WILL RENEGOTIATING NAFTA MAKE CHINA GREAT AGAIN?

By Alan Spearot

Abstract: *Reverting to a pre-NAFTA policy environment may leave Mexico, the U.S., and Canada worse off than before NAFTA was signed, as firms exporting from a post-WTO China may more readily replace decreased trade within the NAFTA zone. Alternatively, deepening integration among NAFTA countries would skew the competitive advantage toward North American businesses, increasing trade within the region while crowding out trade from China and other outsiders. Meeting the challenge of making trade work for all communities will likely be more difficult if we adopt policies that ultimately improve the market position of the region's largest competitor, rather than increasing the efficiency of the North American market.*

A critical aspect of all strategic interactions is the response of outsiders. In trade policy, this is certainly the case for any regional trade agreement. Upon implementation, the economic benefits accruing to its members can either be amplified or mitigated depending on the response of countries outside the agreement. In the case of NAFTA, there is an obvious outsider that complicates any efforts to renegotiate the agreement: China.

Indeed, it is difficult to even refer to China as an "outsider" to the NAFTA zone, since in many ways it is the ultimate insider. Billions of dollars of trade and investment flow into and out of China every year, and our economies, in practical terms, are permanently linked through common firms, supply chains, and dependence on resources. Trade from China has always been a natural competitor to trade within the NAFTA region, and over time, has had a profound effect on the efficacy of NAFTA itself.[34]

NAFTA initially increased the share of imports that were sourced within the NAFTA zone between the years 1994 and 2001. But this market share began to decline after 2001, which was around the time China became a permanent member of the WTO.[35] After this point, the dependence of the NAFTA zone on itself slowly reverted toward its pre-NAFTA averages. Indeed, at present, *the*

[34] For example, Feenstra and Kee (2007) show that increased variety of goods from China reduced the variety of goods imported from Mexico.

[35] WTO membership gave China continued MFN access to the U.S. market, which prior to accession required yearly congressional approval. For an analysis of removing this uncertainty, see Handley and Limao (2017).

NAFTA zone appears to be only modestly more dependent on itself than it was before the agreement was signed.[36]

With China such an important exporter to the NAFTA zone, what should we expect to happen if the U.S. backs out of NAFTA? Implicit in this thought experiment is that NAFTA countries will implement most-favored nation tariffs and other policy barriers that limit trade between the U.S. and Mexico (and perhaps also the U.S. and Canada if the Canada-United States Free Trade Agreement is also terminated).[37] Ultimately, the direct effect of these barriers will be to make the NAFTA market less competitive, especially the U.S. In this new equilibrium, one usually expects higher domestic prices, which consumers dislike, as do firms that use goods as inputs to production. However, tariff revenues will rise and other domestic firms will enjoy the less competitive environment. Raising tariffs, the argument goes, protects domestic industries and workers by reducing foreign competition.

However, with a large exporter such as China, these domestic gains will be attenuated, perhaps very strongly, by Chinese sales to each NAFTA market. Absent additional barriers imposed on imports from China, firms exporting from China will recognize that they can substitute for the decreased exports within the NAFTA zone.[38] This effect is particularly important since we have integrated further with China since NAFTA was signed. Thus, in the presence of a trading outsider such as China that has grown considerably over the last few decades, terminating NAFTA may actually leave countries *worse off* than before NAFTA was signed in the first place. Simply put, we would be reverting to a pre-NAFTA *policy environment*, but in an *economic environment* with a far more formidable global competitor.

As an alternative, consider a scenario in which NAFTA countries attempt to deepen the agreement, with the ultimate goal of making the NAFTA zone more efficient. This could be accomplished by policies that increase common governance, offer enhanced flexibility in labor markets, and generally limit non-tariff barriers to commerce within the NAFTA zone. However unlikely these types of improvements might seem, especially in today's political

[36] Before NAFTA, approximately 25% of imports (excluding raw materials) to NAFTA countries came from other NAFTA countries. This share reached a peak in 2001 at 40%, but fell to approximately 30% by 2016.
[37] Some officials indicate that Canada and Mexico intend to implement NAFTA between themselves even if the U.S. leaves. See "Mexico, Canada to stay in NAFTA even if U.S. leaves: minister," Reuters, August 31, 2017.
[38] Importantly, increased barriers on China would likely run afoul of WTO trade rules, since U.S. tariffs are mostly set at their negotiated bindings.

climate, the stated negotiating objectives of the U.S. trade representative do actually include some sensible ideas for enhanced trade facilitation within NAFTA.[39]

One effect of such policies would be to lower prices and perhaps increase consumer choice, both excellent outcomes for consumers, especially the poor. However, a deepened agreement would also provide a meaningful buttress against increased import competition from China. Deepening integration within the NAFTA zone would skew the competitive advantage toward businesses that operate within the NAFTA zone, increasing trade within the region while crowding out trade from outsiders, China in particular.

Of course, nothing of this speaks to the effects of NAFTA on its individual constituents. Indeed, much of the motivation behind the popular and academic discussions of trade lies in trade's effects on workers and local communities.[40] With a focus squarely on international negotiations, even the best trade deals rarely address the domestic policies that are required to make trade work for all communities. Workers must transition to new industries and locations, and government can play a role in this transition. Critically for any renegotiation of NAFTA, this transition of workers is likely to be more difficult if we adopt policies that ultimately improve the market position of the region's largest competitor, rather than increasing the efficiency of the North American market.

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[39] See the section on "Customs Trade Facilitation, and Rules of Origin" on pages 5 and 6 in "Summary of Objectives for the NAFTA Renegotiation," Executive Office of the President.

[40] The impact of trade shocks varies considerably across localities, depending on their dominant industries, and has been used to evaluate the impact of trade on jobs (Autor, Dorn and Hanson, 2013).

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