

Jütte-Rauhut, Judith

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Judith Jütte-Rauhut*

NAFTA: Results After One Year

Increasing efforts at "regionalisation" can be observed worldwide, initiated particularly by the successes of the European Union (EU), the Association of Southeast Asian Nations (ASEAN) and also through the foundation of the North American Free Trade Agreement (NAFTA). What expectations are involved in such amalgamations, what problems arise and how can future opportunities be assessed, briefly: cui bono? The following paper analyses these questions with the help of experiences and information gained by NAFTA and attempts to answer them.

The implementation of NAFTA incorporated many problems. An important aspect was the attitude of the USA, which was regarded for a long time as a particularly strong supporter of the General Agreement on Tariffs and Trade (GATT). Only within the framework of the 1986 to 1994 GATT negotiations, unsuccessful for a long period of time, did the USA indicate its willingness to sign regional trade agreements – under certain circumstances free trade zones and customs unions are permitted by the GATT regulations. In 1985 the USA signed a free trade agreement with Israel and in 1988 with Canada. The motivation for the agreement with Israel is more political than economic. But the bilateral agreement with Canada (CUSTA, Canada-US Trade Agreement) can be regarded as a foundation-stone for the creation of the trilateral free trade zone between Mexico, Canada and the USA.¹

In February 1991, the governments of these three countries officially declared their intention to create a North American free trade zone. On 1 January 1994, NAFTA was finally implemented. With a population of 360 million and a gross national product of over US\$ 7,000 billion, the world's largest free trade zone was created. Its objectives were defined as follows:

- ☐ removal of trade barriers;
- ☐ promotion of fair competition;
- ☐ increase in investment opportunities;
- ☐ granting of appropriate legal protection for commerce;
- ☐ introduction of appropriate arbitration mechanisms and
- ☐ promotion of trilateral and multilateral cooperation.

Moreover, in the additional agreements negotiated in 1993 objectives and procedures were laid down for cooperation in the fields of environmental protection and implementation of working standards. In general, they abstained from the creation of joint institutions. The three member states do not currently plan any alignment of economic policy based on a joint currency beyond intertrade.²

Member Profiles

The USA, with an overall area of 9.4 million square kilometres, is the fourth largest country in the world and the dominant economic force within NAFTA: with a population of approximately 255 million, in 1993, its gross national product was approximately US\$ 6,300 billion, which corresponds to a per capita income of US\$ 25,000.³ At US\$ 533 billion, Canada's gross national product is clearly lower. But with a population of 29 million, the world's second-largest country has a high per capita income of approximately US\$ 20,000.⁴ Mexico, previously a newly industrialising country and now an industrial nation, clearly presents a different economic picture: the 1993 gross national product of US\$ 360 billion corresponds, with a population of almost 90 million, only to a per capita income of almost US\$ 4,000.⁵ The origin of the national income varies considerably between these three member states.

¹ S. Weintraub: The North American Free Trade Debate, in: The Washington Quarterly, Vol.13, No. 4, Washington 1990, pp. 119-130.

² M. Hart: A North American Free Trade Agreement: The Elements Involved, in: The World Economy, March 1991, pp. 87-102.

³ Bundesstelle für Außenhandelsinformationen (ed.): Länderreport USA, Cologne, January 1995.

⁴ Bundesstelle für Außenhandelsinformationen (ed.): Länderreport Canada, Cologne, January 1995.

⁵ Bundesstelle für Außenhandelsinformationen (ed.): Mexico, Cologne, January 1995.

* Aachen University of Technology, Germany.

The US agricultural sector is the world leader regarding output and productivity. In the extent, variety and processing of raw material reserves, the USA also has a leading position worldwide. The share of manufacturing industry in the gross domestic product amounts to approximately 20% and is, compared with other industrial countries, rather low. Canada has considerable economically significant mineral commodity resources and an efficient agriculture. The share of manufacturing industry in the gross domestic product is decreasing. In Mexico, agriculture provides the income for almost 50% of the population; its share of the gross domestic product amounts to approximately 5.5% (1993). Insufficient increases in productivity, population growth and crop failures are the current situation here. Mexico has considerable mineral deposits which contributed to the relatively rapid industrialisation of the country. The share of manufacturing industry in the gross domestic product is, at 33%, increasing. The Mexican "refinement" industry (Maquiladora) is one of the most dynamic sectors: these are mostly production and assembly plants of US-American parent companies, often located on the border with the USA, which carry out wage-intensive production processes at low costs. The Maquiladora industry (particularly electrical engineering, car accessories, food, chemicals and clothing) has developed into the second most important source of foreign exchange (after crude oil).

What brought these three so different countries to the decision to set up a joint free trade zone? Each country, before negotiations began, saw it as a priority to achieve continuous economic growth. But we can speculate at this stage that the implementation of the free trade zone can be traced back to specific motives of the countries involved and the individual interests of certain social groups (companies, trade unions, environmental protection associations etc.) The different assessments will be analysed below.⁶

Motives for Signing

For the USA, potential economic consequences, in statements regarding NAFTA, were in the foreground. The most important aspects in this connection are the following:

☐ Expansion of the market: access to the Mexican crude oil sector plays a particular role here. In the Canadian market, interests are aimed particularly at the media sector; the inclusion of further economic fields is mainly regulated through existing bilateral free trade agreements.

☐ Increase in demand: the USA hopes to attract more consumers through the Mexican market and therefore increase exports of US products.

☐ Job creation: with an economically stronger Mexico and rising demand as a consequence, the USA hopes to create new jobs.

☐ Improving international competitiveness: the use of lower Mexican wage levels through US American direct investments should contribute to this improvement.

The most important political aspect of the NAFTA negotiations was the stabilisation of Mexico. Linked to an economy which was increasingly recovering (at least until the end of 1994), this indicates an attempt to strengthen the entire region as a counterbalance to the feared EU internal market as well as the increasingly successful Asian countries and the Southeast Asian economic association, ASEAN.

For Mexico, NAFTA membership is an important element of its policy of opening up the economy, initiated by President de la Madrid and continued by President Salinas following the 1988 change of government. Mexico's main motives can therefore be found in various sectors:

☐ Expansion of the market: Mexico's main interest is the long-term contractual safeguarding of access to the US American market. This includes in particular the removal of non-tariff trade barriers and the elimination of negative effects through short-term changes in US American trade policies (which occurred particularly within recent years).

☐ Improving international competitiveness: NAFTA should support the considerable economic reforms which have already been begun. In this context, Mexico aims particularly for the improvement of international competitiveness by accelerating changes in economic structures. This means that, via export diversification, markets beyond the North American free trading zone gain more momentum.

☐ Improvement in the climate for investors: Mexico is interested in creating a positive climate for foreign capital. In order to do this, investors from Japan and Europe in particular need to be attracted, besides the main investors from the USA, so as to counterbalance strong US dominance.

From the political viewpoint, Mexico had little motivation to join but one can assume that the USA

⁶ B. J. Hippler, A. F. Holmer: The North American Free Trade Agreement Negotiations: The Players, Procedures, Prospects and Potential, Washington 1991.

will assert its influence within the framework of Mexican political reformation, for instance by supporting democratic movements. On this point, opponents of the agreement, who fear a loss of national identity and sovereignty, find their position confirmed.

Canada's motives for signing the agreement are also primarily connected with economic factors. But the country is in a special position: on the basis of "damage limitation" the potential danger is to be confronted that trade and investment diversification connected with NAFTA could favour Mexico and be disadvantageous for Canada. The present minor trade connections with Mexico cannot compensate for this deficit. Canada's main motives can therefore be described as follows:

□ Expansion of the market: Canada aspires to get better access to the US American market particularly in the sectors of financial services and public procurement. The Mexican market is also interesting because Canada expects, with economic growth and increased real income, that positive demand stimuli can be expected for Canada's economy too. With a support programme for Canadian firms, the so-called "Access North America", passed in 1993, export opportunities to Mexico are backed. Can\$ 27 million were put at the disposal of the programme for four years.

□ Safeguarding of the negotiation results of the bilateral agreement: Canada is very concerned that the successful 1988 negotiation results regarding the free trade agreement with the USA (CUSTA) be maintained. That applies, for instance, to the beer trade because Canada fears that, through the trilateral free trading agreement, Canadian breweries will be under massive competitive pressure from Mexican breweries.

As can easily be seen, Canada's motives for joining NAFTA are less influenced by political considerations than by the fear of a long-term weakening of the Canadian economy through a lack of competitiveness and the loss of the positive effects from the bilateral agreements with the USA.

It can be summarised that of all the members Mexico sees the agreement as offering most hope in the areas of increased trade and investments, accompanied by growth and stability. The main reasons for the USA's joining in are the access to the dynamic growing Mexican market and foreign policy and security interest in Mexican economic stability. Canada's reasons for joining NAFTA are mostly of a

defensive nature, particularly defined by the fear of a weakening of the successes achieved through the bilateral agreement with the USA. However, the agreement was only signed a year ago and detailed results can hardly be derived from current developments. But it is interesting to examine whether trends indicate that NAFTA is already influencing the current developments within the triad of Canada, Mexico and the USA.

Current Developments

For the USA, NAFTA was the first step in implementing a free trade zone which should, in future, include the entire American continent: from Alaska to Tierra del Fuego. The reason for this lies in the fact that Latin American countries should be given incentives to implement further economic reforms to achieve better economic development. With the so-called "Enterprise for the Americas", the USA pursues both economic and very concrete foreign policy interests: worldwide changes, for instance the end of the Cold War, radical political changes in the formerly communist economies and the, in part, very successful developments of economic blocs on all continents contributed to the classification of Latin America as an attractive economic partner. The three essential elements of this initiative, which should in particular contribute to increased prosperity on the American continent, are:

- liberalisation of trade,
- promotion of investments, and
- debt reduction.

The initiative, proposed by President Bush in 1990, has given the Latin American integration movement new impetus.⁷ Current approaches such as, for instance, Mercosul (Argentina, Brazil, Paraguay and Uruguay) or the Andean Pact (Bolivia, Ecuador, Columbia, Peru and Venezuela) but also CARICOM (13 Caribbean countries) are regarded as important steps towards the long-term objective of a free trade zone encompassing all the Americas. A study by the "Institute for International Economics", published recently, recommends such an extension of the free trade zone (Western Hemisphere Free Trade Area, WHFTA) because an extension could bring strong growth impetus for America. The study also examined to what extent countries of the American continent are

⁷ G. Bush: Remarks Announcing the Enterprise for the Americas Initiative, in: Weekly Compilation of Presidential Documents, Vol. 26, 1990, pp. 1009-1013.

currently able to meet the free trade and investment obligations agreed in NAFTA; as next potential member country, Chile was therefore recommended. Mr. Kantor, the US official responsible for trade, particularly mentioned the following as important criteria for future negotiations regarding an extended NAFTA membership: sufficient safeguarding of intellectual property and investments, environmental protection as well as high standards of workers' rights. The study concluded that, through the extension of WHFTA in 2002, the USA could achieve an increase in exports of US\$ 36 billion and an increase in imports of US\$ 28 billion. At the beginning of December 1994, the 34 democratic nations of the American continent agreed at a summit conference to implement a "Free Trade Area of the Americas", FTAA: by 2005 negotiations for trade and economic integration of the North and South Americas should be concluded, and by 2010 the outlines of an Asian-Pacific free trade zone should be recognisable. If the ideas of President Clinton can be realised, the USA should act as a connecting link between both organisations.

But NAFTA is currently a long way from these visions. Numerous minor and major obstacles impede (for all member countries equally) satisfactory implementation. Below is an attempt to indicate and analyse the important influential factors within the development of NAFTA. This reveals that many problems which still exist are centred on Mexico.

Lack of, or inadequate, infrastructure. This aspect plays a key role, particularly within the framework of cooperation with Mexico. According to estimates, costs for improving the infrastructure at the American-Mexican border would be US\$ 16 billion. These financial resources would be needed for the funding of new bridges, border crossing points, roads, communication facilities and canalisation before the idea of a North American free trade agreement can be implemented. To date, the USA and Mexico have each made US\$ 3 billion available. A suitable way to involve the private sector in the funding is being sought. For the infrastructural development of the rest of the country, the Mexican government planned to invest US\$ 15 billion in 1994; in the previous year it made US\$ 10 billion available.

Lack of qualified workers. The Mexican market, of particular interest to the USA, has a crucial shortage regarding appropriate investments: the very limited number of qualified workers available signifies a special cost factor for investors because the only solution is often expensive internal company training.

Differences in the R&D sector. Almost all Mexican companies (98%) are small to medium-sized; investment in research and development (R&D) was practically non-existent. This has often meant in concrete terms the use of old machines, lack of knowledge within the framework of product development and insufficient quality control. These facts reflect the overall Mexican picture: in the field of R&D, this country lags behind all other OECD member countries; for 1993, the share of R&D of the gross domestic product is declared at 0.33% and for 1994, at just over 0.4%. (In comparison, the share in the USA is 2.75% and in Germany 2.66%.) The technological underdevelopment of Mexico's small to medium-sized companies gives them no chance in competition with the much more efficient US American companies. Particularly affected by the strong competitive pressure are dairies and the electronic and car part sectors. To improve the Mexican situation, a programme for the promotion of science and technology, at this stage limited to three years, was introduced in 1992. With an annual budget of approximately US\$ 100 million, the linkage of publicly promoted research and industrial utilization should be achieved. This development is needed to ensure that the technological gulf between the USA and Canada on the one hand and Mexico on the other does not increase, or at least remains constant.

Renunciation of a supervisory committee on competition policy. The NAFTA agreement provides for the institution of a supervisory committee on competition policy. The task of the committee would be to make recommendations on how potential differences can be settled between the USA, Canada and Mexico regarding competition law and competition policy. But government and trade representatives of the three NAFTA countries agreed that no demand exists for an authority of this kind: the deviation from NAFTA was made for the reason that a fundamental accord exists within the framework of national laws against limitation of competition. Just one year after the ratification of NAFTA one cannot make a concrete assessment as to what extent the harmony in the field of competition law emphasised by the three member countries in fact exists. But problems are already beginning to emerge which cannot easily be resolved. One example is the tension in the agricultural and forestry trade between Canada and the USA: the Washington government imposed a 6.5% duty on certain types of Canadian timber, which clearly reduces Canada's competitiveness with regard to other countries (e.g. Sweden). In contrast, the

Ottawa government plans for July 1995 the introduction of high import duties on milk and dairy products as well as eggs and poultry, which will replace the current import quotas laid down by the Uruguay Round. With the introduction of the new customs tariff, the Canadian market for agricultural products should be protected as effectively from competition from the US economy as through the current quantitative import restrictions. Despite NAFTA, GATT and CUSTA, protective duties remain a central point of dispute between the USA and Canada.

Whether the rejection of the "NAFTA Competition Panel" is sensible remains to be seen. On the one hand, the absence of a committee to point the way ahead, can, particularly in the sensitive area of competition regulations, lead to problems if a country considers its only way to secure the local market, because of current economic problems, is by imposing competition limitations. This danger becomes more realistic if NAFTA is less successful than expected. But on the other hand, the rejection of the NAFTA clause can be interpreted as a retreat from regulations which could (potentially) influence national sovereignty. This view can also be confirmed by the fact that the creation of an organ, comparable to the EU Commission, has been rejected. Time will tell whether an agreement, such as NAFTA, can achieve the set objectives without any supranational body.

High standards of environmental protection. In the field of environmental protection, NAFTA sets standards which cannot currently be met by many Mexican (and also other international) companies. The "Fast-Track-Negotiating Authority", demanded by President Clinton from Congress, should give the US government a mandate for new trade talks for the extension of NAFTA, containing the condition that environmental protection regulations are to be

included. Although from the viewpoint of environmental protection this action must be regarded as essential and sensible, it is an obstacle for NAFTA. The linkage of trade and investment interests with environmental protection standards means a partially insoluble problem not only for Mexico. For other Latin American countries too, this linkage can (along with working standards) develop into an obstacle, difficult to overcome, when the NAFTA extension negotiations continue. As yet, the USA benefits primarily from the great demand for corresponding technologies and services resulting from these environmental protection regulations. The North American Development Bank, which is currently establishing itself in Texas, is to make US\$ 3 billion available for environmental protection projects along the American-Mexican border.

Abolition of customs drawbacks. One regulation of NAFTA includes the abolition of customs drawbacks in the case of re-exports of imports to Canada and Mexico. It can be assumed that this will lead to additional costs for US companies in the region of "double-figure millions" in US dollars. From the four categories of customs drawbacks, the first one has already been removed without replacement in January 1994, when the agreement came into effect; the other three categories are to end in 2001 at the latest. It has been estimated that approximately 100 US companies are affected by the abolition of the first drawback category and that they will then have to deal with an additional expenditure of US\$ 70 million. The drawback programme will only be abolished for NAFTA countries but remains in force for all other countries. Critics of NAFTA see in the abolition of the customs drawbacks programme another argument that the agreement brings considerably more disadvantages than benefits, particularly for the US economy. In contrast, pro-NAFTA experts object that

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the different categories have not proved to be successful: they substantiate this with high administrative costs and, in some cases, complete impracticality.

Final Assessment

From the above aspects, which can influence NAFTA's success, one cannot currently derive a reliable prognosis. As experienced in the European Internal Market, when an agreement comes into force it only means the beginning of an implementation process of medium-term or long-term objectives. Whether the implementation takes place in practice or how long this implementation process takes depends also on the extent of mechanisms which have been planned to implement effective "penalties" if some contractual parts have not been observed. This is, as mentioned above, hardly possible within the framework of NAFTA and currently inconceivable: the policy of this agreement is influenced to a higher degree by sovereign and to a lesser degree by communal concepts. This could lead to the extrapolation that NAFTA could quickly develop into an insignificant idea if the corresponding successes do not take place in the individual member countries. But successes do not mean, as is the case in the European Union, an improvement of regional competitiveness or regional political stability. In this case, short-term and presentable economic results are needed in the individual member countries. To what extent expectations can be fulfilled, with regard to NAFTA, can only be answered, a year after the agreement came into force, with reference to general trends.

Currently, the institutional structure is implemented as agreed in NAFTA. In San Antonio (Texas) the preconditions are to be created to establish the North American Development Bank. In Dallas (Texas), a NAFTA Information Centre and a Secretariat for Labour Market Issues will be set up. In Mexico, a similar authority for trade issues has been established. The US Environmental Authority plans to establish two further local offices in El Paso (Texas) and San Diego (California). Mexico deals also with bilateral environmental projects. Besides its participation in the North American Development Bank, the country is attempting to channel finances for ecological "clearing up projects". Toronto has been selected as headquarters for the multinational NAFTA secretariat. As mentioned above, environmental protection issues form part of the most important subjects of the agreement.

According to the US Bureau of Economic Analysis, the first six months after the agreement came into force showed a clear extension of the trade volume: compared with the comparable period of the previous year, US exports to Mexico increased by 16.7% to US\$ 24.4 billion and to Canada by 9.6% to US\$ 56 billion. Imports from Mexico increased by 20.3% to US\$ 23.7 billion. Canada's exports to the USA increased by 10.2% to US\$ 62.7 billion. According to figures available at the end of 1994, this trend could be confirmed. The high increase in US exports to Mexico can be traced back particularly to the high demand for American cars. According to estimates, the USA was therefore able to offer 100,000 new jobs; the 1993 unemployment rate of 8.5% was reduced to approximately 6% in 1994. In 1994, Mexico was able to attract direct investments of approximately US\$ 9 billion.

But the question arises as to what extent this development can be traced back to a changed, i.e. more positive economic situation in the member countries: can a definite correlation be established between increased regional trade and the NAFTA agreement? Currently, a demonstrable context cannot clearly be substantiated. There are also no clear signs of increased internal investments. It can only be ascertained that NAFTA did not lead to a worsening of trade relations. On the contrary, due to the opening of the markets one can assume advantages in the industrial sector, for instance, through a higher potential demand. Advantages which a country with strong companies can certainly put to good use. Disadvantages can be expected for groups which cannot adapt quickly to a changed situation in competition. This situation can be assumed particularly in Mexico, to be precise, for both Mexican companies and the population: in 1993, the unemployment rate increased to 3.5% (1992 = 2.8%); in 1994, a further increase to approximately 3.7% took place. Many facts indicate that Mexico will drop into a recession: through the drop of the exchange rate of the Peso in late 1994, international sales of Mexican goods increased but so did the danger of inflation (1987: 140%). After 7% in 1994, an inflation rate of 15% has been forecast for 1995. Before the drastic devaluation of the Peso, the USA exported goods and services to Mexico for approximately US\$ 60 billion and obtained in the first nine months of 1994 a trade surplus of US\$ 1.7 billion. This development is currently interrupted; several companies are making depreciations against losses in double-figure millions. A new Mexican crisis even arose at the end of 1994 which, although it was not of the same dimensions as

the crisis of 1982, nevertheless caused uneasiness on international markets. In December 1994 the Mexican government under President Zedillo decided that the Peso should no longer be pegged to the US dollar. Within the space of only a few days the Peso had depreciated against the major western currencies by about 40%. The currency crisis caused nervousness and sudden price falls on the stock exchanges throughout Latin America, but already at the beginning of February 1995 a restabilisation took place; an IMF standby credit, which was increased from US\$ 7.6 billion by US\$ 10 billion and a loan of a further US\$ 10 billion from the Bank for International Settlements contributed to the easing of the situation. In addition, Mexico's integration into NAFTA means that it can hope for aid from Washington, even if this is tied to strict conditions. US \$ 20 billion are to be granted from the Monetary Stabilisation Fund if Mexico guarantees that it will pursue a tighter money supply policy.

The Mexican oil industry plays a decisive role in the providing of collateral for these funds; its profits are to be pledged as security for US loans. Mexico itself is attempting by means of an emergency programme aimed at expanding privatisation to build up investor confidence anew; the most important measure planned is the privatisation of the oil sector. This would represent the first of the steps towards the opening up of the energy sector hoped for by the USA, and Washington could in this way secure its control over Mexico's oil revenues. Within the framework of its austerity policy, the Mexican government is considering the enforcement of a special paragraph of NAFTA: during economic emergencies in a partner country special duties can be imposed unilaterally on imports.

Does the NAFTA agreement only offer benefits for the already privileged, i.e. does the stronger member reap the main advantages from the easing of restrictions whilst the weaker profits only marginally? Assumptions of this kind can certainly not be maintained in such a blatant way. Mexico will benefit strongly from NAFTA but not immediately. NAFTA accelerates the necessity for structural economic changes with regard to the changed situation (particularly privatisation and increased accessibility for foreign investors), and that needs time. The conclusion of a trade and investment agreement between Mexico and Australia at the end of 1994 can therefore be regarded in this connection as a strengthening of Mexico's position: through the creation of a bilateral commission, exchange of goods between

both countries and Australian investments in Mexico are to be promoted.

A fundamental assessment can only be made in the late nineties. In the short-term it is possible that all three member countries – without taking into account economic development worldwide – may experience an increase in unemployment in some sections of the economy, be it through low wages in one country or through more competitive products (or production) in another. But in the long term all participants will benefit because, as shown in the European Union: in the beginning, regional economic cooperation demands concessions (from the strong countries) and inevitably compromises. Ross Perot's negative campaign against NAFTA can be classified from this angle, whose black scenario particularly puts the loss of several million jobs, arising from the free trade agreement, into the foreground. The US Labour Department developed a special adjustment programme for workers who lost their jobs through NAFTA: in 1994, only 10,000 workers were classified as qualifying for support. (The number of applications received was estimated at approximately 20,000). In the long term, NAFTA offers an alternative means of adjustment to the relevant requirements of the world market, without infringement of free and fair competition through protectionism.

The dream of an extensive free trade zone can be realised in this way but the time factor plays a particular role: at the beginning, the current NAFTA formation should have as an objective the removal or at least reduction of existing problems. Only if successes are achieved in this field, should concrete discussions take place regarding an extension. Mexico considers the admission of further countries in the most positive manner by far, because the economic consequences are the least vital for Mexico. Canada is more undecided whilst the USA declared the strongest reservations. In Latin America, the idea of a free market economy currently has new impetus whilst in some countries the demand for internal reforms is accompanied by the desire to join NAFTA. In this context it is important that NAFTA can demonstrate positive results because under such circumstances countries will show increasing willingness and motivation to join NAFTA. This applies not only to the economically weak countries, for which NAFTA can be regarded as an anchor (also during implementation of internal reforms), but also for powerful candidates who would contribute positive impulses for the objectives of the agreement and therefore prosperity for all member countries.