the impact of foreign investment by assuming that products made in different countries, even if made by the same multinational firms, are differentiated by consumers. This makes trade between different countries more important than the production location decision of MNCs. But we reject the assumption that U.S. consumers differentiate between a Zenith television or Smith-Corona typewriter made in Mexico or in the United States.

Unconstrained by the existing evidence, modelers have been free to make assumptions about the future that ignore the facts of the North American labor market. Most of the models start, and end, with the theoretical construct of comparative advantage — a "win-win" scenario. With two of the assumptions required to make trade advantageous to countries — full employment and balanced trade — the models constrain countries to specialize in those products they are comparatively most efficient at producing.

The full employment assumption ignores the poor performance of the U.S. labor market over the past twenty years. In that period, the average real wages of U.S. workers of almost all education levels (except post-graduate) have fallen. The weakness of the U.S. labor market has made U.S. workers skeptical of the findings of economic models that assume the labor market to be in equilibrium, and that declare U.S. workers to be on a path to higher-wage jobs. We will concentrate instead on the actual pattern of employment creation and wage changes in the U.S. economy, without the assumption of full employment. The

focus of this section is particularly on the empirical evidence of the last six years, during which Mexico lowered its tariffs and lifted major restrictions on foreign direct investment, and the U.S. and Canada entered a FTA.

Table 7

| North American Trade, 1989 | | | | | | |
|---|------------------|--------|--------|---|--------|--------|
| All Trade and | | | | | | |
| Trade by U.S. Foreign Affiliates Operating in Mexico and Canada | | | | | | |
| (In U.S. \$billions) | | | | | | |
| Exports To | All Exports From | | | Exports from U.S. Multinationals Located In | | |
| | U.S.A. | Canada | Mexico | U.S.A. | Canada | Mexico |
| U.S.A. | ... | 87.95 | 27.16 | ... | 40.14 | 7.27 |
| Canada | 78.81 | ... | 1.43 | 38.18 | ... | ... |
| Mexico | 24.98 | .52 | ... | 7.59 | ... | ... |
| Totals | 103.79 | 88.37 | 28.59 | 45.77 | 40.14 | 7.27 |

Source: U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 71 (October, 1991): Table 19, page 61 and S-16, S-17 for all U.S. trade; IMF, *Direction of Trade Statistics, Yearbook 1991*, page 156 for Canada-Mexico trade statistics; and authors' calculations.

Table 7 shows the flow of goods between the United States, Mexico and Canada, and the flow of goods among U.S.-owned affiliates operating in Canada and Mexico. Looking at all North American trade, 42% (\$93.18/220.75) can be accounted for by the movement of goods among U.S.-owned affiliates operating in Canada and Mexico. Of course, much of the trade by U.S. multinationals is in the U.S.-Canada free trade area. Still, of the almost \$25 billion that the U.S. exports to Mexico, \$7.6 billion are shipments to U.S. multinationals operating in Mexico — roughly thirty percent of U.S. "exports." A similar proportion of U.S. imports are from U.S. multinationals operating in Mexico. This may seem a small figure when compared to U.S. multinationals and their activities in other countries. But, because of past investment restrictions in Mexico, U.S. firms in Mexico are highly concentrated in manufacturing and virtually absent in primary products. In the previous section we noted that over half of Mexico's exports are in primary

products. In that context, the involvement of U.S. firms is not small. Regardless, a large and growing portion of U.S.-Mexican "trade" is less about the shipment of goods based on comparative advantages, and more about the decision where to produce an item based on minimizing unit labor costs. In order to assess the impact of a FTA, therefore, it is necessary to model the behavior of U.S. multinational firms.

Table 8

**Employment of Manufacturing Production Workers in North America,
at U.S. Multinational Affiliates in Mexico and Canada,
and Domestic Manufacturing Production Workers in the U.S., 1986-1990**

| | Numbers of Workers (1,000s) | | | Annual Change in Number of Workers (1,000s) | | |
|-----------|-----------------------------|-----------|-----------------------------|--|-----------|-----------------------------|
| | U.S. MNC Affiliates | | Total Domestic U.S.A. | U.S. MNC Affiliates | | Total Domestic U.S.A. |
| | In Canada | In Mexico | | In Canada | In Mexico | |
| 1986 | 472.7 | 370.2 | 12,877.0 | ... | ... | ... |
| 1987 | 469.7 | 377.0 | 12,970.0 | -3.0 | 6.8 | 93.0 |
| 1988 | 483.0 | 397.4 | 13,221.0 | 13.3 | 20.4 | 251.0 |
| 1989* | 475.6 | 443.5 | 13,269.0 | -7.4 | 46.1 | 48.0 |
| 1990 | 452.0 | 462.5 | 12,974.0 | -21.1 | 18.5 | -295.0 |
| | Percent Change | | | Total Change | | |
| 1986-1989 | 0.6% | 19.8% | 3.0% | 2.9 | 73.3 | 392.0 |
| 1986-1990 | -4.4 | 24.9 | 0.8 | -20.7 | 92.3 | 97.0 |

* There is a break in employment data from 1988 to 1989 caused by the Benchmark Survey taken in 1989 that was more inclusive than for the annual data used in 1988. In the aggregate, the benchmark caused a net decline of 46.3 thousand workers in all U.S. affiliates--worldwide, and regardless of industrial sector. This is because there were more losses from affiliates leaving the survey, than gains from affiliates being added to the survey. However, there was a net gain in employment among affiliates through an increase in affiliates and an increase in employment in affiliates that operated in both 1988 and 1989. The effect of the benchmark is only for the year to year comparison from 1988 to 1989, and data before 1989 with 1989 and later. The net change in worldwide U.S. affiliate employment represents 17.5 percent of the gross change in worldwide affiliate employment. The effect for individual countries may vary. A revision of the data is forthcoming possibly in 1993.

Source: U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 72 (August, 1992): Table 13.1 and Table 13.2, pages 77-78; Vol. 71 (October, 1991): Table 20.1 and Table 20.2, pages 52-53; Vol. 70 (June, 1990): Table 6, page 37; Vol. 69 (June, 1989): Table 7, page 33 for employment by U.S. multinationals in Canada and Mexico; U.S. Dept. of Labor, Bureau of Labor Statistics, *Hours, and Earnings, United States, 1909-90, Volume 1*, Bulletin 2370 (March, 1991), page 61, *Supplement to Employment, Hours, and Earnings, United States, 1909-90* (July, 1991), page 11, and authors' calculations. Numbers for U.S. affiliates' employment in Canada and Mexico is for all manufacturing workers. Employment in the U.S. is for production workers only. Employment in the U.S. includes all U.S. firms—including U.S. multinationals, domestic U.S. and foreign direct investors in the U.S.

Table 8 shows the potential for the effect of the decisions of U.S. multinationals on production workers in North America. The table compares employment by U.S. multinationals with domestic U.S. employment. We compare U.S. multinational affiliates' employment in Canada and Mexico with total employment in the U.S. in order to capture all the sources of job creation and job loss at home, including national firms (those with no foreign affiliates) and foreign firms (with affiliates in the U.S.) as well as the "parents" of U.S. multinationals. Of course,

this makes the absolute level of the multinational affiliates' employment look small in relation to the total for all U.S. manufacturing. But it is the trends or changes in these levels over the last few years which are of the greatest interest.

Although all the absolute figures for Mexico in Table 8 may look relatively small, in fact the *annual changes* in U.S. MNC employment in Mexico are large enough to have a substantial impact on the U.S. labor market. The number of workers at MNC affiliates in Mexico rose from 370,200 in 1986 to 462,500 by 1990, an increase of 92,300 or 24.9%. The total number of U.S. domestic manufacturing production workers was much larger to start with, about 12.9 million in 1986. This number increased by 392,000 (3%) from 1986 to 1989, and then fell by 295,000 from 1989 to 1990, resulting in a total increase of 97,000 (0.8%). Thus, at the margin, the number of jobs created by U.S. multinational affiliates in Mexico is comparable in magnitude to the number of jobs created in the U.S. domestic manufacturing sector in recent years. The claims that Mexico is too small to have an appreciable effect on the U.S. manufacturing work force are therefore not credible.

In fact, the type of comparison made in Table 8 actually understates the extent to which changes in the North American labor market reflect shifts away from employment in the U.S. and Canada. This is because only the actions of U.S. multinational affiliates are considered when looking at Canada and Mexico, while all firms are included in the U.S. domestic figures. Thus, for example, these data do not include jobs created by Japanese or European firms in Mexican manufacturing. The data may also undercount U.S. multinationals' true employment in Mexico. Some U.S. corporations have used "shell" operations to limit the risk of

outright ownership of a Mexican plant. These shell operations still result in increased employment in Mexico under their control (Sinkin 1990).

In 1986, Canadian workers at U.S. multinationals represented 24.1% (472.7/1,959)¹⁷ of Canadian manufacturing workers. Despite the importance of U.S. multinationals to the Canadian labor market, the decline in Canadian workers in U.S. firms from 1988 to 1989 is offset by a net increase in total Canadian manufacturing employment. From 1988 to 1989, Canadian manufacturing employment increased 0.9%, from 2.072 million to 2.09 million. It also must be remembered that a decline in employment with U.S. firms is not necessarily a decline in employment in Canada. The sale of an U.S. affiliate could leave Canadian employment constant, but decrease Canadian employment in U.S. affiliates. And, while the table includes employment growth for U.S. workers resulting from foreign direct investment in the U.S., the table ignores gains that Canadians may have realized from foreign direct investment from countries other than the United States.

These shifts in the location of employment by U.S. firms should be interpreted carefully. The fact that U.S. firms hired as many Mexican manufacturing workers as Canadian by 1990 does not necessarily mean that U.S. firms are part of the cause of the downturn in the Canadian labor market. But, the fact that U.S. firms in 1990 were still increasing their employment in Mexico while cutting employment in the U.S. and Canada may be contributing to the slow recovery in employment for the U.S. after the recent recession. Further, should that pattern continue, U.S. and Canadian manufacturing employment may not return to their pre-recession levels. The point that U.S. firms created almost as many net new

manufacturing jobs in Mexico as in the U.S. between 1986 and 1990 does not necessarily imply that these shifts are a cause of the downturn in the U.S. market. However, these data do suggest that such shifts may be part of the explanation for the slow recovery of manufacturing jobs since the 1990-91 recession.

Supporters of the NAFTA often argue that changes in total jobs are unimportant, and only the sectoral reallocation of employment matters. They admit that the NAFTA will cause some low-wage jobs to leave the U.S., but claim that this will only free up American workers to enter more highly paid jobs in other sectors. In fact, about three-quarters of the manufacturing jobs created in Mexico by U.S. firms in the last several years have been in just two sectors: transportation equipment (especially automobiles and parts), and electronics. Motor vehicles is a highly capital-intensive industry with above-average wages, while electronics is a "high tech" industry with close-to-average wages.¹⁸ These two industries would probably be considered important ones for the U.S. to keep if it is to move in a high-wage direction. Yet the record shows that the U.S. has been steadily losing jobs in these sectors over the last few years, while U.S. affiliates have been increasing jobs very rapidly in these two sectors in Mexico.

Table 9 shows employment by U.S. multinationals in electrical and electronic products and in transportation equipment in Mexico from 1986 to 1991, along with total domestic employment in the analogous industries. Motor vehicle and equipment production workers are shown separately for the U.S. because most of the transportation equipment jobs in Mexico are in that industry, whereas the transportation equipment category for the U.S. also comprises the aircraft, ship

Table 9

**U.S. Multinationals and U.S. Domestic Employment
Manufacturing Production Workers in Selected Industries in Mexico and the U.S.,
(1,000s of workers) 1986-1990**

| | Mexican Employment in Nonbank U.S. Affiliates in Selected Industries | | U.S. Domestic Employment of Production Workers in Selected Industries | | |
|-----------|---|-----------------------------|--|-----------------------------|-------------------------------|
| | Electric & Electronic | Transportation Equipment | Electric & Electronic | Transportation Equipment | Motor Vehicles & Equipment |
| 1986 | 77.2 | 71.8 | 1,184.2* | 1,258.6 | 670.7 |
| 1987 | 83.2 | 73.3 | 1,175.2* | 1,279.0 | 673.7 |
| 1988 | 98.6 | 84.1 | 1,113.7 | 1,274.2 | 668.3 |
| 1989 | 110.6 | 92.5 | 1,103.9 | 1,279.3 | 664.9 |
| 1990 | 116.5 | 102.6 | 1,055.4 | 1,218.3 | 615.2 |
| | Absolute Change | | Absolute Change | | |
| 1986-1989 | 33.4 | 20.7 | -80.3 | 20.7 | -5.8 |
| 1986-1990 | 39.3 | 30.8 | -128.8 | -40.3 | -55.5 |
| | Percent Change | | Percent Change | | |
| 1986-1989 | 43.3% | 28.8% | -6.8% | 1.6% | -0.9% |
| 1986-1990 | 50.9 | 42.9 | -10.9 | -3.2 | -8.3 |

* For 1986 and 1987 these are the sum of production workers in the 1989 two digit code 36, i.e. SIC 361-369.

Source: U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 72 (August, 1992): Table 13.1 and Table 13.2, pages 77-78; Vol. 71 (October, 1991): Table 20.1 and Table 20.2, pages 52-53; Vol. 70 (June, 1990): Table 6, page 37; Vol. 69 (June, 1989): Table 7, page 33 for employment by U.S. multinationals in Mexico; U.S. Dept. of Labor, Bureau of Labor Statistics, *Hours, and Earnings, United States, 1909-90, Volume 1, Bulletin 2370* (March, 1991) pages 61, 290, 329 and 332, *Supplement to Employment, Hours, and Earnings, United States, 1909-90* (July, 1991), pages 11, 49, and 58; and authors' calculations.

building, railroad, and aerospace industries. Therefore, the transportation equipment category in the U.S. includes some employment trends which are not directly comparable to those in Mexico.

While total U.S. manufacturing production jobs were increasing between 1986 and 1989, as shown in Table 8 (above), U.S. domestic employment in these two industries lagged behind. U.S. employment in the electronics industry declined by 80,300 workers (6.8%) from 1986 to 1989, which was before the U.S. recession. In the meantime, Mexican employment in U.S. firms in that industry increased by 33,400 (43.3%) during that period. U.S. domestic employment in

motor vehicles declined by 5,800 workers (0.9%), while overall employment in transportation equipment (including aircraft etc.) increased by 20,700 (barely 1.6%) — just over half the rate for all manufacturing (3.0%). Mexican employment in U.S. firms in the transportation equipment industry increased by 20,700 (28.8%) during the 1986-1989 period.

If we move to 1990, U.S. employment in all the sectors shown in Table 9 fell during the recession. But employment by U.S. MNCs in Mexico in these same industries continued to rise in 1990. Over the entire period 1986 to 1990, these two sectors were responsible for 70,100 new jobs at U.S. multinational affiliates in Mexico, or 75.9% of the 92,300 total new manufacturing jobs in those affiliates over that period. Meanwhile, domestic employment in these two sectors fell by a total of 184,300 jobs over the same period — even though total manufacturing jobs were still up slightly in 1990 over 1986 (see Table 8, above). Thus, in the very type of industries which the U.S. should be seeking to preserve, the jobs created in Mexico were quite large relative to the jobs lost in the U.S.

The shift in workers was matched by a shift in passenger car production by the Big Three automakers (Chrysler, Ford and General Motors). In 1987, 87.2% of passenger cars assembled in North America by the Big Three were made in the U.S., and 2.3% were made in Mexico (Calculations based on data presented in Herzenberg, 1991). By 1989, the U.S. share fell to 83.6% and the Mexican share increased to 3.7%. In absolute terms, U.S. assembly of Big Three passenger cars fell from 6.5 million to 5.8 million cars over the 1987-1989 period; a fall in production of 11.2%. In Mexico, on the other hand, production for the Big Three increased from 167 thousand to 254 thousand cars; an increase of 52.1%.

Including passenger car assembly by all manufacturers in North America, the U.S. share of production fell from 86.9 to 83.4%, while Mexican production increased from 3.4 to 5.4%. The biggest shifts in production were with Nissan and Volkswagen. The U.S. share of Nissan's North American production fell from 66.9 to 57.1%. Volkswagen now only produces in Mexico for the North American market. But, in 1987 60.4% of its production was in the U.S.

These trends raise the question of why U.S. firms are shifting employment in these particular industries so rapidly in recent years. Supporters of the NAFTA often argue that the incentives for such job shifts are minimal, because the low wages of Mexican workers are offset by their lower productivity. But while Mexican labor has low productivity on average, it can be highly productive in sectors where foreign capital has brought in up-to-date technology and management. In sectors such as domestic corn production, Mexican productivity is of course very low. But in sectors such as electronics and automobiles, Mexican productivity has been converging on U.S. productivity very rapidly in recent years. As Mexican productivity has come closer and closer to American productivity levels in these industries, while Mexican wages have remained far lower, Mexico has acquired an enormous competitive advantage in unit labor costs (wages relative to productivity).

The productivity and wages (hourly compensation) of Mexican workers relative to U.S. workers in the electronics and transportation equipment industries are shown in Table 10. The period covered is 1975 to 1984, which is the latest period for which data on sectoral productivity are available. Much of the convergence in productivity between the U.S. and Mexico is related to the share of

the Mexican sector that is made up of U.S. firms. Thus, with the increase in U.S. investment in Mexico in these sectors since 1984, it is very likely that there has been even further convergence in productivity levels.

Productivity is measured as value added per employee in the industry. The worker compensation cost (wages plus mandated and negotiated benefits and

Table 10

**Mexican Labor Productivity and Hourly Labor Compensation,
as Ratios of the U.S. Levels, 1975-1984**

| | | 1975 | 1979 | 1982 | 1984 |
|--------------------------|--------------|------|------|------|------|
| Electronic Equipment | Productivity | 0.63 | 0.74 | 0.66 | 0.83 |
| | Compensation | 0.24 | 0.24 | 0.20 | 0.15 |
| Transportation Equipment | Productivity | 0.53 | 0.61 | 0.59 | 0.57 |
| | Compensation | 0.31 | 0.28 | 0.20 | 0.13 |

Sources: Magnus Blomstrom and Edward N. Wolff, 'Multinational Corporations and Productivity Convergence in Mexico,' National Bureau of Economic Research Working Paper No. 3141 (Cambridge, MA: October, 1989); Table 8, page 25; U.S. Dept. of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, *Hourly Compensation Costs for Production Workers, 40 Manufacturing Industries, 34 Countries, 1975 and 1979-89*, Unpublished Data (September, 1990); pages 86 and 95; and authors' calculations.

Notes: Productivity is measured by value added per employee. Transportation compensation is for motor vehicle equipment.

taxes) differential in the two industries is also shown. During the period shown, the relative cost of employing Mexican to U.S. workers was declining. In electronics, Mexican workers wages fell from 24 to 15% of U.S. wages in that industry. In transportation equipment, Mexican workers went from 31% of U.S. wages down to 13%. Yet, in transportation equipment, Mexican workers were between 53 and 61% as productive as U.S. workers. In the electronics industry, the difference is even more stark. In electronics, Mexican workers were from 63 to 83% as productive as U.S. workers. Thus, the unit labor costs of production in Mexico are much lower than in the United States. It would not be surprising, therefore, to

see U.S. companies seeking to increase employment in Mexico relative to the U.S. And again, these are not low-wage industries by U.S. standards. These are "high-tech" (electronics) and capital intensive (transportation equipment) industries.

The effect of slow job creation in the U.S. is reflected in the stagnant wages and benefits of production workers in manufacturing. As a shift in investment would suggest, there is a possibility of wage convergence. The shift could lead to convergence in wages through two paths. First, if the shifts in employment are for similar positions, the wages of U.S. production workers would be lowered toward the Mexican wage level. Or, second, if low-wage U.S. jobs are not being created but Mexican jobs are created at higher wages then wages would also converge. The shifts could lead to a divergence in wages if Mexican wages do not rise as fast through new job creation as U.S. or Canadian wages by the loss of the lowest wage workers. But Table 11 shows that this is only occurring in Canada.

Table 11 shows that there is some wage convergence taking place between Mexico and the United States. The real wage of Canadian manufacturing production workers is increasing relative to the Mexican and U.S. work force. Prior to the U.S. and Canadian recession, during the period 1986-1989, convergence between U.S. and Mexican wages was the result of U.S. wages falling faster than Mexican wages — 4.4% for the U.S. compared to Mexico's 2.4%. But while U.S. manufacturing production wages and employment continued to fall during the U.S. recession, Mexican production wages and employment continued to rise. As a result, over the period 1986-1991, the convergence in wages is almost equally divided between a rise in Mexican wages (5.3% higher) and a fall in U.S. wages (6.1% lower). Mexican and Canadian wages diverged between 1986 and 1989

Table 11

Hourly Compensation^a of Production Workers in Manufacturing
Canada, Mexico, and the United States, 1986-1991

| | Real Compensation in Home Currency (In 1991 Currency) | | | Real Compensation in U.S. \$1991 | | |
|----------------|---|----------|--------|----------------------------------|--------|---------|
| | Canada | Mexico | U.S.A. | Canada | Mexico | U.S.A. |
| 1986 | 19.29 | 6,221.23 | 16.46 | \$16.84 | \$2.06 | \$16.46 |
| 1987 | 19.15 | 5,813.88 | 16.19 | 16.71 | 1.93 | 16.19 |
| 1988 | 19.32 | 5,591.28 | 16.02 | 16.86 | 1.85 | 16.02 |
| 1989 | 19.41 | 6,071.21 | 15.73 | 16.93 | 2.01 | 15.73 |
| 1990 | 19.74 | 6,222.31 | 15.52 | 17.23 | 2.06 | 15.52 |
| 1991 | 19.84 | 6,549.00 | 15.45 | 17.31 | 2.17 | 15.45 |
| Percent Change | | | | | | |
| 1986-1989 | 0.6% | -2.4% | -4.4% | 0.5% | -2.4% | -4.4% |
| 1986-1991 | 2.8 | 5.3 | -6.1 | 2.8 | 5.3 | -6.1 |

Source: For wage data and exchange rates, U.S. Dept. Of Labor, Bureau of Labor Statistics, *International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1991*, Report 825 (June, 1992) Table 4, page 8 and Table 6, page 10; for inflation adjustment using consumer price index, International Monetary Fund, *International Financial Statistics*, Volume XLV (April, 1992) Pages 150, 370 and 554; and authors' calculations.

Hourly compensation includes all payments made directly to the worker (pay for time worked--basic time and piece rates plus overtime premiums, shift differentials, other premiums, and bonuses paid regularly each pay period, and cost-of-living adjustments, pay for time not worked--vacations, holidays, and other leave, seasonal or irregular bonuses and other special payments, selected social allowances, and the cost of payments in kind--before payroll deductions of any kind) and employer expenditures for legally required insurance programs and contractual and private benefit plans.

because Canadian wages rose while Mexican wages fell. The effect of the Canadian recession was a slowing down of Canadian wage growth. For the period 1986-1991, there is some convergence between Canadian and Mexican wages because Canadian wages did not rise as fast as Mexico's.

The pattern of job creation and wages for the period 1986-1990 is consistent with U.S. companies creating jobs in Mexico that are similar to those no longer being created in the U.S. These data on shifts in employment in specific industries, productivity differences, and compensation differences suggest that the current trends in employment location may be more than short-lived. It should be remembered that the last six years is a short period, however, and include the most recent U.S. and Canadian recessions. The 1990 U.S. recession, as a macro-

economic phenomenon, had many causes, and measured by lost GDP it was short and shallow. The correlation of employment and wage movements between the U.S. and Mexico in the 1986-1990 period is not proof of a causal relationship. And the effect of such a shift on the entire U.S. work force may not be entirely negative. If employment and wages are rising elsewhere, this trend — if it is a trend — would only represent part of the reshaping of the U.S. labor market.

Table 12

| U.S. Men, All Industries, All Occupations, Real Wages (In Constant \$1991, 1973 and 1987-1990) | | | | |
|---|----------------------|----------------------|-----------------------|----------------------|
| | High School Drop Out | High School Graduate | Four Years of College | College Plus 2 Years |
| 1973 | \$11.48 | \$13.50 | \$18.99 | \$21.09 |
| 1987 | 9.35 | 11.55 | 17.55 | 20.85 |
| 1988 | 9.29 | 11.43 | 17.38 | 20.74 |
| 1989 | 9.01 | 11.15 | 17.13 | 21.05 |
| 1990 | 8.70 | 10.88 | 17.14 | 21.20 |
| Percentage Change | | | | |
| 1987-1990 | -7.0% | -5.8% | -2.3% | 1.7% |
| 1973-1990 | -24.2 | -19.4 | -9.7 | 0.5 |

Source: Lawrence Mishel and Jared Bernstein, "Declining Wages for High School and College Graduates: Pay and Benefits Trends by Education, Gender, Occupation, and State, 1979-1991," Economic Policy Institute (Washington, DC: 1992); and authors' calculations.

The effect of slow job creation in U.S. manufacturing is also reflected in the wages of U.S. workers. Table 12 shows the wages of U.S. men, by education, for the period 1987-1990. The wages reported are weighted by the number of workers, rather than the number of hours. This is to control for the bias of excluding low-wage workers during economic downturns. The table makes it clear that, for all education levels except two years of post-graduate college study, real wages have been falling. Since only 7.8% of the U.S. male work force has two years of postgraduate college study, this means that real wages have been falling for over 90% of U.S. men during this period. The table also shows the real wages

of men in 1973, which reveal that the recent declines in wages are part of a longer-term trend. The lower price levels that are supposed to result from the lower unit labor costs embodied in imported goods have not been sufficient to benefit U.S. workers. Instead, the wages of U.S. workers have not kept pace with inflation. So far, only a tiny fraction of U.S. workers have benefited from the mix of U.S. trade and domestic policies.

Table 13

U. S. A.
Peak to Peak and Trough to Trough Unemployment Rates
(All Civilian Workers, Seasonally Adjusted)

| Business Cycle Peak | Unemployment Rate |
|-----------------------|-------------------|
| December 1969 | 3.5 |
| November 1973 | 4.8 |
| January 1980 | 6.3 |
| July 1981 | 7.2 |
| July 1990 | 5.5 |
| Business Cycle Trough | Unemployment Rate |
| November 1970 | 5.9 |
| March 1975 | 8.6 |
| July 1980 | 7.8 |
| November 1982 | 10.8 |
| June 1992 | 7.6 |

Sources: Dates of business cycles (except trough in 1992), U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 71 (October, 1991): page C-45. Unemployment rates, monthly, seasonally adjusted, U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 71 (October, 1991): page S-10, and U.S. Dept. of Commerce, *Business Statistics, 1961-88* (December, 1989): page 249.

Note: According to the standard criteria, the last cyclical trough was reached in March 1991, at which time the unemployment rate was only 6.8%. However, due to the unusually slow recovery which followed, the unemployment rate continued to rise for more than a year, reaching a peak of 7.6% in June 1992. The latter month is shown in the table.

Additionally, the U.S. labor market has shown structural weakening since the late 1960s. Table 13 shows unemployment rates during each expansion and contraction of the U.S. economy, beginning with the peak in March 1969. Until July 1990, each successive peak followed a path of higher and higher unemployment, and even the July 1990 unemployment rate of 5.5% was still well above

the rates at the cyclical peaks in 1969 and 1973. Up to 1982, each recession trough occurred at a higher and higher unemployment rate. While the most recent recession looks better by the criterion of the unemployment rate, it actually demonstrated worse labor-market performance by other criteria. With the number of jobs virtually unchanged for more than a year after the official recession trough (in March 1991), the unemployment rate continued to rise well into the recovery reaching a maximum of 7.6% in June 1992 (which is shown as the most recent recession trough in the table).¹⁹

The data reviewed here reveal that the U.S. labor market has been deteriorating in its ability to provide rising real wages and expanding employment opportunities for the last 25 years. In light of this worsening performance, the enhanced freedom of firms to shift jobs under the NAFTA must be given careful consideration. The protection afforded to cross-border investment shifts under the NAFTA as currently negotiated is far greater than the ability of labor markets to handle the resulting shifts in employment patterns, and there is no coordination of labor market policies across the three North American partners.

Indeed, labor market policies in the United States are not prepared to handle the quick shifts in labor market conditions brought about by increased international capital mobility and economic integration. The inadequacy of U.S. labor market policies can be inferred from the data on government spending on labor market programs. Table 14 compares public expenditure on labor market programs in the United States, Canada, and Germany. Germany is shown since many like to compare the issues faced by the United States and Canada by the inclusion of Mexico in a NAFTA, with the issues faced by Germany with the

Table 14

Public Expenditure on Labor Market Programs as a Percentage of GDP
Canada, Germany and the United States, 1986-1990

| Country | Program | 1986 | 1987 | 1988 | 1989 | 1990 |
|---------------------|----------------------------------|------|------|------|------|------|
| Canada [*] | Labor Market Training | 0.35 | 0.29 | 0.28 | 0.28 | 0.27 |
| | Youth Measures | 0.02 | 0.02 | 0.02 | 0.02 | 0.02 |
| | All Active Measures ¹ | 0.62 | 0.55 | 0.50 | 0.51 | 0.52 |
| | Income Maintenance ² | 1.86 | 1.64 | 1.57 | 1.57 | ... |
| Germany | Labor Market Training | 0.24 | 0.30 | 0.32 | 0.33 | 0.38 |
| | Youth Measures | 0.05 | 0.06 | 0.05 | 0.05 | 0.04 |
| | All Active Measures ¹ | 0.91 | 1.01 | 1.07 | 1.02 | 1.02 |
| | Income Maintenance ² | 1.32 | 1.36 | 1.36 | 1.22 | 1.16 |
| U.S.A. [*] | Labor Market Training | 0.12 | 0.11 | 0.11 | 0.10 | 0.09 |
| | Youth Measures | 0.03 | 0.03 | 0.03 | 0.03 | 0.03 |
| | All Active Measures ¹ | 0.28 | 0.27 | 0.26 | 0.25 | 0.25 |
| | Income Maintenance ² | 0.56 | 0.51 | 0.44 | 0.47 | 0.60 |

Source: OECD *Employment Outlook* (July, 1991): Pages 239, 241 and 249.

^{*} For the U.S. and Canada data are for fiscal years beginning and ending with calendar years 1986-87 and 1990-91.

¹ Active labor market policies include public employment services and administration; labor market training (including training for unemployed adults and those at risk, and training for employed adults); youth measures (including measures for unemployed and disadvantaged youth, and support of apprenticeship and related forms of general youth training); subsidized employment (including subsidies to regular employment in the private sector, support of unemployed persons starting enterprises and direct job creation in the public or non-profit sector); and, measures for the disabled (including vocational rehabilitation and work for the disabled).

² Income maintenance includes unemployment compensation and early retirement for labor market reasons.

inclusion of Spain and Portugal in the EC. The data shown are for the same period shown above, 1986-1990.

The shifts in job creation that are already occurring, and which are likely to accelerate under the NAFTA, imply that labor training and support for training youth will be very important. Though all three countries invest roughly equal percentages of their GDP on youth, Germany invests proportionally far more than the U.S. or Canada on training for adult workers. Even more disturbing is that during the period shown Germany was increasing its commitment to training while the U.S. and Canada were decreasing theirs. Canada started the period behind Germany in investment in active measures to shape its labor market

(0.62% to Germany's 0.91%), but ahead in the key area of training (0.35% to Germany's 0.24%) and slightly behind in youth measures (0.02% to Germany's 0.05%). Only in the area of youth measures are the U.S. and Germany investing at roughly the same rates. At the end of the period, in 1990, Germany was investing at a rate that was only 0.01% of GDP higher (0.04% for Germany to 0.03 for the U.S.) than for the United States. But, for total active labor market policies, the U.S. is investing in its work force at a rate that is one-fourth that of Germany's.

There is no support in the current pattern of job creation in the U.S. for the notion that more of the same policies will lead to increased incomes in the United States. Instead, the current pattern of slow creation of manufacturing production jobs in the U.S. and a faster creation of those jobs outside the U.S. exacerbates a longer downward trend in the U.S. labor market. The labor market policies of the U.S. have been inadequate to reverse that trend, and are certainly inadequate to cope with even greater shifts in the labor market. This weak labor market is what gives U.S. workers great pause when considering a NAFTA. Policies that encourage a shift in U.S. investment in hopes of changing U.S. trade patterns to offset any job losses from investment shift are not showing themselves to be sufficient to reverse the deterioration in the U.S. labor market. Absent some other policies, if the logic of the NAFTA agreement is pushed into a WHFTA, we would not expect any significant income growth in the United States from U.S. workers moving to higher wage jobs.

While it might be thought that the losses for American workers are necessarily gains for Mexican workers, this is far from clear. As Table 11 showed, the

Table 15

**Mexican Wages as a Percent of GDP,
1980-1990**

| | |
|------|-------|
| 1980 | 36.0% |
| 1981 | 37.6 |
| 1982 | 35.3 |
| 1983 | 29.4 |
| 1984 | 28.7 |
| 1985 | 28.7 |
| 1986 | 28.3 |
| 1987 | 26.5 |
| 1988 | 25.9 |
| 1989 | 15.8 |
| 1990 | 15.0 |

Source: Instituto Nacional de Estadística, Geografía e Informática (INEGI).

Note: Data for 1989 and 1990 are preliminary and estimated figures, respectively.

real wages of Mexican production workers fell after Mexico joined GATT in 1986, only returning to that level in 1990. Only since 1990 have they made real gains from the opening of the Mexican economy. The economy-wide gains of Mexican workers are even less clear. Wages, as a share of the Mexican GDP are shown in Table 15. Prior to the debt crisis, Mexican wages were between one-third and two-fifths of Mexico's GDP — 37.6 to 35.3%. After the debt crisis, and before the opening of the Mexican economy, the share of wages fell to slightly under one-third of GDP — 28.3 to 29.4%. And, after the opening of the Mexican economy in 1986, the wage share is estimated to have fallen to around one-fourth to slightly less than one-sixth of GDP — 26.5 to 15.0%.

Of course, new job creation from foreign direct investment is only one element of the health in a labor market. Any positive effect can be easily dwarfed by macroeconomic policy. In particular, policies aimed at containing inflation by fiscal authorities, or currency management by central bankers can be more important. Workers in the hemisphere may not see the theoretical benefits touted by the economic modelers of trade because of macroeconomic forces that are more important. As an example, the Mexican labor market may not be seeing the benefits of a shift in job creation because of measures taken to keep the Mexican peso's exchange value high in order to control inflation, which has resulted in high interest rates and a trade deficit in the early 1990s. The high interest rates in turn tend to shift GDP towards interest payments and away from wages unless productivity can increase at a very fast rate.

Table 16 shows employment with U.S. multinationals in Latin America and the rest of the Western Hemisphere except Canada and Mexico, and in specific countries. This is a table of total employment with U.S. multinationals including all industries. Overall employment with U.S.-based firms in the hemisphere is down from earlier. The pattern followed by most countries is a drop in economic activity following the debt crisis in 1982, with a slow recovery beginning in 1985-1986. That is, the job creation from U.S. multinationals has followed the health of the local economies. Some countries, however, such as Argentina, Colombia, and Venezuela, show a persistent decline in job growth from U.S. foreign direct investment. The most dramatic growth has been in the Dominican Republic, though this is far from the higher levels of the 1970s. The Dominican Republic, like Mexico, has an "in-bond" manufacturing sector that enjoys favorable duties in

Table 16

Employment by Nonbank Foreign Affiliates of U.S. Parent Companies
Other Western Hemisphere, Selected Countries and the Caribbean,
1977 and 1982-1990 (in 1,000s)

| | Other Western Hemisphere | Argentina | Brazil | Chile | Colombia | Dominican Republic | Caribbean | Venezuela |
|------|--------------------------|-----------|--------|-------|----------|--------------------|-----------|-----------|
| 1977 | 976.9 | 108.0 | 435.7 | 10.1 | 61.3 | 46.6 | 49.1 | 101.2 |
| 1982 | 880.3 | 80.6 | 425.6 | 12.7 | 54.5 | 12.6 | 44.0 | 102.7 |
| 1983 | 799.7 | 82.1 | 377.0 | 12.6 | 54.0 | 10.9 | 41.8 | 83.4 |
| 1984 | 786.7 | 81.0 | 377.0 | 12.7 | 51.7 | 10.6 | 41.2 | 76.4 |
| 1985 | 764.6 | 70.9 | 392.0 | 11.9 | 50.2 | 7.4 | 32.5 | 74.3 |
| 1986 | 753.3 | 68.4 | 403.2 | 13.2 | 40.7 | 9.8 | 29.2 | 68.2 |
| 1987 | 795.1 | 68.4 | 432.7 | 12.9 | 44.2 | 9.7 | 29.5 | 74.3 |
| 1988 | 791.1 | 67.4 | 424.6 | 14.5 | 45.8 | 11.6 | 28.9 | 71.6 |
| 1989 | 780.7 | 60.3 | 440.1 | 18.6 | 39.4 | 18.1 | 28.0 | 60.1 |
| 1990 | 781.8 | 57.7 | 445.0 | 22.0 | 40.1 | 18.7 | 27.8 | 61.7 |

Source: U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 71 (October 1991): Table 4, page 34; and Vol. 72 (August 1992), Tables 13.1 and 13.2, pages 77-78.

Note: Other Western Hemisphere is the Western Hemisphere excluding the U.S., Canada, and Mexico. The Caribbean column includes the Bahamas, Barbados, Bermuda, Jamaica, the Netherlands Antilles, Trinidad and Tobago, and the United Kingdom Islands.

the United States. It is also closer to major U.S. markets than many other countries in the hemisphere. Chile has also experienced growth, but not in manufacturing. Most Chilean jobs with U.S. companies are in other industries. If a WHFTA reinforces current trends, then it is not likely that many other countries will see investment-led job growth in manufacturing unless their economies are healthier. And, it is possible that if barriers are lowered for intra-hemispheric trade, the investment that has been induced to avoid trade barriers may not be present even if the local economies are healthier. Existing job creation patterns may, like the trade patterns discussed in the previous section, create more pitfalls for the poorer Latin American countries.

4. Foreign Investment and the Macroeconomics of Western Hemisphere Integration

It is clear from the preceding discussion that the main impetus for the NAFTA and WHFTA proposals, both for American business and for Latin American governments, is the prospect of massive new infusions of foreign investment (especially direct investment) into Latin America. This section will analyze recent trends in U.S. foreign investment in Mexico and what they imply for future growth and job creation in North America. As before, we shall also examine the extent to which these trends are likely to be followed in the rest of Latin America under a WHFTA.

Creating an Integrated Capital Market

Although the NAFTA is, on the surface, a trade liberalization agreement, in fact it is just as concerned (if not more concerned) with *investment liberalization*. The draft NAFTA agreement contains stringent and unprecedented guarantees for foreign investment in each country, intended mainly to secure U.S. multinational firms from nationalizations or even more moderate restrictions on the mobility of their capital invested in Mexico. Coupled with provisions to liberalize trade in financial services, it is clear that the goal of the NAFTA is to create an *integrated capital market* along with an integrated goods market — although no integration of labor markets is currently contemplated. The NAFTA will therefore have repercussions for capital flows both within North America and with other regions.

This makes it imperative to consider the macroeconomic repercussions of what is really a free trade *and investment* agreement.

Macroeconomic Repercussions for the United States²⁰

Ironically, the prospects for increased capital mobility under the NAFTA have been the source for the biggest projected gains *and* losses in output and employment for the United States. American NAFTA supporters, such as Dornbusch (1991) and Hufbauer and Schott (1992), argue that an increased net capital outflow from the U.S. to Mexico will improve the U.S. current account balance, *ceteris paribus*, and thus raise U.S. GDP and employment.²¹ American NAFTA critics, such as Koechlin et al. (1992), have assumed that increased foreign investment in Mexico comes largely if not exclusively at the expense of domestic investment in the U.S., thus causing losses of output and employment there.

In order to sort out this debate, it is necessary to recall the national income identity:

$$GDP = C + I + G + (X - M),$$

where C is personal consumption expenditures, I is gross domestic investment, G is government purchases, X is exports of goods and services, and M is imports of goods and services.²² Based on this identity, it is clear that both sides in this debate have been taking only partial and incomplete approaches to the question of income determination (and employment determination, assuming employment is roughly proportional to GDP in the short run). The supporters have been looking mainly at the likely changes in the trade balance, $X-M$, arguing that these are likely to be positive for the U.S. The critics have been looking mainly at the

domestic investment term I , claiming that it is likely to be reduced in the U.S. Critics have also tended to argue that the U.S. trade balance $X-M$ will be decreased by the NAFTA, as the U.S. imports more labor-intensive manufactures from Mexico. Each side implicitly assumes that the effects considered by the other side either will not happen or will be inconsequential.

A more complete analysis must address both the question of how much foreign capital will be invested in Mexico as a result of the NAFTA, and the degree to which this capital will be diverted from domestic investment in the United States. Consider, for example, a decision by an American corporation to relocate a particular production activity from Michigan to Monterrey. This will entail capital outflows and, at least initially, reduced investment at the company's facilities in the U.S. The question is whether that reduced investment will automatically be replaced by some other investment. Supporters of NAFTA essentially assume that this corporation or other corporations will necessarily fill the void by investing in new activities, perhaps targeted at exports to Mexico. Critics of NAFTA question whether this is likely to happen.

Traditional neoclassical economic theory, which assumes that investment is determined by available savings, implies that the savings thus released will necessarily find a more profitable outlet somewhere else in the country. But *even that conclusion need not hold once the capital markets of the two countries are integrated*. That is precisely why the capital market integration features of the NAFTA are so important. Even if investment is constrained by savings in the aggregate, in an integrated North American capital market that would only imply that *North American* savings would have to be used to finance investment

somewhere in North America — not necessarily in the country where those savings originate. And if one takes the Keynesian view that investment is the independent variable, and savings adjust (through changes in income levels and factor shares), then there is not even any sense in which there is a predetermined amount of savings "released" which must find an outlet somewhere. In that case, there could be no presumption of the foregone domestic investment being replaced.

The issue of capital flows is further complicated by the potential for investment diversion effects. For example, a U.S. (or foreign) corporation with operations in several countries could decide to increase its investments in Mexico at the expense of its investments in another developing country, rather than at the expense of its investments in the U.S. This would bring new foreign capital into Mexico, but without resulting in capital outflows from the U.S. Alternatively, a foreign corporation seeking access to the U.S. market could decide to invest in Mexico rather than in the U.S. itself, once trade barriers were eliminated. This would reduce domestic investment in the U.S., but without creating a capital outflow from the U.S. that would improve the trade balance. Given these complexities, it is hard to know *a priori* whether the increase in $(X-M)$ or decrease in I will predominate in the U.S. macroeconomy. The estimation of the relative importance of the different factors involved is an important priority for research on this topic.

Furthermore, the dynamics of the foreign capital flows must be considered. Presumably, a large capital outflow is the result of a stock-adjustment process. American firms respond to lower perceived risks and higher expected discounted profits from operations in Mexico, as a result of the trade *and* investment liberal-

ization provisions of the NAFTA, by increasing their desired stocks of capital in Mexico. Capital outflows then occur over time, as needed to bring actual stocks of U.S. assets in Mexico into line with the new desired level. Considerable lags may make this adjustment process prolonged, due to such factors as sunk costs in U.S. facilities, learning about suitable foreign locations, obtaining the necessary financing, training of workers, construction of new facilities, etc. Investment projects may also be delayed due to slowdowns in demand growth (the accelerator effect) or shortfalls of cash flows (which may constrain external as well as internal financing in imperfect capital markets). In addition, some of the increased investment in Mexico is financed with locally raised capital, which does not result in capital outflows from the U.S.

Once the new level of desired foreign capital in Mexico is reached, we would expect the net new capital outflows from the U.S. to be reduced. At that point, the U.S. trade balance with Mexico would fall.²³ At best, then, the prediction of huge net capital outflows is valid for the short-to-medium run, but is not likely to be sustained in the long run. And even this analysis assumes a stable adjustment of foreign capital in Mexico to a new desired level; the swings in the balance of payments could be even more dramatic if there is a boom-bust cycle characterized by overinvestment in Mexico in the short run followed by a subsequent withdrawal of capital (as occurred in U.S. bank lending to Latin America in the late 1970s and early 1980s).

What will be sustained in the long run are the changes in the competitiveness of each country's industries that follow from the new locational pattern of investment. In this respect, the long-term consequences for the U.S. trade balance

could well be negative, once the net capital flows (and the associated exports of capital equipment produced in the U.S.) fall off. As argued in the previous section, if plants located in Mexico are able to combine highly productive modern technology with continued low wages to produce manufactured goods with comparatively low unit labor costs, they can undersell American products in a wide range of products including some which are apparently "capital-intensive" or "high-tech" (such as autos and electronics). Such competitive advantages could be offset by appreciation of the peso, by increased wages of production workers in Mexico, or by shifts of U.S. manufacturing into more knowledge-based products where labor costs are less important. But even if the net effects on U.S. employment are minimal in the long run, the gross job losses and dislocations in sectors such as automobiles, textiles, and electronics are likely to be considerable.

The integration of capital markets also has important implications for the exchange-rate dimension of the NAFTA and, by extension, of a WHFTA.²⁴ The peso is currently (as of early 1993) somewhat overvalued in real terms. This is partly a deliberate consequence of Mexico's anti-inflationary policies, and partly the result of the increased capital inflows into Mexico in recent years, and in turn helps to account for Mexico's growing trade deficit in the early 1990s. Indeed, the real appreciation of the peso is an important "transmission mechanism" for endogenously making the trade balance adjust to the capital account surplus (just as occurred with the U.S. dollar in the early 1980s). If the NAFTA causes capital inflows into Mexico to grow even more, and if Mexico retains its current anti-inflationary fiscal and monetary policies, the peso could rise even more in real terms in the short run. This would help to ameliorate the possible negative effects

of any investment shifts on the U.S., by making Mexican products relatively less competitive and helping to ensure a bilateral U.S. trade surplus with Mexico over the first few years of the agreement. But this would also lessen some of the short-term gains to Mexico. And this is also a warning to other Latin American countries contemplating entering a WHFTA; Latin American countries have a long history of micro-level export-promotion policies which fail partly because of exchange rate misalignment.²⁵

In the long run, however, the overvaluation of the Mexican peso cannot be sustained indefinitely. Once the net capital inflows fall off, there will be downward pressure on the peso, and it will be in Mexico's competitive interest to allow that to happen (assuming fears of high inflation have subsided by then). This would threaten the U.S. with trade deficits, but there would be little the U.S. could do as there is no agreement in the NAFTA to stabilize exchange rates. As in Europe, then, *the integration of commodity and capital markets will bring pressures for exchange rate management, macroeconomic policy coordination, and possibly a monetary union.* While no politicians in North America have dared to make such suggestions yet, the European experience suggests that they may not be far off. The recent conflict between Germany and the other countries in the European Monetary System (EMS) over interest rates and exchange-rate parities demonstrates the problems which smaller countries can face when the hegemonic power in a trading (and monetary) bloc decides to base its policies on domestic considerations, with no concern for the effects on the other states in the bloc.

These same dynamics of capital flows, investment shifts, and exchange rate effects will be played out across Latin America to a greater or lesser extent, and

with different variations, if a WHFTA is created. One would expect, however, that the total amount of U.S. capital which might move to Latin America over the next few decades is not unlimited, and that the addition of more countries into the western hemisphere trading bloc will only dilute the effects on any individual country such as Mexico. Thus, the formation of a WHFTA is not likely to add greatly to the aggregate costs and benefits to the U.S. from integrating its capital market with Mexico, but it could potentially divert some of the gains which Mexico hopes to get to other Latin American countries. Indeed, the fear of diversion of capital to Mexico under a NAFTA may account in part for some other Latin American countries' interest in joining a WHFTA when the prospective trade gains alone are not likely to be large.

Recent Trends in U.S. Direct Foreign Investment in Latin America

It is often argued that the amounts of U.S. DFI in Mexico are so small as to be inconsequential for the overall U.S. economy. It is true that the magnitudes are small, although how small depends on the base of comparison. The largest predictions of job gains or losses for the U.S. from NAFTA are on the order of 500,000 — which is less than 0.5% of total U.S. employment. Nevertheless, just as the job creation by U.S. MNCs in manufacturing in Mexico has been substantial in comparison with the job creation in domestic U.S. manufacturing, as shown in the previous section, likewise the increases in U.S. DFI in manufacturing in Mexico have also been impressive. And economic theory teaches that many of the most important changes are those which occur at the margin.

Often, the magnitudes of DFI are dismissed as negligible by comparison with total U.S. gross private domestic investment, which has been on the order of \$700-800 billion since 1987. But this total includes roughly \$200 billion of residential investment, which is clearly internationally immobile, as well as some nonresidential structures and equipment which are also largely irrelevant to the issues in the NAFTA debate (e.g., commercial and office buildings). Since most of the concern in this debate is over the fate of American manufacturing, the most relevant benchmark is new plant and equipment expenditures (NP&EE) in domestic manufacturing.

Table 17 presents data on U.S. DFI in manufacturing to Mexico and other developing countries over the last five years, compared with U.S. domestic NP&EE in manufacturing. At first glance, even these DFI figures look small by comparison. As of 1991, total DFI in manufacturing in all developing countries was only about 4% of domestic NP&EE in manufacturing, of which about one-third went to Mexico. But what is more noteworthy are the trends in these data. While U.S. domestic manufacturing NP&EE rose by only 30% from 1987 to 1991, manufacturing DFI by U.S. multinationals in all developing countries rose by 69%, and **U.S. manufacturing DFI in Mexico rose by 222%** (i.e., more than tripled) during the first four years following Mexico's liberalization of foreign investment rules.

| Table 17 U.S. Direct Investment in Manufacturing in Mexico and Other Latin American and Developing Countries, 1987 to 1991 (in billions of U.S. dollars) | | | | | |
|---|---|---|---------------------------|----------------------------------|----------------------------------|
| | New Plant and Equipment Expenditures in U.S. Manu- facturing | U.S. Direct Foreign Investment (sum of capital outflows plus reinvested earnings) | | | |
| | | Mexico | Other Latin America | Other Developing Countries | Total Developing Countries |
| 1987 | 141.1 | 0.8 | 1.8 | 1.7 | 4.3 |
| 1988 | 163.5 | 1.3 | 3.0 | 1.6 | 6.0 |
| 1989 | 183.8 | 1.6 | 5.7 | 1.6 | 8.8 |
| 1990 | 192.6 | 2.4 | 3.2 | 2.4 | 8.1 |
| 1991 | 183.6 | 2.5 | 2.0 | 2.6 | 7.2 |
| | Percent of U.S. New Plant and Equipment Expenditures | | | | |
| 1987 | | 0.56% | 1.26% | 1.19% | 3.01% |
| 1988 | | 0.82% | 1.86% | 0.97% | 3.65% |
| 1989 | | 0.86% | 3.10% | 0.84% | 4.81% |
| 1990 | | 1.27% | 1.66% | 1.26% | 4.18% |
| 1991 | | 1.39% | 1.09% | 1.44% | 3.91% |
| | Rate of increase, 1987 to 1991 | | | | |
| | 30.2% | 221.9% | 11.8% | 57.8% | 69.0% |

Sources: U.S. direct investment abroad is from U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, various August issues; new plant and equipment expenditures for U.S. domestic manufacturing are from Bureau of the Census data reported in U.S. Congress, Joint Economic Committee, *Economic Indicators*, June 1992, p. 10; and authors' calculations.

To what extent this extraordinary growth came at the expense of domestic investment in the U.S. versus foreign investment in other countries is impossible to tell. Some evidence for investment diversion is found in the fact that the Mexican share of all U.S. DFI in manufacturing in developing countries rose from

19% in 1987 to 35% in 1991. U.S. domestic NP&EE in manufacturing fell in 1991 due largely to the recession, but could possibly have been higher than it actually was if capital outflows to Mexico (and other countries) had not continued to be strong. It is plausible, although there is no definitive proof, to surmise that the unusually sluggish behavior of domestic investment in the U.S. economic recovery in 1991-92 may have been due, to some degree, to the fact that American and foreign companies were shifting their North American manufacturing investment to other nations such as Mexico.

Finally, the data in Table 17 may give some hints about the interest of other Latin American nations in a hemispheric FTA with similar provisions on foreign investment. After a boom in 1988-89, U.S. DFI in manufacturing in other Latin American countries fell off sharply in 1990 and 1991 while the DFI in Mexico continued to grow. It is possible that the rest of Latin America was already feeling some diversion of U.S. DFI to Mexico. This would support the view that the rest of Latin America seeks a WHFTA in part as a defensive move to prevent Mexico from capturing a larger share of U.S. DFI (as well as trade) in the western hemisphere.

The Question of Markets

In all of the discussions of the NAFTA and WHFTA there has been remarkably little attention to the problem of generating effective demand sufficient to utilize fully the increased productive capacity which would result from greater capital flows and technology transfers. Indeed, there is considerable incongruity

between the expectations of Mexicans and other Latin Americans that export-led growth will be the cure-all for their economic ills, and the current concerns in the U.S. and EC — the main sources of demand for Latin American exports — that the 1990s will be a decade of slow growth. It would be tragic for Latin America if it were to finally embark on a liberal trading regime, for the first time in over a half century, only to find that the industrialized countries were entering a period of depressed global market expansion.

In the mid-1980s, the great motor of world demand growth was the expansionary fiscal policy of the United States under President Ronald Reagan. U.S. budget deficits, coupled with debt-financed spending by American businesses and households, contributed to huge trade deficits at a time when most foreign countries were pursuing contractionary macro policies (see Blecker, 1991a and 1992). The resulting trade surpluses for Japan, the former West Germany, and the East Asian NICs (principally South Korea and Taiwan) in the mid-1980s in turn stimulated their economies, and in the late 1980s led to pressures on those countries to appreciate their currencies and to expand their demand in order to redress the "global imbalances." Thus soaring American demand for foreign products spilled over into a global economic boom in the 1980s — or not quite a global boom, as most of Latin America and sub-Saharan Africa were left out.

But the 1980s are now definitively over, and the proverbial chickens have come home to roost. The U.S. economy suffered a recession in 1990-91 which, although not unusually deep, was unusually prolonged. Although the recession officially ended in mid-1991, the annual growth rate from 1991 to 1992 was only 2.1%, and the pre-recession peak real GDP of \$4,902.7 billion (in constant 1987

dollars) in second quarter 1990 was not surpassed until the third quarter of 1992.²⁶ With a budget deficit on the order of \$300 billion, a national debt approaching \$4 trillion, and an annual net interest bill of over \$200 billion,²⁷ the U.S. federal government has been unable to play its traditional countercyclical role in stimulating the economy during the recovery.

At the same time, U.S. corporations and households have been struggling with huge debt overhangs, and are reluctant to increase capital expenditures. Banks in turn are seeking to restore their balance sheets after more than a decade of imprudent lending policies (which continued domestically after they were curtailed in Latin America), and are rationing credit even to creditworthy customers. Thus the legacies of the excesses of the 1980s have become obstacles to renewed U.S. growth in the 1990s.

In February 1995, President Clinton revealed his economic program which combines a modest fiscal stimulus with larger tax increases, with the net effect of cutting the projected annual federal budget deficit by about \$140 billion by 1997. If this essentially contractionary shift in fiscal policy is put into effect, it will further slow the medium-term growth of the U.S. economy, holding other factors constant. Reductions in long-term interest rates and further dollar depreciation could partly offset the contractionary effects of reducing the budget deficit, but the most likely scenario is for continued slow growth of the U.S. economy in the mid-1990s. Putting all this together, the prospects for rapid growth of the U.S. consumer market in the 1990s are poor.

The picture is not much better if we look at other potential markets for Latin American exports. European growth has been slowed by the high interest-

rate policy of Germany, adopted by the Bundesbank in response to the high fiscal costs of integrating the former East Germany into the Federal Republic. On the other side of the world, Japan is in a recession, and most of the other major economies of East Asia are competitors of Latin America rather than potential markets.

What all of this implies for Latin America is that this is a particularly risky time for it to be putting all of its eggs in the basket of a FTA with the United States. Especially if the Latin American nations are counting on exports to the U.S. to fuel their own recovery and growth, they could be setting themselves up for a major disappointment. Of course, their exports can grow in the short run as industry relocates to Mexico or other Latin America nations, either at the expense of American manufacturing or through investment diversion from East Asia. But these will be once-and-for-all static gains unless the overall U.S. market starts to grow again.

In this century, Latin America has had a long and sorry history of implementing new development strategies just when the conditions that motivated them had passed. Import substitution policies were largely a response to the stagnation of the 1930s, when global depression led to collapsing commodity prices, and the wartime shortages of the 1940s. But import substitution policies were pursued most strongly between the 1950s and the 1970s, when global markets were generally booming and those developing nations that did choose an export-oriented strategy did relatively well. In the 1980s, the East Asian NICs took advantage of the U.S. demand-driven boom and open markets to achieve rapid export-led growth, while most Latin American countries were struggling to

recover from the debt crisis and to implement "stabilization" and "structural adjustment" policies. Now, just when Asia and Europe are turning inward and the U.S. economy has stagnated, Latin America should think twice before accepting a WHFTA as the only framework for growth.

In this context, it is also important also to consider the macroeconomic consequences of the distributional effects of the NAFTA or a WHFTA. The implication of our analysis in section 3 above is that these FTAs are likely to increase the share of profits (capital income) in national income both in the U.S. and abroad — in the U.S. by reducing the bargaining power of industrial workers, and in Mexico by raising the productivity of labor relative to real wages (which are likely to be held down by surplus labor supply). The redistribution of income toward profits could only be exacerbated in a wider WHFTA, if more poor countries end up competing over who can offer the lowest wages (as well as the lowest taxes and least regulatory controls) to foreign capital.

Structuralist macroeconomic theory (Taylor, 1983, 1991) implies that such a redistribution toward capital can have a depressing effect on overall aggregate demand, since workers have a higher marginal propensity to consume than capital owners. A redistribution of income toward profits thus raises the average saving rate by giving a greater weight to incomes which are saved at higher marginal rates. But this in turn reduces effective demand through the Keynesian "paradox of thrift." This implies that even consumer demand (C in the national income identity above) could be adversely affected by FTAs with investment liberalization in the western hemisphere. And if this happens, Latin American nations counting on the U.S. market to fuel their own export-led growth will also suffer.

There are potential offsets to this loss of consumer demand from wage-earners. Reduced prices of consumer goods due to production with cheaper labor could help to preserve purchasing power over tradeable consumption goods, although this would not help in regard to nontradeable goods and services. Investment demand, stimulated by the higher profitability, could substitute for consumption demand. Exports to other regions of the world economy, such as Europe, Asia, or the Middle East could replace some domestic demand. And finally, demand for luxury consumption goods by upper income groups throughout North and South America could substitute for workers' demand for basics — a phenomenon already observed in the United States during the so-called "consumption binge" of the 1980s (see Blecker, 1991a). But all of these offsets, even if realized, would imply a new pattern of growth based on low wages and highly unequal income distributions, with the benefits of the growth skewed toward the wealthy classes in all the countries in the trading bloc.

5. Conclusion: The Political Economy of an Integrated Western Hemisphere

This paper has been intended mainly to raise questions and point out potential problems with the NAFTA and its proposed successor, the WHFTA. We are far from having definitive answers to many of the questions which we have posed here. Nevertheless, if we have induced the reader to think more critically about the current rush to form FTAs in the western hemisphere, and to take seriously some of the difficulties we have noted, then our effort will have succeed-

ed. At a minimum, we have suggested an agenda for future research on issues which are critical to understanding how FTAs will actually affect the majority of the people in this hemisphere.

Our intention is not to throw cold water on the concept of western hemisphere integration, but to stress that it is far from a free lunch, and far from certain to be the panacea it is often made out to be. In this concluding section, we shall seek to identify the main policy issues which our analysis suggests are likely to be important in future hemispheric negotiations, and which will determine the eventual social impact of the integration process.

As we have noted, the NAFTA agreement originally negotiated by President Bush is no mere agreement to liberalize cross-border trade. It is also a set of rules providing guarantees for foreign investors, and a set of restrictions on the kinds of domestic economic regulations and industrial policies which member countries can adopt. It does allow for the continuance of some degree of consumer health and safety regulations, but does nothing effective to prevent "environmental dumping" in regard to pollution produced at the site of production. Moreover, it does nothing at all to guarantee the enforcement of humane labor standards and worker rights throughout North America. Thus goods which were produced in factories which dump toxic wastes or expose workers to harmful substances in one country could not be kept out of the other countries under the NAFTA, and there are no provisions (financial or otherwise) to step up each country's enforcement of its own laws in these areas. Given the lesser degree of enforcement of such laws in Mexico today, the NAFTA agreement in and of itself could give incentives for multinational firms to circumvent American environmental and labor standards by

moving production to Mexico, which would in turn make it harder to maintain and strengthen environmental and labor standards in the U.S. A WHFTA patterned on the original NAFTA agreement would only worsen these problems, especially if it encouraged more countries to offer lax environmental protection and weak worker rights in order to attract foreign investment.

The history of modern efforts at economic integration shows that, if successful, the liberalization of trade and investment eventually leads to moves for further social and political integration as well as macroeconomic policy coordination. The European Community is a case in point, in spite of its current difficulties. In an integrated North American market for goods and capital, citizens of all three countries are inevitably going to become more aware of conditions in their neighboring countries. And, since such an integrated market will make workers and communities in the three countries compete against each other for job opportunities, labor market conditions and social externalities throughout North America will also become the subjects of legitimate public debate and concern. Thus, while the NAFTA itself is likely to create pressures to level social regulations downward, there will be (and already are) countervailing political pressures to level them upward instead. The realization that investors have been protected far more than workers, consumers, or the environment has led to calls for extending the protections of the NAFTA beyond what it initially encompasses.

Recognizing these social and political realities, President Clinton has promised to add labor and environmental conditions onto the agenda for negotiations among the three NAFTA partners. We think it is especially important that these "parallel" negotiations also proceed on a "fast track," so that international

agreements on enforcing existing social regulations and harmonizing them upward are put into effect along with the economic provisions of the NAFTA, not afterward. Otherwise, much damage could be done before future political pressures could be successful at winning such reforms in an already integrated North American economy which lacks integrated democratic political institutions. This is especially true if, as we have argued, the NAFTA is likely to increase the concentration of wealth and power throughout the continent, and to create new vested interests opposed to reform.

These same considerations apply to the more directly economic consequences of trade and investment liberalization. If our analysis is correct, we will see potentially massive dislocations of labor in all the countries involved, with a regressive impact on income distribution, even if *net* changes in employment are relatively small. These problems must largely be dealt with by domestic institutions and policies, which can be adopted unilaterally by each member of the NAFTA. In particular, there is a desperate need to strengthen policies such as adjustment assistance and labor retraining for workers who lose jobs, as well as to work on the eventual international harmonization of labor standards and their enforcement. President Clinton has promised to address these issues for the United States through changes in U.S. labor-market policies, some of which could be enacted unilaterally in the implementing legislation for the NAFTA. Mexico also has serious needs in this area, and might require foreign financial assistance to address them. It would also be in the interest of the U.S. to provide such assistance, in order to relieve migration pressures. The manner in which all of

these concerns are addressed in the NAFTA will be important precedents for whether eventual WHFTA negotiations would take these concerns seriously or not.

Finally, nations will not be able to combine their economies successfully to the degree implied by the NAFTA without eventually having to coordinate their monetary and macroeconomic policies. This again is a central lesson of the European experience, which is only confirmed by the fact that the recent *lack* of policy coordination between Germany and the other countries in the EMS made that system of exchange-rate parities unsustainable. All of North America will have to have reasonably consistent fiscal and monetary policies in order to keep interest rates and inflation rates in line, and thus to prevent destabilizing exchange rate fluctuations and balance-of-payments crises. For all practical purposes, this means that the Bank of Canada and Banco de México will have to subordinate their monetary policies to the U.S. Federal Reserve until such time as a more international monetary authority is established. In effect, the Canadian dollar and Mexican peso will have to be pegged more closely to the dollar, in real (inflation-adjusted) terms. Such problems of coordination would only be multiplied in a WHFTA.

In all of this, the need to provide expanding markets for the products of all member nations of the FTA (NA or WH version) will have to be met. Anti-inflationary policies, while necessary at times, have a contractionary bias, and if combined with regressive income distribution could lead to chronically depressed demand conditions. Many of the problems we have identified, including especially the problems of labor dislocation, could be ameliorated if growth is robust so that new jobs and opportunities are continuously being created. A stagnant hemi-

spheric economy, on the other hand, is bound to engender more conflict both within and between nations. There will have to be renewed attention on reviving domestic growth, consistent with maintaining low inflation and preventing environmental degradation. These are fine lines indeed to walk, but unless they are handled correctly the whole process of western hemisphere integration is unlikely to succeed in the long run.

Notes

1. It is somewhat harder to draw inferences about the likely effects of the NAFTA on Canada, since (as will be shown below) Canadian-Mexican trade is still minuscule. Since the present authors' concern is principally with the U.S. and Mexico we will focus largely on those two countries.
2. See Stanford (1992) for a critique of theoretically based models of U.S.-Mexican trade liberalization and the NAFTA.
3. We are indebted to H. W. Singer for suggesting this point.
4. This conclusion is based on a survey of models which generally show favorable effects of the NAFTA on Mexican employment in the U.S. International Trade Commission (USITC), *Economy-Wide Modeling of the Economic Implications of a FTA with Mexico and a NAFTA with Canada and Mexico*, Report on Investigation No. 332-317, USITC Publication 2516, Washington, DC, May 1992. In this survey, the *highest* estimate of the increase in Mexican employment is a *once-and-for-all* gain of 6.6%, based on the Bachrach-Mizrahi (Policy Economics Group of KPMG Peat Marwick) model with additional capital invested in Mexico (none of which is assumed to displace capital which would have been invested in the U.S.). Since the Mexican labor force is projected to grow by 1.85% *per year* from 1990-2025, or 90% over a 35-year period, even this highly optimistic estimate would provide jobs for only a few years' net entrants into the Mexican labor force. Most of the estimates of the change in Mexican employment from the models surveyed by the USITC are much smaller. One other model (Sobarzo) implies employment gains

in the range of 5.1 to 5.8%; the other estimates range from -0.9% over ten years in one version of Clopper Almon's model to +2.4% in one version of Roland-Holst et al. (of the USITC Research Staff). Almon's model is the only dynamic one; all the others are static.

5. On this point see the compelling analysis of Leamer (1992).

6. This problem has been emphasized in the studies by Levy and van Wijnbergen and by Robinson et al. in USITC (1992), as well as by Hinojosa-Ojeda and Robinson (1992, forthcoming).

7. See Sarkar (1986) on the falling commodity terms of trade.

8. The U.S. trade balance improved somewhat in 1991, mostly as a result of the country's economic recession and the falling value of the dollar (see Blecker, 1991b).

9. These data are taken from the International Monetary Fund, *Direction of Trade Statistics*, various years. This source shows a notably larger deficit for the U.S. in 1990 than some U.S. government sources show. On a balance of payments basis, the U.S. merchandise trade deficit as reported by the Department of Commerce, Bureau of Economic Analysis, was only \$108.9 billion for 1990 (revised as of June 1992). However, on a Census basis, exports (f.a.s) less imports (c.i.f.) was \$-123.4 billion in 1990. The IMF data are closer to a Census basis.

10. In this context, "Latin America" refers to all western hemisphere nations other than the U.S. or Canada.

11. By 1992, the U.S. had a merchandise trade surplus with Mexico of \$5.4 billion (according to the U.S. Department of Commerce, Census Bureau, "U.S. Merchandise Trade: December 1992," released on February 18, 1992). This remarkable shift was due partly to the large capital outflows to Mexico, partly to the growing overvaluation of the peso, and partly to the U.S. recession.
12. This and all other growth rates in Tables 4 and 5 are total rates for the periods shown, *not* average annual rates.
13. Since 1991, U.S. exports to Mexico have been one of the fastest growing parts of U.S. trade.
14. Similar considerations lead H. W. Singer to support a collective approach of Latin American countries to negotiating a WHFTA, in his contribution to this project.
15. Exports to the entire western hemisphere, including the U.S., Canada, and all other countries, are only 40.7% of total exports for Argentina, 37.3% for Brazil, 31.1% for Chile, and 29.7% for Peru, as of 1990 (calculated from data in IMF, *Direction of Trade Statistics*, 1991 Yearbook).
16. The best summary of the models and their prediction of the impact on labor is by Stanford (1993). A more suspect summary is by Hinojosa-Ojeda and Robinson (1992), who assume that the U.S. faces a serious shortfall in labor supply well into the next century. This, they proclaim creates a labor market complementarity between the U.S. and Mexico, because of Mexico's labor surplus. But Mishel and Teixeira (1991) have shown that an honest evaluation of U.S. labor market indicators does not show any sign of a labor shortage developing.

17. OECD, *Labour Force Statistics 1969-1989* (1991). Pages 84-85.

18. In 1990, the average hourly wage for production and nonsupervisory workers was \$10.30 in electrical and electronic equipment and \$14.59 in motor vehicles. These may be compared with averages of \$10.02 for the entire private sector, and \$10.83 for all manufacturing. Data are from U.S. Department of Labor, Bureau of Labor Statistics, *Supplement to Employment, Hours, and Earnings, United States, 1909-90*, July 1991.

19. In the first 22 months after the cycle trough (March 1991 to January 1993), the increase of 498,000 jobs was only 0.5% of the pre-recession peak level of total employment. Except for the abortive 1980-81 recovery, this was far and away the slowest job growth in a recovery in any business cycle since the late 1960s. Based on authors' calculations from unpublished U.S. Department of Labor, BLS data for 1992, and the U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, October 1992, for earlier data.

20. The discussion in this section draws heavily on Blecker (1993), which provides a formal mathematical model for some of the relationships discussed here.

21. Of course, this argument implies that Mexico will have increased trade deficits. But this need not reduce employment in Mexico, and may even increase it, if one assumes that Mexican industry operates at full capacity. With output and employment constrained by available capital, a current account deficit brought about by increased capital inflows can relieve the domestic savings and foreign exchange constraints in a two-gap model, thus permitting increased investment and capital accumulation.

22. In the American national income accounts, public sector investment is included in G ; most other countries' national accounts include public sector investment in I . Using GDP as the income aggregate, the trade balance ($X-M$) excludes net factor income (factor service receipts) from abroad. Those would be included if a GNP aggregate were used instead.

23. The current account balance would fall less than the trade balance due to increased net inflows of investment income. However, net investment income is not included in the ($X-M$) term when the national income identity is defined in terms of GDP.

24. The following discussion was suggested by a conversation with Daniel Schydowsky.

25. Often, Latin American currencies have become overvalued as a result of high differential inflation rates (relative to the industrial countries) not fully offset by nominal devaluations. While the current Mexican case is similar in this regard, the Mexican government is doing this consciously as an anti-inflationary measure.

26. Data from U.S. Department of Commerce, Bureau of Economic Analysis, "Gross Domestic Product: Fourth Quarter 1992 (Preliminary)," release of February 26, 1993, and U.S. Congress, Joint Economic Committee, *Economic Indicators*, December 1992.

27. Data from U.S. Congress, Joint Economic Committee, *Economic Indicators*, December 1992.

References

- Amsden, Alice. *Asia's Next Giant: South Korea and Late Industrialization*. Oxford: Oxford University Press, 1989.
- Blecker, Robert A. "Low Saving Rates and the 'Twin Deficits': Confusing the Symptoms and Causes of Economic Decline," in P. Davidson and J.A. Kregel, eds., *Economic Problems of the 1990s*. Aldershot: Edward Elgar, 1991a.
- Blecker, Robert A. "The Recession, the Dollar, and the Trade Deficit." Briefing Paper, Economic Policy Institute, Washington, DC, August 1991b.
- Blecker, Robert A. *Beyond the Twin Deficits: A Trade Strategy for the 1990s*. Armonk, NY: M.E. Sharpe, Inc. for the Economic Policy Institute, 1992.
- Blecker, Robert A. "Trade and Investment Liberalization in North America: A Structuralist Model of the NAFTA." Paper presented at the Allied Social Sciences Associations meetings, Anaheim, CA, January 1993.
- Dornbusch, Rudiger. "US-Mexico Free Trade: Good Jobs at Good Wages." Testimony before the Subcommittee on Labor-Management Relations and Employment Opportunities, Committee on Education and Labor, U.S. House of Representatives, April 30, 1991.
- Herzenberg, Stephen. "The North American Auto Industry on the Eve of Continental Free Trade Negotiations," Unpublished, U.S. Department of Labor, Bureau of International Labor Affairs, July, 1991.
- Hinojosa-Ojeda, Raúl, and Sherman Robinson. "Labor Issues in a North American Free Trade Area," in N. Lustig, B. P. Bosworth, and R. Z. Lawrence, eds., *North American Free Trade: Assessing the Impact*. Washington, DC: Brookings, 1992.
- Hufbauer, Gary C., and Jeffrey J. Schott. *North American Free Trade: Issues and Recommendations*. Washington, DC: Institute for International Economics, 1992.
- Koechlin, Timothy, Mehrene Larudee, Samuel Bowles, and Gerald Epstein. "Effect of the North American Free Trade Agreement on Investment, Employment and Wages in Mexico and the U.S." Unpublished, University of Massachusetts at Amherst, February 1992.
- Leamer, Edward. "Wage Effects of a U.S. - Mexican Free Trade Agreement." National Bureau of Economic Research, Working Paper No. 3991, February 1992.
- Mishel, Lawrence, and Ruy Teixeira. *The Myth of the Coming Labor Shortage: Jobs, Skills, and Incomes of America's Workforce 2000*. Washington, DC: Economic Policy Institute, 1991.

Sarkar, Prabirjit. "The Singer-Prebisch Hypothesis: A Statistical Evaluation," *Cambridge Journal of Economics*, vol. 10, no. 4 (December 1986): 355-371.

Smith, Stephen C. *Industrial Policy in Developing Countries*. Washington, DC: Economic Policy Institute, 1991.

Stanford, James O. "C.G.E. Models of North American Free Trade: A Critique of Methods and Assumptions," Testimony to the U.S. International Trade Commission, Investigation No. 332-317, Public Hearing on Economy-Wide Modeling of the Economic Implications of Free Trade, April 1992.

Stanford, James O. "Continental Economic Integration: Modeling the Impact on Labor," *Annals of the American Academy of Political and Social Science* (forthcoming, March 1993).

Taylor, Lance. *Structuralist Macroeconomics*. New York: Basic Books, 1983.

Taylor, Lance. *Income Distribution, Inflation, and Growth*. Cambridge: MIT Press, 1991.

United States International Trade Commission (USITC). *Economy-Wide Modeling of the Economic Implications of a FTA with Mexico and a NAFTA with Canada and Mexico*. Report on Investigation No. 332-317, Publication 2516, and Addendum, Publication 2508, May 1992.

Wade, Robert. *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*. Princeton: Princeton University Press, 1990.