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WHITE HOUSE STAFFING MEMORANDUM

DATE: 9/1/93 ACTION/CONCURRENCE/COMMENT DUE BY: COB, TODAY!! SEPT 1

SUBJECT: NAFTA COVER LETTER FOR BRIEFING BOOK

	ACTION	FYI		ACTION	FYI
VICE PRESIDENT	☐	✓	PASTER	✓	☐
McLARTY	☐	✓	RASCO	☐	☐
NEEL	☐	☐	RUBIN	✓	☐
PANETTA	✓	☐	SEGAL	☐	☐
BAGGETT	✓	☐	SEIDMAN	☐	☐
EMANUEL	✓	☐	STEPHANOPOULOS	✓	☐
GEARAN	✓	☐	TYSON	✓	☐
GERGEN	✓	☐	VARNEY	☐	☐
GIBBONS	☐	☐	WATKINS	☐	☐
HALE	✓	☐	WILLIAMS	☐	☐
HERMAN	✓	☐	DALEY, BILL	✓	☐
LAKE	✓	☐		☐	☐
LINDSEY	☐	☐		☐	☐
McGINTY	☐	☐		☐	☐
MONTOYA	☐	☐		☐	☐
NUSSBAUM	☐	☐		☐	☐

REMARKS: The attached letter incorporates edits/comments from the staffing of 8/26. Please provide comments on the attached reconciled version directly to Sylvia Mathews, X2174 BY CLOSE OF BUSINESS TODAY, WED., SEPTEMBER 1. Thank you.

RESPONSE:

cleared. 9/1/93

4:20 pm

JOHN D. PODESTA
Assistant to the President
and Staff Secretary
Ext. 2702

THE WHITE HOUSE

WASHINGTON

Dear Senator [Representative/Mayor/Business Leader]:

Last fall, I announced my support for the North American Free Trade Agreement (NAFTA) after weeks of studying it closely. I felt NAFTA would bring economic growth, create new U.S. jobs, and enhance our ability to compete in the global economy.

At the same time, I thought the agreement failed to address potential problems in the areas of the environment, worker rights, and import surges. I promised I would not send the NAFTA to Congress until those problems were addressed by supplemental accords. After months of tough negotiations, we have reached agreement with Mexico and Canada. on these accords.

The new accords provide tough and enforceable mechanisms to ensure that increased trade does not come at the expense of workers or the environment. For the first time ever, a trade agreement will ensure that national laws on worker rights and the environment will be enforced.

With side agreements complete, my Administration is committed to a major, bipartisan effort this fall to secure NAFTA's passage.

It is time to get away from the hyperbole that has characterized too much of the debate to date. This briefing book is intended to begin that process.

Reforms brought about by President Salinas have given us a preview of NAFTA's potential:

-- After Mexico began reducing trade barriers and opening its markets in 1986, exports from the U.S. to Mexico **more than tripled** -- from $12.4 billion in 1986 to $40.6 billion in 1992.

-- Our $5.7 billion trade deficit with Mexico in 1987 has been transformed into a **$5.4 billion surplus** in 1992.

-- Today, more than **700,000 U.S. jobs** are supported by exports to Mexico.

that have resulted already from Mexico's reforms,

? the

We have had this success despite the fact that Mexico's market is much more closed than ours. In addition to locking-in positive changes, NAFTA creates new opportunities. NAFTA eliminates Mexico's high tariffs, phases out non-tariff barriers, and

~~trade law~~ barriers

removes ~~rules~~ rule that provide~~d~~ incentives to American companies to produce in Mexico. With NAFTA, we expect a **gain of 200,000 export jobs** by 1995.

NAFTA illustrates the close linkages between our international policies and our domestic well-being. NAFTA strengthens our economic base and creates jobs at home. At the same time, greater Mexican prosperity enhances stability and improves the ability of Mexicans to buy U.S.-made exports. Moreover, ~~the~~ NAFTA will facilitate cooperation with Mexico and Canada on a host of tough issues including immigration, illegal drugs, and environmental protection.

Change is always challenging. Uncertainty about change is understandable. But we are at a defining moment in American history. Our victory in the Cold War and the new challenges of a global economy mean that we must make choices about our future role in the world.

~~, and~~ ok!

We can retreat behind walls and watch our leadership erode, our living standards deteriorate, our competitiveness decline. Or we can put in place an economic strategy that enables the U.S. to compete and win in the global marketplace. That strategy starts with facing up to our problems at home, through our economic package and health care. At the same time, we need a trade policy that breaks down barriers to our exports of manufactured goods, services, and agricultural products -- and enables us to compete with the European Community and Japan. This is the forward-looking path to the high-wage, high-skill American economy that we all seek.

I hope you will join me in supporting NAFTA. It's good for America.

Sincerely,

File Copy

LEVEL 1 - 1 OF 1 STORY

The New York Times

July 20, 1993, Tuesday, Late Edition - Final

SECTION: Section A; Page 19; Column 2; Editorial Desk

LENGTH: 1148 words

HEADLINE: Workers of the World, Get Smart

SERIES: Build a Better Workplace -- Second of two articles

BYLINE: By Robert B. Reich; Robert B. Reich is Secretary of Labor.

DATELINE: WASHINGTON

BODY:

Throughout the industrialized world, there seem to be too few good jobs to go around. The problem manifests itself differently in different countries, but the failure of any country to insure good jobs for many able and willing citizens raises a troubling question: Do advanced nations have to choose between good jobs and more jobs?

Over the past two decades, Western Europe has experienced growth in wages but stagnation in employment. Between 1975 and 1992, the real -- that is, inflation-adjusted -- average wages of manufacturing workers in France, Germany, Italy and Britain grew by 30 to 50 percent. But unemployment in European industrialized economies has risen close to a staggering 11 percent.

How does America compare? On the narrow score of the number of jobs, we rank quite well. Since 1975, our economy has generated nearly two million new jobs per year. And although our current unemployment rate of 7 percent is disturbing, more than 800,000 jobs have been created since January, as economic growth has begun to stir.

Our bigger long-term problem is creating jobs that pay well. The average wages of America's production workers, adjusted for inflation, are the lowest they've been since 1967. Eighteen percent of full-time workers don't earn enough to keep a family of four out of poverty; this level is up from 12 percent in 1979. And more Americans who want full-time jobs are working part-time instead.

Wages and incomes in the U.S. have become more unequal since the early 1970's. They have risen for upper-income workers, remained stagnant for the middle class and fallen for those at the bottom. In no other advanced industrialized nation is the income gap so wide between the managers and professionals and production workers.

Must we accept a diabolical trade-off between good jobs and more jobs as factories move to places around the world where labor costs less and as smart machines take on more tasks at home? I believe that a trade-off is not inevitable if we draw the right conclusion from the underlying employment trends.

The pattern of wage inequality in the U.S. provides an important clue. From 1980 to 1991, the weekly real earnings of full-time workers over the age of 25 who had graduated from college rose 9 percent. That's not so bad. But the real weekly earnings of similar workers who had only completed high school dropped 7 percent. And similar workers without high school diplomas suffered a drop in earnings of 14 percent. Today, the weekly earnings of full-time workers over 25 who are college graduates are more than 50 percent above the earnings of otherwise similar workers who are simply high school graduates.

The pattern of unemployment provides a second clue. In Europe and the U.S., the uneducated and unskilled have been hardest hit. While college graduates did not escape the prolonged recession in the U.S., only 3.2 percent were unemployed last year compared with 11.4 percent of those who dropped out of high school.

The long-term crisis in advanced industrial nations reflects in part a shift in relative labor demand against less-educated workers and those doing routine tasks and toward workers with problem-solving skills. So, how do we move a workforce suited to one sort of economy quickly and smoothly into a world grown suddenly quite different?

No country has yet found the formula. But different countries have illustrated different ways to get it wrong. The continental European approach has been to have Government intervene heavily in the wage-setting process and seek to preserve the existing pattern of employment. This has prevented the gap between high-wage and low-wage workers from widening much, but it has not directly addressed the profound changes in the demand for skills. Such policies have maintained wages and job security for the employed, but they have retarded the creation of new jobs.

In the U.S. and Britain, employers have responded more directly to changes in labor force supply and demand. The result has been greater inequality in wages and working conditions. The apparent payoff from this Faustian bargain is a rate of U.S. job growth over the last two decades that has been the envy of Europe. Nevertheless, job growth in the U.S. and Britain has been punctuated by high unemployment in recessions and tarnished by worsening problems of permanent loss of jobs.

A third blind alley is protection from exports. No advanced nation is blameless. Yet escaping from global markets through protectionism is no solution. New technologies will reduce the demand for less-skilled workers even if borders are sealed. And many of the high-wage jobs of the future will be tied to exports and jobs that service the export industry. Protectionism cripples economic progress while failing to save jobs.

Americans have traditionally cast their lot with open trade. In recent years, we have wavered. But in Tokyo, President Clinton led the Group of Seven industrialized countries another major step down the path of openness. The trade agreement initialed there has sharply improved the odds for a new global accord. The President also established ground rules for measuring how far Japan opens its market. The odds of advanced nations adapting to a changing world are higher than they were before the summit meeting, holding hope for our own economic recovery.

In addition, the President's proposed sharp reduction in the budget deficit will remove a significant source of uncertainty about the stability of the world economy and aid recovery.

But domestic policies -- specifically five -- are also needed to deal with the mismatch between the skills Americans have and the skills the economy requires. They are a good basic education for all children, affordable college, school-to-work apprenticeships for young people who don't go on to college, transition help to new jobs for displaced workers and lifetime learning in the workplace.

This list essentially describes the Clinton agenda for the workforce. Some parts of it are already embodied in legislative initiative, others are still taking shape. The imperative of investment in the workforce is so compelling and the goal of building of America's skill base so broadly shared that the debate remains remarkably free of partisan wrangling.

The closing years of this century and the start of the next will be dominated by the advanced countries' efforts to adapt to the new economy. America enters this era with advantages. Our still enormous wealth gives us scope for experimentation and a margin for error. Most importantly, economic dynamism and openness to change are woven deep into our culture.

Our greatest weakness has been the failure to invest adequately in our own learning. In the emerging global, high-tech economy, the development of our human resources will be the key means of creating wealth.

GRAPHIC: Drawing

TYPE: Op-Ed; Series

SUBJECT: LABOR; SURVEYS AND SERIES; UNEMPLOYMENT AND JOB MARKET

NAME: REICH, ROBERT B (SEC)

cc: LDT
SR
File

FAX TRANSMITTAL SHEET

DEPARTMENT OF LABOR · UNITED STATES OF AMERICA

RECEIVER TELECOPIER NUMBER: 395-6947

TO: Laura Tyson

FROM: Larry Katz

DATE: August 30, 1993 **TIME:** 11:08 AM

PAGE NUMBER ONE OF FIVE **PAGES**

TRANSMITTER TELECOPIER: (202) 219-7659

ADDITIONAL COMMENTS:

IF YOU HAVE QUESTIONS REGARDING THIS FAX CALL: 219-5108

Why NAFTA Is Good for American Workers

Robert B. Reich

In an Address to the American Public Radio Annual Convention

May 6, 1993

We stand poised for the next step on the trail we Americans have blazed since the end of World War Two, a trail towards an ever-more open and dynamic global economy. Canada, Mexico, and the United States are negotiating side agreements to a trade pact which promises to make all of North America more prosperous. But some voices call for us not to take that step, and to turn from the path of free trade.

Its benefits notwithstanding, the North American Free Trade Agreement is turning out to be a hard sell here in the United States. The economic trends of the past decade or so have chipped away at the traditional American readiness to seize the challenge of change. Battered by tough times which refuse to end, almost 9 million Americans remain unemployed; millions more are working part-time who would rather have full-time jobs; many are too discouraged even to look for work.

Behind these numbers lies a deeper and broader anxiety, spread across the American workforce, about the security of jobs in an economy subject to searing change. Large corporations are fragmenting, and so too are the hundreds of thousands of jobs which once promised predictable paychecks along with steadily-increasing health and retirement benefits. Today, few Americans with full-time jobs can rest certain that their paychecks and their benefits will be there next year, or even next month.

The anxiety has been compounded by the stagnation in real wages during the past fifteen years. The real earnings of non-supervisory workers--the vast majority--have drifted downward.

These trends have been caused by advancing technologies, which have eroded the steady, sturdy certainty of mass production, and by global trade and investment, which have rendered all markets less predictable. Everywhere, industries built upon rock-hard economies of scales are being replaced by industries resting on the quicksands of risk and uncertainty.

We are thus confronted with a high-stakes choice. The choice is <u>not</u> between change and the status quo; that option is no longer open. It is between embracing change and resisting it, between defining ourselves as the allies, or the victims, of ceaseless economic evolution. In this new economy, those who can quickly identify and solve new problems are at a premium. High-paying jobs that <u>don't</u> demand high skills, meanwhile, are growing scarcer.

Retreating from global markets is not the solution, for the simple reason that trade is not the real problem. Even if millions of workers in developing nations were not eager to do these jobs at a fraction of the wages of American workers, such jobs would still be vanishing. Domestic competition would drive companies to cut costs by installing robots, computer-integrated manufacturing systems, or other means of replicating the work of unskilled Americans with machinery which can be programmed to do much the same thing.

It is perhaps natural in these turbulent times for many Americans to project their anxieties upon supposed menaces lurking beyond our borders. Such projections are not unknown in history, especially during times of economic stress. Japan and Europe--whose economies are now intricately intertwined with our own--are increasingly suspect; Mexico and other low-wage nations are deemed potential dangers. The world is cast as a vast zero-sum game, in which either they win or we win.

The facts are quite the opposite. World trade is not a zero-sum game. There is not a finite number of jobs to be parcelled out among the workers of the world. Trade is a positive-sum game in which all parties stand to gain, and there is no natural limit to the number of jobs which can be created by it.

The American workforce <u>overall</u> has little to fear from NAFTA, and much to hope for. One reason is that the U.S. market for Mexican products <u>already</u> is largely open. U.S. tariffs on Mexican exports average just 4 percent. Customs duties on merchandise assembled with American-made components in <u>maquiladoras</u>--special assembly plants lining the border area--are charged only on value added in Mexico, which typically is about one-half of the cost of the product. On <u>this</u> side of the border, there are simply few major trade barriers for NAFTA to knock down.

In other words, NAFTA doesn't so much open the United States to Mexican exports as it further opens Mexico to American exports. President Carlos Salinas de Gortari and his predecessor have opened Mexico part way, and the results have been hugely beneficial north as well as south of the border. Since 1988, U.S.-Mexican trade has nearly doubled to $76 billion a year, with booming United States exports accounting for much of the increase. In 1991, the United States ran a trade surplus with Mexico for the first time in nearly a decade. Last year, the surplus swelled to $5.5 billion, and it keeps growing.

But restrictions remain. Mexican tariffs on U.S. goods are more than twice as high, on average, as U.S. tariffs on Mexican goods. Other barriers to U.S. exports also remain substantial. For example, non-Mexican automakers with plants in Mexico must export $2 worth of product for every dollar's worth they bring in.

cars imported into Mexico face a 20 percent tariff. By lifting such barriers over the coming decade, NAFTA would give U.S. automakers unlimited access to the Mexican auto market. Since only one Mexican in 16 currently owns a car--compared to one out of two Americans--the potential for growing sales south of the border is enormous, and access to that market is a major prize.

Thanks to more open trade and other liberalizing measures, Mexican incomes already are rising. A more prosperous Mexico, in turn, means greater demand for U.S. exports, and more job creation in the United States. NAFTA promises to create far more American jobs than it will eliminate.

But what of those Americans who _do_ find their jobs at risk as a result of the agreement? How do we answer their very real anxieties, and respond to the vulnerability they face? There are three parts to the answer. First, the sharpest new pressures due to NAFTA will develop gradually, giving extra time for adjustment. Those working in industries which have been most sheltered from competition will see barriers drop in stages, not all at once. Second, the total number of workers displaced by NAFTA and searching for new employment will be quite small relative to the opportunities generated by our large, rapidly changing national economy.

So any "job shock" from NAFTA will be small, and gradual. But that's not good enough. Workers who _are_ hurt by trade policy aren't much comforted by assurances that few others are affected. That is why the Clinton Administration couples its commitment to NAFTA with a pledge to ensure that no American will be left alone to bear the burdens of change. The Administration already is designing a comprehensive worker adjustment program to address the needs of all dislocated workers, including those affected by NAFTA, defense downsizing and other major structural changes. The program will provide timely access to an enriched array of services including retraining and job search assistance.

Job creation north and south of the border is only one positive-sum result; much larger potential benefits could result from the productivity growth stimulated by NAFTA and the side agreements now being negotiated on labor, the environment, and import surges. NAFTA was a good idea as initially negotiated. These additional agreements promise to make it much better. They will ensure that the United States, Mexico and Canada compete with each other by raising productivity, quality, and the rate of innovation, not by lowering labor and environmental standards. And they will give cause for confidence that the widespread benefits of open trade will not be purchased at prices that are hidden, or unfairly distributed.

After World War Two, the United States committed itself to a sustained campaign of domestic investment. Under the conveniently broad banner of national defense we built the interstate highway system, vastly expanded higher education, shored up infrastructure, and sent research and development levels soaring. Meanwhile, we helped forge a new world economy based on the principle of free trade. We created an International Monetary Fund to ensure liquidity, a World Bank to aggregate and direct development finance, and a General Agreement of Tariffs and Trade to guarantee the open trading system.

The years 1945 and 1970 proved the wisdom of our work. These twenty five years witnessed the most dramatic and widely-shared economic growth in the history of mankind. America's own gross national product grew from $200 billion to over $1 trillion. Even allowing for inflation, U.S. real incomes more than doubled in a single generation, as the real value of U.S. trade with the rest of the world quadrupled.

Today, the Clinton Administration is pledged to a renewed surge of investment, this time geared to human capital. We must build a system to prepare American workers for flexible, high-skills production, and support their gradual transition out of the kinds of low-skill, routine work that can be done just as well, and more cheaply, by smart machines or low-wage workers abroad.

Internationally, NAFTA is another step down the same path. The challenges we face today are more complex than in the early postwar years, perhaps, but I am convinced that the basic American attitude of optimism and determination remains the same. It would be sadly ironic if the economic stresses now experienced by most Americans prevented us from enjoying the economic benefits lying just around the corner.

DEPARTMENT OF LABOR · UNITED STATES OF AMERICA ·

FAX TRANSMITTAL SHEET

TO: Laura Tyson

FROM: Larry Katz

PAGE NUMBER ONE OF 2 PAGES.

ADDITIONAL COMMENTS:

IF YOU HAVE QUESTIONS RE THIS

FAX CALL: Chris Stephens 219-5502

8

Trade With Mexico Is a Boon for U.S. Workers

Just five weeks ago, Canada, Mexico and the U.S. began negotiating supplemental agreements to a trade pact which will, if consummated, improve the living standards of workers throughout the Americas. Its benefits notwithstanding, the North American Free Trade Agreement will be a hard sell here in the U.S.

Recent economic trends have chipped away at the traditional American readiness to seize the challenge of change. Anxiety about a lingering recessionary environment has been compounded by the stagnation in real wages during the past 15 years. Real earnings of non-supervisory workers – the vast majority – have drifted downward. And while advancing technologies have eroded the steady,

The Americas

WSJ A13 4/30

By Robert B. Reich

sturdy certainty of mass production, global trade and investment have rendered all markets less predictable. Everywhere, industries built upon rock-hard economies of scale are being replaced by industries founded on the quicksand of risk and uncertainty.

We are thus confronted with a high-stakes choice of either embracing change or resisting it. In this new economy, those who can quickly identify and solve new problems are at a premium. High-wage, unskilled and semi-skilled manufacturing jobs, meanwhile, are growing scarcer. Even if millions of workers in developing nations were not eager to do these jobs at a fraction of the wages of U.S. workers, such jobs would still be vanishing. Domestic competition would drive companies to cut costs by installing robots, computer-integrated manufacturing systems, or other means of replacing the work of unskilled Americans with machinery that can be programmed to do much the same thing.

It is perhaps natural, under these circumstances, for many in the U.S. to project their anxieties upon supposed menaces lurking beyond our borders. The world is cast as a vast zero-sum game, in which either "they" win or "we" win. But the facts are quite the opposite. World trade is not a zero-sum game. There is not a finite number of jobs to be parceled out among the workers of the world. Trade is a positive-sum game in which all parties stand to gain, and there is no natural limit to the number of jobs that can be created by it.

In particular, U.S. workers have little to fear from Nafta, and much to hope for. The U.S. market for Mexican products is already largely open. U.S. tariffs on Mexican exports average just 4%. Customs duties on merchandise assembled with U.S.-made components in *maquiladoras* are charged only on value added in Mexico, which typically is about one-half of the cost of the product. Nafta doesn't so much open the U.S. to Mexican exports as it further opens Mexico to U.S. exports.

President Carlos Salinas de Gotari and his predecessor have opened Mexico part way, and the results have been hugely beneficial north as well as south of the border. Since 1988, U.S.-Mexican trade has nearly doubled to $76 billion a year, with booming U.S. exports accounting for much of the increase. In the past seven years, our merchandise trade balance with Mexico has improved by $10 billion. In 1991, the U.S. ran a trade surplus with Mexico for the first time in nearly a decade. Last year, the surplus swelled to $5.5 billion, and it keeps growing.

But restrictions remain. Mexican tariffs on U.S. goods are more than twice as high on average as U.S. tariffs on Mexican goods. Other barriers to U.S. exports also remain substantial. For example, non-Mexican auto makers must export $2 worth of products for every $1 worth of cars and light trucks they bring in. Cars imported into Mexico face a 20% tariff.

By lifting such barriers over the coming decade, Nafta would give the U.S. auto makers unlimited access to a market that will grow far faster than the market for automobiles in the U.S. Today only one Mexican in 16 owns a car; one in two U.S. citizens owns one. But through more open trade and other liberalizing measures, Mexican incomes have begun to rise, causing greater demand for U.S. exports and more job creation in the U.S.

World trade is not a zero-sum game in which a finite number of jobs are to be parceled out among the workers of the world. Trade is a positive-sum game in which there is no natural limit to the number of jobs that can be created.

What of the U.S. workers who may lose their jobs because of Nafta? Those working in industries that have been most sheltered from competition would face no immediate threat; for them Nafta will be phased in gradually. In any event, any shift in U.S.-based jobs due to Nafta will amount to just a tiny portion of the total number of U.S. workers who must find new jobs in any given year. The administration is seeking to provide retraining, job search assistance and other services to all workers who lose their jobs – including those affected by Nafta, defense downsizing and other major structural changes.

Job creation north and south of the border will be only one positive result of Nafta; much larger potential benefits could result from the productivity growth stimulated by this and the supplemental agreements now being negotiated. These agreements will ensure that the U.S., Mexico and Canada compete with each other by raising productivity, quality and the rate of innovation – not by lowering labor and environmental standards.

After World War II, the U.S. helped forge a new world economy based on the principle of free trade. We created an International Monetary Fund to ensure liquidity, a World Bank to aggregate and direct development finance, and a General Agreement on Tariffs and Trade to guarantee the open trading system. The years between 1945 and 1970 proved the wisdom of our work. These 25 years witnessed the most dramatic and widely-shared economic growth in the history of humankind. The U.S.'s own gross national product grew from $200 billion to over $1 trillion. Even allowing for inflation, U.S. real income more than doubled as the real value of U.S. trade with the rest of the world quadrupled.

Nafta is a small step down the same path, much closer to home. The challenges we face today are more complex, perhaps, but I am convinced that the basic American attitude of optimism and determination remains the same. It would be sadly ironic if the economic stresses now experienced by many Americans prevented us from enjoying the economic benefits that lie just around the corner.

Mr. Reich is U.S. secretary of labor. These remarks were drawn from an address yesterday to the international law section of the American Bar Association.

MEMORANDUM

COUNCIL OF ECONOMIC ADVISERS

October 29, 1993

TO: LAURA TYSON
ALAN BLINDER
JOE STIGLITZ

FROM: SHERMAN ROBINSON SR

SUBJECT: Joint Economic Committee Report on NAFTA

I have attached the formal CEA reply to the JEC report on NAFTA. I suggest that Laura send it directly to the JEC with a cover letter, with a copy to Reischauer (CBO).

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

October 27, 1993

Staff Study by the Joint Economic Committee:
"Potential Economic Impacts of NAFTA: An Assessment of the Debate"

The Joint Economic Committee (JEC) recently released a staff study which surveys some of the studies of the potential economic impacts of NAFTA. The JEC study maintains that these studies are of limited use in determining whether NAFTA should be approved because of the simplifying assumptions they make in modeling the way the economies in North America operate. The JEC study argues that many of these assumptions are unrealistic and bias many studies toward finding that NAFTA is good for the U.S., Canada, and Mexico. Finally, the JEC study argues that there are credible studies, making different assumptions, which find that NAFTA is potentially bad for the U.S.

Our evaluation of the available research and independent surveys by others indicate that the JEC study does not make its case. The very few studies finding that NAFTA is potentially bad for the U.S. are seriously flawed and are not credible compared to the many studies finding that NAFTA is good for all three countries.

All economic models rest on simplifying assumptions, and the models that have been used by numerous researchers to predict the effects of NAFTA on the U.S. economy are no exception. Several different models have been developed to explore the empirical importance of the many changes by which NAFTA will affect the three economies in North America. What is exceptional is that the overwhelming majority of studies, using a variety of different modelling techniques and different assumptions about the economic forces at work, conclude that NAFTA will benefit all three countries. For the U.S., these studies indicate that NAFTA will benefit labor, leading to either increased employment, increased wages, or both. While the JEC attempts to argue that the assumptions underlying the few negative studies are more realistic or valid, this argument has not been found persuasive by any of the independent reviewers of the economic work on NAFTA.

There have been a number of reviews of the economic studies of NAFTA by impartial researchers at institutions such as the Congressional Budget Office, the General Accounting Office, the International Trade Commission, and the Brookings Institution. These reviews have critically examined the various studies, evaluating the validity of their methodologies and underlying assumptions. The reviews are unanimous in their conclusion: NAFTA will benefit all three countries. In a recent letter to the President, 286 academic economists, including 13 Nobel prize winners, representing different theoretical and political traditions, make the same point. Although they disagree on many things, most academic economists agree that NAFTA will create jobs and encourage economic growth in the United States.

Selection of Studies to Survey

There have been a number of surveys of economic studies of NAFTA in the past year. Some have been encyclopedic, but most have been selective, analyzing examples of different types of models. The JEC survey considers a sample of sixteen studies which "provide estimates of aggregate impacts on the U.S. economy." In its survey, the JEC focuses on a single scenario considered by each study: "In general, the scenario with the largest US impacts, whether positive or negative, is chosen."

The JEC report compares its selection of studies with that of a brief survey recently done by the Office of the Special Counselor to the President on NAFTA. The Counselor's survey provides a complete bibliography of NAFTA studies available at the beginning of September 1993. The bibliography classifies studies in various categories: it includes twenty "comprehensive" studies, eleven studies with a variety of focuses, and seven reviews of the empirical literature on the effects of NAFTA. The bibliography also includes closely related papers by the authors of the listed studies.

With the exception of a very recent study by James Stanford, which was not available when the Counselor's bibliography was compiled, all of the studies surveyed by the JEC are included in the Counselor's bibliography. There is an overlap of twelve studies between the JEC's list of sixteen "aggregate" studies and the Counselor's list of twenty "comprehensive" studies. The JEC chose examples of studies of certain types, while the Counselor's list was more inclusive. For example, the JEC excluded multiple papers by the same authors, arguing that these represent "double counting." In fact, there are significant differences in structure and policy focus between the models used in many of the studies excluded from the JEC list and those included.

Assumptions, Models, and Policy Analysis

The JEC review considers the role of models in policy analysis, stating:

> "All economic models are in fact scenarios that must exclude consideration of some questions and simplify others. . . . Because all results from economic models rest in large part on these assumptions, the credibility of the assumptions must be a central consideration when evaluating the results from the models. When these assumptions are not credible, the conclusions should not be a major factor in deciding public policy."

The review goes on to list six issues that are the focus of the debate over NAFTA: (1) investment, particularly diversion of investment from the U.S. to Mexico; (2) trade, both structure and volume; (3) immigration; (4) net job changes in the U.S.; (5) gross job losses in the U.S.; and (6) wages in the U.S.

After briefly discussing the key provisions of NAFTA, the report provides a critical analysis of how the sixteen studies address the six issues, focusing on the role of different assumptions in determining the model results. The report then goes on to discuss the model results, indicating the role of various assumptions in generating the empirical results.

The JEC survey raises a number of valid questions that policymakers should keep in mind when evaluating the different studies. However, the JEC's focus on a single scenario from each model is misleading in that it misses the richness of the analysis in many of the studies.

Although the studies from policy think tanks tend to focus on a narrow range of assumptions and causal links that support their particular viewpoint, all the academic studies surveyed were done by researchers who are well aware of the strengths and limitations of the methodologies they used. All of the researchers discussed the sensitivity of their results to variations in assumptions and considered a variety of scenarios under a variety of assumptions.

Computable General Equilibrium Models

For example, consider the academic studies using computable general equilibrium (CGE) models. CGE models are used in nine of the sixteen studies reviewed by the JEC and sixteen of the twenty comprehensive studies reviewed by the Counselor's office. In all these studies, the models are used as simulation laboratories providing policymakers with the ability to do controlled experiments that permit detailed analysis of the mechanisms by which policy changes affect the various economies. In many cases, researchers made strong assumptions in some scenarios in order to do controlled experiments that isolated the empirical size of various links. The single experiment for each study reported in the JEC survey gives little indication of the usefulness of the models in sorting out the empirical importance of the links between policy changes and economic results, and in evaluating the robustness of those empirical results.

In 1992, the ITC did a meticulous survey of all the CGE models used to study NAFTA and concluded: "Despite the different approaches taken in these studies, there is a surprising degree of unanimity in their results regarding the aggregate effects of a NAFTA. All three countries are expected to gain from a NAFTA. The greatest impact will be on the Mexican economy, with less impact on the Canadian and U.S. economies." While the JEC argues that the results from all the surveyed CGE models depend on their underlying assumptions, which is really a tautology, it was a surprise to the ITC and to the researchers involved to find such agreement across such a wide variety of modelling approaches and behavioral assumptions. Surveys by the Congressional Budget Office and the Brookings Institution considered a wider range of studies and reached similar conclusions —NAFTA is good for all three countries, especially Mexico.

Since the ITC survey, there have been a number of studies using CGE models that support NAFTA and two that find negative impacts. The two negative studies are on the JEC list: (1) the Economic Policy Institute (EPI) study which used a dynamic CGE model developed by Hinojosa and McCleery, and (2) the recent CGE model of the U.S., Canada, and Mexico by James Stanford.

As noted in Table 2 of the JEC review, the EPI model generates a loss of 550,000 jobs in the U.S., a figure which EPI has used often and which appears in various ads. However, the number largely consists of jobs "lost" due to return migration of workers from the U.S. to Mexico. In the scenarios generating this result, growth in Mexico raises Mexican wages, yielding return migration and higher wages in the U.S. These are not jobs "lost" by American workers, but rather U.S. jobs foregone by Mexican workers for whom NAFTA will provide increased income at home. Hinojosa and McCleery wrote a letter to Jeff Faux, the President of EPI, complaining about what they considered to be a gross misuse of their model.

The JEC study presents a new CGE model developed by James Stanford as an improvement over existing CGE models. Stanford, a Ph.D. student at the New School for Social Research, strongly criticizes earlier CGE models of NAFTA for embodying neoclassical economic assumptions of the sort that underlie the theory of comparative advantage. He argues that these assumptions are unrealistic, and goes on to develop a "structuralist" or "institutional" CGE model that incorporates "real world" assumptions about how firms behave, how labor markets operate, and how savings and investment are determined.

In his "institutional" model, wages do not vary with the supply and demand for labor, firms do not seek to maximize profits, unemployment persists indefinitely, and changes in GDP in the long run are largely determined by changes in aggregate demand rather than by changes in the supply side. In this environment, changes in investment flows are very important because they have a strong impact on aggregate employment through the operation of the Keynesian multiplier. Indeed, the impact of changes in investment flows dominate all other effects arising from trade liberalization, such as efficiency gains arising from changes in the structure of trade and production.

Stanford goes on to say (p. 8): "The 'institutional' model of North American trade and investment flows thus incorporates a very different set of assumptions from the neoclassical approach which is reflected in the majority of NAFTA simulation models. Not surprisingly, therefore, the model's results suggest a very different outcome is likely from the NAFTA than has been suggested by many other economists." He later warns the reader: "It must be stressed that this 'institutional' analysis is quite preliminary, in that the behavioural relationships built into the model are novel and hence relatively untested."

Stanford's institutional model is an extreme example of a "structuralist" Keynesian macro model. The assumptions that some markets essentially never clear, that firms do not maximize profits, that wages are set by institutional forces in the long run, and that Keynesian multipliers operate in the long run are certainly controversial, and are not viewed as reasonable by many economists. They also seem out of place in an analysis of the efficiency gains from changes in the structure of trade and production arising from changes in protection, which is, after all, a major focus of NAFTA and of the models seeking to analyze the impact of NAFTA.

To his credit, and as befits a Ph.D. thesis, Stanford also reports runs of his model in "neoclassical" mode. He reports (p. 31) that "[t]he effects of the NAFTA, according to this neoclassical simulation, . . . are quite startling. Just as predicted by other NAFTA models, the agreement has very small positive effects on the U.S. and Canadian economies, including small gains in GDP, wages, consumption, and foreign trade. . . . The effects of the NAFTA on the Mexican economy are more positive (with GDP growing by 2.8 percent), but there are no 'losers' as a result of the NAFTA." Startling? No, but certainly reassuring.

The JEC survey cites Stanford's model approvingly, stating that "Stanford models virtually the full range of issues that concern most people in the NAFTA debate." While an overwhelming majority of economists would disagree strongly with his assumptions, his model specification, and the applicability of that specification to issues of trade liberalization, all would agree with the JEC assessment that "Stanford's work is the clearest illustration of the critical importance of assumptions in affecting empirical results from these models." (p. 34)

Macroeconomic Models of NAFTA

The JEC study criticizes a number of the NAFTA models because they do not adequately consider macroeconomic linkages through which trade might affect: (1) aggregate employment, (2) foreign direct investment in Mexico and diversion of investment to Mexico from the U.S., and (3) the balance of trade between Mexico and the U.S. Many of the NAFTA models, particularly the CGE models, focus on efficiency gains from changes in protection, prices, trade, resource allocation, and production as a result of NAFTA. Given their focus, these models tend to assume that macroeconomic variables are set exogenously, and hence are not directly affected by NAFTA. Most of these models, however, do explore the sensitivity of their results to changes in these variables. In effect, researchers have imposed different macro scenarios on their CGE models to examine the sensitivity of their results to changes in the scenarios.

All of the NAFTA models which find potentially negative impacts of NAFTA on the U.S. economy focus either on changes in the U.S.-Mexican balance of trade (balance-of-trade multiplier models) or on investment diversion from the U.S. to Mexico (investment-employment models).

(1) Macro balance-of-trade multiplier models. According to the CBO report, reviewing balance-of-trade multiplier models (p. 84): "Implementing NAFTA would probably expand total employment in the United States in the short run, as increased exports to Mexico raised the demand for labor. Net gains ranging from 35,000 jobs to 170,000 jobs have been forecast."

The 170,000 figure is from Hufbauer and Schott. They project increased export jobs of 316,000, minus job loss from increased imports of 145,000, yielding 171,000 net (which CBO evidently rounded to 170,000). They present their estimate of job gains as a result of NAFTA, due to the change in the trade balance with Mexico, with the U.S. maintaining a trade surplus with Mexico for an extended period.

The only negative study in this category is a study by Clyde Prestowitz and others of the Economic Strategy Institute, which assumes that the U.S.-Mexico balance of trade moves into deficit. They then apply a balance-of-trade employment multiplier (using a different magnitude than Hufbauer-Schott), and project a loss of more than 900,000 U.S. jobs. Prestowitz, after initially arguing that NAFTA would be bad for the U.S., has since changed his mind and now argues that NAFTA will be good for the U.S.

In this type of model, the result depends critically on the projection of the U.S.-Mexican trade balance. The JEC study argues that the Mexican's will be unable to maintain a current account deficit with the U.S. for very long. The Congressional Budget Office (CB), in chapter 2 of their report ("The Macroeconomics of NAFTA"), analyze this issue by using a dynamic, multi-country, macro model adapted from a model originally developed by Warwick McKibbin and Jeffrey Sachs. This study, which is not included in the JEC survey, is the only one that uses a formal model designed to evaluate questions of changes in the balance of trade between Mexico and the U.S. The model also incorporates international investment flows, and so can also be used to evaluate questions of investment diversion (discussed below).

The CBO researchers run a variety of macro simulations, and conclude that (p. 20) "Mexico's current-account deficit will continue for a substantial period of time," around twenty years or more. This result, which is consistent with the historical experience of other semi-industrial countries, supports the Hufbauer-Schott results, since their net employment gains are based on the assumption that Mexico will continue to run trade deficits with the U.S.

(2) Macro Investment-Employment Models. This type of analysis is used by the Economic Policy Institute (in various papers) and underlies the analysis of Pat Choate, Ross Perot, and Harley Shaiken. It is the "sucking sound" argument.

The argument is that increased investment in Mexico will largely come from the U.S., that this increased investment flow will cause a decline in investment in the U.S., and that therefore employment in the U.S. will fall. It is the mechanism at work in the Stanford and McCleery CGE models, as well as various macro models.

For example, one EPI study (Koechlin *et al.*) makes an extreme assumption that additional U.S. investment flows to Mexico reduce investment in the U.S. dollar-for-dollar. Starting from this premise, the study generates estimates of industrial job losses for the U.S. ranging from 290,000 to 490,000. This approach has been heavily criticized for its faulty methodology and unrealistic assumptions. The CBO did not even bother to review this work.

As noted in the JEC review, this type of analysis depends crucially on the assumption that increased investment in Mexico leads to decreased investment in the U.S. The JEC report argues that such investment diversion is significant, and will lead to reduced investment in the U.S.

The CBO addresses the issue of investment diversion using their multi-country macro model. Their macro simulations indicate that increased investment in Mexico will not be at the expense of investment in the United States. In a section entitled "Increased Investment in Mexico Is Not At the Expense of Investment in the United States," the CBO argues that investment diversion represents a very small share of U.S. aggregate investment, and can be made up by tiny changes in either domestic savings or capital inflows into the U.S. from the rest of the world.

The CBO conclusion is also consistent with the experience of the EC. When Spain, Portugal, and Ireland joined, the argument was made that these countries would drain investment from the rest of the EC. In fact, aggregate investment in the EC rose after the market expanded.

<u>Labor Displacement</u>

The JEC report surveys work on possible gross job dislocation in the U.S. due to NAFTA. They dismiss as wildly unrealistic the claims of Pat Choate that 5.9 million U.S. jobs are "at risk" under NAFTA. The JEC argues that estimates of gross dislocations of 300,000 to 600,000 are plausible.

The CBO report has a chapter on "Workers Displaced by NAFTA" (Chapter 5). They conclude that (pp. 86-87): "The basis for forecasting the number of job losses associated with NAFTA is quite weak. . . . Perhaps 100,000 to 200,000 jobs would be a reasonable range, but considerable skepticism is warranted. . . . Even if the number of workers displaced because of NAFTA were twice the high end of the range of job losses given above, that would still be less than 400,000 losses in an economy of nearly 120 million jobs."

The CBO goes on to report that annual job losses in the U.S. economy in the 1980s ranged from 1.5 million to 2.7 million. The maximum of 400,000 gross job losses due to NAFTA is spread over fifteen years. They conclude (p. xv): "Viewed as part of a larger, dynamic labor market in which nearly 20 million workers were displaced during the 1980s, the effects of NAFTA appear relatively small."

Migration Issues

The issue of migration has become part of the NAFTA debate, and is discussed in the JEC study. The JEC survey notes that only three of the sixteen studies it includes consider migration issues, and they yield a wide variety of results. The JEC cites a recent study by Martin (1993), who reviews economic and demographic studies of Mexican-U.S. migration. Following Martin, the JEC concludes (p. 25) that, as a result of NAFTA, ". . . greater imports of farm products into Mexico would displace labor from Mexico's rural areas more rapidly, which would stimulate migration to urban in Mexico and the U.S."

As Martin notes, Mexican-U.S. migration is affected by "pull" factors on the U.S. side and "push" factors on the Mexican side. From the "push" side, immigration is sensitive to conditions in the Mexican labor market, including both wages and employment growth, and to changes in the exchange rate. All studies agree that NAFTA will, from the start, increase industrial employment in Mexico. The potential problem that has attracted a great deal of attention is what will happen in the Mexican countryside.

When NAFTA was first proposed, a number of researchers worried about the impact on the rural economy of rapid liberalization of Mexican restrictions on agricultural trade. At that time (1991), Mexican agricultural policy involved heavy subsidies to corn and beans, grown largely on communally owned land known as "ejidos." These subsidies raised domestic prices above world levels, and were supported by a system of strict import quotas. Researchers argued that too-rapid removal of those quotas would have undermined the whole agricultural support system, leading to disruption of rural labor markets, increased rural-urban migration within Mexico, and increased migration to the U.S. in the short run.

This scenario is the major argument underlying what Martin (p. 137) calls the "conventional wisdom" that "NAFTA can be expected to increase Mexico-to-US migration, but only temporarily and only marginally compared with the current flow. . . . [A]fter [the year] 2000, the more rapid economic growth and job creation due to NAFTA should reduce the 'normal' Mexican influx."

In the last year and a half, two developments have changed the Mexican policy environment dramatically:

First, the negotiation of NAFTA has been completed, and the agreement explicitly acknowledges the sensitivity of Mexican agriculture. Under NAFTA, Mexico is allowed fifteen years in which to adjust its trade policies in important agricultural sectors; a period long enough to give them flexibility in changing their agricultural support policies.

Second, Mexico has unilaterally undertaken to reform its domestic agricultural policies, regardless of whether NAFTA is implemented. At the end of 1991, the Mexican Constitution was amended to allow private ownership of communal "ejido" lands —a major break with history. In addition, this fall, the Mexican government announced a comprehensive reform of its agricultural subsidy system. They plan to move to a "non-distorting" system of income support for farmers, with quite high support levels that taper off over fifteen years. This new system will employ policy instruments that are consistent with the allowable "green box" agricultural policies currently under discussion in the Uruguay round of GATT negotiations.

In response to the anticipated changes in the rural economy, the Mexican government is also considering a number of additional policy initiatives, including a rural investment program to increase employment opportunities in rural areas. In the long run, the major mechanisms for absorbing this surplus labor will be expansion of the industrial sector and changes in the structure of agriculture, with increases in productivity and shifts toward high-value, labor-intensive crops such as fruits and vegetables. NAFTA will play an important role in supporting these changes.

In the short run, however, migration will be determined largely by how well the Mexican government manages the agricultural reforms that are currently underway. NAFTA, with its provision of a long transition period for agriculture, provides the Mexicans with maneuvering room to manage these changes and is probably no longer an important factor, by itself, in the short run.

By contrast, studies indicate that if NAFTA fails, the Mexican growth rate over the next decade will be 1-2 percent lower than it would be if NAFTA were implemented, and there would also be a depreciation of the Mexican exchange rate. The lower growth rate would certainly exacerbate employment problems in Mexico, and lead to a "push" toward higher migration to the U.S. in the short run. In addition, a depreciated Mexican peso will make U.S. wages look better, increasing the "pull" for potential migrants.

Two years ago, the question was whether too-rapid trade liberalization would disrupt Mexican rural labor markets and exacerbate the migration problem. Now, with negotiations completed and recent changes in Mexican policy, we can see that, as far as migration is concerned, NAFTA is an important part of the solution, not the problem.

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EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

November 1, 1993

MEMORANDUM FOR THE PRESIDENT

FROM: JOE STIGLITZ
SHERMAN ROBINSON SR

THROUGH: BOB RUBIN

SUBJECT: Macroeconomics of NAFTA

In a recent article (Business Week, November 8, 1993), Aaron Bernstein argues "that investment lost under NAFTA could outweigh potential gains from increased trade." He goes on to argue that this issue has not been analyzed in the NAFTA debate. He is wrong on both counts.

There are two major errors in Bernstein's article. First, NAFTA, by increasing demand for U.S. exports, will make investment in the U.S. more attractive, not less. Accordingly, the net macro effect of NAFTA should be positive, not negative. Second, NAFTA will increase investment in Mexico. But, since Mexico imports most of its capital goods from the U.S., such increased investment will translate into increased U.S. exports. The fundamental confusion in Bernstein's reasoning is that he seems to believe that a dollar invested in Mexico must somehow decrease investment in the U.S. by a dollar. Aggregate investment in North America is not fixed.

As Bernstein notes, most studies of NAFTA have focused on efficiency gains arising from trade liberalization. All such studies find that NAFTA is good for all three countries. On the other hand, all of the NAFTA models which find potentially negative impacts of NAFTA on the U.S. economy focus on macro mechanisms, either on changes in the U.S.-Mexican balance of trade (balance-of-trade multiplier models) or on investment diversion from the U.S. to Mexico (investment-employment models). Bernstein focuses on the latter. We review these arguments below.

(1) Macro balance-of-trade multiplier models. According to the CBO report on the effects of NAFTA, reviewing balance-of-trade multiplier models (p. 84): "Implementing NAFTA would probably expand total employment in the United States in the short run, as increased exports to Mexico raised the demand for labor. Net gains ranging from 35,000 jobs to 170,000 jobs have been forecast." The 170,000 figure is from Hufbauer and Schott, and is cited in the Bernstein article. They assume that the U.S. will maintain a trade surplus with Mexico for an extended period.

The only negative study in this category is a study by Clyde Prestowitz and others of the Economic Strategy Institute, which assumes that the U.S.-Mexico balance of trade moves into deficit. They projected a loss of more than 900,000 U.S. jobs. Prestowitz, after initially arguing that NAFTA would be bad for the U.S., has since changed his mind and now argues that NAFTA will be good for the U.S.

In this type of model, the result depends critically on the projection of the U.S.-Mexican trade balance. The CBO, in chapter 2 of their report ("The Macroeconomics of NAFTA"), analyze this issue by using a dynamic, multi-country, macro model adapted from a model originally developed by Warwick McKibbin and Jeffrey Sachs. This study, which is not mentioned by Bernstein, uses a formal model designed to evaluate questions of changes in the balance of trade between Mexico and the U.S. The model also incorporates international investment flows, and so can also be used to evaluate questions of investment diversion (discussed below).

The CBO researchers run a variety of macro simulations, and conclude that (p. 20) "Mexico's current-account deficit will continue for a substantial period of time," around twenty years or more. This result, which is consistent with the historical experience of other semi-industrial countries, supports the Hufbauer-Schott results, since their net employment gains are based on the assumption that Mexico will continue to run trade deficits with the U.S.

(2) Macro Investment-Employment Models. This type of analysis is used by the Economic Policy Institute (EPI) in various papers, including one that draws on the McCleery model cited by Bernstein. This view also implicitly underlies the "sucking sound" argument by Pat Choate and Ross Perot.

The argument is that increased investment in Mexico will largely come from the U.S., that this increased investment flow will cause a decline in investment in the U.S., and that therefore employment in the U.S. will fall.

All this work depends crucially on the assumption that increased investment in Mexico leads to decreased investment in the U.S. In their report on NAFTA, the CBO addresses the issue of investment diversion using their multi-country macro model.[1] In a section entitled "Increased Investment in Mexico Is Not At the Expense of Investment in the United States," the CBO argues that investment diversion represents a very small share of U.S. aggregate investment and, in any case, can be made up by tiny changes in either domestic savings or capital inflows into the U.S. from the rest of the world. Their model results support this argument.

The CBO conclusion is also consistent with the experience of the EC. When Spain, Portugal, and Ireland joined, the argument was made that these countries would drain investment from the rest of the EC. In fact, aggregate investment in the EC rose after the market expanded.

[1]Bruce Arnold of the CBO is cited by Bernstein as saying that no one has studied the issue of investment diversion much. I am frankly puzzled that he appears not to be aware of the CBO model addressing this issue, although it came from a different Division within CBO. Arnold's own review, which is cited by Bernstein, rates about a C+, in Sherman's view. Sherman reviewed that paper while he was a Visiting Scholar at CBO last year, and worked on the CBO macro model.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

November 2, 1993

TO: LAURA TYSON
ALAN BLINDER
JOE STIGLITZ

FROM: SHERMAN ROBINSON SR

SUBJECT: Macroeconomics of NAFTA

In a recent article (Business Week, November 8, 1993), Aaron Bernstein argues incorrectly: (1) "that investment lost under NAFTA could outweigh potential gains from increased trade" and (2) that this issue has not been analyzed in the NAFTA debate. In fact, he presents a rehash of views that were first presented during the fast track debate, have been discussed thoroughly, and were rejected as incorrect by almost all researchers.

All agree that NAFTA should lead to increased investment in Mexico, some of which will be funded by foreign borrowing, much of which, in turn, will come from the U.S. Bernstein argues that this increased U.S. investment in Mexico will cause a corresponding decline in investment in the U.S. and that, as a result, employment in the U.S. will fall. This argument has been used by the Economic Policy Institute (EPI) in various papers, including one that draws on the McCleery model cited by Bernstein, and also implicitly underlies the "sucking sound" argument by Pat Choate and Ross Perot. It rests on two fundamental fallacies: (1) that increased investment in Mexico must somehow lead to a decrease in investment in the U.S., and (2) that a job gained in Mexico must somehow lead to a job lost in the U.S., so that increased investment and growth in Mexico, regardless of source, will be bad for the U.S.

Investment diversion fallacy. In their recent major report on NAFTA (A Budgetary and Economic Analysis of the North American Free Trade Agreement), the Congressional Budget Office (CBO) addresses the issue of investment diversion using both historical analysis and a multi-country macroeconomic model.[1] In a section entitled "Increased Investment in Mexico Is Not At the Expense of Investment in the United States," the CBO argues: (1) that new foreign investment in Mexico represents a very small share of U.S. aggregate investment and, in any case, (2) that any diversion can be made up by tiny changes in either domestic savings or capital inflows into the U.S. from the rest of the world. The CBO model results also support their arguments. The arguments presented by the CBO have been well understood for some time, which explains why, as Bernstein notes, many modelers

[1]Note that this CBO report is not the one cited by Bernstein. Bernstein cites a background paper by Bruce Arnold of the CBO which surveyed NAFTA models. Bernstein quotes Arnold as saying, regarding the investment diversion argument, that "no one has looked at it much." Arnold is probably misquoted, since he must be aware of the CBO modelling work and macroeconomic analysis presented in the full report.

have simply assumed that investment diversion is insignificant —hardly a "bizarre" assumption, given the facts.

The CBO conclusion is also consistent with the experience of the EC. When Spain, Portugal, and Ireland joined, the argument was made that these countries would drain investment from the rest of the EC. In fact, aggregate investment in the EC rose after the market expanded. Similarly, NAFTA will make North America more productive and hence more attractive to both foreign and domestic investors.

Second fallacy: Investment in Mexico is bad for the U.S. Experience in many countries, including Mexico, indicates that increased direct foreign investment leads to increased demand for exports of capital goods from the investing country. Increased U.S. investment in Mexico translates into increased U.S. exports to Mexico. After Mexico unilaterally lowered protection in the mid-1980s and attracted increased foreign investment, U.S. exports to Mexico shot up, supporting a lot of U.S. jobs.

Bernstein adds the argument that increased investment and exports of capital goods to Mexico will be used to expand Mexican exports to the U.S., leading Mexico to run a balance-of-trade surplus with the U.S., with negative effects on U.S. industry and employment. The argument is fallacious on two counts.

> First, Mexico is currently running a current account deficit with the U.S., and should continue to do so for an extended period. The CBO study indicates that Mexico may well run a deficit with the U.S. for twenty years or more, which is consistent with the past experience of a number of other successful semi-industrial countries.
>
> Second, most investment in Mexico is to expand capacity to supply the domestic market in Mexico, leading to increased aggregate growth. All studies agree that a prosperous Mexico is good for the U.S., providing an expanded market and increased trade.

As Bernstein notes, most studies of NAFTA have focused on efficiency gains arising from trade liberalization. All such studies find that NAFTA is good for all three countries. On the other hand, all of the NAFTA models which find potentially negative impacts of NAFTA on the U.S. economy focus on macroeconomic mechanisms involving either investment diversion or changes in the balance of trade. Careful analysis indicates that investment diversion has a negligible effect on aggregate investment in the U.S., that Mexico is capable of running trade deficits with the U.S. for an extended period, and that increased growth in Mexico is good for the U.S.

Commentary/by Aaron Bernstein

AN ANTI-NAFTA ARGUMENT YOU HAVEN'T HEARD

For months, a media juggernaut has rolled over anyone who challenged the North American Free Trade Agreement (NAFTA). That's because economists have won the day by repeating their graduate school lessons like a mantra: History shows that free trade is good, so NAFTA will benefit the U. S. economy. Those who say otherwise are dismissed as ignorant or irresponsible.

But the argument overlooks the treaty's biggest impact, which won't be on trade but on investment, mainly by U. S. companies in Mexico. Most studies rely on the 19th century theory of free trade, which assumes capital doesn't cross borders. Result: The studies miss the drain of U. S. investment dollars—which began several years ago in anticipation of the pact's becoming law.

Some quick arithmetic suggests that investment lost under NAFTA could outweigh potential gains from increased trade. "Most economic models of NAFTA don't look at capital movements," says Edward E. Leamer, a trade economist at the University of California at Los Angeles. "And it might give a different answer as to whether NAFTA is good or bad for the U. S. work force if they did."

"NO ONE HAS LOOKED." Indeed, of 19 NAFTA forecasts reviewed by the Congressional Budget Office (CBO), just five looked at the issue. Four of these assumed—bizarrely—that any investment surge in Mexico would come from somewhere other than the U. S. The only study delving into the issue, by Robert K. McCleery, an American economist at Kobe University in Japan, predicted that NAFTA would displace about $2.5 billion of investment from the U. S. to Mexico annually.

What does that mean for U. S. jobs? McCleery doesn't ask, because he assumes the U. S. economy will fill in lost jobs with new ones. But Georgia State University economist Donald Ratajczak figures that $1 billion of U. S. investment generates about 30,000 jobs. Assuming a $2.5 billion annual capital outflow, that would mean 375,000 potential new jobs lost over five years—more than wiping out the 170,000 gain that Gary Clyde Hufbauer and Jeffrey J. Schott of the Institute for International Economics in Washington predict will occur in five years if NAFTA passes. Bruce G. Arnold, the economist who wrote the CBO paper, acknowledges that investment outflows could wipe out potential job gains from NAFTA, but he admits that "no one has looked at it much."

DAN V ROMER

The pro-NAFTA argument rests on some shaky assumptions about exports, too. Hufbauer and Schott, like most others, assume that higher exports are a net increase for the U. S economy. But the recent export surge to Mexico wasn't fueled by Mexicans on a spending spree. Some 37% of it went to *maquiladoras*, which ship most of their output right back to the U. S., according to a recent General Accounting Office study. That's not a net boost to U. S. gross domestic product—it's production lost to another country.

Moreover, the CBO found that a further third of U. S. exports to Mexico consisted of capital goods. If much of this money comes from U. S. companies closing plants at home and setting up new ones in Mexico, these exports aren't a net gain for the U. S. either.

Lets take an example: Say General Motors Corp. shuts an Ohio plant that had cost $1 billion to build and that employs 30,000 people. Then, it builds a factory in Mexico, buying $1 billion of equipment from U. S. makers. Hufbauer and Schott figure the economy will be swelled by $1 billion in new exports—enough, they estimate, to create 19,600 new jobs for American workers. But the investment and 30,000 jobs lost in Ohio are left out of the equation.

Trade theory is convincing—about the benefits of increased trade. But it doesn't address what's happening between the U. S. and Mexico, which are merging their economies. If the effects of integration overwhelm the trade gains, the U. S. could be the loser. And economists simply don't pay enough attention to that possibility.

Bernstein writes about labor issues for BUSINESS WEEK.