

Proff, Harald Victor

Article — Digitized Version

The North American trade region: The reasons for its creation and its initial economic repercussions

Intereconomics

Suggested Citation: Proff, Harald Victor (1993) : The North American trade region: The reasons for its creation and its initial economic repercussions, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 28, Iss. 6, pp. 279-284, <http://dx.doi.org/10.1007/BF02926214>

This Version is available at:

<http://hdl.handle.net/10419/140424>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Harald Victor Proff*

The North American Trade Region

The Reasons for its Creation and its Initial Economic Repercussions

The North American Free Trade Agreement (NAFTA) that is to take effect at the beginning of 1994 will create a free trade area between three economies which differ substantially in terms of size and stage of development. What were the reasons that led the unequal partners, the USA, Canada and Mexico, to enter into closer trade integration? What will be the economic consequences for the countries involved and for world trade?

Since 1st January 1989 Canada and the United States of America have been in a transitional stage towards free bilateral trade, which should be broadened by the North American Free Trade Agreement (NAFTA) between the USA, Mexico and Canada at the beginning of next year, provided agreement can be reached on certain areas of environmental policy and labour market regulations. The NAFTA will create the first free trade area to establish comprehensive trade agreements between countries at different stages of economic development.

In the light of the hitherto unsuccessful negotiations for a further liberalisation of world trade in the Uruguay Round, trade integration in North America is being discussed primarily in terms of the effect it will have on the future course of world trade. Although US dissatisfaction with the multilateral system of trade was one reason for opening bilateral trade talks first with Canada and then with Mexico, it is not sufficient grounds for the creation of free trade areas in North America. Such a restrictive view ignores the factors that motivated Canada and Mexico to offer to negotiate free trade areas with the United States after decades of resistance to the US desire for closer trade co-operation. In 1911, 1947 and 1953 Canada negotiated free trade agreements with the USA, only to repudiate them at the last moment for fear of a loss of national sovereignty and unacceptably great adjustment in the industrial sector. Until the mid-eighties Mexico pursued a resolute policy of import substitution that was incompatible with a free trade area with the USA. This article will examine the reasons that have led to the creation of the free trade area despite the political and economic dominance of the USA and the resulting heavy dependence of Canada and Mexico on their neighbour. Preliminary predictions of the economic consequences of

the free trade areas in North America can be made on the basis of the agreements that have been negotiated and assumptions about the impact they will have on the countries involved and on world trade.

Unnoticed Integration in North America

Close economic relations already existed between the USA and Canada and between the USA and Mexico even before the creation of the North American free trade areas. In US-Canadian trade, this is evident primarily in the rising share of Canadian exports to the USA since 1970. Trade between the two countries generates the largest bilateral trade flows in the world.¹ The fact that the US and Canadian economies have moved in step in every economic cycle except that of 1982-83 is a further indicator of their interdependence. Their high degree of financial integration means that Canada has only limited scope for an independent monetary and interest rate policy to stabilise the Canadian dollar against the US currency.

The strong economic interdependence in the relationship between Mexico and the United States depends not so much on trade flows as on capital flows due to Mexico's debt towards US banks and the migration problem in the border region. A suspension of the servicing of Mexico's debt would have grave repercussions on the US banking system, which granted Mexico large loans at the end of the seventies.² Positive economic growth in Mexico must therefore be in the interests of the USA, if only to ensure the country's future solvency. Moreover, their

¹ Cf. R. G. Lipsey: Unsettled issues in the great free trade debate, in: Canadian Journal of Economics, Vol. 33 (1989), p. 2.

² Mexico's official foreign debt rose from US\$ 40 to 91 billion between 1979 and 1982, with most of the loans coming from US banks. On the debt crisis, see R. Dornbusch: Mexico: stabilisation, debt and growth, in: Economic Policy, Vol. 7 (1988), pp. 231-283.

* Technische Hochschule Darmstadt, Germany.

common border, which stretches for more than 3,000 km and is the only border in the world between an industrial country and a developing country, cannot be patrolled, so that the migration of Mexico's poor to the USA can only be effectively reduced by improving living conditions in Mexico itself. In 1985 and 1987 the USA and Mexico had already negotiated economic and trade agreements,³ so that the opening of negotiations on the establishment of a free trade area, though a surprise, was not entirely without preparation. Table 1 illustrates exports between the three countries.

The table shows clearly that the USA is the most important export market for Canada and Mexico, but that only a relatively small proportion of US exports goes to the two neighbouring countries. Nevertheless, Canada is the United States' largest trading partner and Mexico its third largest. Trade between Mexico and Canada, on the other hand, is very small.

Even before the creation of the free trade areas, around 80% of trade within North America was free of customs duty or at least enjoyed preferential rates⁴ under special agreements such as the US-Canadian Auto Pact, a free trade agreement in the automobile sector, or the Maquiladora industry agreement, which provides for tariff concessions for the production of labour-intensive products that are primarily re-exported to the USA. Nevertheless, there were and there still are a plethora of tariff and non-tariff trade barriers, some of them highly restrictive. For example, US agriculture is protected by substantial quantitative and seasonal quotas, and Mexico almost completely seals its market in the basic food product maize. The USA protects some sections of the textiles industry with duties of up to 56% and Mexico levies an average duty of over 15% on a wide range of manufactured products despite trade liberalisation.⁵

Many US corporations circumvent trade restrictions by investing in the neighbouring countries direct. In 1985 direct investment in Canada by US corporations totalled

US\$ 59.2 billion, equal to around 80% of total foreign direct investment in the country.⁶ In 1990 some 60% of manufacturing industry and a substantial proportion of the primary products sector was owned by US concerns. A large proportion of finished products exported from Canada consists of goods being moved between plants of the three large US automobile manufacturers operating in Canada. At the end of the eighties the structure of Canadian industry was still heavily biased towards the extraction and initial processing of raw materials, despite the strategy of export diversification pursued since the early seventies.⁷

Mexico, by contrast, managed to diversify its exports significantly during the eighties. Whereas oil exports accounted for more than 70% of total exports in 1981, by 1991 their share was only 30%,⁸ and the proportion of manufactured goods had risen sharply from 17 to 59%.⁹ In Mexico too, US direct investment amounts to more than 60% of total foreign direct investment.¹⁰ In order to circumvent measures to protect firms producing import substitutes, US enterprises have set up factories in Mexico to supply the Mexican market.

An intensive, unnoticed integration of the three North American economies was already taking place before the establishment of the free trade areas. As the GDP of Canada and Mexico is only about 10 and 4% respectively of the GDP of the United States, this trading region will be dominated by the USA. What interest do the three countries of North America have in more far-reaching integration through the creation of free trade areas?

Table 1
Exports between the USA, Canada and Mexico

Importing country	(1990)			Total (in US\$ bn)
	USA (as % of total exports)	Canada	Mexico	
Exporting country				
USA	—	21.0	7.2	393.6
Canada	72.6	—	0.3	129.0
Mexico	73.1	2.4	—	26.7

Sources: Collated from Banco de México: *The Mexican Economy 1991*, Mexico D.F. 1991, p. 131; *The Economist Intelligence Unit: Country Report Canada*, London 1992, p. 3; *United States – Joint Economic Committee: Economic Indicators March 1992*, Washington 1992, p. 35; *Overseas Development Council: The North American Free Trade Agreement*, Washington 1992, p. 3.

³ See G. del Castillo: *Mexico and the United States: The Politics of Free Trade and the Loss of Mexican Options*, in: *Latin America's Future in World Trade. Regional versus World Market Integration*. International Conference, Friedrich Ebert Foundation, Frankfurt, March 1992 (mimeo), p. 8.

⁴ Cf. L. Waverman: *Mini Symposium: Modelling North American Free Trade*, Editorial Introduction, in: *The World Economy*, Vol. 15 (1992), p. 3.

⁵ Cf. D. Cox, R. G. Harris: *North American Free Trade and its Implications for Canada: Results from a CGE Model of North American Trade*, in: *The World Economy*, Vol. 15 (1992), pp. 33 f.; *Government of Canada: The Canada-U.S. Free Trade Agreement, an Economic Assessment*, Ottawa, Department of Finance, Fiscal Policy and Economic Analysis Branch, 1988, pp. 18-20; G. C. Hufbauer, J. J. Schott: *North American Free Trade Issues and Recommendations*, Washington 1992, pp. 209-212, 269 and 288-291.

⁶ Cf. J. Whalley: *Regional Trade Arrangements in North America: CUSTA and NAFTA*, in: *New Dimensions in Regional Integration*. International Conference, The World Bank, Washington, April 1992 (mimeo), p. 33.

⁷ Cf. *Government of Canada (1988)*, op. cit., p. 10.

⁸ Cf. *Organisation for Economic Co-operation and Development (ed.): Economic Surveys – Mexico*, Paris 1992, p. 261.

⁹ Since Mexico reports the exports of Maquiladora plant in the services balance, they are not included in this aggregate.

¹⁰ Cf. F. Kolland: *Technologische Sachzwänge und kulturelle Identität. Transnationale Unternehmen im mexikanischen Entwicklungsprozess*, Saarbrücken 1988, p. 171.

Reasons for Formal Integration

There were essentially four reasons for the Canadian Government's proposal to create a free trade area with the USA in 1985:

1. To create a larger market in order to foster the production of goods with a higher value added, for which the Canadian market is too small. Canada hoped that this would produce a more diversified and internationally competitive industrial structure.

2. To circumvent growing US protectionism, which had had very serious effects on the Canadian export sector, heavily geared to the USA.

3. To gain competitive advantages for Canadian industrial sites in Quebec and Ontario, where intermediate products are made for US enterprises. This would slow down the shift in the industrial centre of gravity of the United States towards the South-West and Mexico.

4. To integrate Canada's provinces and bring greater conformity to their widely differing economic policies. This would limit the disputes between the provinces, which tie up considerable resources of the Federal Government in Ottawa.

Mexico's primary objective in seeking a free trade area with the USA is to present itself as a location for foreign direct investment. The switch of European and Japanese investment towards Eastern Europe and Asia at the end of the eighties led to a sharp fall in the urgently needed capital flows to Mexico. Mexico needs rapid economic growth in order to find jobs in the formal economy for the young people pouring into the labour market. However, the desired pace of growth cannot be achieved by Mexican efforts alone, as the stabilisation policy aimed at curbing inflation dampens domestic growth. Mexico therefore needs foreign (investment) capital. It can borrow only limited amounts in the international capital markets owing to its high existing debt. Mexico is trying to boost economic growth without jeopardising stability partly by expanding its exports, but primarily by stimulating an inflow of capital in the form of direct investment. In addition, it sees the NAFTA as a way of shielding itself from US protectionism and hopes for greater access to the US market.

The USA conducted the free trade negotiations with Canada in a less than single-minded manner.¹¹ The Administration wanted primarily to demonstrate its dissatisfaction with the GATT system of world trade. As the treatment of services is a fiercely contested issue in the GATT negotiations, services were explicitly included in the negotiations with Canada. In addition, the USA attempted to obtain preferential terms for a range of goods and investments in the Canadian market, which it dominates in any case. A free trade area with the NIE Mexico is to be understood as a US challenge to other NIEs to liberalise trade in services. At the same time, the United States wants US manufacturers to be granted wider access to the potential growth market that Mexico offers, with a population expected to reach 100 million by the year 2000. It also wants to use the free trade area to support Mexican economic growth, partly to reduce the problem of migration and debt in the medium term¹² and partly to reap the maximum feedback effects, as most of the additional Mexican imports generated by economic growth will be purchased from the USA.

The silent integration that has been taking place in North America has led to marked economic interdependence between the USA and Canada and between the USA and Mexico, but not between Canada and Mexico. Neither the USA nor Mexico was interested in Canadian participation in the NAFTA, as they feared it would impede the rapid negotiations they both desired. Only when Canada declared that it wanted only to safeguard the trade advantages it had achieved in the free trade agreements with the USA but not to make more far-

Table 2
Share of Duty-free Goods in North American Trade

Importing country	Mexico	Canada	USA
Exporting country			
Mexico ¹	(1994) 79% (1999) 87% (2004) 99% (2009) 100%	(1994) 84% (1999) 92% (2004) 99% (2009) 100%	
Canada	(1994) 41% (1999) 61% (2004) 99% (2009) 100%	—	cf. footnote 2
USA	(1994) 43% (1999) 61% (2004) 99% (2009) 100%	cf. footnote 2	—

¹¹ Cf. M. M. Hart: Reconcilable Differences: Negotiating the Free Trade Agreement, University of Ottawa (Carleton University), Occasional Papers in International Trade Law and Policy, 1990.

¹² Cf. W. A. Cornelius: Impacts of North American Free Trade on Mexican Labor Migration, Center for U.S.-Mexican Studies (UCSD), Symposium on North American Free Trade: Prospects and Analysis, San Diego 1991.

¹³ Cf. Government of Canada: North American Free Trade—An Overview and Description, Ottawa 1992, p. iv.

¹ In the case of Mexico, only non-oil exports are considered.

² Between the USA and Canada the arrangements agreed in the 1989 Free Trade Agreement apply unless amended by special provisions or unless the reduction in duties was brought forward at the request of individual industries; i.e. duty on goods in group A was removed immediately in 1989, that on groups B and C will be eliminated in 1994 and 1998 respectively.

Sources: Government of Canada: The Canada-U.S. Free Trade Agreement, Ottawa, Department of External Affairs 1988, p. 43, and La Jornada 13. 8. 92, p. 28.

reaching demands¹³ did Mexico and the USA agree to Canada's participation. Although the NAFTA replaces some of the arrangements of the bilateral free trade area between the USA and Canada, in practice a distinction can be made between two free trade areas in North America: a homogeneous free trade area between the industrialised countries of the USA and Canada and a heterogeneous free trade area between the USA and the newly industrialising country of Mexico.

The bilateral and trilateral negotiations on a free trade area gave rise to extremely voluminous treaty documents with a multitude of special arrangements.¹⁴ Table 2 shows the timetable for the mutual reduction in customs duties in North America.

Mexico will liberalise its trade more slowly than the USA or Canada, but by the end of the transitional period it will also have removed all customs duties on trade with the other two countries. Trade between the USA and Canada will already be free of duty by 1998 under their bilateral agreements.

In addition to the removal of tariff barriers, arrangements have been agreed to dismantle the many non-tariff barriers, in the textile industry and agriculture for example, which will also be largely removed by the year 2009, although a series of exemptions will remain in this area. The local content, which is generally set at 50% of production costs, has been fixed at 62.5% for the automobile industry within the framework of the NAFTA under pressure from the USA. Trade in services will also be liberalised. The opening-up of the markets in financial services, telecommunications and transport services is of especial importance. In particular, the Mexican rule that only Mexican companies may offer transport services in Mexico has proved in practice to be a tremendous trade barrier, as insufficient capacity was available to carry many US goods to urban centres. The comprehensive rules on investment in Mexico and Canada, which prohibit foreign companies from investing in certain industries and generally give the authorities strong powers to co-determine and control investment, have been eased for US investment in many industries. Trade disputes will be settled by a panel comprising an equal number of members from the countries concerned. In this way the US Congress is ceding national competence in trade matters to an international institution for the first time.

Effects of the Free Trade Areas

The North American free trade areas are being very hotly debated in the countries concerned and with regard to their impact on world trade. A host of widely differing predictions have been made as to their expected economic effects.

□ For Canada, the welfare effects are put at between -1.0% and 9.0% of GDP.

□ For Mexico, trade gains of up to 8% of GDP are predicted, but so too is complete de-industrialisation as regards capital-intensive production.

□ For the United States, predictions range from insignificant changes to massive downward pressure on wages.

□ The free trade areas in North America are seen by some as an interim stage on the path towards multilateral free trade, but by others as a step on the road to the abolition of free trade.

A study of the North American free trade areas and their impact on the participating countries and on world trade¹⁵ makes predictions about their effects on the basis of the theory of free trade areas, the political aims of the countries involved and the concrete courses taken by the negotiations.¹⁶ The study was discussed with governmental bodies, universities and other research institutions during a three-month research stay in the USA, Canada and Mexico and assessed in conjunction with the latest macro-economic studies and industrial surveys in order to identify initial trends and make forecasts about the effects the free trade areas are likely to have on participating countries and on world trade.

Advantages for the Smaller Partners

1. To what extent can a free trade area with an economically larger partner such as the United States produce foreign trade advantages for an economically smaller partner such as Canada or Mexico?

In view of the strong economic integration of Canada and Mexico with the USA, classical and neo-classical foreign trade theory suggests that the two economically smaller countries will derive only minor foreign trade benefits.¹⁷ Given unfavourable combinations of elasticities in both Canada and Mexico, the gains will be

¹⁴ Cf. R. M. Bierwagen, V. Heegemann: Das Freihandelsabkommen zwischen Kanada und den Vereinigten Staaten, in: *Recht der Internationalen Wirtschaft*, Vol. 35 (1989); Government of Canada (1992), op. cit.

¹⁵ H. V. Proff: *Freihandelszonen in Nordamerika – Auswirkungen auf die beteiligten Länder und den Welthandel*, Dissertation, Technische Hochschule Darmstadt 1993.

¹⁶ In order to be able to make a realistic analysis, the classical and neo-classical theory of free trade areas was widened to include explanations of intra-industrial trade as described in the new foreign trade theory. Dynamic processes were also incorporated by taking account of a change in the behaviour of firms with regard to goods production and direct investment; cf. H. V. Proff, op. cit., chapters 2.2 and 3.2.

¹⁷ See for example K. Andersson: *The U.S.-Canada Free Trade Agreement; Who Will Be Better Off?*, in: *Journal of Policy Modelling*, Vol. 12 (1990), pp. 693-713.

significantly less than 1% of GDP. Such small trade gains provide ammunition for the critics of the free trade areas with the USA. At the same time, opponents point to a possible loss of national sovereignty and a difficult process of adjustment.

The globalisation of markets and the internationalisation of production have, however, led to a transition from national to "international economies",¹⁸ whose behaviour influences other countries and which are themselves influenced by other countries, so that nationalistic arguments become increasingly irrelevant.

Moreover, by extending the theoretical analysis to include intra-industry trade flows in the sense used in the new trade theory, it can be shown that a free trade area boosts the intra-industry exchange of goods among member countries. This benefits primarily the smaller economies, as the size of foreign trade gains depends on the economies of scale that can be achieved.¹⁹

In view of the smallness of the Canadian and Mexican domestic markets and the lack of sales opportunities abroad, some industries in both countries are not competitive, as the optimum plant size requires a larger volume of sales than the domestic market can absorb. Given the rising proportion of fixed costs in industrial production, this problem will intensify in future. If Canada aims to boost industrialisation in order to diversify its exports, the market for its goods must be expanded. Since the EC and Japan do not take sufficient Canadian products, there remains only the US market. The expected impact of the free trade area is already being confirmed by the increase in private investment in Canada and Mexico. Moreover, company surveys show that companies have recognised the market opportunities.

Even if the direct welfare effects of the free trade areas cannot be determined finally until the transitional phases have ended, the forecasts based on the hypotheses clearly indicate significant foreign trade gains for Canada and Mexico.

Consequences for Industrial Development

2. Can a free trade area with a highly industrialised country like the USA foster industrial development as well as producing foreign trade gains for an economically smaller, less advanced country such as Mexico?

In less developed countries, foreign trade gains do not necessarily foster industrial development, as in many countries there is a conflict between the objective of increasing macro-economic welfare and that of raising industrial output.²⁰ De-industrialisation as a result of the liberalisation of foreign trade during the creation of a free trade area can only be averted if the industrial sector is

strong enough to ensure the survival of sufficient firms inter-related by sales and supply relationships despite increasing foreign competition. If only niche suppliers operating in isolation remain, there is a danger of de-industrialisation.

Mexico's industrial sector comprises many inefficient and unviable enterprises producing import substitutes, but also strong companies with Mexican capital that will offer competition to US suppliers in particular markets.²¹ Even before the creation of the free trade area, sufficient Mexican firms were able to produce technically advanced products at internationally competitive prices. Thanks to improved access to the US market and the economies of scale that makes possible, they are now in a position to manufacture more capital-intensive products more cheaply. Hence the NAFTA is not likely to lead to de-industrialisation in Mexico, nor is it expected that resources in manufacturing industry will be switched exclusively to wage-intensive products. In 1991, a year after negotiations began, the output of industrial goods was 4.2% higher than in the previous year.²² It is to be expected that this trend will continue and that the NAFTA will not only bring Mexico foreign trade gains but also boost its industrial development.

Need for Adjustment in the USA

3. To what extent will the creation of a free trade area alter the economic structure of an economically strong country such as the USA?

On the basis of the static theory of free trade areas, the establishment of free trade areas with Canada and Mexico is likely to produce only extremely small welfare gains for the USA. Whereas the free trade area with Canada, an industrialised country, has led to only minor changes in the behaviour of US firms, the free trade area with Mexico, a newly industrialising country, will force them to make adjustments. Even greater wage pressure will be put on unskilled US workers, so that labour-intensive mass production with low levels of innovation and technology will become even less attractive in the USA. At the same time, the long-term decline in returns on investment in the

¹⁸ C. Köhler: *Internationalökonomie*, Berlin 1990, p. 14.

¹⁹ Cf. P. R. Krugman: *Rethinking International Trade*, Cambridge (Mass.) 1990, p. 50.

²⁰ Cf. C. A. Cooper, B. F. Massell: *Towards a General Theory of Customs Unions for Developing Countries*, in: *The Journal of Political Economy*, Vol. 73 (1965), pp. 461-476.

²¹ See J. A. García: *Las Empresas Mexicanas, Su Ocupación Y El Tratado De Libre Comercio*, in: *Red Mexicana de Acción Frente al Libre Comercio* (ed.): *Libre Comercio o Explotación Libre?*, Mexico D.F. 1991, pp. 54-57; G. C. Hufbauer, J. J. Schott, *op. cit.*, p. 220.

²² Cf. Statistisches Bundesamt: *Statistik des Auslands, Länderbericht Mexiko*, Stuttgart 1992, p. 72.

United States means that US investment in Mexico will rise, particularly as there are now legal safeguards for investment in this country. As a result, additional jobs will be transferred out of the USA.

The NAFTA will therefore force US industry to make up for its tardy reaction to the globalisation of markets and the internationalisation of production in the eighties. This is one of the main reasons for its declining international competitiveness and the United States' rising trade deficit.²³ By transferring production abroad and optimising the value added chain, US firms will attempt to improve their international competitiveness, so that NAFTA makes Mexico particularly attractive as an investment location for US companies. For the USA, the creation of the NAFTA has the effect of a trade-oriented structural policy as part of a comprehensive strategy to raise the international competitiveness of US industry.²⁴ Despite the difference in the size of the US and Mexican economies, the USA will undergo significant economic changes, particularly in the South.

Impact on World Trade

4. What impact does the increase in the regionalisation of the world economy as a result of the North American free trade areas have on third countries and on the structure of world trade and on the world trade order?

The NAFTA will reinforce the tendency for multinational companies to obtain supplies and to manufacture their products worldwide, and especially in low-wage countries, and hence to reduce the proportion of value added in the industrial countries. Direct investment in Mexico by firms from both the USA and third countries will lead in the medium term to a decline in merchandise trade among the Triad, in other words between the main industrialised trading regions of North America, South-East Asia and Europe, as multinationals from third countries will produce in Mexico, despite the sometimes restrictive local content rules, in order to be able to supply the US market and the potential growth market in Mexico cheaply. Many US firms that have transferred wage-intensive stages in their manufacturing processes to East Asia will give preference to Mexico once the NAFTA has been implemented and will divert individual direct investments to Mexico, as the improved conditions in that country and its geographic proximity will reduce transaction costs. Merchandise trade will generally be more intensive between countries at different stages of development than between countries at the same stage. This trend is further reinforced by trade integration between an industrial country and a developing country such as is occurring in the NAFTA. At the same time, trade in services and production factors between the main trading nations will increase.

The expected regionalisation of merchandise trade is often seen as a threat to world trade. This fear appears to be groundless, for three reasons:

1. Econometric models show that trade wars produce no economic advantage, even for a large trading region.²⁵ Consequently, the USA will not gain a negotiating advantage vis-à-vis the EC as a result of the NAFTA.

2. Welfare analyses show that welfare is not lower in a world trading system consisting of three regions than in the present system of multilateral trade under the rules of the GATT.²⁶

3. Only within the EC is an overwhelming proportion of exports carried out within the trading region (60%).²⁷ By contrast, the NAFTA countries, with 42%, and East Asia, with 33%, must have an interest in open world markets. Since in addition the activities of multinational enterprises and the integration of the international capital markets have created a high degree of interdependence in the world economy, special regional arrangements offer no development prospects. Similarly, the present urgent problems of poverty and environmental pollution can be resolved only through worldwide co-operation.

Increased regionalisation as a result of the creation of free trade areas in North America will not replace or supersede the multilateral system of free trade. Rather, regionalisation can be seen as a step on the path towards multilateral free trade, the future institutional arrangements for which have not yet attracted a consensus.

It is easy to criticise the outcome of the negotiations in view of the safeguard clauses for partner or third countries. However, in view of the lack of ideas or concepts in the economic and trade policy of many industrial countries, the free trade agreements in North America are a positive demonstration that an active regional trade policy can produce welfare gains in countries at different stages of development without impairing the liberalisation of world trade. Moreover, the NAFTA can serve as a model for the closer integration of developing countries into the world economy.

²³ Cf. H. V. Proff, *op. cit.*, chapter 2.1.3.

²⁴ Cf. Competitiveness Policy Council (ed.): *First Annual Report to the President and Congress*, Washington 1992.

²⁵ Cf. D. Gros: *A note on the optimal tariff, retaliation and the welfare loss from tariff wars in a framework with intra-industry trade*, in: *Journal of International Economics*, Vol. 23 (1987), pp. 357-367.

²⁶ Cf. P. R. Krugman: *Is Bilateralism Bad?*, in: E. Helpman, A. Razin (eds.): *International Trade and Trade Policy*, Cambridge (Mass.) 1991, p. 20.

²⁷ Cf. J. J. Schott: *Is the World Developing into Regional Trading Blocs?*, in: E. Kantzenbach, O. G. Mayer (eds.): *Perspektiven der weltwirtschaftlichen Entwicklung und ihre Konsequenzen für die Bundesrepublik Deutschland*, Hamburg 1990, pp. 36-54.