# SIX

# Regional Integration

In response to the dilemmas of trade, most nations have fashioned some amalgam of mercantilist and liberal policies, seeking to capture the benefits of each approach without surrendering to the liabilities of either. One increasingly popular strategy is **regional integration**, which creates free trade within a group of nations but practices mercantilism toward nations outside that group.[1]

In this chapter I examine two variants of regional integration at very different stages of evolution: the European Union (EU) and the North American Free Trade Agreement (NAFTA). The NAFTA and the EU appear to foreshadow a global political economy of regional trading blocs which could signal an end to the open structure that has defined international economic affairs since the end of World War II.[2]

## The evolution of the European Union

The European Union was created in 1993 as the most recent of a progression of institutions that embody a vision of regional integration laid out in a 1946 speech by Winston Churchill: “I see no reason why, under the leadership of the world organization, there should not ultimately arise the United States of Europe, both those of the East and those of the West, which will unify this Continent in a manner never known since the fall of the Roman Empire, and within which all its peoples may dwell together in prosperity, in justice, and in peace.”[3]

For nearly fifty years this image has guided a regional integration effort that has widened from six to fifteen nations and deepened from a narrow technical focus to an ambitious social, political, and economic agenda. The Treaty of Paris, signed in 1951 by France, Germany, Italy, Belgium, the Netherlands, and Luxembourg, founded the European Coal and Steel Community (ECSC).[4] The treaty not only pooled and centralized the production of coal and steel, it also introduced the High Authority, the Council of Ministers, the Court of Justice, and the Parliamentary Assembly, all of which remain part of the institutional framework of the much broader EU [that] has subsequently evolved.

The Treaty of Rome, signed in 1957 by the same six nations, established the European Atomic Energy Community (EURATOM), and the European Economic Community (EEC), which greatly expanded the scope of the ECSC treaty by calling for the dissolution of barriers dividing Europe, the improvement and equalization of living and working standards, the abolition of restrictions on international trade, the removal of obstacles to concerted action among governments, and the enhancement of peace and liberty through closer relations among states. In 1967, the executives of these three European communities were merged. The Single European Act, which went into effect in 1987, was designed to create by 1992 the “single European market” that had been envisioned in the Treaty of Rome but had not been realized, “an area without internal frontiers in which the free movement of goods, persons, services and capitals is ensured”. In 1993 the Treaty on European Union, signed at Maastricht the previous year, entered into force, renaming the expanding web of institutions the European Union.[5] This institutional structure is increasingly state-like with legislative, executive, and judicial branches (Parliament, Commission, Council of Ministers, and Court of Justice); economic institutions (Investment Bank, Central Bank, and Court of Auditors); and a variety of institutions that provide representation for the interests of various groups (Economic and Social Committee, Environmental Agency, Committee on Regions, Ombudsman, and many others). Meanwhile, Britain, Ireland, and Denmark had become members

in 1973; Greece in 1981; Portugal and Spain in 1986; and Austria, Finland, and Sweden in 1995. As of 1999, eleven additional countries have applied for EU membership and several others have reached trade agreements with the EU which give them some of the advantages of membership.

Despite this growth, the future of the EU itself remains somewhat uncertain, because considerable opposition has arisen in many member countries as integration has deepened. A long-standing objection of critics is that European integration implies a substantial abdication of national sovereignty because it requires that national law be brought into accordance with EU law and because regional institutions are slowly eclipsing national ones as governing bodies. In fact, the Treaty on European Union was initially rejected by a national referendum in one member country and survived very close votes in several others. Its most controversial elements were the call for a common defense policy and, especially, a monetary union with a single currency that would replace national ones.

It has long been apparent that the continuing liberalization of trade in Europe required a considerably more stable monetary arrangement than the system of freely floating exchange rate that had existed among all developed countries since the demise of the fixed exchange rate system of Bretton Woods in the early 1970s. The most recent attempt at stabilization, the introduction of the currency called the euro, is discussed in greater detail later on. It illustrates that the dilemmas involved in trade, especially those concerning national sovereignty, carry over into the monetary arrangements required to facilitate it. Because of this concern over national sovereignty, not all the EU nations have joined the euro arrangement. Furthermore, because EU members fear that such intensive ties to nations with weaker economies would introduce too much instability, they established criteria for participation in the euro that many of the nations seeking EU membership would not meet. Regional integration is a strategy that attempts to maximize the benefits and minimize the costs of trade by very carefully selecting partners in trade and in the institutions that must accompany it.

### Integration: liberal on the inside and mercantilist on the outside

Regional integration is best thought of as trade policy that is liberal on the inside and mercantilist on the outside. Within the community, free trade is encouraged by the elimination of trade barriers and the harmonization of economic policies. Trade barriers remain against the outside world, however, and the community achieves mercantilist goals of self-sufficiency and enhanced power that would be impossible for the constituent nations individually.[ Even the largest EU member, Germany, has a GDP barely a quarter of that of the United States, but the economy of the EU as a whole is slightly larger than the U.S.[6]]

Though liberals argue that both peace and prosperity could be achieved more fully through *global* free trade, regional integration may deal more effectively with trade dilemmas. First, regionalism [dampens, though it does not eliminate,] mercantilist worries about sacrificing national self-sufficiency[ and autonomy]. Regional interdependence is less risky than surrendering control of the economy to the vicissitudes of global markets and the economic policies of 150 other nations, especially because regional nations are likely to share basic values and economic structures. Second, regional integration creates a level of governance above the nation that can soften the dislocations and resolve the disputes that inevitably arise from trade.

It is not wholly clear whether regional strategies like NAFTA and the EU are ultimately compatible with the ideal of global liberalism. The bicycle theory of trade policy argues that the two approaches are mutually supporting because as long as free trade moves forward it stays upright, but it inevitably falls if it slows down or stops. Any movement toward free trade (even if regional) keeps the forward momentum going, thus resisting the natural drift toward protectionism that occurs whenever trade policy becomes strictly a national matter.

However, even though free trade areas are GATT-legal under Article 24, they contravene the liberal spirit of the nondiscrimination principle embodied in the most favored nation clause.[7] In

fact, the term "most favored nation" has become a misnomer: The EU, for example, applies the MFN rate to only seven nations—the United States, Japan, Canada, Australia, New Zealand, South Africa, and Taiwan. Nearly all others are charged a *more* favorable rate. Free trade or preferential tariff rates apply not only to the fifteen EU members but to most other European nations (partners in the European Economic Area), twelve Mediterranean nations (EU associates), sixty-nine African, Caribbean, and Pacific countries (under terms of the Lomé convention), and all other developing countries (under the Generalized System of Preferences). As these arrangements multiply, the liberal foundations of the global order suffer severe erosion. A WTO study determined that by the mid-1990s 42% of all global trade flows were conducted under preferential agreements, but other studies have placed the figure as high as 53%. Nearly 75% of trade involving the EU is conducted under preferential arrangements, in contrast to about 28% in North America and 4% in Asia. In 1995 68% of the manufactured imports of EU nations came from other EU members and 59% of foreign direct investment was intra-EU. Thus, while the EU remains publically committed to multilateral liberalism, its interactions have drifted into a pattern of discrimination more often associated with mercantilism.

The mix of liberal and mercantilist motivations for regional integration is most easily illustrated in connection with customs-union theory, which adapts Ricardian ideas concerning global free trade to the special case of regional trade preferences. Canadian economist Jacob Viner's classic 1950 book *The Customs Union Issue* identifies two effects of initiating free trade among members of a regional organization while continuing protection against the outside world.

Trade creation occurs when a customs union allows goods once produced domestically to be imported from a more efficient producer in a member country. The result is the familiar Ricardian gains from trade, in which both countries are better off and the rest of the world is not adversely affected. However, a second pattern, which Viner calls trade diversion, may arise if the establishment of a customs union shifts production from an efficient outside producer to a less efficient inside one. For example, suppose that Germany initially imports a good from its most efficient global producer, a firm in the United States. After the creation of a customs union between France and Germany, Germany would impose a higher tariff on the American product than on the comparable French one. As a result, French imports could replace American imports. This trade diversion modifies the positive liberal assessment of a customs union because it shifts production from a more efficient to a less efficient producer. Whereas trade creation benefits member states without affecting others, the benefits of trade diversion come to member nations at the expense of outside nations.

## THE MERCANTILIST ROOTS OF THE EU

The presence of trade diversion makes it clear why outside nations typically see the mercantilist face of regional integration rather than its liberal face, which is turned inward. From their standpoint, regionalism not only furthers the classical mercantilist goal of protecting domestic industry, it does so through a classical mercantilist melding of foreign policy concerns with economic aims. Rather than erect trade barriers against all foreign competitors equally, the EU discriminates against nations outside the region, often because they are seen as a threat.

Indeed, from its beginnings, European unification has accelerated whenever threats from outside have been perceived. The early EC was designed to protect Europe against the Soviet military threat posed by a large army and aggressive doctrine as well as the American economic threat posed by large productive capacity and expansionist marketing plans. The Single Market initiative culminating in 1992—Carlo DiBenedetti called it "a deadline not to be dead"—was energized by the economic threat of rapidly growing productivity in Asia and the resulting "Euro-pessimism." Again we see that nations turn in a mercantilist direction when their industries fear more competitive firms abroad and when their states fear the rising power of rivals. The EU's goals are no different than those of Queen Elizabeth's sixteenth-century industrial development or Japan's

postwar export promotion: its uniqueness lies in the regional emphasis of its mercantilism, which can be seen most clearly by contrasting liberal and mercantilist viewpoints on trade diversion.

Whereas liberal theory disapproves of trade diversion because it compromises efficiency, mercantilism finds it perfectly acceptable if it helps to achieve other national goals. Since many values and goals conflict with efficiency, nations may prefer to trade with one country rather than another for several reasons. First, a nation may divert trade in order to benefit an economy whose resulting prosperity produces greater side benefits for it. For example, for reasons of physical proximity and economic integration, Germany is much more likely to gain from the prosperity of France than it is from the prosperity of a nation—for example, Japan or the United States—that is thousands of miles away. Second, trade diversion under regional integration is reciprocated: Germany diverts its trade toward France, and in exchange, France diverts its trade toward Germany. Third, most European nations are more comfortable with depending upon other Europeans than upon Japan or even the United States. Not only do they share more security concerns with their European neighbors but they also have more common views on issues that always arise in trade matters (e.g., dilemmas involving job security, welfare arrangements, and environmental protection). Furthermore, they can create regional institutions such as those of the EU to cope with whatever conflict may stem from differences in how they respond to trade dilemmas.

## The liberal roots of the EU

Despite these undeniable mercantilist motivations, the EU is also deeply rooted in liberal ideas, especially the gains from trade promised by Ricardian theory. For example, the Cecchini report (1988) was instrumental in gathering support for the Single Market initiative by estimating trade gains resulting in a 35 percent boost in GDP. However, gains from specialization and enhanced competition are not the only benefits of the EU seen by liberal theorists.

Economies of scale, which have always been a strong motivation for the smaller countries of Europe, were especially visible in the ECSC. Because steelmaking requires large-scale plants and equipment that are efficient only when producing large volumes of output, a steel industry could never emerge in a small country unless a firm could be guaranteed access to the larger European market. The ECSC provided that guarantee in the form of the pledges by European governments not to interfere with free trade in these goods. The result was a key industry with production facilities scattered among different countries, each dependent on other nations to provide both demand for the final product and part of the supply capacity. A side benefit of this arrangement was the fulfillment of the liberal dream of an interdependence that would prevent war by making it suicidal.

In fact, the EU's economic institutions were constructed for a political purpose. The mission of European integration, as stated in the preamble to the ECSC treaty, is to "substitute for age-old rivalries the merger of their essential interests; to create, by establishing an economic community, the basis for a broader and deeper community among peoples long divided by bloody conflicts; and to lay the foundations for institutions which will give direction to a destiny henceforward shared." Thus, the ECSC was an innovative form of peace treaty, designed, in the words of Robert Schuman, to "make it plain that any war between France and Germany becomes, not merely unthinkable, but materially impossible." In the aftermath of two devastating wars in the previous thirty years—which more conventional tools of international politics such as the European balance of power, the League of Nations, and international law could not prevent—European nations were willing to tolerate the erosion of national autonomy and self-sufficiency implied by interdependence in order to weaken the nationalism that had provoked so much violence.

## The Political roots of the EU

Throughout its history, European integration has been seen as a means of escaping the liberal and mercantilist horns of trade dilemmas by providing a regional level of governance to deal with common problems that no single nation could solve. For example, the Common Agricultural Policy (CAP), born in 1962, embraced a concern with the distributional dilemma of trade that would have been at home in parliamentary debates of the eighteenth century: Its goals included "the assurance that those working in agriculture will enjoy a standard of living comparable to that enjoyed by workers in other sectors." Because it was evident as early as 1951 that this motivation implied an ambitious institutional design, the Treaty of Paris went well beyond limited economic objectives to create the executive and legislative institutions that remain at the heart of the contemporary EU. Later, the Treaty of Rome's social and political provisions—which included the creation of the Economic and Social Committee to provide a strong voice for workers, employers, consumers, and academics—made the EC much more than a mechanism for advancing free trade.

These arrangements were a direct outgrowth of the values and theories that influenced *national* economic policies in Europe, especially where working-class political parties of the left came to power—Labour in Britain, Social Democrats in Germany and Scandinavia, and Socialists in France, Italy, and Spain. Rooted in powerful trade union movements, those parties embraced values of egalitarianism that emphasized the welfare and security of workers and shared the conviction that it was safer to entrust these goals to the state than to free markets. They erected welfare states to provide institutional protection against the vagaries of markets that were quite distinct from the more laissez-faire arrangements in the United States. For example, vacations, maternity leave, and health insurance, which are all voluntary fringe benefits in the United States, are determined by law in most EU states. Furthermore, because some constitutions list the right to work among human rights, the ability of firms to hire and fire workers is sharply constrained. When European national governments spend an average of 25 percent of GDP on social protection, it is hardly a surprise that an agreement to increase trade would include a provision to compensate those who would lose in the resulting dislocations. Indeed, the Social Fund, created in 1951 to finance worker retraining and relocation necessitated by the ECSC and now charged with aiding trade-damaged geographic regions, has become the second largest expenditure in the EU budget (behind agriculture).

Economists contend that compensating losers—though second best to laissez-faire—is preferable to protecting jobs through trade barriers, which are inefficient because the price increases they induce cut consumption and reward less efficient domestic producers. The second-best alternative is to augment free trade with programs that directly compensate displaced workers, such as unemployment insurance. However, because the taxes to finance such programs may be more visible to voters than trade barriers, protectionism may be politically first best though economically third best, at least where redistributive measures have limited philosophical support, such as in liberal America. The European socialist tradition makes it easier to sustain much more generous welfare provisions, but such policies are not costless. They may be responsible for unemployment levels of over 10 percent throughout Europe in the 1980s and 1990s, which would be completely unacceptable in the United States both because of the hardship on the unemployed and the tax drain of supporting them. By contrast, European polities would not tolerate the American approach, which accepted "high risk and high reward, and left its losers to be pushed far from the economic and social mainstream," resulting in a "frisky, but cruel economy."[8]

However, it is difficult to maintain social protection—which inevitably imposes costs on business—when diminishing trade barriers force firms to compete with those in other countries that do not bear such burdens. For example, French firms demand a level playing field in competing with Spanish firms whenever the French government mandates employee benefits, health and safety rules, or environmental regulations more costly than those in Spain. In fact, free trade tends to harmonize many national policies, making it especially difficult for a nation to sustain different tax policies than its neighbors. Denmark, for example, found it impossible to maintain a value-added tax (VAT, i.e., sales tax) 8 percent higher than neighboring Germany's

because Danish citizens could simply evade the tax by purchasing goods in Germany and bringing them across the border duty free.

Thus, some trade barriers must exist if nations wish to maintain different laws with respect to many aspects of economic, social, and political life. Of course, different nations do choose different policies because they reflect different values and theories, different economic circumstances, and different balances of political power. Different tax policies, for example, reflect fundamentally different philosophies concerning how big the state should be, what functions it ought to perform, and how progressive taxation should be. In most nations, such key issues trigger mighty partisan battles over philosophical principles and the distribution of costs and benefits. In short, trade poses fundamental dilemmas, made more troublesome when nations pressed together by trade ties view such dilemmas differently, as in the case of the United States and Japan. Indeed, regional integration is attractive to many nations precisely because it increases trade with regional neighbors—who are presumably similar in important ways—while retaining insulation from nations who are more distant not only geographically but in policy preferences.

Even in Europe, however, these dilemmas have been recognized but not resolved; instead, the battleground has shifted from national-level to regional-level politics. For example, workers fear that without regional coordination, diminishing trade barriers will tend to harmonize national policies by driving all nations to emulate those with the weakest social protection, an outcome called social dumping. Recognizing that national policies would increasingly converge, leftist parties successfully sought to foster harmonization in which the more laissez-faire countries emulate those with the most elaborate social policies. For example, the goal of the EU's Social Charter in 1989 was to promote "convergence between social protection policies to avoid ... competition between the systems with the attendant risk of decreasing social standards." In particular, the European Parliament recognized "fundamental social rights which should not be jeopardized because of the pressure of competition or the search for increased competitiveness." Of course, such a preference runs directly contrary to the values, theories, and political constituencies of more conservative parties throughout Europe, who prefer more laissez-faire arrangements.

The EU transformed this political contest between parties of the left and right into a controversy over the dilemma concerning effects of trade (and trade organizations) on the state, especially in Britain. In the 1980s, British labor unions recognized that the social legislation they preferred was more likely to be enacted by the EU than by a British government dominated by Conservatives. In effect, they preferred to have labor law written by the French Socialist Jacques Delors, president of the European Commission, rather than by Conservative British prime minister Margaret Thatcher. By allying with the Socialist Parties of Europe, the British Labour Party sought to reverse through EU legislation the conservative revolution that Thatcher had achieved through national legislation. Such calculations lead to controversies over how much national sovereignty must be sacrificed in order to achieve the gains from trade. Thatcher condemned the EU as an attempt "to suppress nationhood and concentrate powers at the centre of a European conglomerate." She is certainly correct in that assessment, but one wonders whether her defense of national sovereignty would be as spirited if the majority of the EU were more inclined to support her brand of conservatism. In any case, citing national sovereignty, Britain opted out of the Social Charter in 1989, the social-policy annex to the Maastricht Treaty in 1992, and participation in the euro in 1998. In 1994, Conservative prime minister John Major blocked the election of the head of the European Commission because the leading candidate favored a larger role for the EU at the expense of the constituent national governments. The link between trade and other values cannot be severed.

Still, despite the loss of sovereignty implicit in economic interdependence, we can now see why regional trade liberalization generates momentum to create even closer forms of integration. In the liberal vision, every increment of liberalization hints at the greater benefits that lie ahead if integration progresses. For example, if free trade permits low-wage labor in Spain to produce

products cheaply for the rest of Europe, free movement in factors of production such as capital would obviously enable Spain's comparative advantage to be exploited even more fully. As each barrier to trade is diminished, remaining ones become more visible and vulnerable to political pressure. In the mercantilist vision, regional integration also tends to generate momentum: Because each step increases interdependence, it is natural that each nation would welcome more intensive integration arrangements that impose greater constraints on the disruptive policies of other governments. As trade increases, the dilemmas it creates become more onerous and demands for institutions capable of dealing with them rise.

Thus, regionalism tends to progress along parallel tracks, one market-based, the other institutional. Even though the deepening of regional integration encourages greater integrative steps, it tends to sharpen political clashes over the form that it should take, especially the role it should play with respect to trade dilemmas. Liberals emphasize the economic dimension of free trade, in part because its tendency to undermine the capacity of national governments to sustain social protection could further the laissez-faire agenda of diminished state activity and an enhanced role for private enterprise. Fearing just such an outcome, others accept free trade only in exchange for the package of protection against the dilemmas of trade embodied in the social dimension. That is, it opts for an activist regional government to replace the increasingly impotent national governments.

However, greater levels of integration in Europe will require the precise resolution of ambiguities that, up until the early 1990s, were responsible for the acceptance of integration by groups with incompatible views. A key issue has been whether the leveling of trade barriers will arise from the opening of the most protectionist nations or the closing of the most liberal ones. The 1992 Single Market initiative was valued by some for its free trade face (Germany, England, Belgium, and Luxembourg); others were attracted by its protectionist face (France, Italy, and Spain).

The assessment by nations outside the EU will also depend heavily on the balance between trade creation and trade diversion. The real danger is that the complicated games among European governments and interest groups will be resolved principally by shifting costs onto foreigners. The ambivalent U.S. attitude toward the EU has always been heavily dependent upon how protectionist it would become. However, the United States originally supported the EC as a means to European recovery at a time when Europe was seen to be more valuable as a political and military ally than it was seen to be dangerous as an economic competitor. The EC also tied West Germany to the West, discouraging a policy of neutrality or alignment with the Soviet Union in pursuit of German reunification. Now, however, the U.S. interest concerns its own exports, since about a quarter of them go to the EU and most of the rest face competition from EU firms. Further, because any preferential tariff area has the potential to become a heavily protectionist trade bloc, the behavior of the EU is continuously monitored by those who see it as the precursor of an international system composed of such regional arrangements.

While the EU does appear to be moving in a liberal direction--its average MFN tariffs on industrial products should fall under 3 per cent by the turn of the century--in some areas of special interest to the U.S. that movement remains slow. Its agricultural tariffs still average over 20% and import protection and the use of contingency measures remain significant in particular industrial sectors such as textiles, automobiles and consumer electronics, where high tariffs co-exist with intense anti-dumping activity that also limits market access. As protection at the border is gradually reduced, internal obstacles to competitiveness and efficient allocation of resources become more apparent. Community subsidy programs remain sizable by international standards and the opening of public procurement, which accounts for 12 per cent of the Union's GDP, has so far had limited effect on external suppliers.

Within Europe, however, the major controversies concern the tensions provoked by the dilemmas of trade, an enlightening example of which is the chaos surrounding the collapse of the European Monetary System (EMS) and the subsequent creation of the euro.

THE DILEMMAS POSED BY EXCHANGE-RATE POLICY

Since the collapse of the European Monetary System's Exchange Rate Mechanism(ERM) in 1992, exchange-rate policy has been at the center of the trade dilemmas concerning national sovereignty that have threatened to derail further integration. As traditional trade barriers have diminished, the trade-dampening effects of a system of multiple currencies have acquired increasing visibility. The most obvious effects are the simple transaction costs associated with currency exchanges: A consumer purchasing goods made in another country must pay the costs of exchanging the currency of his or her country for that of the nation in which the good was produced. Some costs are direct and visible, as when tourists pay a fee to a foreign-exchange broker; others are born by businesses and passed along invisibly to consumers. In the mid-1990s, currency conversion alone cost European business $15 billion per year, and transaction costs associated with currency exchanges have been estimated to waste 2 percent of the value of trade. Firms also had to maintain accounting systems and bank balances in several currency units simultaneously and cope with multiple currencies in legal contracts, taxation, and strategic planning.

Moreover, when currencies are traded freely in foreign exchange markets, natural variations in supply and demand cause their values to fluctuate unpredictably, sometimes in wild swings of sentiment. This uncertainty concerning future currency valuations represented a major risk for businesses trying to operate across the European market. Long-term production and marketing plans were complicated because firms could not predict costs and revenues that were denominated in different currencies. In particular, firms feared that an increase in the value of their nation's currency would leave them suddenly uncompetitive elsewhere. This risk discouraged trade because firms preferred to plan for the relative predictability of their domestic market. Indeed, as tariff rates among European economies declined, this system of floating currencies came to have a greater trade-dampening effect than traditional trade barriers.

Thus, as a logical extension of the desire to increase trade, a single European currency to replace the fifteen national currencies has been a long-term goal of the EU for more than two decades. However, nations have strongly resisted giving up central elements of their national sovereignty: the rights to issue currency, to profit from the creation of a monetary asset, and to manage the economy by controlling the money supply. Any state harboring even a modicum of the mercantilist inclination to influence the economy—and all states do—would find the ceding of monetary policy to a regional authority an uncomfortable prospect. Moreover, a single currency would not be feasible until the various economies converged into a single market with similar levels of growth, inflation, and interest rates.

In the meantime, a less ambitious strategy was followed that preserved national currencies but restrained changes in their relative valuation. Early steps included a short-lived system of fixed exchange rates dubbed "the snake in the tunnel" in the mid-1970s. The European Monetary System (EMS), which launched the European currency unit (ECU) and included the Exchange Rate Mechanism (ERM), began operation in 1979. EU nations that joined the ERM pledged to maintain currency valuations within a mandated range much like a regional version of the fixed exchange-rate system created under Bretton Woods. Whenever the value of their currency drifted beyond its agreed upon bounds, they were obligated to use foreign-exchange reserves to buy or sell currency until supply and demand were once again in balance at the accepted value. When such actions were ineffective, however, governments were further bound to alter domestic interest rates or other macroeconomic policies in order to stabilize the values of their currencies. It was expected that national economic policies and conditions would eventually converge, thus minimizing exchange-rate volatility and the need for governments to take extraordinary action to maintain their treaty obligations. In fact, however, different economic conditions in different countries--especially trade deficits, inflation, and interest rates--inclined foreign exchange markets

to push the value of national currencies in different directions. Furthermore, because the priorities of different governments conflict, they often adopt policies that become incompatible with their obligation to maintain stable exchange rates. Thus, monetary integration poses the dilemmas of national sovereignty and value trade-offs, which is why only seven nations joined the ERM at its inception, while three others joined more than ten years later.

These dilemmas were brought home even more dramatically in fall 1992 when the ERM shattered and the prospects for further European integration consequently dimmed. At the time, Germany was suffering high inflation while struggling to unify formerly communist East Germany with capitalist West Germany. To restrain further price increases, German monetary authorities maintained high interest rates to slow the economy's growth. Meanwhile, both Britain and Italy, which were suffering high unemployment, sought low interest rates in order to accelerate growth. However, this disparity in interest rates induced British and Italian investors to transfer capital into Germany. As they sold investments denominated in the lira and the pound, the decreased demand for those currencies drove down their values while the higher yielding Deutsche mark increased in value.

Under the terms of the ERM, Britain was required to sustain the pound at a value above 2.78 Deutsche marks (DM), and Italy was bound to maintain a value of 1,000 lira at DM1.30. As the German central bank refused to lower its interest rates, both the pound and lira drifted to the bottom of their legal bands and finally sank beneath them. Britain spent more than $15 billion (half its total foreign-exchange reserves) to support the pound, and the Bundesbank spent nearly $50 billion to support the lira; but those sums were not enough. Italy was forced to acknowledge that it could not meet its treaty obligation to maintain the lira's value and withdrew from the ERM. Britain raised interest rates from 10 percent to 15 percent in a last futile attempt to remain in conformity but eventually abandoned the effort and similarly withdrew from the ERM. The pound quickly fell to DM2.53 and the lira to DM1.18 per 1,000. The Spanish peseta was also devalued by 5 percent and the Irish punt and Portuguese escudo soon followed. A few months later, the French franc was supported by over $10 billion of intervention in a single afternoon before the effort was abandoned. The ERM collapsed in a hail of recriminations that undermined faith in the ability of the EU to simultaneously accomplish region wide goals while respecting differences in national-level priorities.

The ERM had succumbed to the same forces that had doomed the fixed exchange rate system of Bretton Woods twenty years before--large capital flows that would destabilize currency values unless counter-acted by policies that were politically unacceptable. It also foreshadowed the Asian financial crisis five years later, which is described in the following chapter. Economists refer to this interaction among interest rates, exchange rates, and capital flows as the Mundell-Fleming constraint: A nation cannot simultaneously maintain unrestrained capital flows, a stable exchange rate, and independent monetary policy. Yet, the EU was committed to the free movement of capital by the Single European Act, the ERM mandated stable exchange rates, and domestic constituencies demanded monetary policies suitable to the unemployment and inflation conditions in their own country. In effect, to maintain the stable exchange rates that sustained free trade required nations to abandon the freedom to choose policies that would satisfy other goals, such as the reunification of Germany or the control of unemployment in Italy. Faced with this clear dilemma of national sovereignty, several governments chose policy independence over the regional arrangement to encourage trade.

In August 1993, the first attempt to rebuild the ERM acknowledged the Mundell-Fleming constraint, but accepted the primacy of national sovereignty. Nations were required to maintain their currencies only within a very wide band of 15 percent on either side of their central target, virtually an unmanaged float in comparison to the previous stringent requirement of 2.25 percent. The benefits of exchange rate stability for expanding trade were thus sacrificed in this interim agreement so that governments could use monetary policy and even currency devaluations to better achieve domestic goals. But the fear of the disruptive impact of exchange rates that were

permitted to move as much as 30% made this only a temporary expedient, chosen over two even less attractive options.

The first, a return to a real fixed exchange rate system, was incompatible with independent monetary policy, even if it could be accomplished in the face of large scale flows of capital. The need for independent monetary policy could be minimized, of course, if economic conditions were similar across all countries. But to more closely align economic conditions implied even greater constraint on the policies that produced them (the budget deficits that produced inflation, for example) and even greater sacrifice of national sovereignty.

The second option, the preliminary plans for which had been underway for some time, was to proceed with full monetary union by adopting a single currency. This too required policy coordination, especially with respect to budget deficits which could now produce inflation community-wide, and sacrificed even more national sovereignty because it eliminated *all* independent monetary policy. However, this single currency option, later to evolve into the euro, not only offered a more permanent solution to exchange rate instability, it also transformed the national sovereignty problem that most irritated the French. France felt that the old ERM had degenerated into a system in which Germany would use its monetary policy to achieve its own goals --such as unification and the control of inflation--while the pressures of that decision would require that all other ERM members use its monetary policy to keep a stable link with the D-mark. Thus, Germany benefitted from a system that was being sustained by the sacrifice of national sovereignty by all the others. If European nations were to sacrifice economic independence, they preferred that it be surrendered to an independent Central Bank rather than to a long-time political, military and economic rival such as Germany.

So was born the European Monetary Institute, established in 1994, to be transformed into the European Central Bank in January 1999. Its mission was to issue a single currency, the euro, and thus to determine monetary policy for the entire region. The Euro was launched as an accounting unit on January 1,1999 with 11 of the 15 EU nations participating (all but Britain, Sweden, Denmark, and Greece). Euro notes and coins are to be issued on January 1, 2002, and all national currencies of the participating countries will cease to be legal tender on July 1, 2002.

Such an unprecedented ceding of autonomy over monetary policy entailed major risks that required careful selection criteria of participating nations and strict limitations on the economic policies that could be enacted by them subsequently. Without monetary policies to insulate the national economies from the conditions prevailing in others, inflation and high interest rates induced by a budget deficit in one country could quickly spread to the others, for example. Thus, the Maastricht agreement established criteria for entry, the most constraining of which were that the budget deficit must be under 3% of GDP, the national debt under 60% of GDP, and inflation under 3.2%. In fact, these criteria were relaxed, with most nations qualifying only after obvious accounting tricks, but the effort to meet them did have a substantial constraining effect on national policies. Even more constraining is the "stability and growth pact" which requires that all participants continue to observe the 3% limit on budget deficits or face substantial fines.

In democracies where tax and expenditure levels are fiercely debated, the imposition of external controls undermines the ability of citizens to determine the most important policies of their governments. Moreover, the treaty explicitly forbids the European Central Bank to "seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body". These arrangements may also unwisely prevent national governments from stimulating the economy during recession, a concern given greater weight by the statutory goal of the ECB. Unlike the Federal Reserve in the United States, the ECB is not required to take employment or output levels into account, but only to maintain price stability, which it has defined as inflation under 2% a year. "In modern times, no major economy has hit such a target consistently over a run of years...In short, a radically undemocratic institution has been charged to achieve, without compromise, an exceptionally demanding goal of virtually zero inflation". And the public support for such a massive transformation in authority remains precarious, with the

percentage of citizens reporting that they feel well informed about the EMU well under 50% in all eleven euro countries and under a third in eight of them.[9]

Clearly, the EU represents an extreme example of one resolution of the dilemma of national sovereignty raised by the desire to achieve the benefits of free trade. Of course, the EU has other goals as well, many of which are not shared by the regional integration schemes that have sprung up all over the world in partial emulation of the EU. We now turn to the case of NAFTA, in which the dilemmas of trade manifest themselves in similar ways, but a very different type of regional trade arrangement has resolved them quite differently.

## The North American Free Trade Agreement

The North American Free Trade Agreement created a preferential tariff area among the United States, Canada, and Mexico beginning on January 1, 1994. However, the drive for regional economic cooperation had begun as early as 1851 with bilateral free trade negotiations between the United States and Canada. A free trade area involving the United States and all of Latin America was advocated by U.S. secretary of state James Blaine in 1881.

The first successful effort, however, was the landmark 1965 agreement that allowed duty-free trade in automobiles and original equipment parts between the United States and Canada. The resulting explosion of trade in the auto sector—from $625 million in 1964 to over $40 billion (about a third of total U.S.-Canadian trade) by 1984—motivated the Canada–United States Trade Agreement (CUSTA), which expanded free trade to most sectors of the economy beginning in 1989. Most of CUSTA's provisions were retained in NAFTA, which took effect in 1994 after ratification processes in all three countries revealed considerable public uneasiness over issues commonly associated with the dilemmas of trade.[10]

Although some of the motivations for CUSTA/NAFTA parallel those of the EU, both their provisions and the institutional structures that support them are vastly different. NAFTA is indisputably an economic agreement, lacking both the broader social and political sweep of the EU—it contains nothing resembling the EU's Social Charter, for example—and its more ambitious long-term goals for common foreign and defense policy. Thus, NAFTA has no parallel to the EU's web of executive, legislative, and judicial institutions, nor to its elaborate mechanisms for citizen representation. More narrowly yet, NAFTA is principally a trade agreement with only limited provisions concerning investment and none addressing the monetary arrangements and economic policy coordination that are such a prominent part of the EU. The core of NAFTA consists of a phased elimination of tariff and most nontariff barriers over ten years with a few sectors having a fifteen-year transition period. The remaining elements of NAFTA qualify this liberalization and provide a sparse institutional structure to implement the agreement and resolve disputes that arise under it.

Predictably, liberals lament that NAFTA does not go further in promoting free economic exchange. NAFTA attacks tariffs, but it does not prevent other barriers to trade such as subsidies and the procurement practices of governments. Some of these barriers pose the now familiar dilemma of competing values: Policies designed for other purposes—even Canada's government-sponsored national health insurance and America's defense-contracting practices—can be seen as trade barriers because they confer a competitive advantage on some firms. Negotiations on such matters were difficult because the structure of protection is so different across these countries, with the United States objecting principally to Canadian subsidies and Canada protesting that the United States used its trade-remedy laws to stifle legitimate competition.

Liberals also complain that NAFTA does not remove the barriers to movements of capital that prevent the most efficient combination of all factors of production. For example, a government review board is still required to approve foreign investment in some sectors of the Canadian economy, and parts of the energy sector remain off limits in both Canada and Mexico. NAFTA also contains no provision to control fluctuating exchange rates, which can distort trade because

an undervalued currency will "tax" imports by making them more expensive (because it makes foreign exchange more expensive) and "subsidize" exports by making them cheaper. During the CUSTA negotiations, the National Association of Manufacturers and the AFL-CIO contended that the undervaluation of the Canadian dollar acted as a protectionist measure, but exchange rates for the Mexican peso, which have fluctuated wildly, are potentially even more unsettling. For example, the value of the peso declined 33 percent in relation to the dollar during one week in December 1994, wreaking havoc in accurately pricing imports and exports. One year after NAFTA came into effect, the peso had declined by 43 percent; at the fifth anniversary, the peso had lost 70% of its pre-NAFTA value.

If NAFTA is flawed from the standpoint of liberals, its limitations are even more alarming to those concerned about the issues that arise from trade dilemmas. Provisions to deal with those concerns, which are prominent in the EU, are largely missing from NAFTA, in part because the motivations for regional integration were somewhat different in these two cases.

### MOTIVATIONS FOR NAFTA

Like the EU, NAFTA is the product of multiple motivations, the importance of which differed across the three countries. Both Canada and Mexico were driven principally by liberal incentives, emphasizing the value of economic growth over equality, security,and sovereignty. However, NAFTA promised efficiency gains associated with Ricardian comparative advantage that amounted to less than 1 percent of GNP for Canada. Relatively few areas of factor endowment–based comparative advantage remained unexploited because the American and Canadian economies were structurally similar and already largely open. For example, nearly 90 percent of U.S.-Canadian trade faced tariffs of less than 5 percent even before CUSTA. The liberalization that produced trade expansion among EU members began from much higher levels of protection.

However, reminiscent of the ECSC's effect on smaller European countries, CUSTA/NAFTA offered Canada gains from economies of scale estimated at nearly 10 percent of GNP. Furthermore, because the agreement restrained U.S. trade-remedy laws, which produced forty cases of countervailing duties and antidumping sanctions between the United States and Canada from 1980 to 1987, Canadian firms can now exploit these economies of scale without fear that an economic downturn or a political campaign will trigger a disastrous protectionist turn in the United States. Such benefits were thought to be even more significant for Mexico because its smaller market ($214 billion compared to Canada's $572 billion) offered fewer opportunities for large-scale production. Mexico also would seem to benefit more from Ricardian gains from trade even though before NAFTA its exports faced an effective trade-weighted tariff rate of only 3.5 percent in the United States (plus NTBs equivalent to another 1.3 percent).

Mexico's principal motivation, however, was to improve industrial productivity both by exposing Mexican business to foreign competition and by encouraging foreigners to invest in Mexico. The Mexican economy had stagnated, especially during the 1970s and early 1980s, under the Mexican Partido Revolucionario Institucional (PRI), the ruling party for more than three-quarters of a century. The PRI's economic approach, said to constitute a third way between capitalism and socialism, had featured an activist state, sharp restrictions on foreign investment, and extremely protectionist trade policies. For example, in June 1985, Mexico's average tariff rate was 23.5 percent, import permits were required (and usually rejected) for products constituting 92.2 percent of tradable output, and official prices bound 18.7 percent of products. By the late-1980s, the PRI had undergone a revolution in economic policy, which came to emphasize privatization (selling 1,000 of the 1,200 state-owned companies, including the national airlines and the telephone company); budget deficit reduction (from 16 percent of GDP to under 1 percent); elimination of government price fixing; inflation reduction (from over 200 percent to

under 30 percent per year); and import liberalization (by December 1987, tariffs averaged 11.8 percent and only 25.4 percent of goods required import permits).

NAFTA became the symbol of that revolution because it lent credibility to such a marked departure from historical practice, even though more liberalization occurred before NAFTA than was expected to follow its implementation. In particular, NAFTA encourages foreign investors to regard liberalization as permanent because it binds Mexico under international law to an agreement also enforced by the power of the United States. Otherwise, they would not risk a return to the old policies that could make their investment unprofitable. Without an influx of foreign investment, capital from domestic sources would be inadequate to fuel the growth made possible by Mexico's cheap labor force and direct access to the American market.

Judging American motivations is more difficult because the liberal gains that dominated the calculus of both Canada and Mexico were expected to be much smaller for the United States. Because of its much greater size, any gains in access to the markets of its nearest neighbors would have a negligible effect on the American economy: In 1992, total trade with Canada and Mexico amounted to only about 2 percent of U.S. GDP. Obviously, the gains from economies of scale must be tiny, and reducing already low trade barriers promised little improvement in efficiently allocating resources.

These judgments were borne out by many macroeconomic models constructed to predict the effects of NAFTA on American output and employment. The gains were difficult to estimate, but even the most optimistic assessment foresaw a positive U.S. trade balance with Mexico of only $7–$9 billion annually with a net increase of only 170,000 U.S. jobs, a little more than one-tenth of 1 percent of the U.S. workforce. The corresponding efficiency gains would be under $2 billion annually in an economy of more than $5,500 billion. These gains would have been so small that in a dynamic economy we wouldn't have been able to verify them even after the fact. As it happened, these predictions of a $7--$9 billion U.S. trade surplus with Mexico were entirely wrong; rather the U.S. ran a *deficit* of about $20 billion per year in its trade with Mexico in the late 1990s and from $20-$40 billion per year with Canada.

Why the big push for NAFTA if the promised gains were so modest and uncertain? Some of the explanation centers on the indirect benefits the United States could expect to derive from the Mexican prosperity predicted to result from its recent liberalization—if NAFTA could make it permanent. Even if NAFTA created no net trade increases but only shifted some labor-intensive American imports from Asian to Mexican sources, the trade diversion would benefit the United States, which would gain more from growth in Mexico than growth elsewhere. For example, about half of Mexico's export earnings during the 1980s went to repay foreign debt, much of it to American banks. Development in Mexico might also help to stem the tide of immigration that is increasingly politically divisive, particularly in the American Southwest. Because nearly 70 percent of Mexico's trade was with the United States—and because Mexico seemed likely to run a trade deficit for years to come—Mexican prosperity promised to improve the U.S. balance of trade. As it happened, by the end of the 1990s U.S. dominance of Mexico's trade had grown to nearly 80 percent, in part because Mexico raised its tariffs against the products of other nations while it was lowering the rate charged to U.S. goods, giving American products about a 10 percentage point average tariff advantage. This discrimatory move perfectly illustrates regional integration as a trade policy that is liberal on the inside and mercantilist on the outside. However, while U.S. exports to Mexico increased, imports from Mexico grew much more rapidly, so Mexico has become the fourth largest source of U.S. trade deficits, after Japan, China, and Canada.

The United States was also interested in several specific sectors even though their aggregate effects might not be large. By opening the Canadian energy sector to American investment, for example, NAFTA enhanced U.S. energy security, demonstrating that regional integration can secure a classic mercantilist objective by expanding the borders of a self-sufficient area. Domains such as financial services and intellectual property represent growth sectors in the global economy in which the United States has a comparative advantage.

American motivations are also related to other strands in its trade policy. It may be no coincidence that the Uruguay Round of GATT successfully concluded only after NAFTA had been approved. Because the EU has always been able to fall back on regional free trade whenever global negotiations turned sour, the United States lacked the bargaining power to complete the deal until NAFTA demonstrated that the United States had a similar alternative. Moreover, NAFTA introduced innovations that became precedents for global agreements, including its dispute-resolution mechanism (particularly compulsory arbitration and surveillance of trade policies), its treatment of services, and its elaboration of specific rights and obligations concerning national treatment.

But the best explanation for American interest in NAFTA may derive from the Reagan and Bush administrations' conviction that the ideal political economy is structured according to laissez-faire principles of deregulation, liberalization, and privatization. They hoped that the more competitive environment created by NAFTA would strengthen the case for pursuing a competitiveness strategy that emphasizes lower taxes, weaker labor organization, and a diminished welfare state. Thus, NAFTA constituted an external reinforcement for a liberal policy program whose internal elements had been under constant attack from critics as they were adopted piecemeal since Reagan's inauguration in 1981. In Canada, too, NAFTA represented the culmination of a strategy of liberalization - both in the domestic economy and in foreign trade and investment - that commenced with the beginning of the Mulroney government in 1984. Liberal proponents expected that NAFTA would bolster the similar drive that had been underway in Mexico since the early 1980s by enabling the Mexican government to appeal to the necessity of competing with American firms. They hoped that successful development there might serve as a liberal model for other Latin American nations as well. Many of these nations, like Mexico, have engaged in heavily protectionist import-substituting industrialization (ISI) in the past and, in the process, acquired large debts that are potentially destabilizing for their own political systems, hemispheric foreign relations and, perhaps most importantly, the U.S. banking system. In fact, negotiations are currently under way to expand NAFTA's liberal vision throughout the Western Hemisphere in a Free Trade of the Americas Agreement. To see what this liberal ideal entails, we must consider how the various trade dilemmas posed by NAFTA were viewed by political actors in all three nations.

## THE DILEMMAS IN NAFTA AND THE POLITICAL RESPONSE

Public opinion concerning NAFTA divided along the familiar fault lines of nation and class, but national sentiment did not reflect analysts' expectations of relative gains. For example, most analysts believed that the United States would gain less than either Canada or Mexico—and some questioned whether there would be any trade expansion for the United States at all—but the objection to NAFTA on these grounds was negligible among the American public. Apparently, asymmetrical benefits provoke little concern unless the nations involved are perceived as rivals; reciprocity is more important in dealing with Japan than with Mexico. Moreover, NAFTA was expected to have less impact on aggregate economic outcomes than on the issues raised by the dilemmas of trade. Thus, in the United States, the greatest protests emerged over NAFTA's effect on unskilled labor (in response to the distributional dilemma) and the environment (in response to the dilemma of competing values).

In Mexico, NAFTA initially escaped much of the criticism usually directed against the distributional implications of free trade policies simply because the liberalization that preceded NAFTA had already drawn most of that fire. Mexico had been in the process of reducing trade protection and capital controls since the debt crisis of 1982 and more intensively since 1987. During that time trade levels had doubled, but in real terms GNP per capita at the introduction of NAFTA in 1994 remained below its level in 1981. Thus, it was thought that the dislocation costs had already been borne, and so most saw NAFTA as a means to capture with greater certainty and

permanence the benefits that the unilateral policies of the previous five years had only promised. However, a peasant revolt that began in the southern Mexican region of Chiapas in 1993 was directed against the economic priorities of the PRI—especially a tolerance for adverse effects on the poor—which were manifested in both NAFTA and earlier liberalization policies.

Still, NAFTA attracted the usual litany of opposition to liberalization only when its first year of existence witnessed a serious economic collapse that culminated in the worst Mexican depression since the 1930s. This outcome dealt a serious blow to the liberal creed because economic prosperity was deemed to be not only the chief benefit of NAFTA, but so great as to render acceptable the familiar sacrifices associated with trade dilemmas--adverse distributional consequences, diminished national sovereignty, and the erosion of alternative values.

In Canada, the evaluation of NAFTA was colored by the experience of the previous five years with CUSTA (especially the deep recession that initially accompanied it too), the long history of uneasy economic relations with the United States, and uncertainties about the future of the federal system of Canada itself. Anxieties about national sovereignty and the outlook for labor have weighed heavily in Canadian assessments of NAFTA; these assessments became a litmus test of attitudes toward the Conservative government, which negotiated both CUSTA and NAFTA. Antagonism toward free trade contributed to the October 1993 national election in which Conservatives were humiliated by losing all but two of their 169 seats in the 295-member Parliament and winning only 16 percent of the popular vote. New Liberal prime minister Jean Chrétien originally vowed to renegotiate NAFTA but later backed off from this position.

## THE DILEMMA OF NATIONAL SOVEREIGNTY

International agreements that preclude certain national policies—as NAFTA prohibits most trade barriers—invariably involve some loss of national sovereignty. Although this dilemma has affected attitudes toward NAFTA in all three countries, the issue has arisen in a different way and with a different intensity in each nation.

In the United States, national sovereignty was a minor concern, subsumed by greater apprehension about the environment and job issues though related to both. For example, NAFTA shifts some economic and environmental decisions away from national legislatures to binational review panels created to resolve trade disputes. Environmental and other groups that have considerable influence on Congress but none on these panels contend that the transfer of authority to supranational bureaucrats undermines national sovereignty and deprives citizens of rights of access to officials through elections, lobbying, and open public debates. This same issue arose much more powerfully in the context of the WTO, apparently because Americans do not see Canada and Mexico as the grave threat to national sovereignty that a global institution might become.

Mexican concern about national sovereignty produced one major concession in the NAFTA agreement: the exemption of Pemex, the Mexican national oil company, from its investment provisions. Pemex, though inefficient and corrupt, has become a Mexican symbol of independence and autonomy that has resisted privatization and retains protection against foreign competition in some areas.

The national sovereignty issue acquired its greatest prominence in Canada, where closer trade with the United States has always triggered concern about maintaining national autonomy in matters of politics, economics, and culture. The continuing fear of U.S. domination is exemplified by the fate of the 1911 Canadian-American free trade treaty. During its ratification in the U.S. Congress, some proponents represented it as a first step toward the annexation of Canada, an outcome vehemently opposed by most Canadians. As a consequence, the Canadian government was denied reelection in a campaign dominated by the campaign slogan of the opposition, "No truck or trade with the Yankees."

The source of these concerns is not hard to see. In economic terms, critics claimed that NAFTA would increase American domination of Canada. Even before CUSTA, exports to the United States constituted 75 percent of Canada's trade and 20 percent of its total GNP. American foreign direct investment in Canada was valued at $70 billion with 20 percent of Canada's 500 largest firms owned by Americans. About half of Canadian manufacturing was foreign-owned, most by Americans. By 1998, 81% of Canadian exports went to the U.S. and American foreign direct investment in Canada exceeded $100 billion. More Canadian manufactured goods are exported to the United States than are consumed in Canada. Statements like that of U.S. trade representative Clayton Yeutter to a Canadian newspaper shortly after the CUSTA negotiations do not allay those fears: "The Canadians don't understand what they have signed. In 20 years they will be sucked into the U.S. economy." The response is predictable; Shirley Carr, president of the Canadian Labour Congress, remarked, "It is in the interest of the United States to try to take over Canada. ...They want to disrupt and disturb everything we have and bring us down to their level." Of course, intensive trade with a more developed and more powerful nation has fed such anxieties since the days of Friedrich List, but regional integration can be especially troublesome in this regard. Indeed, the dilemma of declining national sovereignty has even dogged the EU, though Germany is much less dominant within the EU than the United States is within NAFTA. American dominance has been especially striking in terms of culture: "Only 3 to 5 percent of all theatrical screen time in Canada goes to Canadian films; 97 percent of profits from films shown in Canada go out of the country, 95 percent to the U.S.; 95 percent of English-language TV drama is non-Canadian; Canadian-owned publishers have only 20 percent of the book market; 77 percent of the magazines sold here are foreign; 85 percent of record and tape sales are non-Canadian."

In response to these concerns, CUSTA's Article 2005 states that "cultural industries are exempt from the provisions of this agreement," thus allowing a continuation of Canadian protection and promotion of cultural industries that has existed for most of the twentieth century. It is interesting that this very same issue also arose in the Uruguay Round talks, with French negotiators eventually winning protection from Hollywood film producers they regarded as symbols of American cultural hegemony.

### The Dilemma of Value Trade-offs and Environmental Politics

Most of the major American environmental groups opposed NAFTA, especially the Sierra Club and Friends of the Earth, which (unsuccessfully) sought a court order to require the administration to file an environmental impact report. For three reasons, critics feared that a commitment to NAFTA's free trade principles would require a compromise with the value of environmental protection. First, the border region of Mexico could become an export platform for companies who want to sell products in the United States but evade American environmental standards. Second, the availability of the border region to polluting industries may produce social-dumping pressures on American state and local governments to save jobs by lowering environmental standards. Third, NAFTA opens American environmental regulation to foreign challenge because it can be interpreted as an illegal barrier to trade.

The direct environmental dangers are concentrated in the border area between Mexico and the United States, which hosts the maquiladora program. Countless reports and studies have documented it as an environmental wasteland with threats to the human population on both sides of the border, especially from water pollution. The Rio Grande, which serves as the U.S.-Mexican border for much of its length, is heavily polluted with metals and raw sewage. It provides drinking water for a million people and irrigation water for a large agricultural area, but its fecal contamination levels "regularly exceed, often by a factor of a hundred, standards to protect public health." The New River, which begins in Mexico and flows into the Salton Sea, California's largest lake, is known as the most polluted river in North America. Beaches within several miles of the outlet of the Tijuana River into the Pacific Ocean have been closed for ten years. In San Elizario,

Texas, 90 percent of the population has contracted hepatitis by age thirty-five because of a polluted aquifer.

This pollution originates largely in maquiladora firms, fully 10 percent of which admitted that they had migrated to avoid American environmental regulations and take advantage of the weaker environmental laws and notoriously lax enforcement in Mexico. For example, the La Paz agreement of 1983 required that industries importing chemicals into Mexico return any resulting hazardous wastes to the country of origin, but a 1988 report of the U.S. EPA showed that only 1 percent of maquiladoras had done so. This record cannot be a surprise: In 1990, the Mexican federal government budget for environmental law enforcement was only $3.15 million.

Environmentalists also feared that NAFTA would trigger value trade-offs similar to those that have arisen from conflicts between various environmental policies and previous free trade agreements, including the WTO. For example, the Bush administration successfully pressured British Columbia to end a government-funded tree-planting program because it was an "unfair subsidy" to the Canadian timber industry. Similarly, government payments to farmers to promote soil and water conservation could be interpreted as an unfair subsidy of agricultural exports. Export restrictions on lumber designed to enforce practices of sustainable forestry could be considered a violation of prohibitions against export restraints. Restricting imports of food contaminated with pesticides now banned in America can be grounds for foreign governments to sue the United States for establishing nontariff barriers to trade.

The most dramatic episode occurred in the 1994 clash known as "GATTzilla versus Flipper", in which a GATT tribunal ruled in favor of a complaint brought by the EU on behalf of European tuna processors who buy tuna from Mexico and other countries that use purse seine nets. The United States boycotts tuna caught in that way, since the procedure also kills a large number of dolphins, but GATT ruled that the U.S. law was an illegal barrier to trade because it discriminated against the fishing fleets of nations that use this technique.

Initial experience with CUSTA confirms that such environmental trade-offs will arise under NAFTA. The first trade dispute under the free trade agreement involved a challenge by the U.S. to regulations under Canada's Fisheries Act established to promote conservation of herring and salmon stocks in Canada's Pacific coast waters. The provision to require reporting was struck down by the dispute panel. Similarly, the Canadian government challenged the U.S. EPA's regulations that require the phaseout of asbestos, a carcinogen once frequently used as a building material. A balance between environmental concerns and free trade principles could be achieved, but NAFTA, which lacks the EU's recognition of the social and political dilemmas of trade, does not do so.

### The Distributional Dilemma and the Politics of Labor Issues

In both Canada and the United States, however, the most controversial issue concerned the impact of NAFTA on jobs and wages. Unlike the Corn Laws, which posed the distributional dilemma principally in terms of sectors of the economy, in NAFTA the dilemma emerged as a class issue. Opponents contended that NAFTA would produce a net loss of jobs, especially among the unskilled, who are least able to adjust; a decline in wages among the unskilled who remain employed; and a transition period involving disruption and risk that is excessive given the small and uncertain projected gains.

Liberal trade theory made a persuasive case for NAFTA's long-term benefits, including more job creation than job loss, though macroeconomic computer models generally showed the net effect to be quite small. Opponents of NAFTA questioned outcomes derived from such computable general equilibrium (CGE) models because they required unrealistic assumptions such as full employment, balanced trade, and capital immobility. It is especially noteworthy that the major fear—job loss—was assumed away by the CGE assumption of full employment. As one critic pointed out, "We might forgive the Ford employee for being less than convinced by a CGE model

that crosses a deep ravine by *assuming* a bridge." Arguments for free trade often appear most convincing to those who have no stake in their truth, but for the workers whose livelihood depends on the accuracy of the trickle-down models, the theories usually seem too flimsy to justify the risks.

Labor concerns arose from the recognition that NAFTA would destroy American jobs as some U.S. firms lost sales to Mexican firms and others moved production facilities to Mexico. Opponents emphasized dislocations from NAFTA-related job loss estimated in the range of 150,000 to 500,000. The transition period can be long and painful: It was estimated that 40 percent of laid-off workers would remain unemployed a year later and that the remainder would suffer wage losses averaging 10 percent for service workers, 20 percent for manufacturing workers, and 30 percent for automobile and steel workers. Within five years, most workers would have recovered their previous wages; but 35 percent would never again make the same wages, and three-fourths of workers would not go back to the same type of job. The average cost of a job loss for a worker was estimated to be about $80,000 over a lifetime.

Proponents observed that NAFTA-related job-loss estimates were modest in relation to the 2 million Americans expected to lose their jobs every year for the next decade for reasons unrelated to NAFTA. Further, they noted that job loss to low-wage countries was inevitable even in the absence of NAFTA. Finally, they pointed out that some job gains from NAFTA were just as inevitable as some job losses. Indeed, the positive employment effects of increasing exports should equal or exceed the negative effects of increasing imports. It is no wonder that businesses emphasized their vision of an efficient, comparative advantage–based economy that would eventually result from NAFTA and that labor organizations emphasized the transition costs that would be borne before such a future could emerge.

Free trade always triggers labor's concern about employment, wages, and social dumping, but three considerations made the issue unusually acute in the case of NAFTA. First, huge disparities in wage rates and working conditions between the United States and Mexico increase the pressure on American workers. With wages for unskilled labor roughly eight to ten times higher in the United States than in Mexico, American firms have a strong incentive to either abandon production requiring unskilled labor or move it to Mexico. Negotiating under this kind of threat, American workers may be unable to resist a decline in wage rates and living standards. "A Wall Street Journal survey of 455 senior corporate executives taken just after NAFTA was initialled, found that 25 percent would use NAFTA to bargain down wages and 40 percent would move production to Mexico." Furthermore, a 1997 study of 600 attempts by labor unions to organize workers or negotiate a first contract revealed that "62 percent of employers threatened to move their operations instead of negotiating with the union." [11] The factor price equalization theorem, an elaboration of Heckscher-Ohlin, states that free trade will cause all factor prices, including wage rates, to equalize across nations. Supporters hoped that NAFTA would bring a growth boom to Mexico that would result in Mexican wages rising to U.S. levels rather than American wages falling to Mexican levels, but such a result is, at best, a long way off. Labor surpluses and weak labor laws in Mexico preclude substantial upward pressure on wage rates for many years. As a result, NAFTA might lower wages in the United States without raising them in Mexico, which would be especially alarming because wages for unskilled labor are already declining in the United States. For example, during the 1980s the real wages of those without a high school diploma fell 10 percent, and a similar effect seems to be spreading to high school graduates.

Second, capital mobility, which makes the relocation of labor-intensive production to Mexico easy, sharpens the competition between American and Mexican labor, especially by eroding productivity differences between them. The factor price equalization theorem holds that wage rates will fully equalize only if the productivity of workers in the two countries is identical. Thus, the current gap in wage rates should persist so long as American workers remain so much more productive than Mexican workers, but the modernization of the Mexican economy fueled by the foreign direct investment (FDI) of American firms could erode that difference for unskilled labor.

By the end of 1991, foreign direct investment in Mexico totaled about $33 billion, with nearly two-thirds of it originating in U. S. corporations. In anticipation of NAFTA, capital inflows to Mexico were estimated at $18 billion in 1992, including $5 billion in foreign direct investment.

The *maquiladora* program can be seen as a kind of pilot project for NAFTA, demonstrating the power of combining American capital with Mexican labor. Since 1965, firms on the Mexican side of the U.S. border, known as maquiladoras, have been permitted to import parts duty free from the United States and to export the assembled product back into the country, also duty free. By 1992, nearly 2,000 factories operating under this program employed nearly 500,000 workers, about 20 percent of the total manufacturing labor force in Mexico. Meanwhile, employment and wages for American unskilled labor had stagnated.

Third, unlike the EU, NAFTA contains very little provision for dealing with dislocations, and, unlike in Europe, the social welfare system in the United States provides less protection from structural unemployment. In Canada, where the welfare state is more advanced than in the United States, the left feared that dislocations would overwhelm its capacity and force the abandonment of prized programs of social insurance. From 1990 to 1997, the proportion of the unemployed eligible to collect unemployment insurance dropped from 89 percent to 43%.[12]

Partisan alignments reflect the Stolper-Samuelson expectation that free trade will benefit the abundant factor of production (capital, in the United States) and harm the scarce one (unskilled labor is scarce in the United States relative to the huge surplus of cheap labor in Mexico). These distributional implications of free trade explain why more than 75 percent of Republicans voted for final passage of NAFTA in the U.S. House of Representatives and why more than 60 percent of Democrats voted no even after heavy lobbying by Democratic president Bill Clinton.

## THE IMPACT OF NAFTA AND THE MEXICAN COLLAPSE

More than five years after its inception, NAFTA's effects continue to be disputed, not because the three economies remain unaltered but because the dramatic changes that have taken place cannot be definitively associated with NAFTA. Trade among the three countries has increased even more than expected - by 1999, it was more than twice its 1990 level - but the effect of NAFTA cannot be isolated from the broader liberalization strategy that was well underway in all three nations before NAFTA took effect. Moreover, trade levels were not the only source of the strikingly divergent paths taken by the three nations in this period. Both Canada and the United States entered recessions shortly after CUSTA took effect in 1989, but the downturn was far longer and deeper in Canada than in the U.S. The period from 1989 to 1996 was the longest period of below potential growth for Canada since the Great Depression in the 1930s, with unemployment rates exceeding 11 percent. Nearly 20 percent of all Canadian manufacturing establishments closed during this period, as many as half in response to the increasing competition under first CUSTA and then NAFTA. This trade competition encouraged fiscal and monetary policy designed to keep production costs low, but the competitiveness strategy also stifled growth in output, wages and employment while weakening government programs that provided social protection. Thus, rising levels of trade and even a growing trade surplus with the U.S. have not prevented a substantial increase in inequality in Canada. However, advocates of liberalization argue that these dislocations were temporary. Furthermore, they contend that the trade competition produced by CUSTA/NAFTA did not *cause* the painful policy changes but only demonstrated that they were necessary to correct pre-existing conditions in Canada.

By contrast, in the U.S. the recovery which began in 1992 produced the longest expansion of the post-World War II period and unemployment rates fell to around 4 percent, the lowest in more than 30 years. NAFTA does not appear to have played any substantial role in this growth, which has, however, easily absorbed whatever modest job loss may have been associated with NAFTA. Fewer than 200,000 workers--under 4 percent of the total number of U.S. workers dislocated during this period--have been certified as qualified for NAFTA-related Trade Adjustment

Assistance. There is also little evidence that NAFTA has had much effect on U.S. wage rates; while real hourly compensation certainly has grown much less slowly than corporate profits, executive compensation, or productivity gains, such inequality in allocating the benefits of prosperity has been a growing trend since at least the late 1970's. In short, though NAFTA has surely benefitted some and harmed others, its aggregate effect on the U.S. economy appears to have justified neither the most optimistic nor the most pessimistic predictions.

In Mexico too the effect of NAFTA is disputed because of its entanglement with other dramatic economic events, but here it is far easier to see the case made by critics. It is certainly impossible to evaluate NAFTA without considering the dramatic collapse of the Mexican economy barely a year after its initiation. The meltdown began with a currency crisis, which was marked by a 43 percent decline in the value of the peso that not only disrupted regional trade and precipitated a deep depression in Mexico but also triggered concern about Mexico's ability to meet its foreign-debt obligation. In response, the Clinton administration, fearful of the political and economic consequences of a collapse in the Mexican economy, provided a $20 billion line of credit as part of a $50 billion international effort to rescue Mexico from imminent default.

It is instructive to note that NAFTA both contributed to Mexico's economic problems and helped export them to the United States. The key role was played by the Mexican peso, which despite a temporary boost from NAFTA could not maintain its value under the pressure imposed by Mexico's trade liberalization. As trade barriers fell throughout the liberalization of the late 1980s and early 1990s, Mexican imports soared, producing a trade deficit that finally reached 8 percent of GDP in 1994. Ordinarily this deficit would have caused the peso to decline steadily until its equilibrium value was reached, but instead it was offset for a while by a huge—but temporary—inflow of capital from abroad, more than $60 billion in portfolio investment alone from 1990 to 1993. Much of this originated from foreign investors, especially in the U.S., who were persuaded by enthusiastic supporters of liberalization that post-NAFTA Mexico represented the next great investment opportunity. Inevitably, this capital inflow began to decline, putting downward pressure on the value of the peso. The Salinas government recognized that a falling peso would produce domestic inflation, erode the confidence of foreign investors, and undermine the reputation of the PRI for financial management, all of which it wanted to avoid during the 1994 presidential election. Thus, it expended treasury funds to artificially support the peso (and pressured the central bank to expand the money supply by over 20 percent). With foreign reserves nearly exhausted—falling below $7 billion—the new president, Ernesto Zedillo, was forced to announce a 13 percent devaluation of the peso less than three weeks after his inauguration in December 1994. This became the last in a string of incidents—among them the Chiapas revolt, a contested election result, and a political assassination—that had alarmed foreign investors over the previous year. The devaluation effectively acknowledged an economic crisis, which drove frightened investors to react in panic. Nearly $30 billion fled the country in a few weeks. During 1995, the peso declined by 43 percent, the Mexican stock market sank by 38 percent, inflation soared to 60 percent, and unemployment nearly doubled. With American economic interests now tied to the stability of the Mexican economy and NAFTA's prestige bound up with the success of the Mexican liberalization program, the Clinton administration arranged an emergency bailout with help from the IMF and other institutions. When default on foreign debt loomed, both the Zedillo administration and its supporters (primarily in the Clinton administration and the IMF) were seen to give priority to bailing out investors—especially those abroad—while ignoring the plight of the Mexican masses.

The changes in Mexican macroeconomic policy required by the crisis itself and those imposed as part of the bailout agreement guaranteed a sharp recession that, among other effects, would reduce the trade between Mexico and the United States that NAFTA was designed to boost. More significantly, real GDP per capita, already 10% below the level it had reached at the beginning of the 1980s, declined another seven percent in 1995. As the economy hit bottom in 1995 Mexico registered a 13% decline in private consumption, a 50 percent inflation rate, interest rates at 40

percent, a 20% decline in real wages, and a 70% increase in official unemployment (to 6.3%, but another 20% were reduced to part-time work). Since then Mexico has experienced a recovery, once again led by foreign investment.

At the turn of the century, the dislocations associated with Mexico's trade liberalization and the NAFTA agreement meant to signify its permanence are more apparent than the benefits that remain projected for the future. The dilemmas of trade have been expressed in a variety of ways. Inequality has grown substantially throughout the liberalization process. The percentage of GDP going to labor declined from 38% in 1980 to under 25% in 1990 and has likely fallen further since then. The wage gap has widened between white-collar and blue-collar workers, skilled and unskilled labor, export-oriented vs. domestic manufacturing, and between border and non-border areas. The security of workers is increasingly precarious, with fewer covered by Social Security and more employed in the informal sector, while the minimum wage has fallen to half its 1987 value. Foreign dependence has grown and self-sufficiency has declined. Not only has trade expanded, but it is increasingly integrated into the productive capacity of the economy. In 1994, 58% of the value of exports was composed of the imported inputs required to produce them (up from 12% in 1983). Foreign debt exceeds $170 billion, two and a half times its level during the debt crisis of 1982. As Teresa Gutierrez Haces puts it, "Mexico has converted itself into a country that is very attractive to international investors but not for millions of Mexicans who daily face conditions of extreme poverty."[13]

## Conclusion: lessons from NAFTA

Trade ties together the fate of nations. Prosperity in one country can be "exported" to another through trade, but dependence on others can also transmit less pleasing conditions. Trade is not equally desirable under all circumstances or with all possible partners, especially because its effect on value trade-offs, distributional patterns, and state concerns can vary dramatically. In this light, regional integration offers a cautious compromise between self-sufficiency and global free trade by allowing a nation to selectively choose its partners in destiny. Despite difficulties in the past and uncertainties about the future, the EU exemplifies the virtue of such an approach, taking advantage of the economic, political, and social compatibility of its members to forge an organization that can address common problems and achieve shared goals.

The early experience with NAFTA is less clear, and the decision to bind together the fate of all three North American nations cannot yet be definitively assessed. However, a major currency crisis that began less than a year after NAFTA's implementation in January 1994 has cast doubt on whether Mexico is yet stable enough to be a reliable member of a regional trade organization.

Nonetheless, enthusiasm for liberalizing regional agreements remains strong, especially in the western hemisphere where MERCOSUR, the Central American Common Market, CARICOM, and the Andean Community are all in operation. In fact, less than a year after NAFTA's inauguration, 34 democratically elected leaders in the region met to initiate negotiations over a Free Trade Area of the Americas (FTAA) which would reach from Alaska to Argentina and encompass a market of nearly 800 million people. Nine different negotiating groups are now considering various facets of this proposal, with negotiations scheduled to conclude by 2005. On a separate track, the U.S. is a leading member of the Asia Pacific Economic Cooperation (APEC) forum, a groupof twentyone nations on both sides of the Pacific committed to greater liberalization of trade and investment. This is a far larger group--its members account for more than half of global trade--but it is much more loosely integrated and at an earlier stage in its development.

Trade generates dilemmas that can overwhelm its advantages unless nations and organizations are prepared to respond to them. The regional option is one strategy that appeals to some nations, but others are not located in a region where such an approach is feasible. For them, such as the Asian NICs considered in the next chapter, trade-led growth must occur in a context of globalization.

Endnotes

1. Regional integration can take a variety of forms. In a preferential trade area, a group of countries establishes lower barriers to the import of goods from member countries than from outside countries. The free trade area is a special case of a preferential trade area in which trade barriers between members are reduced to zero. A customs union is a preferential trade area in which the members adopt a common external tariff. A common market allows the free movement of factors of production such as capital and labor as well as free trade in goods. Finally, an economic union or community occurs when the economic policies of common market nations are coordinated and harmonized under supranational control and a single currency.

2.Between 1990 and 1994, 26 preferential trade agreements were signed in the Western Hemisphere alone. 22 new regional trade agreements were reported to the WTO between mid-1997 and mid-1998.

3. Timothy M. Devinney and William C. Hightower, *European Markets After 1992* (Lexington, Mass.: Lexington Books, 1991), p. 21.

4. The Benelux customs union among Belgium, Luxembourg, and the Netherlands had been formed in 1948.

5. For convenience, I will use the label EU to refer to both the current European Union and its predecessor organizations.

6. The EU remains slightly smaller than NAFTA in GDP, but its trade is more than twice as large.

7. The United States has never fully accepted the EU's conformity with Article 24 because it has not eliminated tariffs on "substantially all" goods (failing, most notably, with respect to agriculture). Nonetheless, the U.S. has not opposed the EU, but it has been active in pushing the WTO to examine the conformity of all regional agreements with GATT.

8. "The Slippery Slope," Economist, July 30, 1994.

9. "Gambling on the Euro," *The Economist*, January 2, 1999.

10. Congress had nearly blocked the initial negotiations for the less controversial CUSTA but failed to do so when the Senate Finance Committee deadlocked at 10 to 10.

11. Bruce Campbell, Andrew Jackson, Mehrene Larudess and Teresa Gutierrez Haces, "Labour market effects under CUFTA/NAFTA," (Geneva: International Labour Office,1999), p. 8.

12. *Labor market effects*," p. 9.

13. *Labour market effects*, p. 118