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EDITORIAL/OPINION

How Nafta Can Improve Trade

By GRACIELA CHICHILNISKY

The spectacular success of regional trade agreements in the last 10 years means a world increasingly clustered into trade blocs.

Since 1980, the European Community has gradually enlarged its scope. In a strategic response, the North American free-trade agreement, or Nafta, is the first step in what could well be a broad march to unify the Americas into a free-trade zone. The same trend is also at work in Asia and South America.

The contrast between the success of the regional trading blocs and the lackluster performance of the world trade organization, the General Agreement on Tariffs and Trade, raises various reactions. One view is that free trade is not defunct but just being organized differently. Another is that all trading blocs conflict with the GATT negotiations toward global trade liberalization.

Is Nafta, then, a foe of worldwide free trade? The answer to this question hinges crucially on the internal trade patterns among the members of Nafta itself.

One pattern is based on traditional comparative advantages. This means that natural resources, raw materials and other labor-intensive goods are exported by labor-rich countries such as Mexico in exchange for capital and technology-intensive goods, such as machine tools and electronics, which are exported by capital-rich countries such as the United States.

The second, quite different, view of trade is based on the efficiency gains from economies of scale and learning. In this view, countries trade with each other because their combined markets are larger, leading to the corresponding rationalization of production, and thus to efficiency gains. Larger markets mean larger "knowledge pools" for production, management and technological innovation. In time, these lead to productivity gains that typically spread across the entire economy.

Economies of scale not only allow the rationalization of production but also lead to a pool of skilled labor. This can be a great asset in international competitiveness, as German industry has shown to the rest of the world. Technology-based firms such as Siemens view the experience and the skill of their labor force as central to their competitive advantage in products where automation is so far advanced that labor costs become secondary.

It is widely believed that the European Community is organized around economies of scale. Evidence for this was provided by the Ceccini report to the Commission of the European Communities. The report's estimate of a 7% GDP gain from the 1991 single-market program rests heavily on gains from increased competition and rationalization.

The European Community has rejected the traditional view of comparative advantage in another way — by allowing the free mobility of labor and capital among the countries. While southern Europe has less expensive labor than northern Europe, the complete mobility of labor and capital means companies set up manufacturing plants looking at the European market as a whole, rather than at national markets. Economies of scale can actually be achieved.

Nafta presents a stark contrast to all this. It is widely accepted that, up to now, trade in the Americas has been based on traditional comparative advantage. Most of the resources imported by the United States — including oil — come from the Americas. Indeed, roughly two-thirds of the Latin American exports are resources. In contrast with the European model, the mobility of labor across Nafta borders is not contemplated. Those countries that have more labor are expected to export labor-intensive goods, and those with more capital, capital-intensive goods. As each does what it does best, in theory, both gain.

Traditional theory says this type of trade could lead to gains for all, although it's clear such gains are not distributed equally within the trading economies. For example, labor in the capital-rich country typically loses out as free trade opens up with a labor-rich country, since this means lower labor costs. U.S. labor unions have not missed this point.

Comparative advantage as a foundation for trade strategy is still the prevailing view in U.S. policy circles. Yet the evidence against this view is overwhelming. One compelling example of this is that the newly industrialized Asian countries that have gained most from trade have not followed this route, instead moving quickly into skill-intensive products such as consumer electronics and microprocessors. In contrast, Latin America and Africa are heavily focused on resource and labor-intensive exports, with a lackluster growth performance to match.

Traditional economic theory predicts that the formation of trading blocs such as Nafta will lead to trade wars between the blocs through higher tariffs. But if trade within the Americas were organized on the principle of economies of scale — an updated vision of trade — much of the drive toward tariffs would lose force. A strategy based on economies of scale takes the wind out of the protectionist sails. The reason is that tariffs and other forms of trade intervention control market prices at the cost of restricting trade. The frequent destruction of crops and the myriad incentives to decrease agricultural production in Europe and the United States are all based on this principle.

But in countries that organize trade around economies of scale, these incentives lose much of their appeal. In time they restrict the size of the market, and thus the gains from an expanded market are lost.

For example, the rationalization of manufacturing in Europe's white goods needs the larger unrestricted European market. Service functions such as accounting are being rationalized as well, and this also requires a larger unrestricted market. The potential for large benefits from both the U.S.-Canada free-trade agreement and Europe 1992 rests largely on increased competition and rationalization.

While the road is far from smooth and the Nafta countries more dissimilar than their European counterparts, the message is still clear. To compete with the other blocs, Nafta must give precedence to economies of scale and the technological innovations that accompany them. Economies of scale unleash an appetite for expanding markets that can defeat the gains from tariff wars. Moreover, this strategy could make the formation of the Nafta part of a broader march toward the liberalization of world trade.

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