LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

KEY TAKEAWAYS

NAFTA's history is one of both bi-partisanship and deep-seated rancor.

The agreement has been successful at increasing trade between all three countries.

NAFTA remains controversial because its positive and negative impacts are not distributed evenly; some industries and regions have suffered as a result.

February 6 2017

FACTS ON NAFTA

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SOME BACKGROUND ON NAFTA

The history of the North American Free Trade Agreement (NAFTA) reminds us of the children's nursery rhyme "Solomon Grundy" (*"Born on Monday...Buried on Sunday"*). NAFTA was proposed by Reagan, signed by George H.W. Bush, implemented by Clinton, defended by George W. Bush, and largely ignored by Obama. Will Trump finish the rhyme by burying NAFTA? An examination of the history, controversies, and some of the results of NAFTA may provide some answers.

HISTORY OF RATIFICATION

NAFTA was originally proposed by Ronald Reagan as he began his campaign for president in 1979, suggesting an agreement leading to "a North American continent in which the goods and people of the three countries will cross boundaries more freely." The conservative Heritage Foundation, then a newly established think tank, was one of the primary supporters of the concept. Negotiations began during the Reagan administration and were finished under the George H.W. Bush administration. President George H.W. Bush actually signed the agreement in 1992. However, it was not formally ratified by Congress until after Bill Clinton took office; therefore it was President Clinton that signed the U.S. laws ratifying NAFTA in 1993. Clinton had been a supporter of NAFTA throughout the 1992 presidential campaign.

1 **1993 NAFTA VOTE SHOWS BIPARTISAN CONSENSUS**

		Yea	Nay
Senate	Democrat	27	26
	Republican	34	12
	Total	61	38
House	Democrat	102	156
	Republican	132	43
	Total	234	200

Source: LPL Research; www.govtrack.us 02/06/17

Bernie Sanders's nay vote is counted with the House Democrats, though Sanders was an independent.

Support for NAFTA has always been bi-partisan but controversial. Ultimately, it was passed with more Republican support than Democratic [Figure 1], on a close vote with the political center largely in support. Much of the most vocal opposition came from the left, initially by labor unions that feared a loss of jobs to Mexico due to lower wages (helped by poor working conditions). Consumer and environmental activists also feared harm from lower Mexican safety and environmental standards. Human rights advocates worried about the direct impact on Mexican workers. Conservative opposition to NAFTA was somewhat muted, due in part to Reagan's backing and support from stalwart conservative and libertarian think tanks like Heritage, the American Enterprise Institute, and the Cato Institute. However, there were well-known political conservatives, most notably Patrick Buchanan and former Nevada Senator Paul Laxalt, who opposed NAFTA on grounds of loss of national sovereignty (as decisions made by U.S. firms could be undone by an international tribunal) and due to fears that increased trade would lead to increased drug smuggling and illegal immigration.

Of course, Ross Perot made opposition to NAFTA the cornerstone of his 1992 presidential campaign. Perot's criticism of NAFTA came mostly from the traditional left viewpoint. While the phrase "giant sucking sound" has remained part of popular culture, his actual statement was somewhat more wide reaching:

> We have got to stop sending jobs overseas… If you're paying $12, $13, $14 an hour… you can move your factory south… pay a dollar an hour for labor... have no healthcare—that's the most expensive single element in making a car—have no environmental controls, no pollution controls, and no retirement… and you don't care about anything but making money, there will be a giant sucking sound going south.

WHAT NAFTA DID

One of the reasons that NAFTA remains so controversial is how it operated. Immediately on its effective date (January 1, 1994), NAFTA completely removed tariffs on approximately 50% of the goods imported from Mexico to the United States, with the goal of eliminating the rest of the tariffs over the next 15 years. The last remaining tariffs were in fact removed on January 1, 2008. The U.S. and Canada already had a tariff-free border since 1989. However, as Mexico had very different environmental and labor laws than the U.S., there were two separate pieces of legislation designed to promote harmonization of national laws in these areas.

One of the main features of the agreement involves "rules of origin," which dictate the definition of where a product comes from. However, in modern commerce, these rules can be complicated and confusing. If a transistor is made in China, put into an automatic car seat control panel in Mexico, which is then put into a car seat in Canada, and ultimately put into a car in the U.S., at each step these components need to be evaluated for their true country of origin. These complexities provide the basis of some criticism of NAFTA.

SO WHAT HAPPENED? TRADE WITH MEXICO

So what happened to U.S. trade with Mexico and Canada between 1993 (the year before NAFTA took effect) and today, and what about that "giant sucking sound" of jobs moving south from the U.S. to Mexico? In 1993, the U.S. exported $42 billion of goods and $10 billion of services, and imported $40 billion of goods and $7 billion of services for a net trade surplus with Mexico of $5 billion. By 1995, the trade surplus had turned into a trade deficit on goods and services of $12 billion, with all the deterioration coming on the goods side of the ledger. In 2015—the last full year of available data—the U.S. trade deficit with Mexico was $58 billion, or just 0.3% of gross domestic product (GDP), with the goods deficit of $68 billion more than offsetting the $10 billion trade surplus we run with Mexico on the service side of the economy [Figure 2]. In 1993 our largest export to Mexico was capital goods, and our largest import was machinery and electrical equipment. Today, our top export to Mexico is motor vehicles and parts along with petroleum and coal products, while our top imports from Mexico are motor vehicles and motor vehicle parts.

SO WHAT HAPPENED? TRADE WITH CANADA

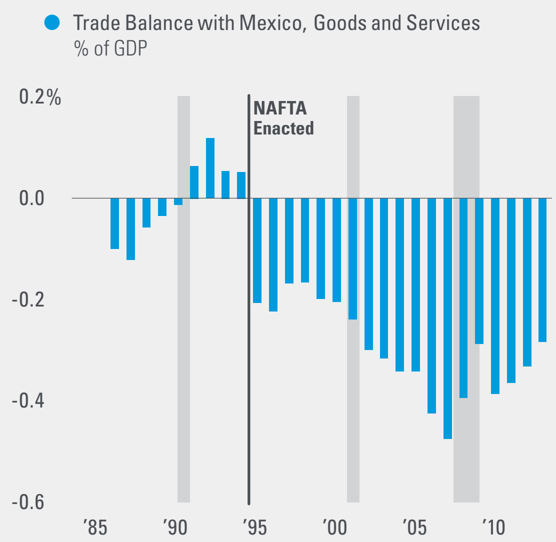
Let's now turn to Canada. In the year before NAFTA, 1993, the U.S. ran an $11 billion deficit in goods with Canada but a services surplus of $8 billion, for an overall deficit of $3 billion, well under 1% of GDP. By 1995, the deficit was $12 billion, with the $7 billion services surplus more than offset by a $19 billion goods deficit. In 2015, the last full year of available data, the U.S. ran a $6 billion trade surplus (0.03% of GDP) with Canada, as the $21 billion goods deficit was more than offset by the $27 billion services surplus [Figure 3]. In 1993, our top export to Canada was capital goods and our top import was consumer goods. Today, our top export to Canada is motor vehicles and motor vehicle parts, and our top imports from Canada are oil and gas and motor vehicles.

On balance, total U.S. trade (imports plus exports) with Mexico and Canada in 1993 equaled about 5% of U.S. GDP. Today, that figure is 7% of GDP, so trade to and from Mexico and Canada has expanded by 40% over the past 25 years as a percent of GDP.

IMPACT ON JOBS AND WAGES

In the 10 years before NAFTA (1984-1994) U.S. manufacturing jobs decreased by 4% from 17.6 million in 1984 to 17.2 million in 1994. As a

2 AFTER NAFTA, THE U.S. TRADE DEFICIT WITH MEXICO WIDENED OUT NOTABLY, BUT REMAINED A SMALL PERCENTAGE OF GDP



Source: LPL Research, Haver Analytics 02/06/17

Shaded areas indicate recession.

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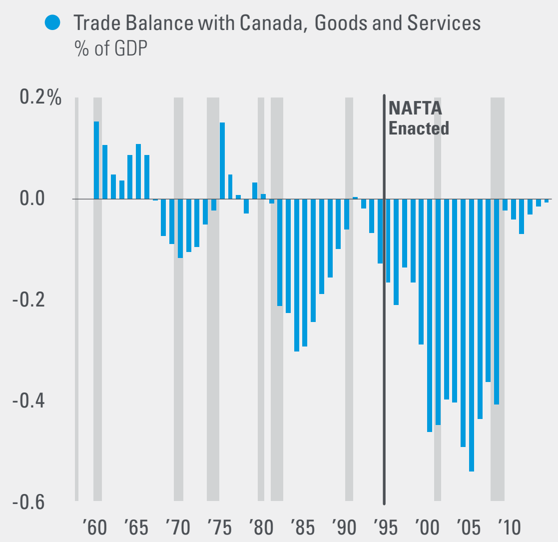
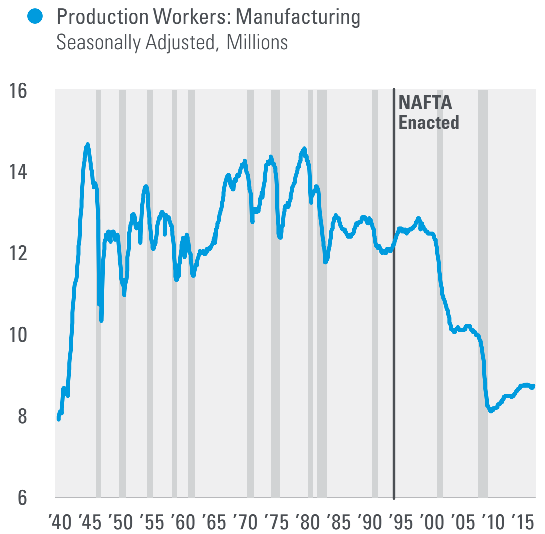


Source: LPL Research, Haver Analytics 02/06/17

Shaded areas indicate recession.

4 **MANUFACTURING EMPLOYMENT PEAKED IN WWII AND WAS HEADED LOWER EVEN BEFORE NAFTA**



Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 02/06/17

Shaded areas indicate recession.

5 **PACE OF MANUFACTURING JOB LOSSES INCREASED AFTER NAFTA, BUT SERVICE SECTOR JOB GAINS REMAINED ROBUST**

	1984	1994	2004
Manufacturing Jobs (Millions)	17.6	17.2	14.3
% Change (Prior 10 years)	+2%	-4%	-17%
Service Sector Jobs (Millions)	53.4	73.7	89
% Change (Prior 10 years)	+33%	+31%	+21%

Source: LPL Research, Bureau of Labor Statistics 02/06/17

6 **WAGE GROWTH ACCELERATED IN BOTH MANUFACTURING AND SERVICES SECTOR AFTER NAFTA WAS ENACTED**

	Average Hourly Earnings	
	10 Years Ending	
	1994	2004
Manufacturing	+21%	+34%
Services	+37%	+40%

Source: LPL Research, Bureau of Labor Statistics 02/06/17

reminder, the U.S. economy had a recession between mid-1990 and early 1991 after a long and robust economic expansion between 1982 and 1990. Nonsupervisory manufacturing jobs peaked during World War II, in 1943, at nearly 18 million; service jobs increased by even more, from 53.4 million in 1984 to 73.9 million at the end of 1994, or 31%. In the 10 years after NAFTA (1994-2004), U.S. manufacturing jobs decreased by 17%, from 17.2 million to 14.3 million, while service jobs increased by 21% [Figure 4]. In 1994, the average manufacturing job in the U.S. paid $12/hr and had increased 21% over the prior 10 years. The average service sector job paid $11/hr in 1994, up 37% from 1984's $8/hr. In the 10 years following NAFTA, the average manufacturing wage moved 34% higher (from $12/hr to over $16/hr), while service pay increased by 40%, from $11/hr to $15/hr. During that time, the U.S. economy experienced the tech boom and bust, a mild recession in 2001, and the rise of China as the dominant force in global manufacturing [Figures 5 & 6].

Did NAFTA contribute to the 17% decline in manufacturing jobs between 1994 and 2004, or did it help increase the average wage in manufacturing by 34%? Or neither?

CONCLUSION

The political difficulty with any trade deal (and perhaps any government policy) is that the beneficiaries may be many but diffuse, perhaps not even knowing they have been a beneficiary. For example, everyone in the U.S. benefits from muted inflation caused by importing cheaper goods, but few are likely to associate low prices with NAFTA. But those who have been harmed by a trade deal know exactly how they have been hurt. This has great political implications. As we have seen by NAFTA's history, issues regarding trade do not fall cleanly on our traditional liberal and conservative spectrum. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

RES 5784 0217 | Tracking #1-579456 (Exp. 02/18)