China's Trade with North America:
What Does this Mean for NAFTA?

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While enjoying more than a decade of preferential access to each other's markets under the North American Free Trade Agreement (NAFTA), Canada, Mexico and the U.S. now find themselves face-to-face with Chinese competitors in sectors once deemed "North American." Since the turn of the millennium and China's commercial success as a newly admitted member to the World Trade Organization (WTO), its stealth as a global trader is now hitting the NAFTA bloc where it most hurts. Despite the impressive numbers on trade and investment expansion between the three NAFTA countries, China bumped Mexico a notch down in its export ranking toward the U.S. market in 2003 and is quickly advancing on Canada, still the top single U.S. trade partner.

Investment trends mirror this trade scenario, as China has become a prime portfolio investor in the U.S. and is now buying up fixed assets in the Western Hemisphere---including minority ownership in Canadian firms involved in exploiting that country's uranium, natural gas, and vast oil-sands reserves in the western province of Alberta. This enormous westward shift in trade and capital flows from China was much less a possibility at the time of NAFTA's negotiation,[1] but now bears directly on the ability of the U.S. and its partners to retain a competitive edge in sectors like electronics, machinery, and autos that have thus far been the impetus for intra-bloc growth.

In some North American quarters China's incredible economic rise has prompted an alarmist reaction reminiscent of that invoked by Japan's similarly rapid economic ascendance in the 1970s. And, like earlier responses to Japan's growing economic might, the slippage of Canadian and Mexican exports in U.S. markets, as well as the explosion of the U.S. trade deficit with China, have been attributed to China's cheap exchange rate and even cheaper wages. This has been the gist of recent debates within the U.S. Congress, where bipartisan protectionist proposals have proliferated in the way of trade quotas, safeguards and even penalties for companies that outsource jobs in sectors threatened by competition from China.[2]

Moreover, at least a dozen bills touting incentives that would induce China to raise the value of its currency (the yuan) have been tabled before both houses of Congress, based on the assumption that this would make the purchase of China's imports cheaper for domestic consumers in that market and its exports more costly within North American markets. It was these Congressional threats that apparently prompted the People's Bank of China to announce a loosening of the dollar-yuan peg in July 2005, which resulted in an appreciation of the yuan by about 2 percent.

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[1] Nicholas R. Lardy, "China: The Great New Economic Challenge?" in C. Fred Bergsten, ed., *The United States and the World Economy* (Washington, DC: Institute for International Economics, 2005), 121-141.
[2] Gary Clyde Hufbauer and Yee Wong, "China Bashing 2004" (International Economics Policy Briefs, Institute for International Economics, Washington, DC, September 2004).

Not so long ago, this very dynamic played out as Japanese policymakers moved to upwardly adjust the yen under similarly fierce U.S. pressure, with little improvement in the U.S. trade balance. [3] In the end, it was the onset of Japan's prolonged economic downturn in the early 1990s and the simultaneous takeoff of an unprecedented U.S. productivity boom that closed this bitter chapter on Japan-U.S. economic relations. This time around, with China's sheer size and economies of scale propelling a remarkable wave of growth and market initiative, the onus is on North American producers and policymakers to pick up their own competitive pace. This means the coupling of some badly needed domestic reforms in all three countries with measures that promote greater overall competitiveness within the North American bloc.

For example, Canada, assuming the implementation of a recently proposed package of productivity measures, stands to make out quite well vis-à-vis China---both within NAFTA, and as an energy exporter and destination of an increasingly diversified Chinese investment portfolio that spans several sectors and provinces. For the U.S., twist the kaleidoscope slightly and the figures on debts and deficits that have been cited as reflections of the "Chinese threat" become just as much an indictment of Washington's refusal to properly tackle these macroeconomic headaches. As former Treasury Secretary Robert Rubin recently wrote in the *New York Times*, in the event that policymakers can buckle down and undertake the necessary debt and deficit reductions "then with our flexible labor and capital markets, and our historic embrace of change and willingness to take risks, our prospects over time should be very favorable."[4]

This insight is confirmed by even a cursory walk through some of the data on China's participation in North American markets, which suggest ample room for the expansion of China-NAFTA trade and investment ties in a manner that is both competitive and complementary. But on the North American side this will also require some retooling of NAFTA, where restrictions on labor mobility, a large technology gap, and the coddling of sectors like autos and textiles behind antiquated content rules has done little to encourage the kinds of dynamic restructuring now demanded by China's powerful entry into North American markets.

On this point, it's Mexico that is most on the ropes with regard to competition from China, as domestic producers have lacked the resources and incentives to fully transform the leading sectors under NAFTA into fully integrated productive structures.[5] Some of this reform lag can be traced to the policy stalemate that has plagued the administration of President Vicente Fox since it took office in mid-2000; however, even under the most successful domestic reform scenario Mexico would still require considerable technological guidance and infrastructure support from its NAFTA partners to bolster its foothold in the leading North American markets.

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[3] Wendy Dobson, "Taking a Giant's Measure: Canada, NAFTA, and an Emergent China" (C.D. Howe Institute Commentary, University of Toronto, Toronto, Canada, September, 2004), 5-6.

[4] Robert Rubin, "Attention: Deficit Disorder," *New York Times*, get date.

[5] Enrique Dussel Peters, *Economic Opportunities and Challenges Posed by China for Mexico and Central America* (Bonn: German Development Institute, 2005).

China's Trade with North America: A Reality Check

It is perhaps the U.S.-China bilateral trade deficit---which hit an all-time record of $201.6 billion in 2005[6]---that has most fanned the flames of U.S. protectionism. Particularly daunting is the rapidity with which Chinese exports to the U.S. are growing in a handful of sectors that represent the very core of NAFTA, i.e. a highly specialized network of cross-border investment and intra-industry trade within which Canada and Mexico serve as productive spokes to the U.S. hub. Although Washington's spotlight has been on apparel imports from China, this is not the most important case in point.

What matters most are China's market gains in NAFTA's key sectors---electronics, machinery and parts, and to a lesser extent autos. This is where China and Mexico, in particular, are increasingly butting heads in the U.S. market. A broad range of machinery and parts, for example, accounted for nearly 23 percent of U.S. imports from China in 2004, versus just 3 percent in 1990. The runner-up in 2004 was the category of electronics, including telecom, computer peripherals, and sound and television equipment, which accounted for some 20 percent of Chinese exports to the U.S. market, versus 13 percent in 1990.

Although vehicles and auto parts account for nearly 25 percent of U.S. two-way trade with Canada and Mexico, China has still not climbed on to the U.S.'s top-ten list in this sector.[7] Despite the failure of North America's "Big-Three" auto producers over the past decade to adequately restructure company costs and diversify into more fuel-efficient product lines, this sector is still up for grabs.[8]

This broad scenario offers up three reality checks. First, as the economic giant and industrial anchor within NAFTA, the U.S. is a final destination for finished products from both its NAFTA partners and for goods assembled within a similar East Asian cross-border production network in which China now serves as the locus for final assembly and export to the West. As a result, the U.S. has borne the brunt of North America's collective trade deficit with China, meaning that the equivalent figures for Canada and Mexico are less than half those of the U.S.-China deficit. On the other side of the Pacific, China's exaggerated trade surplus with the U.S. also reflects a gradual decline in the goods shipped directly from Hong Kong, Japan, Korea, and Taiwan, as these goods are now processed in China and shipped directly to the U.S. from there.[9] Thus, the much-feared U.S.-China bilateral trade deficit actually reflects a more complicated mode of East-West and North-South intra-industry trade and production than the figures tend to convey.

Second, and true to the political economic "logic" of protectionism, there is an inverse relationship between the high level of public outcry in a sector like textiles and apparel, and the relatively low percentage of North American trade that this sector actually represents. In fact, the textiles and apparel sector accounted for just 11 percent of total U.S. imports from China in 2004, a figure that was actually higher back in 1990.

[6] Vikas Bajaj, "U.S. Trade Deficit Sets Record, with China and Oil the Causes," *New York Times*, February 11, 2006, p. A1.

[7] Author's interview with Michael Raubacher, Manager of Production Control and Logistics, Shanghai GM, Shanghai, China, January 2006.

[8] Keith Bradsher, "China Looms as the World's Next Leading Auto Exporter," *New York Times*, April 22, 2005.

[9] David Barboza, "Some Assembly Needed: China as Asia's Factory," *New York Times*, February 9, 2006, p. C1.

With the expiration of the longstanding Multi-Fiber Agreement and the liberalization of the textile trade on January 1, 2005, this percentage is clearly growing.

Yet this trend simply confirms what has long been evident: despite NAFTA's hefty rules of origin meant to insulate and preserve the North American textile market, neither the U.S. nor Canada has any particular comparative advantage in the low-skilled end of textile production where China is now booming. As the low-cost producer within NAFTA, Mexico presumably has more potential here, but its share in the NAFTA textile production chain amounted to less than 5 percent of its total registered trade in 2004. In Mexico's case, one perverse effect of NAFTA's rules of origin has been the flight of more than half the country's textile trade into the informal economy, where the number of countries now participating in Mexico's garment industry has more than doubled since 1994.[10]

A third reality check concerns the possibilities for a complementary set of NAFTA-China ties in those sectors where China is clearly on the move. Although U.S. public opinion bristles at the notion of a Canadian strategy involving China's purchase of natural resource assets and its sale of lower value-added and medium-tech goods to the Canadian market, Mexico is slowly coming around to this way of thinking. With President Hu Jintao's September 2005 visit to Mexico the two countries have begun discussions that seek to exploit similar complementarities.[11] For U.S.-China relations, the complementarities clearly lie in the exporting of technology, services, and the high-end of the production chain to China, while the latter will continue to dominate in more labor-intensive and lower value-added activities for some time to come. The burden is now on the shoulders of U.S. foreign economy policymakers to articulate a cohesive strategy that capitalizes on these complementarities.

It is also important not to underestimate China's determination to climb steeply up the industrial learning curve. According to the Inter-American Development Bank, the high-tech content of Chinese exports grew from less than 5 percent in the mid-1980s to 30 percent by 2002.[12] Ironically, as George Gilboy has recently argued, it's China's own contradictory approach to global integration that could hamper this boom.[13] China's high ratio of trade and foreign direct investment (FDI) as a percent of gross domestic product (GDP) has earned it the ranking as the largest contributor to the growth of world trade, and the very top geographical destination for FDI.[14] Yet, the tenacity of central-command politics and the associated institutional limitations on private sector innovation directly undermine the possibilities for the kind of competitive transformation witnessed, for instance, in the U.S. over the past decade.

Multinational firms based in North America have been quick to seize on the immense possibilities, and market analysts have been eager to point to the benefits for North American consumers. As top brand names like Boeing, Dell, Hewlett-Packard, Motorola, Wal-Mart, Nike, and Liz Claiborne have either contracted out their work to

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[10] Marla Dickerson, "Textile City Weeps Over What It Can't Sew," *The Herald Mexico*, December 18, 2005, p. 3.

[11] Author's interview with Rocío Ruiz, Sub-secretary of Industry and Commerce, Ministry of Economy, Mexico City, November 2005.

[12] "China Ascendant: A Snapshot of Economic Performance," *IDEA* 6 (Jan.-Apr. 2005): 5-6.

[13] George Gilboy, "The Myth Behind China's Miracle," *Foreign Affairs* 83 (July/August 2004): 33-48.

[14] Author's interview, Rowena Chu, Managing Director of Equity Capital Markets Asia, Deutsche Bank, Hong Kong, January 2006.

China or established operations there, the result has been ever lower consumer prices and a more diverse range of products from which to choose. For cutting edge sectors (e.g. computers, telecom, electronics), the farming out of the lower end of the production line has enabled these firms to focus more on what they do best---innovation, product design, R&D.

For North American firms operating in the more traditional old economy sectors that are literally being displaced by Chinese exports (e.g. textiles, apparel, shoes, wood furniture), the task is to similarly upgrade into more sophisticated product and distribution lines for goods that are driven less by price and more by higher-niche consumer demand.[15] As lower-cost producers like Cambodia and Vietnam offer to under-price China in the assembly of these old economy durable goods, the application of quotas and tariffs to these sectors is like using a band-aid to halt a hemorrhage.

In both old and new sectors, then, the challenge that China poses for North America is that of generating higher value-added, expanding into new products and markets, and shifting the productive process more toward services, distribution, and the generation of knowledge-based goods. As integral spokes to the U.S. hub, Canada and Mexico are strategically located to benefit within this scenario, and policymakers in both countries are beginning to act accordingly. Unfortunately, it's the U.S. that remains stuck in a defensive and reactive mode. A more successful China-NAFTA relationship will ultimately lie in the willingness of the U.S. to lead the way in terms of tackling its own reform backlog and in sprucing up a NAFTA agreement that could easily be eclipsed by China's advances in this region.

NAFTA as a Competitive Venue?

The tenth anniversary of NAFTA in 2004 was met with a spate of assessments, most of which judged its success or failure according to the growth of intra-bloc trade and investment flows, the net employment effects on each member country, and the accompanying distributional impacts. In brief, these analyses found that intra-bloc trade had grown by more than 200 percent and annual FDI to Mexico had quintupled from its pre-NAFTA levels;[16] on the downside, wage and labor markets had turned increasingly volatile in all three countries and distribution had worsened by varying degrees. Perhaps most troubling was the World Bank's finding that Mexico's "FDI performance in the post-NAFTA period was not significantly above the Latin America norm;"[17] neither were its aggregate or per capita growth rates. When analyzed from these vantage points, NAFTA's reviews ranged from deleterious to mildly favorable.[18]

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[15] Hufbauer and Wong, "China Bashing 2004," 19-20.

[16] See Gary Hufbauer and Jeffrey Schott, *NAFTA Revisited* (Washington, DC: Institute for International Economics, 2005), 22-36.

[17] Daniel Lederman, William F. Mahoney and Luis Servén, *Lessons from NAFTA for Latin America and the Caribbean* (Palo Alto, CA and Washington, DC: Stanford University Press and the World Bank, 2005), 18.

[18] On the deleterious side see John Audley et al, *NAFTA's Promise and Reality* (Washington, DC: Carnegie Endowment for International Peace, 2003), and Miguel D. Ramirez, "Mexico under NAFTA: A Critical Assessment," *The Quarterly Review of Economics and Finance* 43 (2003): 863-892; for more favorable assessments see Hufbauer and Schott, *NAFTA Revisited*, Lederman, Mahoney and Servén, *Lessons from NAFTA*, and Sidney Weintraub, "Trade, Investment, and Economic Growth" in Sidney Weintraub, ed., *NAFTA's Impact on North America* (Washington, DC: Center for Strategic and International Studies, 2004), 3-20.

The continued lack of enthusiasm or consensus over NAFTA's purpose and impacts reflects the gulf between the wishful theoretical thinking and the concrete empirical asymmetries that underpinned its launching back in the early 1990s. As the guiding principle for North American integration, neoclassical trade theory assumed a state of perfect competition and constant returns to scale under a free trade agreement such as NAFTA.[19] "Because barriers to regional trade and investment restrict opportunities to take advantage of differences between countries in wages, skills, or capital costs, firms seek regional arrangements if they can redeploy intermediate production between labor-rich and labor-scarce areas."[20]

With Mexico and Canada accounting for 60.5 percent of U.S. intra-firm trade in 1989 (led by autos, computers, office equipment, electronics, machinery and parts), regional liberalization clearly offered producers the opportunity to reduce manufacturing costs and realize higher profit margins. Conventional trade theory also suggested that a NAFTA-style arrangement, i.e. the elimination of barriers to the free flow of goods, capital, and services within a regional integration scheme, would trigger a process of income convergence across the member countries.[21] Add to this the inclusion of a country like Mexico---decidedly less developed and more highly protected than its fellow NAFTA members at the outset---and these same conventional approaches argued that Mexico would be expected to undergo a more painful adjustment in the earlier stages of regional integration, but over time would also reap disproportionate gains compared with Canada and the U.S.

The latter would include faster growth driven by investment and trade, but in ways that directly capture the benefits of regional integration: scale economies related to greater specialization, increased technological capabilities, and a more rapid and efficient deployment of those endowment factors for which Mexico has a comparative advantage (geographical proximity, natural resources, and an abundance of semi-skilled labor). Apart from the development opportunities that this scenario offers for Mexico itself, NAFTA's competitive potential in the long run rests in the dynamic blending of Mexico's endowment factors with the abundance of capital, technology and know-how that Canada and the U.S. bring to the table.

But has NAFTA thus far measured up to this scenario of increasing convergence between the three countries, with the U.S. largely setting the benchmarks for its partners to meet? Whereas a decade is admittedly just a moment in integration time, the data do confirm a pattern of convergence on the part of both Canada and Mexico toward the more highly developed U.S. standard in terms of macroeconomic performance---inflation, exchange rate movements, interest rates and aggregate growth. It's the microeconomic

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[19] For a good overview of these neoclassical assumptions see Timothy J. Kehoe, "Assessing the Economic Impact of North American Free Trade" in M. Delal Baer and Sidney Weintraub, eds., *The NAFTA Debate: Grappling with Unconventional Trade Issues* (Boulder, CO: Lynne Rienner Publishers, 1994), 3-29.

[20] Kerry Chase, "Economic Interests and Regional Trading Arrangements," *International Organization* 57 (2003): 141.

[21] The convergence argument is reviewed in Jeffrey Sachs and Andrew Warner, "Economic Convergence and Economic Policies." NBER Working Paper No. 5039, February 1995, and Sebastian Edwards, "Openness, Productivity and Growth: What Do We Really Know?" *Economic Journal* 108 (1998): 383-389.

track record that has thus far defied the laws of integration, at least according to the dictates of conventional trade theory.

For example, although Canadian income distribution is the most equitable in North America, Canada's purchasing power per capita remains about 75 percent of that of the U.S. and productivity and investment ratios are similarly trailing.[22] Mexico's lack of progress in the micro realm (wage rates, income distribution, productivity, innovation policies, and the enforcement of economic rules and norms) is more generalized: average annual per capita GDP has doubled since 1990, but the current rate of around US$6,000 is still far below North American standards.

Mexico's productivity rates have been higher than Canada's, but so has its pattern of un- and under-employment in the NAFTA era. Ostensibly, the combination of preferential access to the U.S. market and the exposure of Mexican firms to increased competition would induce a dynamic micro-level restructuring move favorable to wage and income gains---for example, along the lines experienced by Ireland and Spain once each integrated into the former European Economic Community. But for reasons discussed below, Mexico has yet to land on a similar path of microeconomic transformation.

Still, the macroeconomic gains for both NAFTA countries have been significant. Mexico's inflation rate, which hovered at three digits through most of the 1980s, is now running in the 4-5 percent range, and the currency regime has been modernized such that the peso now moves flexibly according to market signals. Despite the country's 1994 financial meltdown, GDP growth averaged 5.5 percent from 1996-2000, took a hit with the 2001 U.S. recession and is now running around 4 percent. With the recent completion of a painful restructuring of the domestic banking system, it is doubtful that Mexico runs the risk of another significant macroeconomic crisis on the order of the 1994 peso crash.

Given Canada's leg-up as a G-8 country at the outset of NAFTA, its macroeconomic performance has been even more impressive. As the country's longstanding mercantilist policies had virtually imploded by the early 1990s, Canadian policymakers seized the opportunity of tighter integration with the U.S. market and executed major fiscal cuts and deep structural reforms through the 1990s.[23] Although these bold moves were politically anathema to most Canadians at the time, they have paid off in spades. Since 1997 Canada has been the fastest growing G-8 economy, registering a fiscal surplus for seven consecutive years; net public debt has been reduced by nearly 30 percent of GDP and the public pension and healthcare systems are on sound fiscal footing.

While some of Canada's uninterrupted growth was due to the luck of high commodity prices since 2001, it was also policy-induced. The current gap between Canada's sound macro performance and its less dynamic micro returns suggests that policymakers may have invested too much faith in the integration process as a catalyst for microeconomic restructuring. As a 2005 report from Canada's Ministry of Economic Development and Trade notes, Canadians have simply not been "as successful as their

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[22] Hufbauer and Schott, *NAFTA Revisited*, 53.

[23] Michael Hart, *A Trading Nation: Canadian Trade Policy from Colonialism to Globalization* (Vancouver: University of British Columbia, 2002).

U.S. counterparts in creating value from our labor, intellectual, physical, and natural resources."

However, compared with Mexico's income stagnation and microeconomic disarray, Canada's adjustment lag under NAFTA amounts to just that---a productivity gap that is readily susceptible to improvement under the thrust of more assertive domestic policy reforms (e.g., tax incentives that spur rather than deter investment; increased ties between R&D, universities, and private initiative; and the application of more advanced technology to the production of goods).[24] As China's rapid entry into North American markets offers to further exacerbate the Canada-U.S. productivity gap, the domestic policy debate has become increasingly focused on ways to more directly promote Canadian competitiveness both within North America and with regard to Canada-China relations.

Mexico & the Politics of Economic Divergence

Back in the early 1990s, the eagerness of Mexican policymakers to close the NAFTA deal was such that former President Carlos Salinas vowed to forgo Mexico's developing country status at the NAFTA negotiating table. Although other developing countries like Greece, Ireland, and Spain had similarly integrated with more economically advanced countries in the context of the European Union (EU), all three registered at least double the levels of per capita income at the time of entry than did Mexico on the eve of NAFTA.[25] The EU, moreover, coupled mutual market access for these poorer entrants with development assistance to adequately prepare them for EU membership, the free movement of labor within the EU bloc and other measures meant to compensate for the steep asymmetries at hand. Not so NAFTA, which means that the huge gap between Mexico and its NAFTA partners renders this integration project one of the starkest examples of asymmetrical integration currently underway.

Even so, Mexico has benefited in spite of its decision to walk the integration tightrope with little of the EU-style preparation and supports to ease the adjustment process. The country has successfully shifted away from its heavy dependence on oil exports to a diversified mix of higher value-added goods over the past two decades. And, as Daniel Lederman and his colleagues at the World Bank's Latin America and Caribbean Division have argued, "Mexico's global exports would have been about 50 percent lower and foreign direct investment (FDI) would have been about 40 percent less without NAFTA. Also, the amount of time required for Mexican manufacturers to adopt U.S. technological innovations was cut in half…NAFTA made Mexico richer by about 4 percent of its gross domestic product (GDP) per capita."

Yet, and in contrast to the earlier entry of less developed countries into the EU, Mexico's own market restructuring program was still gathering steam in 1994, meaning that the country's political and economic elite seized NAFTA entry as a way to permanently lock-in a liberal development strategy. The risks inherent in this liberalization-cum-integration approach were made evident by the 1994 peso crash and meltdown of the country's banking system. In turn, the distributional fallout and lingering risk adversity related to these dramatic events have deterred Mexico from

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[24] Wendy Dobson, "Taking a Giant's Measure: Canada, NAFTA, and an Emergent China."

[25] Werner Baer and Larry Neal, "Introduction," *The Quarterly Review of Economics and Finance* 43 (2003): 714.

achieving the higher productivity, growth, and per capita gains that have pushed Ireland and Spain closer to the front of the economic pack.[26]

But NAFTA's designers, and the U.S. in particular, were clear from the start that this North American project would remain distinct from the EU, i.e. a free trade agreement that had no aspirations toward the creation of a fully integrated political and economic union. True to its Anglo-Saxon roots, the goal set for NAFTA was mainly an economistic one, this in itself a political decision that was cast in apolitical terms by executive leaders in all three countries.[27] But for Mexico, NAFTA entry catalyzed a long overdue process of political liberalization that culminated in 2000 in the first opposition presidential victory that the country had seen since the installation of the heavy-handed Institutional Revolutionary Party (PRI) back in 1929. Obviously, for all three NAFTA countries, the changes wrought by economic integration turned out to be profoundly political, but only in Mexico have these changes been wrenching.

EU-style supports may have facilitated a smoother pattern of adjustment for Mexico, but the lagging performance of Greece and Portugal within the EU confirms that any given country is invariably on its own with regard to engineering a full-blown economic transformation.[28] In the end, Mexico's microeconomic funk lies mainly in the frailties of domestic politics and institutions, as the country's much acclaimed democratic transition fell short of a cohesive majority coalition to usher Fox's reform agenda through the legislature.[29] The ability of the political opposition to block essential reforms in such areas as fiscal policy, industrial restructuring, and the modernization of the country's languishing energy sector has everything to do with China's impingement on Mexican exports in North American markets.

Consider, for example, the broader mix of policies that underpins China's growing presence alongside Mexico in the U.S. market: lower costs for utility inputs to industrial production; greater labor market mobility; more conducive tax incentives, and an education system that is turning out some 2 million engineers and other qualified professionals each year. Mexico's challenge will be to break out of the costly collective action gridlock that has held policymakers hostage for Fox's entire six-year term, to further modernize the country's political and economic institutions, and to orchestrate a more integrated proactive strategy that links the various macro- and microeconomic variables discussed here in ways that directly tap the country's competitive potential.

NAFTA Redux?

There are also some ways in which a revamped NAFTA could better facilitate the completion of these pending reform tasks across North America. Perhaps the most appropriate departure point for such a discussion is the 2005 Independent Task Force Report on "Building a North American Community" published by the Council on Foreign

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[26] Ramirez, "Mexico under NAFTA."

[27] Aaron Tornell and Gerardo Esquivel, "The Political Economy of Mexico's Entry into NAFTA" in Takatoshi Ito and Anne O. Krueger, eds., *Regionalism versus Multilateral Trade Arrangements* (Chicago, IL: University of Chicago Press, 1997), 25-55.

[28] Nancy Birdsall, Dani Rodrik, Arvind Subramanian, "How to Help Poor Countries," *Foreign Affairs* 84 (July/August 2005):

[29] Manuel Pastor and Carol Wise, "The Lost *Sexenio*: Vicente Fox and the 'New' Politics of Economic Reform in Mexico," *Latin American Politics and Society* 47 (2005): 135-160.

Relations.[30] The Task Force seeks to actualize commitments made at the Texas summit of March 2005, where executive leaders of the three NAFTA countries launched a new Security and Prosperity Partnership. Of the forty some proposals put forward, the most crucial ones for striking a more competitive and complementary balance in NAFTA-China relations fall in the areas of regulatory reform, strengthening regional infrastructure, increased labor mobility, and the design of a cohesive policy framework to promote competitiveness.

A much bigger push in these four issue areas offers to capitalize on the one obvious advantage that Canada and Mexico have over China: proximity to the U.S. market. While the lowering of transaction costs---the harmonization of regulatory standards and the regionalization of infrastructure networks---was ostensibly a main reason for the launching of NAFTA, progress on this front has been erratic. North American producers lobbied for NAFTA as an opportunity to reorganize their domestic operations and to develop continental-wide corporate strategies, however, in the post-9/11 era this laissez-faire approach to integration has run its course. The explosion of intra-bloc trade has swamped regional transport systems, and this, along with heightened security concerns and divergent regulatory standards has lengthened, not shortened, delays at the border.[31] On this count, the Task Force's call for a rapid expansion in border infrastructure and the immediate implementation of a North American regulatory action plan could not be timelier.

The burdensome compliance with NAFTA's rules of origin constitutes another set of barriers to the smooth flow of business, not to mention an outdated regime that has deterred privileged sectors like autos and textiles from adapting to changing market conditions. Whereas the Task Force Report proposes the replacement of these rules with a common external tariff by 2010, the complex web of bilateral trade treaties that each NAFTA member has negotiated with outsiders works directly against this recommendation. A more plausible alternative to these content rules would be to establish a common import tariff at most-favored-nation rates, as suggested by Luis de la Calle, former Mexican Undersecretary of International Trade.[32]

Increased labor market mobility is another crucial piece of this competitive puzzle, as the effect of liberalizing all other factors but labor has created integration's worst nightmare: escalating violence along the 2,000-mile U.S.-Mexico border, related partly to the northward flow of illegal Mexican migrants in search of work, and the under-utilization of those workers upon entering the U.S. job market. The economic contradictions of a "closed border" for labor are mounting, as the Bush administration's tired strategy of policing the problem has been an outright failure. The unabated rise in illegal people flows and the recent declaration of immigration-related states of emergency in Arizona and New Mexico are testimony to the need for an explicit strategy that better harnesses the potential of this highly entrepreneurial migrant labor pool.

Although here illegally, Mexican workers have filled a range of lower-paid, semi-skilled niches within the U.S. labor market, thus enabling producers in a range of sectors to achieve the productivity gains and economies of scale necessary to remain

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[30] Council on Foreign Relations, "Building a North American Community" (Independent Task Force Report No. 53, Council on Foreign Relations, New York, NY, 2005).

[31] Author's interview, Luis Gutiérrez, President, Grupo Accion, Mexico City, November 2005.

[32] Council on Foreign Relations, "Building a North American Community," 35.

competitive. Meanwhile, these same workers continue to contribute to the U.S. tax base and to social security, the returns on which most will never see, and over time they are proving to be high savers. In 2003-2004, for example, remittances sent back to Mexico outpaced the country's inflows of FDI, and continue to run at about 2.6 percent of Mexico's GDP. The Bush administration has neither tapped this economic synergy, nor has it gone after those U.S. employers who have greatly benefited from the hiring of Mexican illegals. The issue is not the lack of viable policy options, which are astutely laid out in the Task Force Report, but rather the absence of executive leadership and political will to make good on earlier promises for a more flexible immigration strategy.

Finally, the Task Force Report acknowledges the need to promote competitiveness and devise incentives for more efficient and widespread technological adaptation, especially for Mexico. Although Mexico's high-tech exports as a percent of GDP have more than tripled in the NAFTA era, most of these gains are shallowly rooted in the foreign-dominated export-processing sector. More telling indicators of competitiveness, for example Mexico's R&D expenditures and the number of patents granted, have stagnated under NAFTA and pale next to U.S. and Canadian indicators. This is one explanation for Mexico's inability to fully integrate its productive clusters in the core NAFTA sectors, for example, autos and transport equipment.

The Task Force recognizes that these markets are not just Mexico's to lose, and hence proposes the creation of a new North American Investment Fund to be financed on a sliding scale by all three countries and directed specifically toward enhanced productivity and competitiveness. This, combined with a more pragmatic approach to labor mobility, would help to reinvigorate the original rationale for NAFTA: the realization of higher productivity gains and greater market share based on the merging of Mexico's endowment factors with the abundance of capital, technology and know-how on the part of Canada and the U.S. Herein lies the ability of North American producers to position themselves further up on the industrial learning curve and more directly counter the challenges emanating from China.

For some Washington policymakers these proposed reforms will resonate too closely with the EU approach to integration. But this skirts the main point, which is the urgent need to renovate and increase the provision of public goods within NAFTA. As much as Washington may wish to abdicate on the hegemon's responsibility to lead the reform process and finance a disproportionate share of these necessary public goods, this is not an appealing option. The jury may still be out on the extent to which China can successfully juggle the political demands of economic liberalization with its own hefty backlog of reforms,[33] but there is no doubt that it will conquer vulnerable North American markets (e.g. autos) and displace Mexico altogether in some U.S. sectors without a serious departure from the current status quo.

[33] Nicholas Lardy, *China's Unfinished Economic Revolution* (Washington, DC: Brookings Institution, 1998), and Dorothy Solinger, *Contesting Citizenship in Urban China* (Berkeley: University of California Press, 1999).