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# 2 American Bilateral Trading Arrangements and East Asian Interests

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One of the major success stories of the era since the Second World War has been the liberalization of the international trading system. Trade in goods and services among nations has grown at a rate more than one and a half times the rate of growth of world GNP. Partly in consequence of rapid growth of trade, growth rates of world real output reached sustained levels previously unattained in human history.

There is no question but that the open, multilateral trading system (the GATT system, for short) was a major factor in contributing to world economic growth and that future growth of trade and of the world economy is dependent on the maintenance of the system. However, one important reason why the GATT system flourished was American support for it. The U.S. commitment to the principle of most-favored-nation treatment of all trading partners and its support of GATT provided the leadership that enabled successive rounds of multilateral reductions in trade barriers and trade liberalization.

In recent years, the American commitment to an open multilateral system has been, at least to a degree, eroded, as U.S. policy has shifted to a "two-pronged" approach. On the one hand, the United States has continued to participate in the Uruguay Round of trade negotiations; on the other hand, the United States has indicated a willingness to bargain bilaterally for free trade areas with individual trading nations.[1]

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1. It is outside the purpose of this paper to attempt to analyze the reasons for this shift in approach. Suffice it to say that there are several motives, and different parties undoubtedly place different weight on each of them. For some, frustration with the American inability to proceed further under GATT has been a factor, and this has certainly been the stated American position. For these individuals, bilateralism is intended as a supplement to GATT. For some others, bilateralism has appeared as an attractive alternative to multilateralism, even perhaps providing an

As a consequence of that willingness, the U.S.-Canada Free Trade Agreement has already been signed, and the U.S.-Canada free trade area is in its transition phase. The United States and Mexico have announced their intention to negotiate a free trade agreement (FTA), with Canada included in the bargaining, and President Bush has announced the Enterprise for the Americas, under which it is contemplated that the United States might enter into FTAs with other Latin American countries.[2]

The possibility of a hemisphere-wide trading area raises a number of important questions. The most significant issues concern the degree of commitment the United States maintains for the open, multilateral system. The United States has maintained that its free trade area arrangements will be consistent with GATT and, indeed, will constitute "super-GATT" arrangements among countries willing to pursue free trade beyond their commitments in GATT. Whether that contention is valid is itself a subject in need of considerable analysis, although the test will be in the evolution of the GATT system, the outcome of the Uruguay Round, and subsequent trading relations. A second major issue is the extent to which the world trading system may degenerate into trading blocks. Some fear that the European Community (EC) arrangements may turn into a "Fortress Europe," although events to date surrounding 1992 do not support that view. Were Europe and the Western Hemisphere each to evolve trading arrangements that gave strong preferences to regional trading partners, it would surely elicit responses from other trading countries. That possibility appears remote at the present time: not only are trading relations between Europe, North America, and East Asia important to all groups of countries, but the market forces emanating from lowered costs of communications and transportation continue to lead to incentives for increasing integration of the world economy and greater economic losses for countries that choose to erect protective barriers against imports.

On the assumption that the basic framework for international trade will remain the open, multilateral trading system, questions arise as to the likely effect of FTAs between the United States and other Western Hemisphere countries on East Asian countries. The purpose of this paper is to examine that question. It is assumed that American negotiations with other Western Hemisphere countries are and will continue to be GATT compatible. In that context, I examine the potential effects of such American bilateral Western Hemi-

umbrella under which protection for their interests might be increased. For still others, a foreign policy motive, especially regarding Canada and Mexico, has been important. For a discussion, see Schott (1989b).

2. The United States has taken other steps that indicate an erosion of the traditional commitment to multilateral trading arrangements. Bilateral bargaining over trade barriers is a prominent example. Perhaps best known, however, is the inclusion of "Super-301" in the 1988 Trade Expansion Act. Under that provision, the U.S. trade representative is authorized unilaterally to declare countries "unfair traders" without resort to GATT procedures. For a discussion of "Super-301," see Bhagwati and Patrick (1990) and Bhagwati (1988).

spheric trading arrangements on other American trading partners and especially the East Asian "superexporters," who have long relied on the relatively open American market in pursuing their strategy of export-led growth.

It is well known that preferential trading arrangements can be welfare improving or welfare reducing depending in part on whether they are "trade creating" or "trade diverting." Especially given the likelihood that the United States will sequentially enter into FTAs with other Western Hemisphere countries, there is the potential for trade diversion and rediversion throughout the hemisphere. In addition, there are significant questions about how those arrangements might affect East Asian trading partners.

I will argue that any assessment of existing economic conditions and trading patterns among Western Hemisphere countries suggests that the direct trade diversion resulting from these arrangements on East Asian trade will be minimal. Indeed, given the small share of East Asian exports in the Latin American markets at the present time, it can be argued that, *if* the Western Hemisphere FTAs are successful, they should stimulate more rapid economic growth in the Latin American countries. To the extent that they do that, East Asian countries may gain as the increased participation in international trade and the more rapid economic growth of the countries in question more than offset whatever small amount of trade diversion there may be.

The analysis proceeds as follows. The first section reviews the current status of Western Hemisphere bilateral trading arrangements. Even the prospective Mexican agreement has not yet been negotiated, and there are many questions pertaining to the extent that it will actually free trade between the United States and Mexico. The second section then analyzes the current patterns of trade between the relevant pairs of trading countries. The dominance of the United States in trade with Canada and Mexico is seen, which limits the possible order of magnitude of trade diversion from existing trade flows. The third section then considers the commodity composition of U.S. trade with East Asian countries and the possible initial order of magnitude of trade diversion of the current bilateral trading arrangements. The final section then assesses the relation of the current and prospective Western Hemisphere trading arrangements in the context of an open, multilateral trading system. It will be argued that U.S. tariffs are low enough that the potential for trade diversion from East Asia to Latin America is limited, although there are interesting questions concerning the effect of the FTA arrangements on the Multifiber Arrangement (MFA) and world trade in textiles and apparel. However, levels of protection in Latin American countries remain significantly higher. Should FTAs be negotiated, there would be an initial wide margin of preference for commodities from other FTA members. An offsetting consideration, however, is that businesses in FTA countries other than the United States would perceive themselves to be subject to higher costs than their U.S. counterparts because of these tariffs; pressures should therefore arise for reductions in protection throughout Latin America. If that happens, the growth potential from the FTA would be greater and the potential for trade diversion considerably weakened.

## 2.1 A Western Hemisphere Free Trade Area?

Although American officials spoke of their willingness to enter into bilateral agreements with "like-minded free trading countries" as early as 1983 and actually signed an FTA with Israel, it was not until the U.S.-Canada Free Trade Agreement was successfully negotiated in 1987 that these statements began to assume importance.[3] Even then, Canada and the United States have such a long border and sufficiently close trading relations that a Free Trade Agreement could be regarded as a natural "GATT-plus" arrangement under which barriers in addition to those negotiated away under GATT could be removed.

Even after it was negotiated, it was at least plausible that the U.S.-Canada arrangement would be the only major initiative under announced American policy and that it would be largely trade creating. During the period 1986–88, few thought that any Latin American country would seriously contemplate entering into such an arrangement, despite the fact that "framework agreements" had already been entered into by several Latin American countries.[4] Not only were most Latin American countries still highly protectionist, but many of them continued to experience severe macroeconomic instability; in these circumstances, it appeared highly unrealistic to think that a free trade area was a serious alternative.

However, all that changed when the president of Mexico announced in the spring of 1990 the intention of the government of Mexico to seek an FTA with the United States. Although Mexico had a long history of very high protection against imports (both through tariffs and, after 1982, through quantitative restrictions on imports) and was experiencing rapid inflation, in the mid- and late 1980s the Mexican government had already undertaken a series of steps designed to reform economic policies. Not only had quantitative restrictions on imports been almost entirely removed, but the average level of tariffs had

3. The U.S.-Israel Free Trade Agreement is not analyzed in this paper. Israel's trade with the United States is sufficiently small and different from that of Latin American and East Asian countries that it is not a major consideration for an analysis of potential effects of a North American free trade area on East Asian exporters. For an analysis of the agreement, see Rosen (1989). The Caribbean Basin Initiative, which was passed by Congress in 1983, was the first use of regional trade preferences under U.S. trade law. While not creating a free trade area, the Caribbean Basin Economic Recovery Act of 1983 (and subsequent amendments) provided duty-free access to the U.S. market for certain commodities not already covered by preferential treatment under the Generalized System of Preferences.

The U.S.-Canada Free Trade Agreement came into force on 2 January 1988 and provided for a ten-year phase-in of agreed-on liberalizing measures. To date, tariffs have been reduced at a rate more rapid than that envisaged in the agreement. The idea of a U.S.-Canada free trade area was not a new one. It had been seriously considered several times before, but rejected by Canada (see U.S. Council of Economic Advisers 1988, chap. 4).

4. For a listing of the countries with which the United States has signed framework agreements, see U.S. Council of Economic Advisers (1991, 253).

been sharply reduced. In addition, serious efforts to deregulate domestic economic activities (such as freight transport) and to privatize state-owned firms were under way. While inflation remained (and remains) a difficult problem, associated in part with heavy obligations for servicing internal as well as external debt, the idea of a free trade area with the United States did not appear as unrealistic as it would have had the policies of the 1960s and 1970s still been in effect.

At the time this paper was written (mid-1991), negotiations had not begun on the U.S.-Mexico FTA. Since the ultimate agreement may take a variety of forms, any judgment as to the effects of the agreement must be based on some assumptions regarding the outcome of the negotiations.[5] A number of significant questions remain to be addressed, including the key issue of the relation of the U.S.-Mexico FTA to the U.S.-Canada FTA and the subsequent linkages between Mexico and Canada and any further signatories of FTAs with the United States.[6] In addition, it is not known whether the agreement will be across the board or sectoral in nature.

From a Mexican perspective, major concerns arise over U.S. willingness to permit Mexican construction firms, trucking companies, and other labor-intensive services to operate in the United States. The United States, in turn, wants access to the Mexican market in high-tech services and liberal conditions governing direct foreign investment in Mexico. A key issue in all free trade agreements, but especially so when there is a long, open border, is what rules of origin will be adopted and what criteria and mechanisms will be established for their enforcement. There are also important questions regarding the treatment of Mexican imports into the United States (and possibly into Canada) of textiles and clothing in commodity lines for which MFA quotas are in force. Finally, as with the U.S.-Canada agreement, key issues concern the application of U.S. antidumping and countervailing duty provisions to Mexican exports to the United States.

How "trade creating" the U.S.-Mexico FTA will be will depend greatly on these provisions and the evolution of the agreement. As of the summer of 1991, that outcome is by no means clear. There are a number of issues that are politically contentious in the United States, and the opposition of American labor to any agreement has been vehement.[7] There will be especially difficult

5. There are also important questions regarding Mexican exchange rate policy and macroeconomic balance that will have an important effect on the evolution of any U.S.-Mexico FTA. Should the Mexican authorities attempt to control the nominal exchange rate in the face of domestic inflation, e.g., the probable outcome would be unsustainable current account deficits with the United States in the short run. The response to this event would have to be either to alter monetary/fiscal/exchange rate policy or to abandon the FTA. Which of these courses would be chosen is a matter for speculation.

6. For analyses of the potential difficulties with a series of bilateral agreements between the United States and individual trading partners, see Park and Yoo (1989) and Wonnacott (1990).

7. American labor has been joined in its opposition by some environmental groups, and it is unclear how the American administration will deal with these issues. The U.S. trade representative has provided Congress with assurances that these issues will be dealt with in the course of the negotiations (*New York Times*, 15 May 1991, 1, C2).

issues concerning Mexico's access to the American market for textiles and apparel, for many agricultural products (where phytosanitary regulations are the main trade barrier), and for overland and ocean shipping. On the Mexican side, there are questions as to macroeconomic policy, American access to Mexican petroleum resources and various parts of the services industries, regulations governing direct foreign investment, and other issues.

As a consequence of these uncertainties, one can well imagine a *de minimus* agreement, to be phased in over a long time period, with negligible effects on the flow of goods and services between Mexico and its northern neighbors for the foreseeable future. Alternatively, one can equally imagine an agreement that effectively removes most trade barriers within a reasonably short period of time and the consequent rapid expansion of flows. For purposes of this paper, it will be assumed that the FTA takes the latter form, providing virtually full mobility of goods, services, and capital within the foreseeable future.[8]

Subsequent to the announcement that there would be negotiations for a U.S.-Mexico FTA, President Bush announced the Enterprise for the Americas in June 1990. In effect, this was a statement of American willingness to enter into FTAs with any interested Latin American countries willing to meet certain conditions.[9] Again, the relationships of new FTA entrants to those already party to an FTA have not been clarified, and no negotiations have begun. To date, Chile has expressed serious interest in such negotiations. Given the low level of prevailing Chilean tariffs and Chile's stable macroeconomic situation, it is economically realistic to assume that such an FTA could be agreed on and implemented within a fairly short period of time.

For other Latin American countries, however, the situation is very different.

8. Even should the negotiated agreement itself be toward much freer trade, there are questions as to whether Mexico can achieve the stated goal of maintaining a fixed exchange rate vis-à-vis the dollar as the agreement enters force. There are two serious dangers. (1) The Mexican authorities might attempt to fix the nominal exchange rate at an unrealistic level. If this happened, the consequences for income and employment in Mexico would not be dissimilar to those for East Germany after reunification with West Germany in 1990, and it is questionable whether any Mexican government could continue with that policy stance. (2) The initial exchange rate might be established in such a way that the real exchange rate was initially realistic, but Mexican monetary and fiscal policy might be incompatible with the maintenance of that real rate at a fixed nominal exchange rate. A fixed exchange rate regime in conjunction with the FTA would not be sustainable in that circumstance. Should either of these dangers materialize, monetary/fiscal/exchange rate policy would have to change, or the FTA would have to be abandoned in the longer run.

9. These conditions included primarily the reliance on the private sector and market forces to guide the preponderance of economic activity and the existence of relatively open access for foreign direct investment. Inducements to join the Enterprise for the Americas included the promise of not only preferential access to the American market but also favorable consideration for debt-relief negotiations. A number of important questions remain unresolved. Chief among them is whether negotiations will be bilateral, with the result that many countries will have FTAs with the United States but not with each other, or whether a technique will be found for multilateralizing the FTA. The existence of a number of bilateral FTAs between the United States and individual Western Hemisphere countries would create a number of legal and administrative issues. For an analysis, see Wonnacott (1990).

Most of them retain very high walls of protection against imports, which implies that a move toward an FTA with the United States would require a major realignment of the existing trade regime.[10] In addition, a number of Latin American countries exhibit a high degree of macroeconomic instability. Despite repeated announcements of plans and programs to stabilize the economy and reduce inflation, success has been elusive in most countries.[11]

For that reason, analysis in this paper is largely confined to the potential effect of a U.S.-Mexico FTA under the assumption that the agreement is one that permits virtually free movement of goods, services, and capital across the border. On the one hand, it is not even clear whether the U.S.-Mexico FTA will be that liberalizing, and other FTAs are even further in the future. On the other hand, Mexico is a very large trading country, representing a sizable share of all U.S.–Latin America trade. An examination of the potential orders of magnitude of the effects of a U.S.-Mexico FTA provides, therefore, a reasonable basis for a judgment as to what may happen over the intermediate term for the entire Western Hemisphere trading arrangements.

## 2.2 Current Trading Patterns

It thus seems plausible to assume that, over the next five years, any Western Hemisphere integration that does occur will take place between Canada, the United States, and Mexico. Table 2.1 gives some salient data on their trade. As can be seen, the United States is the "giant" among the three. Although Mexico's population, at 85 million, is about one-third that of the United States, its per capita income is about one-tenth that of the United States.[12] Thus, Canada, with a much smaller population but a per capita income similar to that in the United States, has a GNP approximately one-quarter that of the United States, while Mexico's GNP in dollar terms in 1989 was about 3 percent that of the United States.

10. For many Latin American countries that still have highly restrictive trade regimes and countries that are in the process of removing trade barriers, there are significant questions as to why they should not liberalize unilaterally vis-à-vis the entire world, rather than joining a Western Hemisphere FTA. The issue is perhaps most important for those countries whose share of trade with the United States is smaller than that of Mexico and Canada. For an analysis, see Nogues (1990).

11. The macroeconomic instability issue is most pronounced in Argentina and Brazil—the two largest exporters in South America. Those two countries, along with Uruguay and Paraguay, recently entered an agreement to form an FTA among themselves within five years. That FTA was announced as a "first step" toward a hemisphere-wide arrangement. Even among those four countries, macroeconomic imbalances are large, and trade barriers are high. It is thus questionable whether they can achieve welfare-improving integration among themselves over the next five years and virtually certain that their entry into a hemisphere-wide FTA would not begin for the better part of a decade.

12. These proportions are not very different from those between East and West Germany at the time of German reunification. East Germany had a population of about 17 million and a per capita income estimated to be about one-eighth that of West Germany; West Germany's population was about 51 million.

Table 2.1 **Basic Data on the United States, Canada, and Mexico, 1989**

| | U.S. | Canada | Mexico |
|---|---|---|---|
| Population (millions) | 248.8 | 26.2 | 84.5 |
| GNP (billions of U.S.$) | 5,200.8 | 528.9 | 175.7[a] |
| GNP per capita | 20,903.5 | 20,170.4 | 2,079.0 |
| Total exports (billions of U.S.$) | 364.0 | 121.4 | 24.8 |
| Percentage exports of GNP | 7.0 | 22.9 | 14.1 |
| Percentage of exports to: | . . . | 70.3 | 63.3 |
| U.S. | | | |
| Canada | 21.5 | . . . | 2.4 |
| Mexico | 6.9 | .4 | . . . |
| Total imports (billions of U.S.$) | 492.2 | 118.2 | 25.1 |
| Percentage imports of GNP | 9.5 | 22.4 | 14.3 |
| Percentage of imports from: | | | |
| U.S. | . . . | 63.1 | 67.0 |
| Canada | 18.2 | . . . | 1.8 |
| Mexico | 5.6 | 1.2 | . . . |

*Sources:* International Monetary Fund, *International Financial Statistics Yearbook,* 1990; and *Direction of Trade Statistics Yearbook,* 1990.

*Note:* Exports are c.i.f.; imports are f.o.b.

[a]GDP for Mexico.

If attention turns to relative importance in trade, relative size is not dissimilar: Canadian exports represent more than one-fifth of GNP and were $121 billion in 1989; American exports were $364 billion and 7 percent of GNP. Absolutely, however, U.S. exports were much larger, at $364 billion, contrasted with Canada's $121 billion. Mexico's exports constituted just 14 percent of GNP, reflecting in part the residual effect of that country's half-century-long policy of protection. Total Mexican exports, at $24.8 billion in 1989, were about 8 percent of those of the United States. The figures for imports are roughly comparable.

Turning our attention to the relative importance of each of the countries as trading partners for the other two, asymmetry is immediately evident. The United States is the destination for 70 percent of Canada's exports and 63 percent of Mexico's; Canada obtains 63 percent of its imports from the United States and Mexico 67 percent. But when the U.S. trade pattern is examined, the relationship is very different. Although Canada is the United States's largest trading partner, only 21.5 percent of exports are destined for Canada and 6.9 percent for Mexico; on the import side, 18 percent of American imports originated in Canada and 1.8 percent originated in Mexico. Interestingly, also, trade relations between Canada and Mexico are symmetrically very small. Less than 1 percent of Canadian exports went to Mexico, and 2.4 percent of Mexico's exports went to Canada, with a similar pattern on the import side.

The United States is clearly the predominant trading partner for Canada and Mexico. Moreover, American protection levels for most imports are considerably lower than those of Canada and Mexico.[13] The average Canadian tariff level against imports from the United States was estimated to be 10.4 percent, while the average American tariff against Canada was 3.3 percent at the time the FTA went into effect (U.S. Council of Economic Advisers 1988). Mexico's average tariff level against U.S. imports is currently estimated to be about 10 percent, while the average U.S. tariff against Mexican imports is about 4 percent (U.S. Council of Economic Advisers 1991). Because of the large size of the American market and its general openness, it is reasonable to conclude that, for Canada and Mexico, the decision to enter an FTA with the United States is largely trade creating.

Given the low average U.S. tariff level, the margin of preference for Canadian and Mexican goods is and will continue to be fairly small. This fact, combined with the very low levels of trade between Mexico and Canada, on the one hand, and East Asia, on the other, suggests that the potential for trade diversion from East Asian sources to U.S. sources for Canadian and Mexican imports is fairly small.[14]

Table 2.2 gives data on Canada's commodity composition of exports. As can be seen, except for road vehicles (where the U.S.-Canada Auto Pact accounted for almost the entire volume of trade), Canada's comparative advantage is based strongly on its abundance of natural resources. Of the $29.6 billion of Canadian exports destined to countries other than the United States, $20 billion consisted of primary commodities. It is therefore unlikely that Canada will be able to use the small margin of preference under American tariffs to divert U.S. or Mexican imports from East Asian sources to Canadian sources. Likewise, Canadian imports of manufactured commodities from East Asian countries are small (and negligible from Mexico), and trade diversion in significant orders of magnitude does not appear to be a realistic possibility. The average Canadian tariff of 10.4 percent suggests that there may be scope for increased Canadian imports from the United States as tariff barriers are reduced. Those increases should, however, be largely trade creating.

Rather, it is with Mexico that East Asian exporters may be more concerned. Mexico's low wage rate and other advantages in manufacturing vis-à-vis the United States appear more similar to those historically held by East Asia. Canadian hourly compensation costs for production workers averaged $14.72 in 1989. This figure was above the U.S. average of $14.31 and the Japanese $12.73. Not only was Mexico's average $1.72 well below those in the industrialized countries, as would be expected, but it was also below average hourly

13. The important exception is textiles and clothing. See the discussion in sec. 2.3 below.

14. In 1985, the last year for which data are available from international sources, Japanese imports from Mexico were $1.7 billion, of which more than $1.5 billion was petroleum. Mexican imports from Japan were $842 million, of which more than half were machinery and transport equipment and much of the remainder chemical products. Data are from United Nations (1988).

**Table 2.2** **Canadian Trade with the World and with the United States, 1990 (billions of U.S. dollars)**

| | Exports to: | | Imports from: | |
|---|---|---|---|---|
| | World | U.S. | World | U.S. |
| Total | 119.4 | 89.8 | 116.1 | 74.8 |
| 0. Food and livestock | 9.2 | 3.8 | 6.2 | 3.6 |
| 1. Beverages and tobacco | .7 | .4 | .6 | .1 |
| 2. Crude materials | 17.3 | 7.7 | 3.9 | 2.8 |
| 3. Mineral fuels | 13.0 | 11.0 | 7.4 | 2.1 |
| 4. Animal fats | .2 | .1 | .1 | .1 |
| 5. Chemical products | 6.6 | 4.5 | 7.8 | 5.8 |
| 6. Manufactures based on primary commodities | 20.1 | 16.1 | 14.8 | 9.6 |
| 6.4 Paper | 7.7 | 6.5 | 1.6 | 1.3 |
| 6.5 Textiles | .6 | .4 | 2.3 | 1.2 |
| 6.6 Mineral products | .8 | .7 | 1.9 | 1.1 |
| 6.7 Iron and steel | 2.0 | 1.6 | 2.3 | 1.3 |
| 6.8 Nonferrous metal products | 5.5 | 4.0 | 1.7 | 1.3 |
| 6.9 Metal products | 1.6 | 1.4 | 3.1 | 2.1 |
| 7. Machinery and transport equipment | 45.6 | 41.0 | 58.7 | 41.9 |
| 7.1 Power machinery | 3.4 | 2.7 | 5.3 | 4.0 |
| 7.2 Special machinery | 1.9 | 1.4 | 4.8 | 3.0 |
| 7.5 Office machinery | 2.4 | 1.9 | 5.2 | 3.3 |
| 7.6 Telecommunications | 1.5 | 1.0 | 3.0 | 1.3 |
| 7.7 Electric machinery | 3.7 | 3.4 | 8.8 | 6.3 |
| 7.8 Road vehicles | 26.8 | 26.3 | 22.2 | 17.0 |
| 8. Miscellaneous manufactures | 4.3 | 3.6 | 13.9 | 7.3 |
| 8.2 Furniture | 1.3 | 1.2 | 1.1 | .7 |
| 8.4 Apparel | .3 | .2 | 2.4 | .2 |
| 8.5 Footwear | .1 | .1 | .8 | .1 |
| 8.7 Scientific equipment | .7 | .5 | 2.4 | 1.9 |
| 8.8 Cameras and clocks | .2 | .2 | 1.1 | .5 |
| 9. Miscellaneous manufactures | 2.4 | 1.3 | 2.6 | 1.5 |

*Source:* Organization for Economic Cooperation and Development, *Foreign Trade by Commodities,* ser. C, 1990, vols. 2 and 3 (Paris, 1991).

compensation for Korea ($3.57), Taiwan ($3.53), and other East Asian newly industrializing countries.[15]

## 2.3 Trade Diversion from Asia?

It thus appears that, if there is any quantitatively significant concern about trade diversion from East Asian countries resulting from the formation of a North American (and possibly, ultimately, a Western Hemisphere) free trade

15. U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, Data Sheets, September 1990.

area, that concern should center on Mexico's ability to compete, primarily in the U.S. market, because of her margin of preference under the FTA. Even there, several considerations suggest that there may be significant, perhaps even total, offsets to any trade diversion that does occur. First and most important, Mexico encountered enormous economic difficulties in the 1980s, reflected in its debt crisis in 1982, stagnant per capita income over much of the decade, and high rates of inflation. In responding to these economic difficulties, the government has already shifted from a highly restrictive, inner-oriented trade regime to a much more liberalized one with relatively low tariffs, and growth has gradually resumed. Although inflation remains problematic for Mexico, there is some basis for optimism that it may be controlled, or at least its side effects suppressed. Should that happen, the potential for accelerated economic growth in Mexico is substantial and would be so even in the absence of an FTA. That growth would naturally be spearheaded by expanding exports, as producers respond to the altered incentives that a more liberalized trade regime and realistic exchange rates created. As such, Mexico might in any event become more competitive, especially in labor-intensive commodities as labor costs rise in the East Asian countries. To a degree, it might be more natural to consider Mexico as a competitor for the "next tier" of countries that may achieve rapid development through export-oriented growth—countries such as Sri Lanka, Turkey, and perhaps Brazil, where hourly compensation is also well below that in East Asian newly industrialized countries (NICs).

A second, equally important consideration is that Mexican export-led growth would naturally be accompanied by rising imports. Therefore, even should some trade diversion occur as a result of the FTA, it would be at least partially offset, from an East Asian perspective, by more rapid growth of total Mexican imports, a growth in which East Asia would doubtless share.[16]

The notion of trade diversion is static and refers to existing trade whose sources might be altered as a consequence of preferential trading arrangements. Any examination of the possible orders of magnitude should be based on the existing commodity composition of trade, in this case U.S. imports.

Table 2.3 gives data on U.S. imports from Mexico, other Latin American countries, and East Asian countries in 1990. A first significant characteristic to note is that almost half of U.S. imports from Latin America are from Mexico, reflecting the close ties that already exist between those two countries. The second phenomenon is equally important: American imports from East Asia are much greater than are those from Latin America. Mexico's total ex-

16. The argument is similar to one that can be made retrospectively for Europe: it is no doubt true that there was some trade diversion as the European Common Market was created. The more important reality, however, was that the EC was created in the context of overall trade liberalization and that liberalization spurred economic growth. On net, therefore, trade flows with third countries grew more rapidly than they would have in the absence of the Common Market and trade liberalization. Thus, U.S. trade with Europe increased rapidly during the period of European integration.

ble 2.3 **U.S. Imports from Western Hemisphere and East Asian Countries, 1990 (billions of U.S. dollars)**

| | Mexico | Other Latin America | Japan | Korea | Taiwan | Singapore | Hong Kong |
|---|---|---|---|---|---|---|---|
| tal U.S. imports | 30.8 | 36.0 | 93.1 | 19.3 | 23.8 | 10.1 | 9.9 |
| Food & livestock | 2.8 | 7.3 | .3 | .2 | .3 | .1 | .1 |
| Beverages & tobacco | .3 | .3 | .0 | .0 | .0 | .0 | .0 |
| Crude materials | .8 | 1.8 | .2 | .1 | .1 | .0 | .0 |
| Mineral fuels | 5.5 | 13.6 | .1 | .0 | .0 | .2 | .0 |
| Animal fats | .0 | .0 | .0 | .0 | .0 | .0 | .0 |
| Chemicals | .7 | 1.2 | 2.5 | .3 | .4 | .4 | .0 |
| Manufactures based on primary commodities | 2.6 | 3.6 | 7.3 | 2.3 | 3.3 | .1 | .6 |
| Machinery & transport equipment | 13.8 | 2.5 | 71.6 | 7.8 | 9.4 | 7.8 | 2.3 |
| Miscellaneous manufactures | 3.1 | 4.9 | 9.6 | 8.6 | 10.0 | 1.0 | 6.5 |
| Other | 1.3 | .5 | 1.4 | .1 | .3 | .4 | .3 |

*ırce:* Organization for Economic Cooperation and Development, *Foreign Trade by Commodities*, ser. 1990, vol. 3 (Paris, 1991).

ports to the United States (including oil) are about the same in total magnitude as those from Taiwan and Hong Kong and less than one-third those from Japan. Moreover, almost all the East Asian exports to the United States consist of manufactured products, whereas more than one-third of Mexico's and about two-thirds of the rest of Latin America's exports to the United States are in commodity categories 0–4. Thus, if one eliminates those categories in which East Asia is not now exporting to the U.S. market, Latin America's total exports to the United States were $65.3 billion in 1990, contrasted with $156.2 billion from East Asia. While Latin American exports—most of which are Mexican—of manufactures to the United States are not negligible, they are small contrasted with those of East Asia.

Closer examination of the commodity composition of manufactured imports to the United States suggests that the scope for trade diversion out of existing trade flows is even smaller than that. Table 2.4 gives the commodity composition of American imports of manufactures by countries. As can be seen, the major commodity category in which there appears to be significant U.S. imports from both East Asia and Mexico is machinery and transport equipment. In that category, Mexico is a much larger exporter than the rest of Latin America combined, exporting $13.8 billion in 1990, contrasted with Japan's exports of $71.6 billion and exports from Singapore, Korea, and Taiwan of $7.8, $7.8, and $9.4 billion, respectively.

It should be noted, however, that the machinery and transport equipment category is the one with the greatest Mexican maquiladora exports.[17] Because

17. The maquiladora industries operate under special sections of the U.S. trade law that permit the export of parts and components for assembly abroad. Mexico has special legislation governing

**Table 2.4** **U.S. Imports of Manufactures from Latin America and East Asia by Two-Digit Industries, 1990 (billions of U.S. dollars)**

| | Mexico | Other Latin America | Japan | Korea | Taiwan | Singapore | Hong Kong |
|---|---|---|---|---|---|---|---|
| 6. Manufactures based on primary materials | 2.6 | 3.6 | 7.3 | 2.3 | 3.3 | .1 | .6 |
| 6.4 Paper | .2 | .1 | .3 | .1 | .1 | .0 | .0 |
| 6.5 Textiles | .3 | .4 | .6 | .5 | .5 | .0 | .2 |
| 6.6 Mineral products | .5 | .4 | .8 | .1 | .4 | .0 | .2 |
| 6.7 Iron and steel | .4 | .9 | 2.3 | .6 | .2 | .0 | .0 |
| 6.8 Nonferrous metals | .5 | 1.0 | .5 | .0 | .0 | .0 | .0 |
| 6.9 Metal products | .5 | .2 | 1.7 | .6 | 1.7 | .0 | .2 |
| 7. Machinery and transport equipment | 13.8 | 2.5 | 71.6 | 7.8 | 9.4 | 7.8 | 2.3 |
| 7.1 Power mach. | 1.1 | .6 | 3.4 | .1 | .1 | .1 | .0 |
| 7.2 Special mach. | .1 | .3 | 3.5 | .1 | .3 | .0 | .0 |
| 7.5 Office mach. | .7 | .1 | 11.3 | 1.4 | 3.2 | 4.4 | .8 |
| 7.6 Telecommunications | 2.8 | .0 | 9.6 | 1.7 | 1.5 | 1.3 | .5 |
| 7.7 Electric machinery | 4.6 | .4 | 9.1 | 2.6 | 2.3 | 1.5 | .8 |
| 7.8 Road vehicles | 3.7 | .5 | 28.7 | 1.4 | .9 | .0 | .0 |
| 8. Miscellaneous manufactures | 3.1 | 4.9 | 9.6 | 8.6 | 10.0 | 1.0 | 6.5 |
| 8.2 Furniture | .6 | .1 | .2 | .1 | 1.1 | .0 | .0 |
| 8.4 Clothing | .7 | 2.6 | .2 | 3.4 | 2.6 | .7 | 4.2 |
| 8.5 Footwear | .2 | 1.4 | .0 | 2.7 | 1.6 | .0 | .1 |
| 8.7 Scientific equipment | .5 | .1 | 1.7 | .1 | .2 | .1 | .1 |
| 8.8 Cameras and clocks | .1 | .0 | 2.8 | .1 | .4 | .0 | .6 |

*Source:* Organization for Economic Cooperation and Development, *Foreign Trade by Commodities,* ser. C, 1990, vol. 2 (Paris, 1991).

those exports are already duty free and compete head-on with East Asian exports (entering under the same provisions of the trade law) under current U.S. trade law, these activities are ones where an FTA is unlikely to provide any additional competitive advantage to Mexico. Even when U.S. imports do not originate in maquiladoras, the average tariff rate on machinery and equipment imports into the United States is 4.5 percent.

For Mexican exports outside maquiladoras, U.S. duties are low on most commodities, and there are few quantitative restrictions on manufactured imports except for textiles and apparel. As can be seen from table 2.4, Mexican exports to the United States in those commodity categories are currently very small, but it is conceivable that they are constrained by the Multifiber Arrangement, rather than by any lack of comparative advantage. Although Ja-

the operation of the maquiladora factories; their output has been a major part of the expansion of manufactures in recent years. For an analysis of maquiladora industries, see Zermaño (1987). It is estimated that 45 percent of Mexico's manufactured exports to the United States in 1988 originated in maquiladoras (U.S. Council of Economic Advisers 1991, 254).

pan's exports of these commodities are insignificant, Korea and Taiwan continue to export substantially under their MFA quotas, and *if* Mexican imports were permitted freely under the FTA, there could be trade diversion in that commodity category.

To examine how severe such trade diversion might be, U.S. imports under the Multifiber Arrangement were separately examined. The data are given in table 2.5. As can be seen, Mexico has been a relatively small exporter of textiles and apparel.[18] East Asian countries exported only $8.7 billion to the U.S. market in 1990 under the MFA, out of total U.S. imports under the MFA of $27.9 billion. It would thus appear that, at least as far as a U.S.-Mexico free trade area is concerned, any trade diversion in textiles and apparel would be likely to be relatively small and would have more effect on suppliers other than the East Asian NICS and Japan.

## 2.4 Implication of a North American FTA on the World Trading System

Despite the size of Mexico and Latin America in terms both of population and geography, the economic policies adopted by the countries of the region have left them very small and poor economically. The negative economic consequences of inner-oriented policies did not become evident until the 1980s, when economic growth ground to a halt in most of Latin America. Although efforts at policy reform are under way in a number of countries, there are many—including notably the biggest, Brazil and Argentina—where efforts have not as yet been able to reverse the decline in economic activity.

When policy reform is successful, economic growth can accelerate, based on export-led growth in response to altered incentives. This was demonstrated by the East Asian NICs several decades ago. As export-led growth accelerates, exporters in the countries whose policies have been successfully altered will no doubt increase their competitiveness and their share of world markets. That share is currently abnormally low in response to the highly protective policies that have been followed. To a considerable extent, policy reform in Latin America would increase Latin American competitiveness (as it already has for Chile), regardless of whether there are preferential trading arrangements with Canada and the United States.

Should policies be successfully reformed, there will be a major reduction in the overall level of protection that Latin American countries accord their domestic producers. Moreover, a successful FTA with the United States would result in pressure by Latin American exporters for even further tariff reductions: insofar as U.S. tariffs were lower than those of Latin American countries even after policy reform, those countries' producers would be confronted with higher costs of imports than would their American counterparts.

18. Indeed, Mexico is a net importer of apparel from the United States.

**Table 2.5** **U.S. Imports of Multifiber Arrangement Products, 1990 (billions of U.S. dollars)**

| | Total | Cotton | Wool | Man-Made | Other |
|---|---|---|---|---|---|
| All countries | 27.9 | 12.0 | 2.4 | 12.0 | 1.6 |
| Mexico | .7 | .3 | .0 | .3 | .0 |
| Japan | .6 | .2 | .0 | .4 | .0 |
| Korea | 2.7 | .5 | .1 | 1.9 | .2 |
| Taiwan | 3.0 | .8 | .0 | 2.1 | .0 |
| Singapore | .6 | .3 | .0 | .3 | .0 |
| Hong Kong | 3.8 | 2.1 | .4 | 1.0 | .3 |
| Thailand | .6 | .3 | .0 | .3 | .0 |
| Philippines | 1.1 | .5 | .0 | .5 | .0 |
| China, P.R. | 3.5 | 1.4 | .2 | 1.3 | .7 |

*Source:* U.S. International Trade Commission, *U.S. Imports of Textiles and Apparel under the Multifiber Arrangement: Annual Report for 1990* (Washington, D.C., May 1991).

It thus must be concluded that the major change that can happen in Latin America is significantly trade creating, as previous walls of protection are significantly reduced. Latin American economic growth should then make Latin American countries more competitive in their export markets but also result in increased demand by Latin America for goods produced in North America and in the rest of the world.

When current trade flows and relative economic sizes of countries are examined, the overwhelming conclusion is that the small volume of trade emanating from Latin America at the present time implies little opportunity for trade diversion. To be sure, the cumulative consequences of trade preferences within North America over a ten- or fifteen-year period could be substantial. Moreover, it is to be expected that some foreign direct investment that might otherwise have been destined for East Asia will instead be directed to Mexico, if for no other reason than a smaller likelihood of actions under U.S.-administered trade provisions. There are already anecdotal reports of companies relocating from East Asia to Mexico in anticipation of an FTA (Hufbauer and Schott, 1992, 16). Even so, if the Western Hemisphere countries do open their economies and achieve more rapid economic growth, the total effect should be more like that of the European Communities over their first thirty years: overall expansion was sufficiently large that trade and investment flows increased externally and internally.

From the viewpoint of the United States, Latin American markets are simply too small relative to Asian and European markets for the United States to be able to afford to cut itself off from these other geographic areas. The important question is why the United States should be willing to enter into FTAs with Latin American countries. From an American perspective, any trade diversion that does occur will make the United States less competitive in world markets, while there are few benefits to an FTA that cannot be realized in an open, multilateral system. If American officials believe that a Western Hemisphere FTA for the United States represents a genuine economic alternative to the present U.S. position as a nondiscriminatory multilateral trader, examination of the volumes of trade possible with Latin American countries and their specializations should dissuade officials from those views.

If the Uruguay Round succeeds and existing tariff and nontariff barriers to trade are further reduced multilaterally, the potential for trade diversion would be minimized. In that context, a Western Hemisphere FTA might provide encouragement to Latin American countries to undertake the policy reforms that are in any event in their self-interest. Growth in Latin America could accelerate sufficiently to be a net benefit to the United States economically.

An examination of East Asian interests in any potential Western Hemisphere free trade arrangement, therefore, shows that they lie in ensuring the success of the Uruguay Round and the maintenance of an open, multilateral trading system. In that case, accelerated Latin American growth would constitute rapidly growing markets for imports, and East Asia should continue to be competitive in those markets. The smaller the margin of preference accorded by the United States to Latin American countries, the larger the trade-liberalizing effects of the Uruguay Round.

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## Comment Robert E. Baldwin

A major conclusion of Anne Krueger's paper is that the potential for trade diversion from East Asia to Latin America under U.S. free trade agreements with Mexico and possibly with other Latin American countries is quite limited. While I basically agree with this, I do think that there could well be somewhat greater trade diversion than she believes will occur. However, I agree completely with another of her conclusions, which is implicit in her paper, namely, that any trade diversion that does occur will not cause serious adjustment problems for East Asian exporters. It seems to me that this is the message of the numbers she cites concerning the small volume of U.S. imports from Latin America compared to U.S. imports from East Asia in those product lines where trade diversion is possible. Even if the Latin American countries are able to mobilize investment and labor resources quite rapidly and thus increase their exports to the United States at high annual rates in categories where trade diversion is possible, this still implies relatively modest rates of decline in the exports of these goods by the East Asian countries to the United States. Thus, any required adjustment should be handled quite easily.

As far as the extent of trade diversion is concerned, Krueger argues that it will be small because the level of U.S. protection against Mexican exports is already low. The average U.S. tariff against Mexican imports of only 4 percent is, of course, an average weighted by current trade volumes. For some low-volume imports from Mexico, tariffs are relatively high, namely, on footwear and various miscellaneous items like sporting goods. I would not be surprised to see a significant volume of trade diversion in these product lines, especially because rising wages in Taiwan and Korea are beginning to make these goods noncompetitive anyway. Investors from Taiwan and Korea may lead the way in shifting production to Mexico. As Krueger points out, apparel and textiles are other categories where significant diversion is possible if the United States permits free imports of these products from Mexico. I doubt that U.S. textile and apparel manufacturers will allow this, however.

In addition to the statutory levels of tariff protection, another condition that can significantly affect the extent of trade diversion in such products as chemicals and steel is the manner in which the antidumping and countervailing duty laws are enforced in a U.S.-Mexico Free Trade Agreement (FTA). If, as in the U.S.-Canada agreement, the antidumping and countervailing duty laws are not administered as strictly as against nonmember countries, the production of some of these goods could be shifted from East Asia to Mexico and other potential Latin American members.

The point that Krueger makes about the potential for trade diversion in the

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machinery and transportation equipment category is a very good one. As she points out, U.S. imports from Mexico in this category are composed largely of products whose components are exported to Mexico from the United States and then assembled by Mexican labor. Duty is paid only on the Mexican value-added component in the final product. This means that the average implicit duty on these goods is quite low—a fact that does not leave much room for trade diversion. However, the extent to which East Asian and other exporters ship components to Mexico after the FTA will also depend crucially on the foreign-content rules in the agreement. If a product can have a high foreign content and still be regarded as a Mexican product with duty-free privileges, then diversion via this route could become important. But U.S. domestic interests are likely to block this.

Two other factors that Krueger touches on and that are likely to operate to keep both trade diversion and trade creation down are the rules concerning environmental conditions and labor standards that are likely to be included in the agreement. The president did have to make concessions on these matters in order to get Congress to extend the fast-track authority needed for negotiating a North American FTA. If new imports from Mexico (and perhaps existing imports) must be based on production conforming to stricter environmental and labor standards than now prevail, this will act as a new nontariff barrier to these imports. Conceivably, what is gained in trade terms by Mexico because of a zero-duty tariff on its exports to the United States could be offset by such new nontariff trade measures. For example, it is quite possible that imports from Mexico will be subject to countervailing duties if they are not produced in a manner that meets strict environmental and labor standards. I think that shortly we will see such environmental standards pushed strongly in multilateral forums as well as regional ones.

In conclusion, I think that, while there are some categories of goods where trade diversion may be important, it will have only a modest adjustment effect on East Asian countries, like Taiwan and Korea, that are already upgrading beyond labor-intensive manufacturers. The greatest effect of any trade diversion is, as Krueger points out, likely to be on countries like Indonesia and Sri Lanka, which like Mexico also abound in unskilled labor.

## Comment Kuo-shu Liang

I read Anne Krueger's paper with great interest and relief. She pointed out that, "in recent years, the American commitment to an open multilateral system has been, at least to a degree, eroded as U.S. policy has shifted to a "two-

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pronged" approach. On the one hand, the United States has continued to participate in the Uruguay Round of trade negotiations; on the other hand, the United States has indicated a willingness to bargain bilaterally for free trade areas with individual trading nations." She concludes that "it . . . seems plausible to assume that, over the next five years, any Western Hemisphere integration that does occur will take place between Canada, the United States, and Mexico." However, "it is . . . unlikely that Canada will be able to use the small margin of preference under American tariffs to divert U.S. or Mexican imports from East Asian sources. . . . Likewise, Canadian imports . . . from East Asian countries are small (and negligible from Mexico), and trade diversion in significant orders of magnitude does not appear to be a realistic possibility. . . . Rather, it is with Mexico that East Asian exporters may be more concerned." "Mexico might in any event," she continues, "become more competitive, especially in labor-intensive commodities." But the Mexican rising imports would at least partially offset some trade diversion that may occur. If Mexican imports were permitted freely under a free trade agreement (FTA), there could be only a relatively small trade diversion in textiles and apparels.

Concerning the important question of "why the United States should be willing to enter into FTAs with Latin American countries," Krueger stresses that FTAs "might provide encouragement to Latin American countries to undertake the policy reforms that are in any event in their self-interest and that the effect on growth and living standards in Latin America could be sufficiently positive to be a net benefit to the United States economically." Krueger also stresses that the margin of preference accorded by the United States would be smaller the larger the trade-liberalizing effects of the Uruguay Round. Therefore, if one examines "East Asian interests in any potential Western Hemisphere free trade agreement," those interests "lie in ensuring the success of the Uruguay Round and the maintenance of an open, multilateral trading system."

I fully agree with Krueger's conclusion that, if the Uruguay Round crumbles, the barriers will become tougher. However, the important question that has to be answered is whether bilateral trade deals can coexist with GATT's multilateral body.

Reflecting multilateralism and nondiscrimination, GATT provides rules that would enable the contracting parties to gain from trade according to the principles of the theory of comparative advantage. However, GATT's success in reducing import quotas and tariffs has led nations to turn to other methods to obtain trade advantages, such as production subsidies, restrictive quality standards, and other barriers that are more difficult to identify and police. In accommodating the political objectives of powerful members, GATT also compromises on the most-favored-nation principle in dealing with the question of integration. Article XXIV legitimates the formation of customs unions and free trade areas to lower tariffs among participants without extending the privilege to other nonparticipating countries, thus denying them the benefits of most-favored-nation rights. The United States used Article XXIV to initiate a looser Western Hemisphere free trade area. By encouraging bilateral trade deals rather than GATT's multilateral sort, the 1988 Trade Act has given exporters a new, bilateral lever, the threat of trade retaliation, with which to open markets abroad.

However, even while Krueger and others may argue that the emerging Western Hemisphere free trade area will be trade creating and offer little opportunity for trade diversion, the East Asian countries have been concerned that the free trade area may replace the freer, multilateral trading system by a trade bloc, and they may take retaliatory actions under the pretext of unfair trade or antidumping protests. As a result, the politically powerful trade bloc will divert trade from less powerful but efficient rivals. In a bilateral confrontation, the weak will concede—resentfully—and the strong will retaliate. It is recommended that discriminatory trade agreements be put under the surveillance of GATT, with strict rules and effective measures for mediation.

Of Professor Krueger's argument that FTAs might encourage Latin American countries to undertake policy reform, the reasons why bilateral attempts will work better than multilateral attempts need to be elaborated. Trade policy may be utilized to secure a particular economic objective, but this will be related to a "policy assignment" problem. The bilateral "open foreign markets aggressively" policies, based on an exaggerated "I am more open than thou" presumption, may produce an atmosphere of mutual hostility, the suspicion of unfair manipulation, and charges of unfair trade (Bhagwati 1988, 126). Trade policy has to be used to secure gains from trade, and other policies have to be used to reform economic policies not related to trade.

Finally, Taiwan has shown a great interest in negotiating with the United States to form a U.S.-Taiwan free trade area. It is recommended that the United States and other major industrial powers support Taiwan's entrance into the General Agreement on Tariffs and Trade. In the past forty years, exceptionally high rates of economic growth have transformed Taiwan from an underdeveloped island into the fifteenth largest trading power in the world and one of the world's most dynamic economies. Taiwan's entrance into GATT will be a significant step toward ending its economic and diplomatic isolation and will enable it to play a more active role in the world economy.

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