The Uncomfortable Truth about NAFTA: It's Foreign Policy, Stupid
Author(s): Paul Krugman
Source: *Foreign Affairs*, Vol. 72, No. 5 (Nov. - Dec., 1993), pp. 13-19
Published by: Council on Foreign Relations
Stable URL: http://www.jstor.org/stable/20045808

The Uncomfortable Truth about NAFTA

It's Foreign Policy, Stupid

Paul Krugman

The debate over the proposed North American Free Trade Agreement has taken on an astonishing salience in American politics. Not since the Smoot-Hawley tariff has trade legislation produced such a bitter polarization of opinion.

The intensity of this debate cannot be understood in terms of the real content or likely consequences of the agreement, nor is the debate's outcome likely to turn on any serious examination of the evidence. It is as hopeless to try to argue with many of NAFTA's opponents as it would have been to try to convince William Jennings Bryan's followers that free silver was not the answer to farmers' problems.

Indeed, the parallel is quite close. The populism of the 1890s represented a desperate attempt to defend agricultural America against deep economic forces that were changing it into an industrial nation. The choice of a monetary standard had very little to do with the real problems of the farm sector; a burst of inflation might have given some highly indebted farmers a brief respite, but it would have done nothing to reverse or even materially slow the industrializing trend.

Nonetheless, the opposition between free silver and the gold standard was an easily understood symbol—"you shall not crucify this country on a cross of gold" was the nineteenth-century equivalent of a sound bite. And so the almost irrelevant demand for free silver became the core of the populist agenda.

Similarly, the hard-core opposition to NAFTA is rooted in a modern populism

PAUL KRUGMAN is Professor of Economics at the Massachusetts Institute of Technology.

that desperately wants to defend industrial America against the forces that are transforming us into a service economy. International trade in general, and trade with Mexico in particular, have very little to do with those forces; clinging to the four percent average tariff the United States currently levies on imports of manufactures from Mexico might save a few low-wage industrial jobs for a little while, but it would do almost nothing to stop or even slow the long-run trends that are the real concern of NAFTA's opponents.

It is an unfortunate fact of politics, however, that bad arguments tend to drive out good. With NAFTA's opponents resorting to simplistic but politically effective rhetoric, the agreement's supporters have responded in kind if not in degree. In the glowing picture now presented by NAFTA advocates inside and outside the administration, the agreement will create hundreds of thousands of high-paying jobs, do wonders for U.S. competitiveness, and assure the prosperity of North America as a whole. This picture is not as grossly false as that painted by NAFTA's opponents, but it does considerably glamorize the reality.

The truth about NAFTA may be summarized in five propositions:

- NAFTA will have no effect on the number of jobs in the United States;
- NAFTA will not hurt and may help the environment;
- NAFTA will, however, produce only a small gain in overall U.S. real income;
- NAFTA will also probably lead to a slight fall in the real wages of unskilled U.S. workers;
- For the United States, NAFTA is essentially a foreign-policy rather than an economic issue.

NAFTA AND JOBS

There has been an extensive debate over the prospective job impacts of NAFTA. Some opponents claim that the inflow of imports from, and the outflow of capital to, Mexico will eliminate hundreds of thousands of American jobs. Many supporters, on the other hand, claim that a booming post-NAFTA Mexico will provide a market for sharply increased U.S. exports, adding hundreds of thousands of jobs.[1]

Neither claim is right, nor does the truth lie somewhere in between. Rather, the whole idea of counting jobs gained and lost through trade represents a misunderstanding of the way the U.S. economy works. In particular, it overlooks the fact that other economic policies, especially monetary policy, will almost surely neutralize any potential impact of NAFTA on jobs.

This point seems to be extraordinarily hard to convey to even the sophisticated public. Everyone who thinks about it realizes that the economy is a complex system in which everything affects everything else. Yet people quickly become impatient with the suggestion that one can't understand the likely effects of a change in trade policy without taking into account the probable response of monetary policy-

[1] A good summary of the arguments and counterarguments is provided in Gary Hufbauer and Jeffrey Schott, *NAFTA: An Assessment*, Washington, D.C.: Institute for International Economics, 1993.

makers. Unfortunately, you can't.

Think of the U.S. economy over the next decade as an automobile driving from Boston to New York. Let the average speed of that automobile over the route represent the average level of employment over that decade. And let the dispute over the direct employment effects of NAFTA be represented as an argument over whether there will be a head wind or a tail wind as the car makes its way along the interstate. Then assessing NAFTA's overall job impact is like predicting how the extra wind will affect the car's speed. Job-counting exercises do this by assuming that nothing else changes—in effect, they assume that the engine in our car will receive exactly the same flow of gas that it would have been given in the absence of any wind.

Nobody would think that this was a sensible procedure for predicting automobile speed. After all, cars have drivers, and drivers are not passive—they adjust the flow of gas to achieve a desired speed. I tend to drive interstates at about 63 miles per hour—above the speed limit because I'm always in a hurry, not too far above because I would prefer that the police chase someone else. A five-mile-per-hour head wind or tail wind will not change that average speed; I will simply offset the wind by changing the pressure on my gas pedal.

The U.S. economy also has a driver: the Federal Reserve. Every six weeks or so the Federal Reserve's Open Market Committee meets to decide on a target range for U.S. interest rates. That choice has a far more powerful impact on the unemployment rate than any trade policy. Moreover, it is a choice that responds to economic conditions; the decision to raise or lower interest rates represents a trade-off between the Fed's desire to raise employment (drive somewhere) and its fear of inflation (a speeding ticket). The Fed often miscalculates and ends up with more inflation or less employment than it wanted, but right or wrong the Fed's actions are the most powerful determinants of job growth in America.

Suppose that NAFTA really does lead to a rise in U.S. imports from Mexico, one that would, other things being the same, reduce U.S. employment by 500,000 over the next ten years. Will other things actually be the same? Of course not. The Fed, faced with the prospect of a weaker economy, will set interest rates lower than it otherwise would have. Conversely, other things being equal, if NAFTA would add half a million jobs, interest rates would be higher. The Fed will, without doubt, miss the target—but it is as likely to overshoot as to undershoot, and over the course of a decade there is no reason to suppose that the average level of employment will be any different with NAFTA than without.

This conclusion does not depend on the details of the agreement. If you told me that the direct impact of NAFTA would be a cost to the U.S. economy of five million jobs, perhaps I might worry about whether the Fed would actually have the power to offset this blow, just as I might have trouble driving against gale-force winds. In fact, however, even harsh critics of NAFTA rarely estimate job losses of more than 500,000—less than half of one percent of U.S. employment. The reason the estimates are uniformly small is that anyone who looks at the numbers immediately realizes that U.S. trade barriers against Mexico are already quite low—a four percent tariff on manufactures, higher tariffs on some agricultural products, and a scattering of quantitative restrictions. If Mexico's low wages were the kind of overwhelming attraction to U.S. industry that would generate Ross Perot's "giant sucking sound," those firms would have moved already.

A job loss (or gain) on the order of half of a percent is, however, small change compared with the effects of Federal Reserve policy. Such a change can and will be offset with a change in interest rates of a fraction of a percentage point.

NAFTA AND THE ENVIRONMENT

Aside from job fears, the most effective argument against NAFTA has been the claim that the agreement will hurt the environment because industry will move south to take advantage of lax Mexican environmental laws and, especially, enforcement of those laws. And there is no question that a Mexican factory typically does more damage to the environment than its U.S. counterpart.

But that is the wrong comparison. Since NAFTA will not lead to a shift of jobs from the United States to Mexico (or vice versa), the relevant question is not whether the Mexican factories that will emerge under NAFTA will be less friendly to the environment than equivalent U.S. plants, but whether they will do more damage than the factories in which Mexican workers would otherwise have been employed.

This is not a question with an obvious answer, but there are at least two reasons to think that on balance NAFTA will be good for Mexico's environment.

One reason is simply that the United States has made the environment an issue, and as a result Mexico will enforce its environmental laws more strictly than it otherwise would have. Despite this fact, Mexican factories will still look pretty bad compared with those in the United States, but that is irrelevant. The point is that they will be cleaner than they would otherwise have been.

A more surprising environmental benefit of NAFTA will be the relocation of Mexican industry. Before 1980 Mexican industrialization, focused on its own domestic market, was largely concentrated in and around Mexico City. Anyone who has been there knows why that presents an environmental problem of literally breathtaking proportions. By contrast, the new export-oriented factories built since Mexico began to follow its new, export-oriented policies are mostly in the north of the country. They may not be models of green production, but at least they are not in the middle of an enclosed valley, a mile above sea level, with 20 million residents.

THE GAINS FROM NAFTA

NAFTA will neither create nor destroy jobs, but it will make the existing North American labor force slightly more productive. No serious study—defined as a study by someone whose mind could conceivably have been changed by the evidence—has failed to find that NAFTA will produce a small net gain for the United States. This benefit will come from the usual sources of gains from international trade. First, each country will tend to increase its output in industries in which it is relatively productive, raising the efficiency of the North American economy as a whole. Second, larger markets will allow for better exploitation of economies of scale. Finally, the larger market will lead to greater competition, reducing the inefficiency associated with monopoly power.

The operative word, however, is "small." Few studies indicate that NAFTA could add much more than 0.1 percent to U.S. real income.

Why are the gains so small? First, the United States and Mexico have already moved most of the way to free trade in advance of NAFTA; the agreement does not do all that much more to integrate markets. Second, Mexico's economy is so small—its GDP is less than four percent that of the United States—that for the foreseeable future it will be neither a major supplier nor a major market.

The gains to Mexico from NAFTA are, not surprisingly, much larger as a percentage of that country's national income, if only because the Mexican economy is so much smaller to start with. One recent estimate is representative: it finds that the dollar value of gains from NAFTA will be roughly equally divided between the United States and Mexico (about $6 billion each annually). But this represents a gain of only a little more than 0.1 percent of U.S. GDP, compared with more than 4 percent for Mexico.[2]

NAFTA AND LOW-WAGE U.S. WORKERS

When a country with a highly skilled labor force increases its trade with a country in which skill is at a greater premium, it can expect a decline in the real wages of its own unskilled workers. As a matter of economic principles, we should expect to see at least some adverse impact of NAFTA on the wages of American manual workers.

All the evidence suggests, however, that this effect will be extremely small. For one thing, since the existing barriers to trade between the United States and Mexico are already quite low, it is hard to see how removing them could have any dramatic effect on wage rates.

Moreover, while economic theory suggests that trade between the United States and Mexico should involve an exchange of skill-intensive for labor-intensive products, such a bias in trade against low-wage U.S. workers is surprisingly elusive in the actual trade data. Most notably, the widely cited study of NAFTA by Gary Hufbauer and Jeffrey Schott finds that U.S. industries that compete with imports from Mexico pay almost exactly the same average wage as industries that export to Mexico.

It's worth pointing out that this lack of evidence that trade really does worsen American income distribution is not unique to the Mexican case. Two economists who expected to find a significant effect of trade on wages have concluded that virtually none of the growth in wage inequality in the United States since 1979 is due to international factors. A survey by Lawrence Katz reaches the

[2] Drusilla K. Brown, Alan V. Deardorff, and Robert M. Stern, "A North American Free Trade Agreement: Analytical Issues and a Computational Assessment," *The World Economy*, January 1992, pp. 15-29.

same conclusion.[3]

As a matter of theory, then, we must concede that NAFTA should be expected to hurt low-skill U.S. workers. In practice, there is no evidence supporting this belief, and the best guess has to be that any such effect will be extremely small.

NAFTA AS FOREIGN POLICY

While NAFTA's labor and environmental costs will be minimal, the U.S. public believes otherwise. At the same time, NAFTA's economic benefit to the United States, while real, will be small. One might then ask: Why should the Clinton administration expend a great deal of its depleted political capital in pursuit of an unpopular and economically trivial agreement? The answer is that Mexico's government needs NAFTA, and the United States has a strong interest in helping that government.

Carlos Salinas de Gortari's government is not a model of democratic virtue. From the U.S. point of view, however, it is the best Mexican government in either nation's history. Salinas' market-oriented reformers have done their best to break with a long tradition of anti-American rhetoric. While Mexico has not yet had a truly free presidential election, the trend is clearly toward greater openness and democracy. Not that long ago U.S. intelligence analysts worried that a Mexico hammered by the debt crisis and plunging oil prices might become a radicalized national security nightmare. The friendly neighbor it has instead become is like a State Department dream come true.

But the long-run success of Mexican reform is not guaranteed. Salinas has overseen a radical liberalization of the Mexican economy, above all in international trade. The maximum tariff rate has fallen from 100 percent to 20 percent; the fraction of imports that requires permits has fallen from 93 percent to less than one quarter. These reforms have succeeded in restoring Mexico to the favor of international investors, who have poured huge sums into the Mexican economy since 1990. But the reform has not yet delivered convincing results where it counts: improved living standards among ordinary Mexicans. After eight years of stagnation, in 1990 the Mexican economy began to grow again. The growth, however, has barely kept pace with labor-force expansion. Unemployment remains far higher and real wages far lower than in 1980.

Most economists believe that Mexico's reforms will eventually bear more abundant fruit. In the meantime, however, there is always the risk that either the Mexican populace or the foreign investors who have been supporting the revival of growth will lose faith and patience in the path of reform.

Salinas' decision to seek free trade with the United States should be seen in this context. For his government, NAFTA is a sort of pledge—a pledge to foreign investors that Mexican reform will continue (and that the U.S. market will

[3] Robert Z. Lawrence and Matthew Slaughter, "Trade and Wages: Giant Sucking Sound or Small Hiccup?" *Brookings Papers on Economic Activity: Microeconomics 1993*, forthcoming; and Lawrence Katz, "Understanding Recent Changes in the Wage Structure," *NBER Reporter*, Winter 1992/93.

remain open to goods produced in Mexico). It is also a pledge to the Mexican population that better times are coming.

With the benefit of hindsight, we can see that it might have been better if Salinas had not proposed NAFTA. Perhaps Mexico could have continued down the unilateral path of trade liberalization it has followed since the mid-1980s. This policy would have taken advantage of a U.S. market that was already quite open to Mexican exports of manufactures without stirring up the passions that a formal proposal for free trade has aroused. But it is too late now to reverse course. A rejection of NAFTA by the United States now that the agreement has been negotiated would be a devastating slap in the face to Mexico's reformers.

Nobody can be sure what will happen if NAFTA fails. Perhaps Mexican reform will continue, sadder but wiser. But the most likely forecast is far grimmer: financial crisis for Mexico as investors realize that the success of reform is not guaranteed, political crisis as Mexican populists like Cuauhtémoc Cárdenas Solórzano—who may well have really won the last Presidential election—taunt the leadership with the way America rewards its friends.

If the United States rejects NAFTA, it will virtually be asking for a return to the bad old days of U.S.-Mexican relations. For the United States, this agreement is not about jobs. It is not even about economic efficiency and growth. It is about doing what we can to help a friendly government succeed. It will be a monument to our foolishness if our almost wholly irrational fears about NAFTA end up producing an alienated or even hostile nation on our southern border.