Outline: Preferential Trading Arrangements and the NAFTA

• What Are PTAs?
• Examples
  – European Union (EU)
  – North American Free Trade Agreement (NAFTA)
• Effects of PTAs
  – Not the Same as Free Trade
    • Trade Creation
    • Trade Diversion
  – Market Diagram Illustration
• NAFTA
  – History
  – Analysis
  – What Happened?
• NAFTA Renegotiation and USMCA

What Are PTAs?

• A Preferential Trading Arrangement (PTA) is a trade policy that favors one country over another
  – Most obvious cases: Charge a lower, or zero, tariff on imports from one country while charging a higher tariff on imports from another
  – Also called a Regional Trade Agreement (RTA – the term used by the Gerber textbook and by the WTO) when a group of countries in a region do this with each other
    • Term is used even when the countries are not near each other
What Are PTAs?

• In WTO (and GATT), the MFN principle would prohibit this
  – All members are supposed to be charged a country’s MFN (Most Favored Nation) tariff
  – However, some exceptions are explicitly permitted in rules of GATT & WTO

Outline: Preferential Trading Arrangements and the NAFTA

• What Are PTAs?
• Examples
  – European Union (EU)
  – North American Free Trade Agreement (NAFTA)
• Effects of PTAs
  – Not the Same as Free Trade
    + Trade Creation
    + Trade Diversion
  – Market Diagram Illustration
• NAFTA
  – History
  – Analysis
  – What Happened?
• NAFTA Renegotiation and USMCA

Examples of Legal PTAs

Permitted by WTO:
• Free Trade Areas (FTAs)
  – Members have zero tariffs against each other on essentially everything (also Customs Unions and Common Markets, which include FTAs)
• GSP = Generalized System of Preferences
  – Developed countries have lower (not usually zero) tariffs on some goods from developing countries
Examples of Legal PTAs

Permitted by WTO:

- Anti Dumping Duties (higher tariff against some than against others)
- Countervailing Duties (ditto)
- Note: “safeguards” tariffs are also permitted,
  - But they are not normally PTAs; they are supposed to be nondiscriminatory

Examples of PTAs

- Variations on FTAs
  - FTA:
    - Two or more countries set zero tariffs on all (or almost all) imports from each other
    - Keeping their old (presumably different) tariffs against outside countries
    - Must include “rules of origin” (ROOs)
      - ROO = criteria that must be met, regarding location of production, for a good to cross a border tariff-free within the FTA
      - Otherwise, all trade would enter through lowest-tariff country

- Customs Union (CU)
  = FTA + Common External Tariffs (on each good)
  (no need for ROOs)

- Common Market
  = CU + free movement of factors (capital and labor) among members
Examples of PTAs

• European Union (EU)
  – A Customs Union
    • Originally among 6 countries (France, Germany, Italy, Belgium, Netherlands, Luxembourg)
    – Called, then, the “European Economic Community” (EEC)
  – Later
    • Became a Common Market
    • Grew intermittently to 15 countries
      – then, to 25 in 2004, to 27 in 2007
      – and, in 2013, to 28 (adding Croatia)
    • Changed name
      – First to “European Community” (EC)
      – Then later to “European Union”

EU Members

Austria  Belgium  Bulgaria
Croatia  Czech Repub.  Cyprus
Denmark  Estonia  Finland
France  Germany  Greece
Hungary  Ireland

Examples of PTAs

• North American Free Trade Area (NAFTA)
  – US, Canada, Mexico
  – Started in 1994
  – More on this later

• Mercosur
  – Customs union in South America
  – Includes Brazil, Argentina, Paraguay, Uruguay, Venezuela
Examples of PTAs

- US also now has smaller FTAs with
  - Israel (since 1985)
  - 2-country FTAs with Australia, Bahrain, Chile, Jordan, Morocco, Oman, Peru, Singapore
  - A somewhat recent, and contentious, FTA was CAFTA (Central American Free Trade Agreement), approved 2005
  - Most recently, 3 more (Colombia, Panama, and S. Korea)
    - Negotiated 2007
    - Approved late 2011
    - Went into effect in 2012

- There are more than 400 FTAs and similar arrangements that have been notified to the WTO
Outline: Preferential Trading Arrangements and the NAFTA

• What Are PTAs?
• Examples
  – European Union (EU)
  – North American Free Trade Agreement (NAFTA)
• Effects of PTAs
  – Not the Same as Free Trade
    • Trade Creation
    • Trade Diversion
    – Market Diagram Illustration
• NAFTA
  – History
  – Analysis
  – What Happened?
• NAFTA Renegotiation and USMCA

Effects of PTAs

• They are NOT the same as multilateral free trade, when a country eliminates tariffs against all other countries
  – The name “free trade area” is misleading
  – It is likely that countries outside a PTA will lose from it
  – Even the members of the PTA may lose from it!

Effects of PTAs

• Two main effects of a PTA
  – Trade Creation
    = Importing from the partner what you previously produced at home
  – Trade Diversion
    = Importing from the partner what you previously imported from another (“third”) country
Effects of PTAs

- Welfare effects of one country reducing its tariff on a good from a partner country:
  - Importing country
    - Gains from trade creation
    - Loses from trade diversion (we'll see why shortly)
  - Partner country gains regardless
  - Rest of world
    - Loses from trade diversion
    - Not much affected by trade creation

Effects of PTAs

- Reasons
  - Trade creation is much like true free trade
    - At zero tariff, import from partner only if its cost is lower
    - Thus resources are used more efficiently
  - Trade diversion is not like true free trade
    - What was imported from 3rd country, not partner, when both paid the same tariff, must have cost more in the partner than in the 3rd country
    - Switching to the partner is a switch to a higher cost source for the good

Effects of PTAs

- With trade diversion, importing country is paying more for the good
  - The importing person is not paying more, since the person doesn't pay a tariff on imports from the partner
  - But the importing country got to keep the tariff revenue on imports from 3rd countries
    - Thus the price a person paid on import from 3rd country was higher than the price the country paid
**Effects of PTAs**

- **Example**
  - Suppose that, before NAFTA
    - The US imported sugar subject to a 25% tariff
    - The cost of sugar was
      - $8 in Haiti
      - $9 in Mexico
    - US sugar importers would pay, with the tariff,
      - $1.25 × $10.00 from Haiti
      - $1.25 × $11.25 from Mexico
    - So they buy from Haiti
      - The importers pay $10.00
      - The US government keeps $2.00 of that
      - So the US as a **country** pays only $8.00

**EXAMPLE:**

<table>
<thead>
<tr>
<th></th>
<th>Without NAFTA</th>
<th>With NAFTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Price in Haiti</td>
<td>$8</td>
<td>$8</td>
</tr>
<tr>
<td>b. Price in Mexico</td>
<td>$9</td>
<td>$9</td>
</tr>
<tr>
<td>c. Tariff on Haiti</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>d. Tariff on Mexico</td>
<td>25%</td>
<td>0%</td>
</tr>
<tr>
<td>e. Price from Haiti</td>
<td>$10.00</td>
<td>$10.00</td>
</tr>
<tr>
<td>f. Price from Mexico</td>
<td>$11.25</td>
<td>$9.00</td>
</tr>
<tr>
<td>g. Imports come from</td>
<td>Haiti</td>
<td>Mexico</td>
</tr>
<tr>
<td>h. Importers pay</td>
<td>$10.00</td>
<td>$9.00</td>
</tr>
<tr>
<td>i. Government gets</td>
<td>$2.00</td>
<td>0</td>
</tr>
<tr>
<td>j. Country’s net cost</td>
<td>$8.00</td>
<td>$9.00</td>
</tr>
</tbody>
</table>
Outline: Preferential Trading Arrangements and the NAFTA

- What Are PTAs?
- Examples
  - European Union (EU)
  - North American Free Trade Agreement (NAFTA)
- Effects of PTAs
  - Not the Same as Free Trade
    - Trade Creation
    - Trade Diversion
  - Market Diagram Illustration
- NAFTA
  - History
  - Analysis
  - What Happened?
- NAFTA Renegotiation and USMCA

Effects of PTAs

- Market-diagram Illustration
  - Suppose Country A can import a good from either Country B or Country C at prices
    \[ P_C < P_B \]
  - And Country A has a tariff greater than the price difference:
    \[ t > (P_B - P_C) \]
  - What happens when Country A forms a PTA with high-cost Country B, lowering its tariff to zero on imports from Country B?

Effects of PTAs

Before FTA
\[ P_C + t < P_B + t, \text{ so} \]
A imports from C

With FTA
\[ P_B < P_C + t, \text{ so} \]
A imports from B
Effects of PTAs

FTA of Country A and Country B:

Welfare effects
Producers lose $-a$
Consumers gain $+(a+b+c+d)$
Gov’t loses $-(c+e)$
Net $+(b+d)-e$

Market in Country A

FTA of Country A and Country B:

Implication:
Country A can lose from the FTA in this market, if $e > (b+d)$
(as it is in this picture)

Effects of PTAs

FTA of Country A and Country B:

Outline: Preferential Trading Arrangements and the NAFTA

• What Are PTAs?
• Examples
  – European Union (EU)
  – North American Free Trade Agreement (NAFTA)
• Effects of PTAs
  – Not the Same as Free Trade
    • Trade Creation
    • Trade Diversion
    – Market Diagram Illustration
• NAFTA
  – History
  – Analysis
  – What Happened?
• NAFTA Renegotiation and USMCA
NAFTA: What Happened

• Posen (see reading) says
  – “For every 100 jobs US manufacturers created in Mexican manufacturing, they added nearly 250 jobs at their larger US home operations.”
  – Unemployment in US was actually lower after NAFTA than before (until the 2008 financial crisis)
  – Fears of Mexican farmers crossing border into US haven’t happened:
    • Border apprehensions have fallen since 2000,
    • As have most estimates of illegal immigration
  – Critics say NAFTA cost 45,000 jobs a year.
    • That may be true
    • But this is only 0.1% of normal job turnover in the US, where 4m-6m workers leave or lose jobs per month.

• Villarreal & Fergusson (see reading) say
  – “In reality, NAFTA did not cause the huge job losses feared by the critics or the large economic gains predicted by supporters.”
  – “The net overall effect of NAFTA on the U.S. economy appears to have been relatively modest, primarily because trade with Canada and Mexico accounts for a small percentage of U.S. GDP.”
  – “However, there were worker and firm adjustment costs as the three countries adjusted to more open trade and investment among their economies.”

• DeLong (see reading) notes that
  – The shift from manufacturing to services is just one of many such shifts that have happened in history
    • From hunter-gatherers to agriculture
    • From agriculture to manufacturing
    • From agriculture to manufacturing
  – Estimates of any jobs lost (shifted really) due to NAFTA were a tiny fraction of US employment
  – The decline in US manufacturing employment did not start, or even speed up, with NAFTA.
NAFTA: What Should Happen?

• During 2008 primary campaign, Obama (& Clinton) argued for "renegotiating NAFTA"
  – Early on, said NAFTA was "devastating" and "a big mistake"
  – Obama later said only that he would "open up a dialogue" with Canada and Mexico
  – Wanted stronger agreements on labor and environmental standards

• After 2008
  – Obama administration did not tamper with NAFTA
  – NAFTA was not an issue in the 2012 campaign

NAFTA: What Should Happen?

• Faux (see reading) says
  – NAFTA has
    • Caused a larger wage gap between US and Mexico
    • Turned US bilateral trade surplus into deficit
    • Driven 2 million Mexican farmers off the land (due to US subsidies)
    • Caused illegal immigration from Mexico to double
  – Reason: Mexico is "run by a small elite of crony capitalists" who were strengthened by NAFTA
  – Argues for a deal that would
    • Create a "fund for investment in Mexico" (like what EU did for Spain, Portugal, Ireland, Greece)
    • In exchange, require "guarantees for free trade unions, enforceable minimum wages, and an increase in education and other social spending"
NAFTA: What Should Happen?

• Donald Trump, before election
  – Trump opposed NAFTA as early as 1993
    • “The Mexicans want it, and that doesn’t sound good to me.”
    • Called NAFTA “The single worst trade deal ever approved in this country”
  – Called NAFTA “The single worst trade deal ever approved in this country”
• Donald Trump, after election
  – Called for renegotiation of NAFTA, as promised
  – May 18, 2017, Trump formally launched renegotiation
  – Aug 16, 2017, negotiations began

Outline: Preferential Trading Arrangements and the NAFTA

• What Are PTAs?
• Examples
  – European Union (EU)
  – North American Free Trade Agreement (NAFTA)
• Effects of PTAs
  – Not the Same as Free Trade
    • Trade Creation
    • Trade Diversion
  – Market Diagram Illustration
• NAFTA
  – History
  – Analysis
  – What Happened?
• NAFTA Renegotiation and USMCA

NAFTA Renegotiation Issues

• Trade imbalances: Trump wants deficits to fall
• Rules of origin: tighten them
• Dispute mechanisms: keep or remove
  – Chapter 11: Investor-State Dispute Settlement (ISDS)
  – Chapter 19: Dumping and CVD
• Dairy and poultry (Canada’s policies)
• Sunset clause
• New issues (digital trade, state-owned enterprises, labor standards)
USMCA

• Outcome of the Renegotiation
  – May 18, 2017: Renegotiation began
  – Aug 27, 2018: Agreement reached between US and Mexico
  – Sep 30, 2018: Agreement reached with Canada to join USMCA

• USMCA U.S.-Mexico-Canada Trade Agreement

USMCA

• Features of USMCA
  – Auto rules of origin
    • Required North American content raised from 62.5% to 75%
    • 40-45% content must be from labor paid $15/hr or more (but does not rise with inflation)

USMCA

• Features of USMCA
  – New rules (similar to TPP) on
    • Intellectual property
    • Environment
    • Labor
    • Financial services
    • Digital trade
USMCA

• Features of USMCA
  – Sunset clause? Not exactly
  – Revisit deal after 6 years
    – If happy, extend for 10 more
    – If not, new negotiations

• Features of USMCA
  – Canadian dairy
    • Canada will increase permitted imports of dairy from US, to 3.6% of its market
    • Canada to cease selling some dairy ingredients abroad at low prices and will tax exports over over some threshold

• Features of USMCA
  – Currencies
    • Commitment to “refrain from competitive devaluations and targeting exchange rates”
USMCA

• Features of USMCA
  – Trade with China
    • Countries must inform US 3 months before beginning trade negotiations with any "non-market economy" (i.e., China)
    • If agreement with such economy is reached, US can terminate USMCA with six months notice.

USMCA

• Features of USMCA
  – Chapter 19
    • Keeps this dispute settlement system for trade remedies such as anti-dumping
    • Does not apply them to "national-security-based" tariffs

USMCA

• Features of USMCA
  – Chapter 11 (ISDS)
    • Removes this for disputes between US and Canada
    • Keeps it for disputes with Mexico
USMCA

- “Side letter” of USMCA
  - Promise to shield Canada Mexico from future “national-security-based” tariffs (i.e., cars) (not enforceable)

USMCA

- NOT a Feature of USMCA
  - Removal of US recent tariffs on steel and aluminum from Canada and Mexico

USMCA

- Prospects for approval
  - Must be approved by all three legislatures
    - Canada: Dairy will resist, but approval assures
    - Mexico: Incoming President wants it done
    - US: Contentious, but best hope is approval in lame-duck session
USMCA

- Importance of USMCA
  - Trump: "It's not NAFTA redone, it's a brand-new deal"
  - NYT: "a consequential set of revisions"
  - Economist: "a modest revision", "inferior to the agreement it replaces"
  - Bown: deal to "result in less trade, not more"

Next Time (after exam)

- International Policies for Economic Development: Trade
  - The Issues
  - Washington Consensus
  - Pros and cons of free trade for developing countries
  - Policy recommendations