NAFTA

The North American Free Trade Agreement: A Requiem

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Despite the emphasis that then-presidential candidate Barack Obama placed on the need to renegotiate the North American Free Trade Agreement (NAFTA) during his 2008 US presidential campaign, this promise has thus far come to naught. Once elected, President Obama's first foreign visit was to Mexico to confer with President Felipe Calderón. During this diplomatic foray Obama assured Calderón that the United States mainly intended to upgrade those parts of NAFTA that were of most concern to US voters, namely, labor standards and environmental protection. Yet, when the 'Three Amigos' met for their first NAFTA summit in 2009, the agenda discussed by Obama, Calderón, and Canadian Prime Minister Stephen Harper was dominated by the problem of undocumented migration of Mexican workers into the United States and Canada and by the explosion of drug trafficking and cartel-related violence along the US-Mexico border.

As palpable as the domestic debate over the need for NAFTA reform may have seemed at the time of the 2008 US presidential election, the fact is that NAFTA is more or less beside the point at this political economic juncture. This is because 99 percent of all tariffs on those goods and services covered by NAFTA have basically been eliminated, and because politicians and policy makers in all three of the member countries have failed to institutionalize and update the agreement in ways that address problems that are multiplier effects of NAFTA itself. At the top of this list – apart from the easy flow of drugs and undocumented migrants across the border – would be the failure to promote export competitiveness and to foster the development of NAFTA as a regional project proper. With NAFTA now fully implemented, the inability of political leaders in North America to renovate and expand on the accord has meant its eclipse by more compelling global forces.

The most remarkable force is the rapidity with which China has gained a foothold in sectors once considered 'North American', such as computer peripherals, sound and television equipment, telecoms, electrical machinery, equipment and parts. Since China's 2001 entry into the World Trade Organization (WTO) its exports have steadily surpassed those of Mexico and Canada in any number of US market niches. What's more, US exports, mainly in auto parts and production, are quietly being displaced by Chinese investors in Mexico's northern export processing, or *maquila*, zones. Canada and Mexico remain the most important trading partners of the United States overall, and together represent the largest supply of US energy imports; however, when it comes to remedies for today's economic pain, China, it seems, should be the main departure point for any debate over the current sources of job dislocation and associated economic stress in the United States and larger North American market.

Economic policy and public discourse across North America has yet to register the full implications of China's rapid ascendance in regional markets. Even though the prospect of the 'China threat' has spawned a whole cottage industry of academic and popular books in the West, apart from launching a series of elite diplomatic dialogues and pressuring the Chinese to revalue their currency, Washington, Ottawa and Mexico City have been slow to react.

Nevertheless, although competition from China may be the most obvious factor in accounting for heightened job insecurity in both the United States and Mexico, NAFTA still bears its own share of the public's wrath. Despite NAFTA's considerable breakthroughs, the North American project has been stymied by continued political gridlock over trade policy in the United States, as well as some bitter disappointments over expectations versus actual outcomes with regard to labor and the environment. NAFTA may still carry symbolic weight for the US

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electorate, but at this point it seems safe to say that the agreement has been steadily relegated to history's junk heap.

NAFTA: from glitz to gloom

It is now twenty years since former Mexican trade minister Jaime Serra Puche and US Trade Representative Carla Hills sat down at the annual Davos Forum to explore the possibilities for negotiating what would later become the North American Free Trade Agreement. The Uruguay Round was in limbo at the time and the decision of the US to negotiate a bilateral free trade agreement (FTA) that included a developing country was unprecedented. But this is just one way in which NAFTA broke new ground.

A second benchmark for NAFTA was Mexico's willingness to forgo any special or different treatment related to its developing country status at the NAFTA negotiating table. It is difficult to exaggerate the extent to which this stance represented a complete U-turn in Mexico's approach to foreign economic policy. The decision marked the advent of a new generation of more technocratic policy makers within the upper echelons of the state bureaucracy and the eagerness of this market-oriented cohort to lock in an entirely new set of policies based on liberalization, privatization, and deregulation.

This paved the way for a final agreement that went well beyond what had been accomplished to date within the Uruguay Round. On this count, NAFTA's key innovations were the protection of intellectual property rights (IPRs), the liberalization of investment and trade in services, and the creation of mechanisms to resolve investment disputes based on binding international arbitration. For the first time, 'old' issues on the multilateral trade agenda (market access for agricultural and industrial goods) were combined in one agreement with the kinds of 'new' issues (services, investment and IPRs) that the OECD countries had been pushing for at least since the Tokyo Round of the General Agreement on Tariffs and Trade (GATT).

The fourth breakthrough was the negotiation and attachment of labor and environmental side accords to the NAFTA agreement, as the prospect of Mexico's entry into an FTA with the United States and Canada had invoked valid worries about environmental dumping and the abuse of labor rights in these latter countries. Historical in their own right, these labor and environmental agreements were offered up by the Clinton administration as side payments to garner congressional votes for NAFTA and to counter the political blowback on the domestic front that had arisen with regard to the steep asymmetries between Mexico and the United States.

Along with the side agreements on labor standards and environmental protection, the NAFTA accord promoted the free flow of goods, investment, and services within the North American bloc over a 15-year timeline that ended in 2009. Tariffs and non-tariff barriers were eliminated on 65 percent of North American goods by the 5-year point; tariff reductions on automobiles occurred over a 10-year period, with the rules-of-origin stipulation that such vehicles must meet a 62.5 percent local-content requirement in order to qualify.[1] In the agricultural sector, sensitive products were allotted a 15-year liberalization schedule that ended in 2009.

In the end, negotiating tensions were such that sugar and dairy products were excluded altogether in trade between Canada and Mexico. This is just one way in which NAFTA still fell short of its mandate to liberalize substantially all trade between the three partners. First, administered protection persisted in the setting of hefty percentages for local content under NAFTA's rules of origin in such sectors as autos, high-tech products and textiles and apparel. Second, little progress was made toward the elimination of antidumping practices and countervailing duties. Despite the ability of special interests to secure these protectionist concessions, hindsight suggests that NAFTA has been a liberalizing force overall, as each participant was clearly looking to reduce transaction costs while simultaneously increasing the benefits of cooperation.

Canada and Mexico saw an opportunity to secure access to the US market and establish clearly defined rules and procedures for resolving trade and investment disputes. The United States, while also concerned with promoting and rationalizing economic ties within the North American bloc, primarily sought to bolster the rules and norms that constituted the international trade regime codified within the GATT.

[1] In order to qualify for NAFTA's preferences, goods have to: (1) be produced entirely within the NAFTA bloc; (2) incorporate only those non-NAFTA materials that are sufficiently processed in North America to qualify for a tariff reclassification; and (3) satisfy a minimum-content rule.

Although pragmatic in the sense that all three parties sought to strengthen and institutionalize respective political-economic ties that had long been in place but had heretofore been managed in an ad hoc manner, hindsight shows that NAFTA also unexpectedly unleashed its own share of animal spirits in North America.

From the launching of the negotiations in September 1991 to the ratification vote in the US House of Representatives in November 1993, the tone of the NAFTA debate was counter-intuitive. Economic integration theory suggests that both the United States and Canada, as larger, wealthier and more open G8 economies, should anticipate that marginal adjustments would occur. In turn, Mexico, as the smaller, poorer and more closed economy, should expect to undergo a more costly adjustment in the short term, but to realize considerable dynamic gains in the medium to long term.

From this theory it should follow that the debate over whether to pursue an FTA would be more heated in Mexico, the country that had the most at stake. Conversely, given that the United States and Canada had much less on the line, one would expect a fairly tame discussion about whether to negotiate an FTA that included Mexico. Paradoxically, the opposite scenario emerged.

In Mexico, the administration of Carlos Salinas (1988–1994), which oversaw the NAFTA negotiations, was able to quell open debate over NAFTA by drawing on the authoritarian clout of its ruling Revolutionary Institutional Party (PRI) to reinforce informational asymmetries and marginalize dissenters. In Canada and the United States, the NAFTA debate literally exploded. In the United States, in particular, a full-scale national controversy ensued, a main upshot being the emergence of a blue-green coalition of grassroots labor and environmental activists that managed to insert non-trade issues onto the US trade policy-making agenda like never before.

First was a realistic reaction to the miserable working conditions and badly polluted *maquila* factory sites that lined the US-Mexico border. If NAFTA signified the free flow of goods, services, and capital between all three countries, what was to stop the flow northward of environmental pollution and sub-standard working conditions? To the chagrin of free trade purists like Jagdish Bhagwati,[2] it was this coalition that compelled the senior Bush administration to expend political capital on border cleanup and the enforcement of much higher environmental standards. With the election of President Bill Clinton in 1992, the formal negotiation of labor and environmental side agreements to accompany NAFTA was offered as a *quid pro quo* for the blue-green endorsement of the 1993 NAFTA-implementing legislation.

The second reaction was largely symbolic, whereby NAFTA came to embody all that was cumulatively wrong with the US political economy at the outset of the 1990s. What had started out as an issue-oriented blue-green coalition in 1991 blossomed into a full-blown anti-NAFTA movement that included everyone from job-seeking college graduates to downsized business executives, laid-off factory workers to teachers' unions. Regardless of the actual effect that NAFTA would have on any of these constituents, they were united in the perception that they had somehow been excluded from the prosperity that surrounded them in the late twentieth century, and they were understandably angry about it.

NAFTA's self-appointed 'losers' have thus kept the opposition to further trade pacts alive, as witnessed in the paper thin margins by which subsequent US bilateral FTAs have been ratified by the US Congress, including the 2006 US-Central America FTA. But beyond this phenomenon of NAFTA coming to symbolize a general sense of downward mobility in the United States, it is the tenacity of the blue-green coalition and its effect on congressional deliberations that perhaps best accounts for the testiness of US trade policy since the launching of NAFTA.

Although this coalition won the battle in securing the attachment of labor and environmental side agreements to NAFTA, the lackluster enforcement of those agreements has further prolonged the trade policy war on the domestic side. During the entire Bush administration in the 2000s, for example, just two labor complaints against Mexico were accepted for review, whereas on the environmental side just seven cases involving Mexico have been resolved over the life time of the agreement. Thus, much of the fight has centered on correcting the institutional weaknesses in those earlier agreements, namely, the obligation of each country to enforce its own existing national laws but with little regard for strengthening and har-

[2] See Bhagwati (2008).

monizing North American labor and environmental standards overall.

The blue-green opposition has continued its demands for more binding commitments in enforcing labor and environmental standards. Hence, the US insistence on incorporating labor and environmental stipulations into the pending Doha agreement, as well as the subsequent FTAs signed in the 2000s. Even seemingly easy US bilateral talks with countries that are otherwise ready and willing to constructively adhere to the full menu of blue-green demands (South Korea, Panama, Colombia) have proved to be quite cumbersome.

NAFTA's uneven returns

NAFTA's critics have arguably done a better job of advertising its failures than its proponents have done in touting the concrete gains that have underpinned North American integration since the early 1990s. At least at the aggregate level, it would be difficult to paint NAFTA as anything but a success. This is especially so when NAFTA is judged according to its own goals: the creation of a free trade area in which all three partners have pursued an economic growth strategy via the liberalization of goods, capital, and services amongst themselves.

Total NAFTA trade now accounts for some 30 percent of all US trade,[3] and the number of jobs gained in the US economy since NAFTA's implementation in 1994 more than compensates for those jobs lost – even when considering the massive job losses that have occurred in the wake of the 2007–2009 US financial crisis. US trade in goods and services with Canada and Mexico tripled – from 341 billion US dollars in 1993 to more than 1 trillion US dollars in 2007 – and inward foreign direct investment quintupled among the three countries and increased tenfold in Mexico between 1990 and 2005 (Pastor 2008). In terms of gross product, the NAFTA zone has now surpassed the European Union (EU); however, the impacts of regional integration in North America have been quite uneven.

Again, when viewed from the dictates of economic integration theory, it was expected that NAFTA would benefit all three countries, but especially Mexico, through the deepening of already strong ties in cross-border production and intra-industry trade. First, the elimination of barriers at the border would promote scale economies related to greater specialization, increased technological capabilities, and more rapid and efficient deployment of those factors for which Mexico has a comparative advantage (natural resources and comparatively cheap labor).

Second, it was argued that the blending of Mexico's abundant factors with the capital, technology, and know-how that Canada and the United States brought to the table would trigger a dynamic pattern of income convergence among the three members. According to this largely neoclassical trade narrative, Mexico would readily advance up the industrial and technological learning curve, substantially increase its per capita income, and more authentically approximate the economic indicators of its fellow OECD members.

The data show that NAFTA has delivered rather erratically on these expectations. At the macroeconomic level, Canada and Mexico have clearly converged toward the more highly developed US standard in terms of aggregate growth, interest rates, exchange rate stability and the lowering of inflation to under five percent annually. But the microeconomic data tell a different story, which highlights the need for sound domestic policy reforms to complement and maximize on the opportunities intrinsic to a regional integration scheme.

After rebounding from the disastrous 1994 peso crisis, the growth of per capita gross domestic product (GDP) in Mexico has hit a virtual standstill in the 2000s and is still 6.3 times lower than that of the United States. Even Canada, despite its advantage as a G8 country, has lagged in this regard. Although Canadian income distribution is the most equitable in North America, Canada's per capita income remains about 20 percent lower than that of the United States and its productivity and investment ratios are similarly trailing.

While the roots of microeconomic under-performance appear to lie somewhere in the gulf between neoclassical trade theory – which assumes a state of perfect competition and constant returns to scale under NAFTA – and the concrete empirical obstacles that underpinned its launching back in the early 1990s, the persistent divergence between the United States and its NAFTA partners can also be chalked up to the nature of political institutions and policy

[3] TradeStats Express, International Trade Administration, US Department of Commerce.

making in these countries. In short, both Canada and Mexico, albeit in greatly varying degrees, are still in need of more proactive competition policies that spur rather than deter investments, increase ties between research and development (R&D), universities and private initiative, and promote the application of advanced technology to the extraction of natural resources and the production of goods.

NAFTA's potential here is limited, as it has delivered its punch in terms of the role that enhanced levels of trade and investment can play in catalyzing further microeconomic change for both Canada and Mexico. Because of the minimalist institutional framework that all three members agreed to at the outset, NAFTA has basically been frozen in place and is sorely out of date when it comes to tackling today's microeconomic challenges.

The twilight of North American integration

The importance of Canada and Mexico as US trade and investment partners is indisputable, and the impressive growth of North American gross product is testimony to the depth of these ties. At this point, however, NAFTA's operational tendencies are still more akin to two bilateral deals that have basically been cobbled together, meaning that the whole is no greater that the sum of its parts. Whereas the very creation of NAFTA is testimony to the possibilities of trilateral coordination based on the national interests of each trade partner, all three countries adamantly resisted the option of strengthening this cooperation via the creation of European Union (EU)-style supranational institutions.

Canada and Mexico opposed the institutional formalization of NAFTA on the grounds that they would be pushed around and further disempowered by the United States if North America were to take the supranational institutional route. The United States reacted in its typical Anglo-Saxon fashion, pejoratively equating the creation of supranational institutions with the proliferation of the 'Brussels bureaucracy' in North America. This insistence that NAFTA remain a free trade area in the absence of sound institutional moorings has thus stunted its evolution into a more compelling regional project. Case in point: the growth in total NAFTA trade in the 2000s has been about 3 percent, versus the 9.8 percent growth rate registered in 1994–2000 (Pastor 2008).

In light of this impasse, it seems safe to say that the authentic revival of NAFTA as a regional project would require that the United States, as the hegemonic member and industrial anchor, step forward with the necessary leadership and provision of public goods. Yet, the most visible US commitment in the Bush junior era was the construction of a double-layered wall and hundreds of miles of vehicle barriers along the 1,933-mile US-Mexico border meant to halt the northward flow of undocumented workers. Mandated by the Secure Fence Act of 2006 in the wake of failed efforts within the US Congress to reach bipartisan agreement on any number of sticking points in the proposed immigration legislation, the US Department of Homeland Security expects to complete this project by 2011 at a cost of 7.6 billion US dollars. Rather than investing in badly needed improvements in the highway infrastructure that links the three countries, this hefty US financial commitment to construct further border barriers has understandably enraged its NAFTA partners.

A final wedge is China, now a major trade and investment presence throughout the Western Hemisphere. Whereas China's trade relationship with South America is based on more traditional patterns of comparative advantage – China's export of lower-end industrial goods and its import of primary products from Argentina, Brazil, Chile and Peru, in particular – the China-NAFTA relationship is one of export similarity and fierce competition for manufacturing market share, especially with regard to Mexico and the United States (Devlin 2008).

Between 2002 and 2008, Mexico's share of the US import market slipped by 11 percent, from 11.6 to 10.3 percent, while China's share rose by 50 percent, from 10.8 percent to 16.2 percent (Watkins 2009). Given that nearly all of Mexico's manufactured exports to the United States are goods produced by companies that operate under the *maquila* (two-thirds of manufactured exports) or *Pitex* (one-third of manufactured exports) programs, i.e. programs that were specifically designed to deepen US-Mexican integration in these sectors, it is incumbent upon both sides in this partnership to work jointly to combat these intense competitive challenges from China. Remarkably, US and Mexican leaders in the public and private sector have been completely passive on this count.

Along with China's outpacing of all other developing countries in its growth of manufactured exports from 2000–2006, it is now increasing its competitiveness in high technology exports at an even greater speed than in manufacturing as a whole (Gallagher and Porzecanski 2010). Although Mexico is the only Latin American country to rank amongst the top twenty developing countries in terms of the technological content of its manufactured exports, Kevin Gallagher and others report that as of 2006, 82 percent of Mexican exports in this category were under some degree of competitive threat from China (Gallagher and Porzecanski 2010).

The irony in Mexico's case is that the stated purpose of the country's 1994 entry into NAFTA was precisely to advance steadily up the industrial learning curve and to situate domestic producers more securely on the technological frontier. What went wrong? Prior to entering NAFTA, trade and investment were liberalized and longstanding industrial policies were dismantled. Under NAFTA, the innovation process, including technology transfer and R&D, was relegated to foreign direct investment (FDI) in Mexico's assembly plants, and it was envisioned that innovation would result from the dynamic spillovers and multiplier effects of heightened trade and investment flows. However, sixteen years later, expenditures on R&D have actually declined since 1994, and under the prevailing *laissez-faire* regime the country's Information Technology (IT) sector and firms have been decimated.

With US policy makers fixated on the completion of a highly symbolic wall along the Mexican border, and US public opinion holding on to its longstanding NAFTA grudge, Chinese investors are also quietly staking out their claims in the Mexican market. The overriding goal is to establish manufacturing operations in Mexico based on integrated global production chains, with an eye toward exporting to the US market.

For example, while still an incipient trend, the Chinese computer company Lenovo is establishing supply facilities in the northern Mexican state of Chihuahua, the Golden Dragon firm is constructing a plant to produce copper tubes in the state of Coahuila and, in the Mexican state of Hidalgo, China's Giant Engine Company has invested 50 million US dollars to acquire an auto assembly plant (Ellis 2009). Through joint partnerships with companies such as Mexico's Grupo Elektra, a major distributor and financier of infrastructure, Chinese automakers like Zhongxing, the First Automobile Works, and others have set their sights on jointly producing some 1.6 million cars per year in Mexico by 2012.

Thus, the United States could soon be facing the worst-case scenario of all with regard to its mammoth commercial deficit: the displacement of US suppliers by Chinese firms in Mexico's *maquila* assembly plants – a trend that is now underway – and China's ability to offset Mexico's higher labor and production costs by meeting NAFTA's regional content requirements and thereby gaining duty-free access to the US market.

Needless to say, this is a far cry from what NAFTA's architects originally had in mind. Unhappily, the daunting domestic and regional repercussions of the 2007–2009 financial meltdown in the United States, combined with President Obama's considerable losses in the US 2010 mid-term elections, do not bode well for policy innovation *vis-a-vis* NAFTA. As Canada looks once again to the EU for answers and Mexico retreats into a survival-oriented mode, it seems safe to say that North America has officially entered the post-NAFTA era.

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