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NAFTA: A Progress Report

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A. Introduction

The completion of the North American Free Trade Agreement (NAFTA) negotiations nearly a decade ago was an historic event. NAFTA is the first reciprocal free trade treaty among two industrialized countries and a developing one. It is based on principles of equality and full reciprocity, in spite of vast asymmetries (the size of the Mexican economy is just 5% of the United States). NAFTA created the second largest free trade area in the world, with almost 400 million people and a third of world GDP (around US$8 trillion). NAFTA also seeks to encourage foreign investment in the member countries, especially direct investment (in plant and equipment) and to further the integration of the three North American countries through changes in institutions to facilitate cooperation through procedures to expedite dispute resolution. The NAFTA also includes supplemental cooperation agreements to enhance and encourage protection of the environment and to improve and enforce labor standards in the region

As a free trade area, the NAFTA project – which was launched by the Canada-US Free Trade Agreement of 1989 -- will be essentially complete by 2005. Virtually all tariffs and quotas -- outside of agriculture – will be eliminated. Investment restrictions have been liberalized in Canada and Mexico. By 2005, only the core of the Mexican energy sector is likely to remain off-limits to foreign investors. The current crop of major trade disputes should be resolved in the next few years – softwood lumber (pitting the United States against Canada), trucking (pitting the United States against Mexico) and sugar (pitting Mexico against the United States and vice versa). While disputes will occupy NAFTA officials for the indefinite future, new blockbuster

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trade issues do not appear to be looming over the horizon. Probably the biggest new controversy centers on NAFTA Chapter 11 *investment* disputes – in particular arbitral awards that characterize regulatory measures as "tantamount to expropriation", or find that judicial procedures fail NAFTA's "fair and equitable" test.

Does *commercial* and investment success mean that everyone in North America has prospered? Of course not. Mexicans, in particularly, were devastated by the peso crisis of 1994/95, and many Mexicans have seen no increase in their real wages in over a decade. Canadians have on average done much better, but Canadian prosperity in the 1990s lagged by comparison with the "new economy" boom that swept the United States. Trade agreements cannot, of course, be held responsible for all manner of financial and structural shortcomings that slow down (or even reverse) economic progress. Within a narrow commercial sphere, NAFTA has succeeded beyond the expectations of its advocates.

Meanwhile, as a political proposition, NAFTA enjoys strong support in Mexico, moderate support in Canada, and grudging acceptance in the United States. In the US political debate, strident NAFTA opponents – such as Ross Perot, Pat Buchanan, Public Citizen, and the AFL-CIO – no longer attract much attention, and their erstwhile Congressional allies have stopped calling for repeal. On the other hand, prominent NAFTA advocates, such as former Vice President Al Gore, have muted their support.

With this mixture of commercial success and political ambivalence, it's entirely possible that all three countries would have wanted to take a rest from new integration initiatives. New initiatives would inevitably invade policy realms that so far have proven immune to the forces of

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globalization. Sovereign powers of state and provincial governments might be threatened, and the specter of super-national institutions might trouble legislative branches in all three countries.

On the other hand, the attacks of September 11 added a new dimension to the NAFTA project. If economic borders have largely been dismantled under the banner of free trade, security borders suddenly became more sensitive. Unless NAFTA comes to grips with this new reality, the progressively higher level of economic integration achieved between 1989 and 2005 may simply come to a halt. NAFTA countries as a result have begun to address the new security dimensions and are negotiating new agreements on "smart borders" -- the aim is to secure the borders while keeping them open to legitimate commerce. In our paper, however, we will suggest that other dimensions -- besides border inspections -- will have to be addressed to satisfy these twin goals.

In the second section of this paper: *NAFTA after 8: Commercial and Investment Success,* we recap the story of NAFTA's success and review the very substantial achievements NAFTA members have made in their original goal of economic integration. In the third section, *Commercial Success did not Benefit Everyone*, however, we highlight the limitations of NAFTA for the purpose of achieving prosperity in North America. In this section, we discuss how -- despite the significant contributions of NAFTA to the financial recovery of Mexico and economic growth of the three partners -- it has not been enough and could not be enough . While trade policy can be a powerful instrument to promote development, it cannot be the only one, nor can it be a substitute for complementary domestic policies to address structural problems. The final section concludes our paper and highlights the significance of the September 11th attack for the NAFTA project.

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B. NAFTA After 8: Commercial and Investment Success

The central purpose of the North American Free Trade Agreement (NAFTA) was to liberalize trade and investment between the three North American partners. An auxiliary goal was to improve the management of commercial conflicts, and to this end new dispute settlement procedures were created.[ii]

This section will begin with a descriptive account showing the evolution of Canada-US-Mexico trade, its growth and composition, and its impact at the provincial and state levels. Next, we examine how the NAFTA has affected foreign direct investment in the region. Finally, we assess the NAFTA dispute settlement process in managing relations within the region. Throughout, we focus on the perspective of the two smaller partners.

Trade within NAFTA

Since NAFTA went into effect, trade flows between the partners have experienced tremendous growth, surpassing the most optimistic predictions of free trade proponents. As shown in table 1, between 1993 and 2000, trade in the NAFTA region grew at an annual rate of 12.5 percent, a rate substantially higher than the average annual growth rate for world trade (8 percent). Trade among the NAFTA partners, between 1993 and 2000, increased by 128 percent, from $289 billion to $659 billion (throughout our paper, all money figures are expressed in US dollars).

Between Canada and the United States, total trade has more than doubled, and merchandise exports as a share of Canadian GDP expanded from 15 percent in 1989 to more that 30 percent in 2000 (see table 1). Moreover the share of Canadian merchandise exports shipped to the United

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States rose from 71 percent in 1989 to 94 percent in 2000. As shown in chart 1, total Canada-US trade in services almost doubled between 1993 and 1998, rising from $30.4 billion to $58.9 billion. These trends have consolidated Canada as the most important trading partner for the United States.

In the case of Mexico and the United States, two-way trade boomed at an average annual growth rate of 17 percent, tripling between 1993 and 2000, rising from $85 billion to $263 billion (see table 1). Two-way trade grew from 34 percent of Mexican GDP (measured at market exchange rates) to 63 percent. Mexican products increased their share in the US import market from less than 7 percent in 1993 to 11.2 percent in 2000, and Mexico displaced Japan as the second largest export market for the United States.[iii]

Mexico-Canada trade has also increased under NAFTA, despite the geographic distance and limited historic ties. In 2000, seven years after implementation, Canada-Mexico two-way trade reached $12 billion, up from $4 billion in 1993 (table 1). Mexico has become Canada's main trading partner in Latin America and its third leading supplier worldwide. Likewise, Canada has become Mexico's fourth trading partner after the United States, Japan and the European Union. While bilateral trade numbers are small when compared to bilateral trade with the United States, the Canada-Mexico trade link has the potential for sharp expansion.

Other factors, besides CUSFTA and NAFTA, explain part of this trade growth -- notably the strong U.S. economy in the 1990s, and unilateral and multilateral trade liberalization (Krueger, 1999). Empirical studies, however, persuasively show that CUSFTA and NAFTA were responsible for the *exceptionally* rapid expansion of regional trade. In an early study, Canadian

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economist Daniel Schwanen (1997) showed that, between 1988 and 1995, Canadian exports to the United States of goods that had been liberalized by the CUSFTA in 1989 increased by 139 percent, as compared with 65 percent for goods that had not been liberalized. Mexican economists Enrique Espinoza and Pedro Noyola (1997) in their study of Mexico-U.S. trade, demonstrated that the patterns of sector-by-sector trade growth could only be explained by the shape of NAFTA liberalization. More recent studies of NAFTA reach similar conclusions. Ben Goodrich (2002), for example, used panel techniques to assess the causal effect of CUSTA and NAFTA on North American trade. He reached the conclusion that, in all six directions, North American merchandise trade substantially increased, and often doubled compared to what trade would have been in the absence of NAFTA. Goodrich also showed that trade created by CUSTA and NAFTA far exceeds trade diverted.

In the past Mexico's export operations were almost entirely concentrated at the northern border and major interior cities -- Mexico City, Guadalajara and Monterrey. Today most of the 31 Mexican states, including rural states like Aguascalientes, Campeche, Durango, and Yucatan, participate in international trade. Textile exporting firms have expanded in states such as Hidalgo, Morelos, Puebla, Tlaxcala and Yucatan. Export-oriented firms in the household appliance sector have boomed in San Luis Potosi, while automotive export plants have expanded in Queretaro.[iv]

Likewise, as John McCallum (2000) has shown for Canada, historically Alberta, Ontario and Quebec were the main providers of Canadian exports to the United States. Since CUSTA and NAFTA, all provinces have experienced a dramatic growth in exports bound for the United States. Expressed as a share of provincial GDP, export growth has ranged from lows of around 50 percent for Atlantic Canada and British Columbia to highs well over 100 percent for Manitoba

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and Quebec. Meanwhile, individual US states significantly increased their exports to Canada (see table 2).

Many US states similarly benefited from rising exports to Mexico. In 1993, Mexico was the third largest export market for California, a position maintained in 1999. Mexico rose to become the third most important market for Texas and Arizona, and a number of U.S. states sent significant exports to Mexico (see table 2).

Foreign Direct Investment

NAFTA is also an investment agreement, aimed at facilitating both foreign direct investment (FDI) and portfolio investment. Unlike the trade provisions, the investment provisions of NAFTA have been implemented on a most-favored-nation (MFN) basis by the member countries. Gravity models and other sophisticated techniques for discerning the investment impact of FTAs have yet to be applied. However, using a simple-minded technique, we examine the data to see whether there appears to be a crude "NAFTA effect" on foreign direct investment (FDI), especially for Mexico and Canada, and perhaps even for the United States.[v]

Table 3 shows the evolution of FDI flows in the three NAFTA countries over the period 1989 to 2000, divided between two sub-periods, six years up to NAFTA and six years after NAFTA. Canada, Mexico and the United States all received sizable of FDI flows during the 12-year period, but there is a striking contrast between *intra*-NAFTA flows in the pre-NAFTA and post NAFTA periods. Total FDI flows between the three countries were $63 billion between 1989-1994; during the second period, 1995-2000, total flows increased to $202 billion, more than tripling in dollar volume. FDI flows into the NAFTA region from non-NAFTA countries also

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increased in the post-NAFTA period, but not as dramatically. Particularly in the case of Mexico, nearly all the FDI growth was from NAFTA partners.

How important are FDI flows for the North American economies? We can gain a sense of their relative importance by relating the flows to GDP (charts 2, 3 and 4). In each of the NAFTA countries, FDI inflows surpassed 2.5 percent of GDP annually in the first five years following ratification; in the period previous period, FDI inflows were below 1.5 percent of GDP annually in Canada and the United States, and below 2 percent annually in Mexico.

While other factors were at work, we think these crude comparisons indicate the positive impact of NAFTA on FDI inflows. Since NAFTA was ratified, Canada, Mexico and the United States have attracted larger flows of FDI to their economies. In part, this reflects worldwide growth of FDI: rising from $200 billion annually during the 1989-1994 period (0.9 percent of world GNP in 1990) to $705 billion annually during the period 1995-2000 (2.3 percent of world GNP in 2000).[vi] Panel analysis by MacDermott (2001), however, strongly indicates that NAFTA increased total investment into North America, after taking other forces into account. Equally remarkable is that FDI flows between the three partners increased more dramatically that with the rest of the world. This happened even though the three countries implemented their NAFTA investment provisions on an MFN basis. This growth in intra-regional FDI occurred in tandem with a tremendous expansion of intra-regional trade. The obvious and well-known conclusion is that NAFTA accelerated the rationalization of North American production facilities, especially in integrated sectors like autos, computers, chemicals and pharmaceutical products.[vii]

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The connection between trade liberalization and investment growth is illustrated by three sectors where commercial ties have been most extensive: the automotive industry, textiles and clothing, and the electronics industry. In Appendix A, we review the evolution of these sectors since NAFTA came into force. By way of summary, we can mention here that, in these three sectors, deeper integration is clearly evident between the three economies. Canadian, Mexican and US firms have relocated their production facilities and repositioned their supply patterns throughout the region, and they have used mergers and acquisitions across North America to strengthen their competitive stance. The reward has been higher productivity generally and a new role for Mexico particularly. Within Mexico, NAFTA has encouraged more sophisticated automotive, textile and clothing, and electronic products -- going beyond mere assembly -- with significant research and development work now conducted in Mexico.

Trade and Investment Disputes

Besides promoting trade and investment, a final important objective in NAFTA was to create effective procedures for settling disputes.[viii] Since the partners carry out one of the busiest trade relations in the world, it was to be expected that numerous disputes would arise as NAFTA was implemented. This expectation has not been wrong.

Have the new mechanisms created in NAFTA Chapters 11, 14, 19 and 20 helped the management of Canada-Mexico-U.S. relations? The answer has to be positive.[ix] Dozens of difficult issues have been resolved under the auspices of high-quality dispute settlement panels which, except in a very few cases, have not split along national lines.[x] The application of clear rules within a set of binding procedures ensured equality of standing among the three parties. Agreed rules, not power politics, determine outcomes.

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Three high-profile exceptions have gotten a lot of media attention: the continuing saga of softwood lumber (pitting the United States against Canada); trucking (pitting the United States against Mexico); and sugar and high fructose corn syrup (pitting Mexico against the United States and vice versa). The Chapter 11 Methanex case was recently added to the list, thanks in part to a Bill Moyers TV show on PBS.[xi] But these cases are the exception, not the norm. Eventually they too will be resolved given the mutual interest of the NAFTA partners in maintaining robust trade and investment relations.[xii]

C. Commercial Success did not benefit everyone

While NAFTA has been a huge commercial success, it did not, and could not, bring universal prosperity to North America. During the second half of the 1990s, the United States enjoyed exceptionally strong growth, and Canada closely followed. But Canadians worry about several disturbing trends, including Canada's poor productivity performance relative to the United States, low levels of research and development, a declining share of global foreign direct investment, and persistently higher levels of unemployment than the United States. The hallmark of Canada's *relative* decline was the persistent fall in the exchange value of the Canadian dollar, from 86 U.S. cents in 1990, to 67 cents in 2000 (and 62 cents in February 2002). As a consequence, between 1990 and 2000, Canadian average per capita GDP, expressed at market value exchange rates, fell from 87 percent of the US level to 65 percent.[xiii]

If Canada had a slow slide, Mexico had a sharp fall. Mexico experienced, in 1994-1995, one of its worst economic crises since the great Depression. This crisis cannot be blamed on NAFTA,

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but rather on a combination of adverse political factors, unsound financial practices, and mismanaged monetary policy.[xiv] From the perspective of our paper, the important observation is that recovery from the peso crash of 1994-95 was remarkably fast compared to recovery from the debt default and devaluation episode beginning in 1982. The difference can largely be attributed to the existence of NAFTA.

In 1982, Mexico's immediate response to the debt crisis was to drastically slash imports, building a protective fortress through stringent import quotas and prohibitive tariffs. Mexican imports fell by more than 50 percent, from $24 billion in 1981 to only $9 billion in 1983. It took Mexico seven years to get back to pre-crisis import levels. After the 1994-1995 peso crisis, by contrast, Mexico's membership in NAFTA did two things: it fostered a quick and ample financial rescue package, led by President Clinton; and it guaranteed continuity of Mexico's trade policy, led by President Zedillo. Mexico actually accelerated its liberalization program, and pre-crisis import levels were restored in around 18 months.[xv]

Another revealing indicator is industrial production. After the 1982 debt crisis, it took Mexico about 9 years to get back to its pre-crisis level of industrial output; in contrast, after the 1994-1995 crash, it took Mexico less than two years to recover 1994 output levels (Heath, 1998).

Mexican employment declined by more than 4 percent in 1995, but employment grew 4 percent in 1996, 8 percent in 1997, and 7 percent in 1998.[xvi] Between August 1995 and August 1999, the Mexican economy generated 2 million new jobs. Around a million of these were related directly or indirectly to export activity.

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In terms of wages, while export growth has exerted a positive impact,[xvii] the majority of Mexican workers have not seen an increase in real wages in over a decade (Heath 1998). Mexico's dual economy excludes the majority of people from highly productive jobs. A perennial problem is the lack of credit to finance plant expansion and modernization by small business firms – even those involved in export activities.[xviii] All that said, better times could be ahead on the Mexican wage front. Employment as a percentage of the labor force rose from 84 percent in 1993 to 98 percent in 2000. Meanwhile, the percentage of the workforce engaged in agriculture dropped from 28 percent to 17 percent.[xix] Tighter labor markets in urban areas could point to higher real wages in the next decade.

To conclude the commercial story: NAFTA has boosted North American trade and investment to a remarkable extent. Yet Mexico and Canada, each in its own way, faced economic difficulties in the 1990s. At best, a solid trade and investment agreement, such as NAFTA, can enable a country to reach its economic potential, taking into account embedded constraints. Sometimes, as NAFTA illustrates, a trade agreement can help overcome those constraints.[xx] When countries face structural problems (as Canada has throughout the 1990s), or shocks (as Mexico did in the mid-1990s), a solid agreement can help guide constructive responses, both by the country and by its partners. Within these spheres, NAFTA succeeded far beyond the expectations of its advocates.

D. Conclusions

Canada, Mexico and the United States have reached a critical juncture in their economic and security relations. As a result of the implementation of CUSTA in 1989 and NAFTA in 1994, the

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three countries have developed one of the closest and busiest trade and investment relations in the world. With daily two-way trade amounting to $1.3 billion, Canada and the United States are each other's largest trading partners: 40,000 commercial shipments and 300,000 people cross their shared borders every day. Similarly, US-Mexico trade more than tripled between 1993 and 2000, rising from $85 billion to $263 billion, making Mexico the second most important trading partner for the United States. In 1998, 278 million people, 86 million cars, and 4 million trucks and rail cars legally entered the United States from Mexico.

Canada and Mexico likewise have seen their economic relations dramatically increase under NAFTA, despite geographic distance and limited historic ties. In 2000, seven years after implementation, Canada-Mexico two-way trade reached $12 billion, up from $4 billion in 1993, making Mexico the main trading partner for Canada in Latin America and its third leading supplier worldwide.

All this does not mean that everyone in North America has prospered. Mexicans, in particular, were devastated by the peso crisis of 1994/95, and have seen no increase in real wages in over a decade. Canadians have on average done much better, but Canadian prosperity in the 1990s lagged by comparison with the "new economy" boom that swept the United States. NAFTA, in our opinion, cannot be held responsible for all the financial and structural shortcomings that have slowed down (or even reversed) economic progress within North America. In its narrow commercial sphere, NAFTA has succeeded beyond the expectations of its advocates.

In light of its commercial success and the lukewarm political environment, it is not surprising that the three countries might want a rest from new integration initiatives. New initiatives would

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inevitably invade policy realms that so far have proven immune to the forces of globalization. Sovereign powers of state and provincial governments might be threatened, and the specter of super-national institutions might trouble legislative branches in all three countries.

The Significance of September 11th

However, the attacks of September 11 added a new dimension to the NAFTA project. If economic borders have largely been dismantled under the banner of free trade, security borders suddenly became more sensitive.[xxi] Unless NAFTA comes to grips with this new reality, the progress toward closer economic integration that was achieved between 1989 and 2005 could simply come to a halt. Under a worse case scenario, new security barriers could prove every bit as daunting to trade and investment flows as the tariffs and quotas that were negotiated away under NAFTA.[xxii]

Canadian and Mexican responses, after a period of uncertainty and delay, were to negotiate with the United States what have been called "smart borders" -- plans aimed at moving the border away from the border. The Mexico-U. S. Border Action Plan,[xxiii] for example, aims at three objectives: to secure infrastructure, to secure the flow of people, and to secure the flow of goods. Securing infrastructure will start with "a joint survey … to identify bottlenecks that impede the movement of goods and people…to develop integrated infrastructure investment plans…and to conduct security assessments of critical infrastructure and take steps to protect them from terrorist attacks".[xxiv] Securing flows of people will begin with "technology systems at ports of entry to speed the flow of bona-fide travelers; to cooperate to identify individuals who pose threats… [and] to coordinate efforts to deter smuggling of third-country nationals and establish a joint U.S. Mexico Advanced Passenger Information Exchange System."[xxv] Finally, securing the flow of

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goods will start by implementing "technology-sharing programs to place non-intrusive inspection systems on cross-border rail lines and high-volume ports of entry; … technology systems to increase security at all points of the supply chain that links producers and consumers and … partnerships with the private sector to increase security of commercial shipments".[xxvi] These are sensible beginning measures to secure an open border for legitimate goods and services.

However, it is our belief, that in order to prevent a worse case scenario the three countries will have to adopt a common project which addresses not only border and supply line inspections but also cooperative polices in four other fronts: external trade barriers; a defense alliance; a common currency and migration.

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APPENDIX A

The Automotive Industry

The auto industry, including both vehicle manufacturers and auto parts producers, is the largest manufacturing industry in each NAFTA country. Automotive products are the largest component in bilateral trade among the three North American partners when the NAFTA negotiations were announced, accounting for roughly a seventh of total bilateral trade between Mexico and the United States, and a third of total bilateral trade between Canada and the United States.

Thus it is not surprising that the automotive sector was particularly sensitive during NAFTA negotiations. From the Mexican perspective, the sector is not only the largest exporter and importer of manufactured goods, but also a prime example of the kind of intra-industry trade that NAFTA was designed to boost. Free trade encourages auto firms to relocate their production facilities and their supply chains among NAFTA countries, taking advantage of cost savings, specialization and economies of scale.

Since the 1960s, as a result of the Auto Pact negotiated between Canada and the United States, the Canadian and U.S. automotive sectors had already achieved a high degree of integration. This was further consolidated with the negotiation of the CUSTA. A central purpose of the NAFTA negotiation was to integrate the Mexican automotive industry with that of its two neighbors, and to force a major realignment of Mexico's industrial policy. Prior to 1994,

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Mexico's auto industry was both highly protected and heavily regulated. NAFTA ended an assortment of industrial policies that both imposed strict production and export requirements, and curtailed imports of vehicles and components. Gradual deregulation and liberalization under NAFTA promoted Mexican specialization in small and medium-sized cars, light trucks and auto parts.[xxvii] For example, Mexico's annual exports of engines now exceed two million units, placing it seventh in engine manufacturing worldwide.[xxviii]

Under NAFTA, the Mexican auto industry has become highly integrated with its Canadian and U.S. counterparts, and vehicles made in Mexico have a high U.S. and Canadian content. Trade in automotive products has consequently exploded. U.S.-Mexico trade in vehicles and auto parts expanded from $14.6 billion to $47.1 billion between 1993 and 2000. Almost 25 per cent of U.S. auto parts imports come from Mexico.[xxix] Around 90 percent of Mexico's vehicle exports are sold in the U.S. market, 6 percent in Canada, and 3 percent to Germany. Mexico has become the second largest export market (after Canada) for both U.S. vehicles and auto parts. In 2000, U.S. car exports to Mexico totaled $4.3 billion.

The 1995 peso crisis had a devastating effect on Mexican auto production, with domestic sales falling 80 per cent. NAFTA enabled a speedy recovery, as production was diverted to the U.S. market.

Today, the auto industry accounts for 2 percent of Mexican GDP, 11 percent of manufacturing value added, and 20 percent of total exports. This progression of statistics shows that Mexican negotiators correctly sensed that NAFTA could unlock Mexico's latent comparative advantage in

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the auto sector. In 2000, auto industry exports reached $33.9 billion (up from $10.8 billion in 1993), and maquiladoras in the auto sector employed nearly 250,000 workers

The Textile and Clothing Industry

Liberalization in the textile and clothing sector was particularly complex given the international protection scheme known as the Multifiber Agreement (MFA). This complex and restrictive agreement basically manages world trade through quota allocations. In the United States and Canada, a powerful lobby of textile and clothing producers (both firms and unions) has kept the North American market highly protected since the early 1960s, through high tariffs reinforced by the MFA and predecessor arrangements.

A major goal for Mexico in the NAFTA negotiation was to gain improved access to the U.S. market for its textile and clothing products, through full elimination of tariffs and MFA quotas. Prior to NAFTA, the so-called Special Regime enabled Mexican apparel assembled from U.S. fabric to benefit from flexible quotas and the application of U.S. tariffs only on the non-U.S. value added (in other words, "round trip" U.S. fabric was free from duty). Intensive utilization of the Special Regime by Mexican exporters established the basis of a fast-growing garment industry and jobs for low-skilled workers. Under NAFTA, immediate elimination of MFA quotas, coupled with substantial cuts on exceptionally high tariffs as NAFTA entered into force, extended the gains achieved under the Special Regime. Benefits were also extended to Mexican fabric producers, who became qualifying suppliers under the complex NAFTA rules of origin.[xxx]

From the point of view of the United States, whether or not quota restrictions were removed and tariffs eliminated on textile and clothing trade with Mexico, the fact was that the most labor-

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intensive segment of the industry (generally clothing production) would inexorably lose jobs to low-wage countries, many located in the Far East. To the extent those downstream activities moved further away from North America, the more competitive segments of the U.S. textile complex (such as high-tech yarn and fabric production) would face lesser demand for their products. The industry's anticipation (which proved correct) that the MFA would be phased by the Uruguay Round accord, meant that exempting Mexico from U.S. MFA quotas amounted to no more than giving Mexico a head-start *vis-à-vis* other suppliers of textiles and clothing to the North American market.

At the outset of NAFTA's implementation, Mexico granted duty free access to around 20 percent of U.S. exports of textiles and clothing. By 1999, almost all textile products reached duty free status in both directions. However, tariff-free and quota-free access depends on textiles and clothing being made of yarn spun in North America or from textiles fabricated from North American fibers. NAFTA's protective rules of origin can certainly be criticized from the standpoint of the multilateral trading system, but they have encouraged investment in new facilities throughout North America.

After eight and a half years under NAFTA, performance of the Mexican textile and clothing industry bears out the initial expectations . In 1995, the Mexican industry suffered from the collapse of the domestic economy. Like the auto industry, it was able to export its way to recovery thanks to preferential market access. After a sharp 6 percent decline in 1995, the industry grew 15 percent, 10 percent, and 5 percent in the 1996, 1997, and 1998, respectively.

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In 2000, Mexico's textile and clothing industry exported $11 billion, contributing more than 6.5 percent of Mexico's total exports. Two-way Mexico-U.S. trade in textiles and clothing increased from $4.1 billion in 1993 to $15.3 billion in 2000.[xxxi] In 1998, Mexico became the leading supplier of textile and clothing products to the United States, displacing China.[xxxii] Significantly, Mexico has also become the largest market for U.S. textile products.[xxxiii] Today Mexico's textile and clothing industry includes almost 1,200 maquiladora plants, employing close to 286,000 workers.

The Electronics Industry

The electronics industry, in a fashion similar to the automotive and textile/clothing sectors, became a major export player for Mexico as a result of trade and investment opening promoted by the NAFTA. Mexico established itself as the main trading partner for the United States in electronics, surpassing such key players as Japan, Canada, Taiwan, Korea and Singapore. In 2000, both Mexican exports of electronics to the United States, and U.S. exports to Mexico, amounted to about $34 billion in each direction. Electronics trade between Mexico and Canada rose from $210 million in 1993 to $773 million in 2000. Zero tariffs and a stable investment climate are behind these trade statistics.

NAFTA has encouraged Mexican production of sophisticated electronic products that go beyond mere assembly, with significant research and development now conducted in Mexico (Carrillo and Hualde, 1997). The 1970s stereotype of low-cost, labor-intensive assembly no longer characterizes the new generation of electronics production (Lowe and Kenney, 1999).

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Some 570 maquiladora plants now operate in the electrical and electronics sectors, representing almost 12 percent of the total number of maquiladora plants in Mexico. In 2000, these firms employed approximately 350,000 workers, an increase of 80 percent over 1993 levels.

The trade and investment story for electronics, as for autos and textiles and clothing, finds firms re-positioning themselves through mergers, acquisitions and greenfield investments, and restructuring their chains of supply. The result is far deeper integration of the North American economies. The reward has been higher productivity in favored sectors, a strengthened position in the world economy, and booming intra-industry trade. Mexican sectors that have not enjoyed the same degree of corporate involvement and capital inflows from the north have not enjoyed the same kind of success.[xxxiv]

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Endnotes

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[ii] See Hufbauer and Schott (1993), Weintraub (1997), and Mayer (1998). NAFTA was originally conceived as a trade and investment agreement but objections from influential groups led to the addition of labor and environmental side agreements. This transformed NAFTA into the beginnings of a social pact. However, we do not discuss the side agreements.

[iii] Some observers speculate that, at current rates of growth, within a few years Mexico could become the first trading partner of the United States, surpassing Canada.

[iv] See Secofi-NAFTA Office, 2000. Mexico a Global Partner for Trade, Investment and Growth.

[v] Given its economic size, and its role as the world's largest source and destination of direct investment, the United States was obviously less affected by NAFTA than Mexico or Canada.

[vi] FDI data are taken from United Nations (2001); world GDP figures (measured using purchasing power exchange rates) are taken from World Bank (1992, 2001).

[vii] See, Weintraub (1997), Unger (1994), Rugman (1998), and Merrett (1996).

[viii] To accomplish these goals, the three countries established an innovative and relatively complex set of dispute settlement mechanisms on investment, financial services, antidumping and countervailing duties and general disputes in four NAFTA Chapters 11, 14, 19 and 20.

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[ix] While we have to recognize that NAFTA Chapter 11 has become very controversial, a careful study of the five cases that have been resolved through arbitral tribunals so far give us grounds to suggest it is too early to reach any firm conclusions about the operation of the Chapter. In fact, in our opinion the cases decided so far, namely, the The Azinian, The Waste Management, The Metalclad, The S.D. Myers; and, The Pope and Talbot Cases give room for optimism. The governments also have been ready to address the most important criticisms raised against chapter 11 and despite some concerns about the lack of clarity of some of the provisions of the Chapter, the governments seem to have a clear sense of what the main purpose of the chapter should be.

[x] NAFTA Chapter 19, for example, allows Canadian , Mexican and U.S. firms the option of taking a disputed antidumping or countervailing action issued by a national authority to a binational panel of experts. The panel has binding powers to review the action and decide if it was consistent with the law of the national authority. The panels can sustain national decisions, remand them, seek clarification, or vacate the decisions. Between January 1994 and January 2002, 78 cases were initiated, including cases completed, terminated or continuing during the period. Experts reviewing the reasoning in completed cases generally agree that the panels of experts have performed their tasks professionally and thoroughly. See Gantz (1998) and Pan (1999).

[xi] See the rightly critical op-ed on Bill Moyers' show, written by Sebastian Malaby, that appeared in the *Washington Post*, February 18, 2002.

[xii] The softwood lumber, trucking services and sugar exceptions seem to have an echo in a number of high-profile WTO cases like the EU ban on hormone-treated beef and U.S foreign sales corporations (FSC) which similarly remain to be resolved despite the benefits of panel proceedings. In these cases both the EU and the US authorities have determined that they would

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rather face the wrath of their trading partners than that of the public or constituencies, and have not taken satisfactory action to implement the decision of the WTO panels.

[xiii] Many economists argue that these figures give an overly dismal portrait of the Canadian economy, because they do not reflect low Canadian inflation in the 1990s or the purchasing power of the Canadian dollar. See Laidler and Aba (2002). Such arguments do not make most Canadian feel any better.

[xiv] See Naim and Edwards (1997)

[xv] While macroeconomic stabilization was the immediate task, the increased openness of the economy facilitated a fast recovery. Measured by trade to GDP, the openness of the Mexican economy increased from 38 percent in 1993 to 62 percent in 1998. Structural reforms in the wake of the crisis also speeded the recovery – further liberalization of the foreign investment regime, reforms in the social security system and the banking sector, and additional privatizations. WTO (1997).

[xvi] According to INEGI data and analysis from the Federal Reserve Bank of Dallas (1999), Mexico's overall unemployment situation has improved since 1995. In January 1997, the open unemployment rate was 4.5 percent, while by October 1999 this figure was 2.5 percent. INEGI, http://dgcnesyp.inegi.gob.mx/bdi.html-ssi

[xvii] Manufacturing workers in export-oriented firms are better paid than others. In 2000, real wages in the maquila manufacturing sector were almost 25 percent higher than wages in the non-maquila manufacturing sector. See SECOFI (1998a).

[xviii] To illustrate the difficulty, in 1994, Mexico's export-import bank, Bancomext, approved loans of more than $15 billion; in 1995 these fell to $8 billion; in 1996 to $6 billion; in 1997 to $5 billion; and in 1998 they recovered only to $6 billion.

[xix] OECD (2001).

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[xx] To cite a few instances, NAFTA pressures helped Canada get its fiscal accounts in order, and reduce the heavy burden of corporate taxation. NAFTA pressures also helped Mexico privatize many state-run firms, and give a more professional tone to many aspects of public administrations.

[xxi] On September 11th, the U.S. adopted a series of measures at its borders north and south like the adoption of a high level alert of sustained and intense inspection which provoked a disruption of commercial traffic lasting for several weeks with a concomitant crisis for just-in-time manufacturers, particularly auto companies, and a plunging of crossborder retail shopping and tourism. The INS also announced plans to introduce an entry/exit system by 2004 at the largest 50 land entry points, which will require visitors, including those of Canada and Mexico to have their names recorded every time they enter and leave the country.

[xxii] In our opinion, a worse case scenario could occur if, for example, there would occur in the future an attack by trained terrorist armed with biological or nuclear weapons, slipping into the United States from Tijuana or Vancouver, or grain contaminated with natural or man-made biohazards was shipped from the United States to Canada or Mexico or Guerilla insurgence would develop fueled by drug money, creating Colombia-style conditions in southern Mexico.

[xxiii] See, “Smart Border: 22 Point Agreement-U.S.-Mexico Border Partnership Action Plan”in htpp://www.state.gov/p/wha/rls/fs/8909.htm

[xxiv] See “Specific Measures that Comprise Joint Action Plan with Mexico” in htpp://www.state.gov/p/wha/rls/fs/8910.htm

[xxv] Ibid.

[xxvi] Ibid.

[xxvii] For a detailed analysis of the auto industry under NAFTA, see Weintraub and Sands (1998).

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[xxviii] Total production of engines in Mexico is close to 3 million units.

[xxix] Among the main auto parts that the U.S. buys from Mexico are wire harnesses, auto stereos, auto body parts, speedometers, engines and air conditioning parts. For its part, Mexico buys from the United States engines, wheels, seat parts, and auto stereos. A similar type of integration has occurred between the Mexican and Canadian automotive sectors.

[xxx] NAFTA stipulates that no new quotas in the textile and clothing sector may be imposed except under specific safeguard provisions. Moreover, some products that do not meet the NAFTA rules of origin may still qualify for preferential treatment up to a "tariff preference level", or up to a specified import level, which is negotiated among the three countries. See Hufbauer and Schott (1993).

[xxxi] SECOFI (2000b).

[xxxii] Mexico's main textile and clothing exports to the United States are denim products, knit fabric, synthetic fabric, trousers, T-shirts, sweaters and underwear.

[xxxiii] Approximately 75 percent of Mexico's clothing production incorporates U.S. fabric. Kurt Salmon Associates (1999).

[xxxiv] The distinction is particularly striking in Mexican agriculture, where NAFTA has had very different impacts on Mexico's two-tier agricultural sector. In the first tier, booming well-capitalized agribusinesses has increased its exports as a result of improved access to the United States and Canadian markets. In the second tier, the traditional subsistence sector has had no discernable benefits from the NAFTA – apart from urban jobs for those leaving the rural areas.

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