AFTERTHOUGHTS ON NAFTA

By J. Bradford DeLong

Abstract: *We anticipated that NAFTA would be a material benefit for Mexico and an effective zero for the United States. In fact, NAFTA has not realized the anticipated gains for Mexico, and the country likely would be better off if it had instead focused on a development strategy of more educational uplift and greater infrastructure investment. But for Mexico, the harm is over and done with and canceling NAFTA would be a new destructive shock. In the U.S., NAFTA has allowed us to take advantage of an important and unanticipated change in international trade: The move to a regime of "value chain" trade in which wealth and growth went to those who could best place each part of a long production process in the most efficient location. For the U.S., North American economic integration is likely to continue to benefit producers.*

Nearly a quarter century ago, early in the Clinton administration, I was one of the leads on the team responsible for constructing estimates of the economic impact of NAFTA. And I definitely have some explaining to do.

Our models showed NAFTA as a small plus for American consumers and a substantial plus for Mexico. We also anticipated that the agreement would negatively impact other developing countries that were potential competitors with Mexico for the American market. For American manufacturing, we estimated a small plus for capital-intensive manufacturing (machine tools, aircraft, high-end silicon); a small minus for labor-intensive manufacturing (apparel, food processing); and a substantial minus for manufacturing that had been sheltering behind protectionist walls constructed with the help of lobbyists (leather, furniture).

As expected, NAFTA turned out to be a plus for American consumers and a minus for other developing countries competing with Mexico. And American manufacturing was impacted as expected. It was also a major win for Wall Street and a significantly larger than expected plus for manufacturing that could be disaggregated into transnational value chains. The trade agreement was a substantial short-run minus for Mexico as reflected in the 1994-95 financial crisis, but a long-run plus for Mexico because of the substantial value of guaranteed tariff- and quota-free access to the U.S. market.

What Did We Get Wrong?

We got two things wrong, one of which made NAFTA worse than we expected for Mexico (but had little impact on the United States), and the second of which made NAFTA better for both Mexico and the United States than we had forecast back in the early 1990s.

The most important aspect of NAFTA turned out to be the Mexican financial liberalization that allowed Mexico's rich to cheaply purchase political risk insurance from Wall Street by getting their money into New York (this did little harm to the U.S.). Mexicans did not buy as many U.S. manufactured goods as we had forecast, but they did finance construction and plant expansion through investment in America. As a result, the loss of jobs in the predominantly blue-collar male occupation of consumer-goods manufacturing was offset by a gain of jobs in the predominantly blue-collar male occupations of construction and intermediate- and capital-goods manufacturing. Even in the depths of the Great Recession in 2009-2011, the trade deficit with Mexico was a negligible player in American net job losses.

But the outflow of money from Mexico to the United States did great harm to Mexico when combined with the Mexican government's mismanagement of its reserve accounts: It led directly to the 1994-1995 financial crisis, which raised unemployment in Mexico by roughly 4 percent for about three years. That crisis and recession was a bigger harm to the Mexican economy than the benefits of expanded trade with the U.S. Of course, that does not mean that Mexico would in any way benefit from the abrogation of NAFTA today: The harm is over and done with, the benefits continue to mount, and canceling NAFTA would be a new destructive shock inflicting more harm and disrupting the pattern of Mexico's division of labor that has grown up over the past quarter century.

But in hindsight, Mexico would probably be better off if it had not undertaken NAFTA, and had focused instead on a development strategy of more educational uplift and greater infrastructure investment. The U.S., by contrast, is on the whole better off because of NAFTA—and primarily because of what turned out to be the second most important aspect of NAFTA, an aspect that our team analyzing NAFTA early in the Clinton administration missed almost completely.

Auto parts will serve as an example—one of the particular industries that was supposed to have been placed under the most dire threat by competition from Mexico by both right-wing critics of NAFTA such as Ross Perot and left-wing critics such as my colleague Harley Shaiken. Autos and auto parts were at the top of their "endangered jobs" lists. Mexico, they said, had high-quality workers earning low wages in auto assembly plants, and the U.S. simply would not be able to compete.

But in the three years after NAFTA was implemented, employment in the American automotive industry grew by 14.1 percent, worker hourly earnings grew by 5.6 percent, and Ford, Chrysler, and GM invested $39.1 billion in new manufacturing plants and equipment in the U.S.—and only $3 billion in Mexico. What seems to have happened is that the North American auto industry reacted to NAFTA by rationalizing itself—moving those parts of it that could be effectively performed by relatively low-skill workers to Mexico, and thus gaining a cost advantage vis-à-vis European and Japanese producers.

As trade economists Mary E. Burfisher, Sherman Robinson, and Karen Thierfelder wrote in 2001 in the *Journal of Economic Perspectives*, there was "a dramatic increase in [North American] intra-industry trade in autos and parts.... [Economic] efficiency gains from finer specialization ... do not appear to be 'Ricardian,' in that they are not primarily based on ... [exploiting low wages] but 'Smithian' in the sense that NAFTA widened the extent of the market and permitted increasing returns to finer specialization. Most fears about the ill effects of NAFTA on the U.S. auto industry, whether in term of employment, wages, or investment, have been proven wrong."[11]

The 1990s saw the world move from an international trade regime of "Heckscher-Ohlin-Vanek" trade in which countries exported goods in which their factors of production and level of technology gave them a comparative advantage to a regime of "value chain" trade in which wealth and growth went to those businesses, regions, and countries that could best take advantage of the ability to place each part of a long production process in a location where the configuration of prices and exchange rates allowed it to be done more effectively. NAFTA was a material aid to that for the United States: Mexico, and close economic integration with Mexico, turned out to be an important resource and benefit for American producers over the past quarter century. And it is highly likely to be so for the next quarter century—unless NAFTA is abrogated, and a trade war with our neighbor to the south begins.

We anticipated back in the early 1990s that NAFTA would be a material benefit for Mexico and an effective zero for the United States. NAFTA, as it worked

[11] I cannot cite this article as evidence independent of my viewpoint—for I commissioned and edited it—but I do strongly believe that it is correct.

out, turned out to be a small net minus for Mexico, and a not overwhelmingly large but still a welcome net plus for the United States. I am trying to do better with my forecasts today than I did with those I made back then, a quarter century ago.

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