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## CANADA-MEXICO TRADE: AN ARRANGED MARRIAGE COMES OF AGE<sup>†</sup>

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### SUMMARY

If Canada's interest in the North American Free Trade Agreement was in deepening regional trade integration between our economy and the U.S. and Mexico, then we could say it certainly succeeded – at least for about five years.

By 1999, however, Canada's NAFTA trade had peaked, and it has since only declined as a share of its trade with the rest of the world: from 79 to 66 per cent. Truly free trade with the U.S. has proved elusive – the number of professions granted labour-mobility concessions under NAFTA has gone virtually unchanged for 20 years – and trade irritants continue to rankle on both sides of the Canada-U.S. border (think: country-of-origin labelling and “Buy America” rules). That has left Canada looking to strike more free-trade deals in new, farther-flung markets, as a way of diversifying its export markets.

In the meantime, the low-cost labour advantages that Mexico 20 years ago offered its NAFTA partners were soon eroded by Asian emerging-market competitors, particularly China. But while Canada was scouring the globe for promising new bilateral trade partnerships, we overlooked the transformation happening on our doorstep in Mexico: it has become an especially promising emerging market itself. It has a growing consumer base, with its middle class alone exceeding the entire population of Canada. The number of Mexican students in higher education has tripled over the last three decades. Its recent economic growth rates have been 1.5 to two times higher than that of either Canada or the U.S. and its GDP is projected to quadruple by 2050, making it one of the world's five-largest economies.

Mexico has also become an enthusiastic trader, eagerly pursuing new global trade opportunities while persistently calling for the expansion of North American trade linkages, including direct bilateral deals with Canada. Meanwhile, global value chains are increasingly regional in nature, suggesting there exists a great deal of potential in a deeper relationship between Canada and Mexico, rather than each country largely relating to one another through their mutual relationship with the United States.

There are a number of barriers in the way of course. Canada is displeased with Mexico's impediments to Canadian beef imports, and Mexicans remain aggravated over Canada's heightened visa restrictions. The relationship is tepid and its future uncertain. But the two countries do have a head start in pursuing deeper integration, thanks to the common trade rules and dispute-settlement procedures already established through their partnership in NAFTA, and a closer relationship with one another would help both countries form an effective counterbalance against the U.S. on matters of joint interest.

A medium-sized economy like Canada cannot be competitive everywhere. Our greatest advantage lies at home, in North America, where we can advance our role in the regional supply chain. Putting our greatest focus on North America means intensifying our trading relationship with Mexico. Fortunately for us, it happens to be one of the most promising emerging markets in the world.

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## COMMERCE CANADA-MEXIQUE: UN MARIAGE ARRANGÉ ARRIVÉ À MATURITÉ<sup>†</sup>

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### SOMMAIRE

Si l'intérêt du Canada dans le cadre de l'Accord de libre-échange nord-américain (ALENA) était de consolider l'intégration commerciale régionale entre notre économie et celles des États-Unis et du Mexique, on pourrait dire que cette entente a été couronnée de succès, du moins pendant environ cinq ans.

Dès 1999, toutefois, le commerce canadien dans le cadre de l'ALENA avait atteint un sommet et, depuis lors, il n'a fait que décliner en tant que pourcentage de ses échanges avec le reste du monde, de 79 à 66 pour cent. L'établissement d'un véritable libre-échange avec les É.-U. s'est avéré difficile à réaliser. Le nombre de professions bénéficiant de concessions en matière de mobilité de la main-d'œuvre en vertu de l'ALENA est demeuré pratiquement inchangé depuis 20 ans et les différends commerciaux continuent à être une source de mécontentement des deux côtés de la frontière canado-américaine (il suffit de penser au marquage du pays d'origine et aux règles privilégiant l'achat de biens américains). Cela a poussé le Canada à rechercher la conclusion d'autres accords de libre-échange dans de nouveaux marchés, plus éloignés, comme moyen de diversifier ses marchés d'exportation.

Entretemps, les avantages d'une main-d'œuvre à faible coût que le Mexique offrait il y a 20 ans à ses partenaires de l'ALENA ont rapidement été érodés par des compétiteurs de marchés asiatiques émergents, la Chine en particulier. Pendant que le Canada fouillait la planète à la recherche de nouveaux partenariats commerciaux bilatéraux prometteurs, nous avons négligé la transformation qui se produisait à nos portes, au Mexique, pays qui est lui-même devenu un marché émergent particulièrement prometteur. Son bassin de consommateurs est en pleine croissance, sa classe moyenne dépassant à elle seule l'ensemble de la population canadienne. Le nombre d'étudiants mexicains poursuivant des études supérieures a triplé au cours des trois dernières décennies. Son taux de croissance économique récent a été de 1,5 à 2 fois supérieur à celui du Canada et des É.-U. et l'on prévoit que son PIB va quadrupler d'ici 2050, plaçant son économie parmi les cinq plus importantes au monde.

Le Mexique s'est également lancé avec enthousiasme dans le commerce, recherchant avidement les occasions d'échanges internationaux tout en demandant avec insistance l'expansion des liens commerciaux nord-américains, y compris des accords bilatéraux directs avec le Canada. Pendant ce temps, les chaînes de valeur mondiales sont de nature de plus en plus régionale, ce qui suggère qu'il existe un important potentiel pour approfondir la relation entre le Canada et le Mexique, plutôt que de laisser les relations entre ces deux pays dépendre de celle que chacun d'eux entretient avec les États-Unis.

Il existe, bien entendu, un certain nombre d'obstacles. Le Canada est mécontent des entraves imposées par le Mexique aux importations de bœuf canadien et les Mexicains sont exaspérés par les restrictions plus sévères en matière de visas imposées par le Canada. La relation est tiède et son avenir incertain. Les deux pays sont toutefois sur la bonne voie pour parvenir à une intensification de l'intégration grâce à des règles commerciales et à des procédures de règlement des différends communes déjà établies par l'intermédiaire de leur partenariat dans l'ALENA. Une relation plus étroite entre eux aiderait les deux pays à faire contrepoids efficacement aux États-Unis sur des questions d'intérêt commun.

Une économie de taille moyenne comme celle du Canada ne peut être concurrentielle partout. Notre avantage le plus important, on le retrouve ici, en Amérique du Nord, où nous pouvons faire progresser notre rôle dans la chaîne d'approvisionnement régionale. La priorisation de l'Amérique du Nord signifie l'intensification de notre relation commerciale avec le Mexique. Heureusement pour nous, il se trouve qu'il s'agit là de l'un des marchés émergents les plus prometteurs au monde.

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## INTRODUCTION

With the 1994 North American Free Trade Agreement (NAFTA), Canada and Mexico entered a trade relationship for which there was little commercial rationale at the time because the two countries had few direct trade linkages or interests. But, ready or not, NAFTA provided key mechanisms to bring the two economies together. The two now share common trade rules, dispute-settlement procedures, and integrated supply chains. Twenty years after the start of this uncertain courtship, the NAFTA framework not only provides the foundation for North American competitiveness, it provides Canada with a fast-growing emerging-market partner with a large consumer class and affordable labour, and provides Mexico with a source of innovation and investment.

Why haven't Canada and Mexico focused more on their two-way trade, apart from their trade with the United States? Perhaps both parties have become accustomed to the mutual relationship playing second fiddle to the opportunities and irritants of their larger relationship with the U.S. And, while Mexico continues to reach out to Canada, the Canadian government seems to prefer the novelty of farther fields in its emerging-market prospects, overlooking the thriving Mexican market, with whom it already shares an integrated trade-regulatory regime.

The economic complementarity between Canada and Mexico was not particularly strong when NAFTA was signed in 1994, but both economies have changed and evolved over the ensuing decades. Mexico has become the kind of export and production partner that Canada needs. It has a large, youthful market to complement Canada's relatively small and aging market. Mexico's pool of affordable skilled labour is ideally suited to help Canadian manufacturers deal with the conundrum of high domestic innovative capacity constrained by high domestic labour costs. Canada and Mexico are not merely spokes in a U.S. production hub; they have developed mutual synergies that are woefully underdeveloped.

The NAFTA relationship is a foundation for North American competitiveness in the world. By neglecting or mismanaging it, we are hurting our own prospects for future economic sustainability. This report discusses the evolution of Canada-Mexico economic engagement; opportunities and challenges within the North American regional value chain; and provides recommendations for maximizing the benefits of the relationship.

## RELUCTANT SUITORS

In the early days of NAFTA, there were few natural trade complementarities between Mexico and Canada. Mexico was an exporter of raw commodities and a producer of petroleum products; Canada had a similar commodities endowment but also had manufactured goods and services to sell. High levels of Canadian exports to Mexico were unlikely because, in the early 1990s, Mexico's economy was volatile, burdened by macroeconomic instability and a weak consumer base. Canada-Mexico trade has also been hindered by differing languages and cultural backgrounds, a small intercultural diaspora, and the fact that the U.S. market is much larger, closer and easier to access for both countries.<sup>1</sup>

Fast-forward 20 years and a lot has changed. The NAFTA-led reductions in tariff and non-tariff barriers provided Canada and Mexico with significant trade gains in the United States. The WTO Uruguay Round, completed in 1994, brought a number of new emerging markets into the international trading

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<sup>1</sup> Canada insisted on being added to the U.S. bilateral agreement with Mexico out of concerns that its preferences in the Canada-U.S. Free Trade Agreement (1989) would be eroded through the new agreement. See Laura Dawson, Christopher Sands and Duncan Woods, *North American Competitiveness: The San Diego Agenda* (Dawson Strategic, Hudson Institute, Institute of the Americas and Mexico Institute, November 2013). Mexico probably would have preferred to maintain a bilateral negotiation, but it wanted a free-trade agreement (FTA) with the U.S. and was willing to accept the request to add Canada to facilitate completion of the negotiation.

system and pushed established, industrialized economies to reduce their tariffs even further to maintain cost competitiveness.

China's 2001 entry to the WTO was a major disruption to North America's trade-integration trajectory. While trade among the NAFTA partners has continued to grow, new trade growth peaked in 1999 and has declined since then. Table 1 shows how Canada's NAFTA trade has not kept pace with its trade with the rest of the world.

**TABLE 1**

Year	Canada Trade with World			Total NAFTA Trade as % of Total World Trade
	Exports	Imports	Total Trade	
1994	165,220	148,425	<b>313,644</b>	76
1995	191,062	164,315	<b>355,377</b>	75
1996	202,286	170,564	<b>372,849</b>	76
1997	215,296	197,149	<b>412,445</b>	76
1998	214,707	201,202	<b>415,909</b>	78
<b>1999</b>	<b>239,198</b>	<b>215,635</b>	<b>454,833</b>	<b>79</b>
2000	278,218	240,363	<b>518,581</b>	78
2001	260,959	221,581	<b>482,539</b>	78
2002	252,416	222,216	<b>474,632</b>	78
2003	271,966	239,837	<b>511,803</b>	76
2004	316,762	273,427	<b>590,190</b>	75
2005	360,164	314,360	<b>674,524</b>	73
2006	388,314	350,113	<b>738,427</b>	71
2007	418,978	378,953	<b>797,931</b>	70
2008	453,560	407,135	<b>860,695</b>	68
2009	315,036	319,945	<b>634,981</b>	66
2010	387,290	391,994	<b>779,284</b>	66
2011	452,424	451,353	<b>903,777</b>	65
2012	454,643	462,257	<b>916,900</b>	66

Source: Statistics Canada, U.S. Census Bureau, and Mexico Ministry of Economy.  
Units: Value in millions of U.S. dollars.

After just five years, the NAFTA honeymoon was over. The lower-cost labour advantages offered by other emerging-market competitors — particularly China, but also South Korea, Vietnam and other participants in Asian supply chains — eroded Mexico's labour-cost advantages and virtually eliminated low-wage assembly jobs in Canada and the United States. New emerging-market competitors caused investment and production to flow from North America to Asia, marking a fundamental change from national to global production chains.

The NAFTA advantages were not totally eliminated by Chinese competition because labour costs are not the only factor informing business investment decisions. As General Electric vice-president Karan Bhatia notes, multinationals also consider productivity, access to markets and human resources when deciding where to invest.<sup>2</sup> Also, for those companies that already had sunk costs in North American supply chains, it was not feasible to relocate again to China. Fortunately, after the first wave of offshoring to Asia was complete, many Canadian business owners realized that North American supply chains offered superior benefits.

<sup>2</sup> World Economic Forum, *The Shifting Geography of Global Value Chains: Implications for Developing Countries and Trade Policy* (2012), 7.

Among Mexico's advantages are: cheaper and faster shipping to customers in the U.S. and Canada;<sup>3</sup> a skilled (and rapidly skilling) workforce; and a good (and improving) logistics network to ensure a reliable source of supply. The CEO of Canada's Palliser Furniture notes, for example, that if a machine breaks down at his Winnipeg plant, his Mexican team can seamlessly manufacture and ship product to a customer with no deviations in price, time or quality.<sup>4</sup> Even on labour costs, Mexico has managed to remain competitive, since wage rates in Mexico have not been rising as quickly as China's have.<sup>5</sup>

As the global economy has changed, so too have the NAFTA economies. Canada's most successful manufacturers have kept knowledge- and capital-intensive activities at home, but have had to offshore basic assembly jobs to lower-cost locations. As global competition increases, Canada's success relies on staying at the front end of the innovation cycle, finding ways to commercialize and market technology, maintaining a highly skilled workforce, and reducing unnecessary transaction costs such as border barriers and regulatory red tape.

The United States, while still the largest economy in the world, is shrinking in terms of relative market power, demand, and productive capacity. Within NAFTA, U.S. firms are increasingly supply-chain partners with, not competitors to, companies in Canada and Mexico. The uncertainty over who is a partner and who is a competitor has created a policy ambivalence in the U.S. It is no longer a simple matter for Congress to protect domestic jobs by closing markets, when U.S. exporters are demanding that legislators open new global markets and foster integrated supply chains.

The promise of NAFTA was to create a single, borderless market for the movement of goods, services, investment, people and ideas. While the reality has fallen far short of the promise, government policies based on blunt mercantilism that do not acknowledge the realities of cross-border supply chains are no longer satisfactory to either producers or consumers.

The transition from national to transnational production has been particularly difficult for U.S. trade policy-makers. Since the mid-1990s, policy has tended to make wide swings between market-seeking and market-closing behaviour, with neither direction fully dominant. These divisions are exacerbated by a highly polarized and non-productive Congress, meaning that the U.S. can do very little that requires legislative action. This also helps explain why U.S. political leadership on North American integration has been absent during the Obama presidency and why the U.S., as the leading protagonist of the Trans-Pacific Partnership, has struggled to get Trade Promotion Authority from Congress. It also helps to explain the contradiction between U.S. statements about the need to upgrade NAFTA within new trade arrangements with Asia and the European Union, but the lack of any formal consultative mechanisms through which to operationalize this co-operation within current trade negotiations.<sup>6</sup>

## **MEXICO COMES INTO ITS OWN**

Mexico meanwhile, has been actively pursuing an outward-oriented economic policy and today has 12 free-trade agreements involving 44 countries on three different continents, providing preferential access to a potential market of more than 1 billion consumers and investors.<sup>7</sup> Mexico (together with Canada)

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<sup>3</sup> A container leaving Shanghai takes around 31 days to reach New Jersey; a similar container from Veracruz takes five days.

<sup>4</sup> Comments from Art deFehr, CEO of Palliser Furniture (December 2013).

<sup>5</sup> "Mexico hourly wages now lower than China's – study," Reuters, April 4, 2013.

<sup>6</sup> U.S. Commerce Secretary Penny Pritzker has frequently called NAFTA outdated and in need of reform. See United States, Department of State/IIP Digital website, "Commerce Secretary Pritzker on U.S.-Mexican Economic Relations," statement (February 2014).

<sup>7</sup> Canada currently has free-trade agreements in force with 15 countries. Its recently completed agreements with the EU and South Korea bring this number up to 44, but the latter agreements may not take effect for months or years.

entered the TPP negotiations in 2012 and its FTA with the European Union took effect in 2000. In June 2013, Mexico signed the so-called Tequila Agreement aimed at increasing Mexico's exports to China and reducing its trade deficit with that country.<sup>8</sup>

Since 1994, Mexico has engaged in an ambitious campaign of economic and governance reforms. While there is still room for improvement, adherence to the rule of law, transparent dispute settlement and commercial law practices that are broadly similar to Canada's, make Mexico a much easier market for Canadian businesses than other developing countries in Asia, Africa or Eastern Europe.

Of particular interest to Canada is Mexico's leadership in the Pacific Alliance. The alliance is a progressive group of like-minded Latin American traders — including Mexico, Colombia, Peru and Chile — that goes beyond traditional trade agreements to include advantageous provisions on rules of origin, labour mobility, regulatory alignment and even a common stock exchange. While Canada has not joined the Pacific Alliance negotiations, it has become an interested observer with the June 2014 meeting attended by Canada's Minister of Foreign Affairs, John Baird.

Mexico's aggressive external-trade and domestic-reform campaign is dispelling any notions of that country as a junior partner in need of bolstering from more advanced economies. Mexico has doggedly pursued new global trade opportunities while continuing to call for the expansion of North American trade linkages by any means possible, including direct bilateral deals with Canada.<sup>9</sup>

Among Mexico's strengths are a growing consumer base and an increasingly educated workforce. Goldman Sachs predicts that by 2050, Mexico will be one of the world's five largest economies and its GDP will quadruple to \$9.3 trillion.<sup>10</sup> Recent growth rates<sup>11</sup> have been 1.5 to two times higher than those of the United States or Canada. In February 2014, Moody's elevated Mexico's credit rating, making it the second Latin American economy after Chile to achieve an A-grade rating.

With a total population of 122 million, not only is the Mexican market more than three times the size of Canada's, Mexico's middle class alone exceeds the entire population of Canada.<sup>12</sup> Mexico also boasts substantial increases in GDP per capita and has seen a tripling of the number of Mexican students in higher education over the last three decades.<sup>13</sup>

Mexico still has many challenges, however. Topping the list is crime, which serves as both a real and psychological barrier to potential investors. While big companies are better able to insulate themselves from security challenges than are smaller ones, a *Financial Times* editorial speculated that insecurity has become the number one deterrent to all sorts of investors because of perceptions that weak rule of law in the criminal sphere will also affect economic activities.<sup>14</sup>

In 2006, Mexico's then president Felipe Calderón launched a crackdown on Mexico's extensive narco-trafficking networks. While successful in breaking up large cartels, these efforts also succeeded in

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<sup>8</sup> Neither Canada nor the United States have a bilateral free-trade agreement with China.

<sup>9</sup> Mexican Ambassador to Canada Francisco Suarez Davila, is a forceful advocate for closer Canada-Mexico relations. See Campbell Clark, "Mexico pushes for direct ties with Canada, apart from U.S. influence," *The Globe and Mail*, June 17, 2013.

<sup>10</sup> Goldman Sachs Global Economics, *The BRICs 10 Years On: Halfway Through the Great Transformation* (December 2011).

<sup>11</sup> Mexico's real GDP growth rates were 3.6 per cent for 2012, 1.2 per cent (est.) for 2013, and 3.4 per cent (est.) for 2014. Source: CIA World Factbook and Banco de México.

<sup>12</sup> The Migration Policy Institute estimates that Mexico's middle class is between 30 and 60 per cent of the population, or 37 to 74 million people. Migration Policy Institute and Woodrow Wilson Center, "Thinking Regionally to Compete Globally: Leveraging Migration & Human Capital in the U.S., Mexico and South America" (May 2013).

<sup>13</sup> *ibid.*

<sup>14</sup> *Financial Times*, "Mexico is struggling in battle for rule of law: The country needs security and order as much as economic reform," October 2014.

splintering large, professionalized networks into decentralized local gangs engaged in violent turf wars and extortion, often under the protection of local police forces. The 2014 kidnapping and murder of 43 students ignited social unrest and threatens to destabilize the government. In response, current President Enrique Peña Nieto has committed to imposing state and federal control over those police forces with corrupt or criminal ties, and establishing special economic zones in the poorest regions<sup>15</sup> where crime rates are also the highest.<sup>16</sup>

Although Mexico's economic growth over the past two decades has been impressive, it has not been enough to make the leap from a developing economy to developed one. It continues in a state of semi-dependence, unable to attract sufficient (or the right kind of) investment to add more domestic value added to the production cycle.<sup>17</sup> As the Mexican business press observed, "Mexico is a country that re-exports what it imports but produces very little on its own."<sup>18</sup> Through economic and fiscal reforms undertaken by the Peña Nieto administration, Mexico is focused on renewing its industry to become more export competitive. In the meantime however, Mexico is challenged with creating enough jobs to keep up with population growth. (The gap between job creation and population growth explains why Mexico's wage growth rates are relatively flatter than China's.)

Analysis by the Mexico Institute suggests there is a weak structure in place linking the country's public policies, education system, and private sector. "Even with its most skilled labor force ever, Mexico is experiencing limited job creation and low labor force productivity."<sup>19</sup> Lack of funding for innovation through government and private-sector investment had dampened Mexican productivity and eroded international competitiveness, especially in relation to China, which has boosted its investment in science and technology. In its outreach to potential foreign investors, Mexico has therefore put increasing focus on R&D, training and innovation partnerships. The efforts of Bombardier and Mexican officials to create an aerospace-training network that includes Montreal and Querétaro is cited as a model project to be emulated in other sectors.

## STATE OF THE RELATIONSHIP

Even though NAFTA'S economic integration project included partners that were either mismatched or simply reluctant, Canada and Mexico now have an advantage that few global trading partners enjoy. While most free-trade agreements in force today have been signed within the last decade, the NAFTA partners have more than two decades of experience with transparent trade rules and mechanisms for dispute settlement, leading to the growth of strong trilateral supply chains in such sectors as automotive, aerospace and agrifoods.<sup>20</sup>

But despite strong prospects and isolated success stories, the current state of the Canada-Mexico relationship is tepid and future growth is uncertain. One reason for this is asymmetrical investment flows. Business and supply-chain integration depends on robust two-way investment. While some Canadian businesses such as Scotiabank (finance), Bombardier (aerospace and rail), Linamar (auto parts), and Newgold (mining) have done very well in Mexico, the same cannot be said for Mexican investment in Canada. Mexican outbound investment has been increasing in other parts of the world,

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<sup>15</sup> Guerrero, Oaxáca and Chiapas.

<sup>16</sup> Claudio Herrera-Pahl, "For a Powerful Mexico Without Organized Crime," *Deutsche-Welle*, November 2014.

<sup>17</sup> Jorge Castañeda, "The View From Mexico," *Foreign Affairs*, January 2014.

<sup>18</sup> Comercio Exterior y Logística, "Del TLCAN al TPP" (March 2014).

<sup>19</sup> Duncan Wood, Christopher Wilson and Alejandro Garcia, "Fostering Innovation in Mexico: Ideas from the High-Level Innovation Forum for Policymakers" (Mexico Institute, Woodrow Wilson Center, September 2014).

<sup>20</sup> Of the more than 240 regional free-trade agreements notified to the WTO, only about 40 of them predate NAFTA.

but Canada has done a poor job in attracting it. In 2012, Mexico had outward foreign direct investment (FDI) flows of more than \$26 billion, acquiring companies in the United States, the European Union, and Latin America. The 2014 acquisition of Canada Bread by Grupo Bimbo may signal a change from the predominantly one-way investment flows.

Secondly, most aspects of the Canada-Mexico economic relationship are mediated by the United States, and Canadian officials have shown a marked preference for dealing with the U.S. directly on trade matters rather than through a trilateral framework. Consequently, both Canada and Mexico have established bilateral dialogues with the United States on regulatory co-operation, energy and border measures, but Mexico and Canada do not have a formal mechanism for communicating with each other on these issues.

Finally, certain irritants between the two countries have gone unresolved and are undermining the relationship. For Canada, an outstanding concern has been the restoration of market access for Canadian beef following the BSE scare of 2003.<sup>21</sup> For Mexico's part, the continuation of a supposedly temporary visa requirement by Canada on Mexican nationals is considered by Mexican business and government leaders to be intrusive and insulting.<sup>22</sup> Canada has been paying the price in terms of sharply reduced tourist flows and untold losses in goodwill and potential business investment. Rumours of a streamlined entry system modelled on the U.S. Electronic System for Travel Authorization have not been confirmed.

Is this relationship worth the effort? The following section discusses how regional value chains are the key to competitiveness in the global economy and the ways in which Mexico and Canada are interdependent partners and allies within the North American value chain.

## THE POLITICAL ECONOMY OF GLOBAL AND REGIONAL VALUE CHAINS

The term global value chain (GVC) describes the disaggregation of sourcing, production, and distribution across multiple sites within and across national borders. GVCs rose to prominence in the 1980s as technological advances made it easier to move goods, capital and digital services across long distances. These advances also made it easier for global producers to source lower-cost labour and other resources from developing countries

In order to take advantage of value-chain efficiencies, companies set up plants or affiliates in new markets, what Markusen calls vertical investment.<sup>23</sup> These investment decisions are based on complex sourcing and integration strategies that evaluate trade costs and comparative advantages across the stages of production.<sup>24</sup> Intermediate goods cross and re-cross national borders many times on the road to becoming a finished good.

The foreign-content share in global exports has almost doubled since 1970.<sup>25</sup> Thus, the internationalization of production blurs the line between domestic and international policies and overturns the distinctions between allies and competitors. For instance, Mexican exports to the U.S.

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<sup>21</sup> Two-way beef trade has opened up considerably in 2014 as a result of co-operation between Mexican and Canadian food safety authorities to achieve mutual recognition of standards and inspections.

<sup>22</sup> CBC news, "Mexico 'really mad' at Canada for imposing travel visas," September 2013.

<sup>23</sup> James R. Markusen, "Multinationals, Multi-Plant Economies, and the Gains from Trade," *Journal of International Economics* 16, 3-4 (1984).

<sup>24</sup> International Monetary Fund, *Trade Interconnectedness: The World With Global Value Chains* (August 2013), 30.

<sup>25</sup> *ibid.*, 3.



include an average of 40 per cent U.S. content, and Canadian exports to the U.S. contain an average of 25 per cent U.S. content.<sup>26</sup>

Integration is not limited to manufacturing and commodities. Services are also key to global value chains. For example, more than 30 per cent of the value of a finished automobile comes from services.<sup>27</sup> Canada has room for growth in services exports. While 70 per cent of domestic GDP is derived from services, only about 15 per cent of Canadian exports are service exports.<sup>28</sup>

The benefits of vertical integration are now being realized. Higher national growth rates are associated with more intensive participation in global value chains.<sup>29</sup> The greatest growth benefits go to those economies and enterprises with the highest levels of value added in their exports as well as their imports.<sup>30</sup>

Growth has been particularly strong in emerging markets that rely heavily on advanced economies for sophisticated intermediate inputs required for final products to export.<sup>31</sup> Cross-border production stimulates technical improvement and knowledge spillovers, encourages competition, and leads firms toward more productive activities.<sup>32</sup>

But, there is a downside. The interdependence created by value-chain participation also increases vulnerability to political and economic shocks transmitted across national borders, particularly supply-and-demand disruptions.<sup>33</sup> Therefore, policy co-ordination is necessary in order to minimize external shocks.

## REGIONAL VALUE CHAINS

True global value chains are, in fact, quite rare and limited to some of the world's largest corporations such as General Electric and Nestlé. Regional value chains are more common because the production cycle is very sensitive to distance — fuel costs, shipping time, etc. — especially when moving intermediate goods through a geographically disaggregated production cycle.<sup>34</sup>

Canadian auto parts companies working in Mexico report that manufacturers want their suppliers within 100 miles of assembly operations.<sup>35</sup> Efficient value chains require face-to-face interaction, dependable sources of supply, and easy movement of capital, goods and people.

Today, global production is centered in Asia, North America and Europe, and each regional “factory” is directed by a “hub.” Control of technology and markets influences a region's benefits and determines its position as a hub or spoke. Hub economies, such as the U.S., Japan, and Germany, orchestrate the

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<sup>26</sup> Christopher Wilson, *Working Together: Economic Ties Between the United States and Mexico*, Mexico Institute, Woodrow Wilson International Center for Scholars, November 2011.

<sup>27</sup> World Economic Forum, *The Shifting*, 18.

<sup>28</sup> DFATD, *Canada's State of Trade and Investment 2014*.

<sup>29</sup> Gianluca Orefice and Nadia Rocha, “Deep Integration and Production Networks: an Empirical Analysis,” World Trade Organization Staff Working Paper ERSD-2011-11 (Geneva: World Trade Organization, 2011).

<sup>30</sup> International Monetary Fund, *Trade Interconnectedness*, 11-12.

<sup>31</sup> *ibid.*, 3.

<sup>32</sup> *ibid.*, 11.

<sup>33</sup> *ibid.*, 3.

<sup>34</sup> Richard Baldwin, “WTO 2.0: Global Governance of Supply Chain Trade,” Centre for Economic Policy Research, Policy Insight No. 64 (December 2012), 5.

<sup>35</sup> Author's interviews, December 2013.

production networks, while spoke economies such as Canada and Mexico compete to attract offshored jobs and investment.<sup>36</sup>

There are large flows of goods and services between the hub and the spokes, but flows between the spokes are small. This therefore contributes to the misperception that Canada and Mexico are not important to each other's trade prospects. Even though direct trade flows between the two are small, the regional (NAFTA) supply chains are critically important, even if the trade is mediated by the U.S. hub.

Canada operates as a spoke in the NAFTA supply chain, but it is a spoke that provides both primary commodities, such as petroleum, minerals and grain, as well as capital-intensive activities requiring higher skills or technology. For its part, Mexico provides labour-intensive inputs, but it also has a large domestic market, and preferential access to some markets that Canada and the United States do not have.

In order to prosper and grow, Canada does not have to control all nodes of the value chain, but it must have preferential access to all of them. Mexico and Canada thus have high levels of complementarity in terms of their capacities and future prospects. Interviews with Canadian and Mexican businesses reveal many examples of virtuous circles where, for instance, Canada provides the designs, Mexico provides the assembly, and later, Mexico also introduces innovations to the production process that are subsequently adopted in both Canada and Mexico.<sup>37</sup>

## VALUE-CHAIN GOVERNANCE AND POLICY

The proliferation of free-trade agreements in the 1990s and 2000s cut many of the costs of cross-border production by lowering tariffs, but these early agreements did little to reduce non-tariff or "behind-the-border" barriers such as regulatory differences, and transportation and logistics bottlenecks.

Regional and multilateral free-trade agreements helped to reduce the cost of importing inputs from, and selling products to other countries. But, as competition among regions increases, progressively greater efficiencies are required. The success of a regional value chain depends on its ability to maximize the complementary endowments of all members while minimizing costs associated with the cross-border movement of goods, services, knowledge and people.<sup>38</sup>

The need for deeper integration and co-ordinated behind-the-border policies has been a major challenge in North America because of NAFTA's weak trilateral governance and renewal arrangements. Unlike the European Union, North America lacks a strong supranational governance mechanism and improvements to NAFTA have tended to be marginal and under the radar.<sup>39</sup> Of the many NAFTA working groups formed to monitor implementation of the agreement, only highly technical groups covering such subjects as rules of origin and pesticide limits have managed to fulfill their original mandate. By contrast, the list of professions granted labour-mobility concessions under NAFTA has gone virtually unchanged for 20 years.

The prospect of formally re-opening NAFTA sends U.S. politicians running for cover. Canadian trade officials meanwhile have adopted a "NAFTA if necessary, but not necessarily NAFTA" approach as they struggle to maintain privileged access to U.S. markets while managing complex negotiations in the

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<sup>36</sup> Baldwin, "WTO 2.0," 5.

<sup>37</sup> See case studies in Laura Dawson, *Canada's Trade With Mexico: Where We've Been, Where We're Going and Why It Matters* (Canadian Council of Chief Executives, February 2014).

<sup>38</sup> International Monetary Fund, *Trade Interconnectedness*, 27.

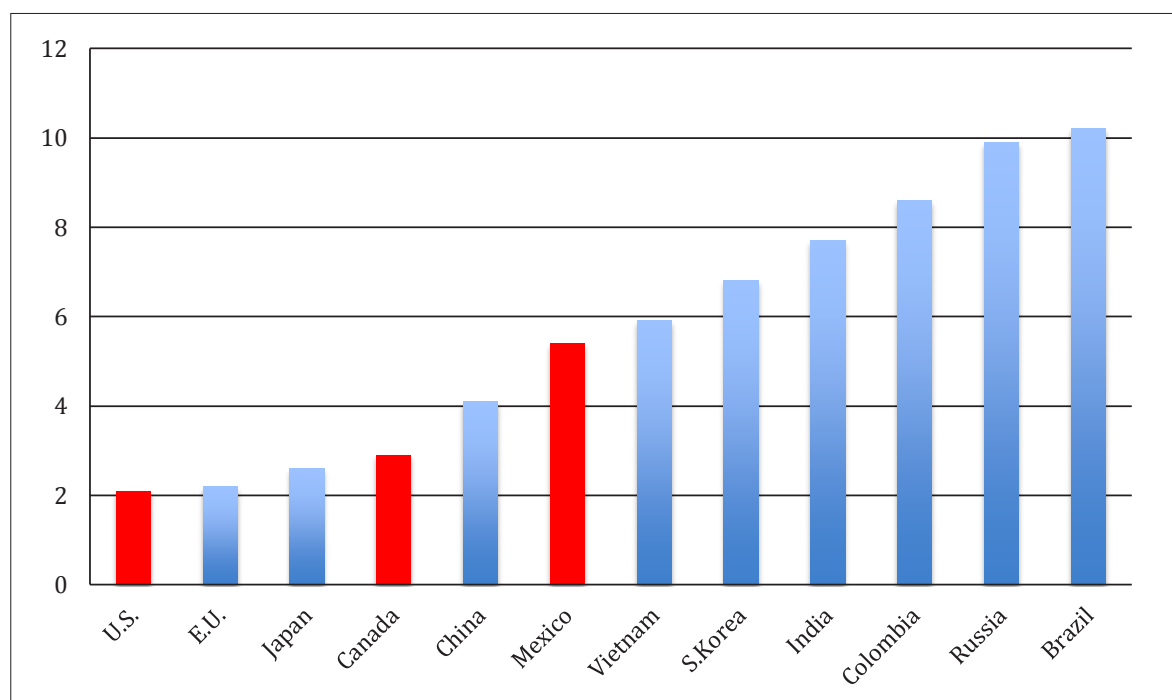
<sup>39</sup> Rules of origin, for example, have been successfully updated through a relatively straightforward notification system, but few of the NAFTA working groups established to support and expand the relationship, such as the working group on temporary entry (labour mobility), now have any substantive contact.

European Union, Asia Pacific, India, Japan, South Korea and the Caribbean, as well as various WTO commitments.

Baldwin<sup>40</sup> argues that traditional trade rules were designed with the goal of helping exporters sell finished products in other countries. To support this, the early days of GATT and WTO negotiations were focused on tariff reduction. Today, with average trade-weighted tariffs at low levels among industrialized states (see Figure 1), the focus for NAFTA trade policy is on behind-the-border measures such as reducing the administrative burden of rules of origin.<sup>41</sup>

Reduction of non-tariff barriers becomes even more important as more small and medium-sized enterprises (SMEs) enter the trading system. Large companies can afford workarounds for inefficient and duplicative policies — some may even benefit from competitive advantages of operating in markets that are too expensive for other firms — but SMEs require a supportive and transparent regulatory environment to operate successfully in multiple jurisdictions. Since proximity means that NAFTA partners are each other’s most likely first trading partners for new exporters, the importance of reducing red tape and transaction costs within North America is that much greater.

**FIGURE 1: AVERAGE INDUSTRIAL TRADE-WEIGHTED<sup>42</sup> TARIFFS (PER CENT)**



Source: WTO, “Tariff and Tariff Indicators,” 2011, “<http://www.wto.org>”[www.wto.org](http://www.wto.org).

The benefits of trade agreements diminish in relative terms over time as firms become more competitive. As discussed earlier, the growth benefits of NAFTA were largely absorbed in the first five years of the agreement’s existence. In order for firms to remain competitive, behind-the-border policies must be continually broadened and deepened through new trade agreements and other instruments. This has given rise to mega-regional negotiations such as the Trans-Pacific Partnership and the U.S.-EU Transatlantic Trade and Investment Partnership (TTIP). The disadvantage of deep integration within

<sup>40</sup> Baldwin, “WTO 2.0.”

<sup>41</sup> In negotiations with emerging markets, there remains a dual focus on tariff and non-tariff measures.

<sup>42</sup> Trade weighting puts more emphasis on products with relatively higher import levels, indicating products that are more likely to be moving through supply chains.

regional trade agreements, as opposed to the inclusive WTO, is that it risks creating regulatory segmentation, exclusion and discrimination.<sup>43</sup>

The question for Canada then is, what are the risks and opportunities of investing in deeper NAFTA integration? As stated above, truly global value chains are rare, so the proximity and familiarity benefits of regional value chains make them the best option for all but the largest enterprises.

Although it is possible to maintain footholds in a number of global markets, the fragmentary nature of regional trading blocks makes it very difficult for a medium-sized economy like Canada to be equally competitive everywhere in the world. Consider, for example, the regulatory differences between the United States and the European Union in their respective treatment of genetically modified organisms, vehicle safety standards or even the naming of cheese. For a medium-sized economy like Canada, to align with one large market is to disadvantage itself in another large market, at least until the two giants work out a common position between them.

## **A STRONGER CANADA-MEXICO RELATIONSHIP WITHIN A STRENGTHENED NAFTA**

Canada's relative competitiveness within NAFTA is not as strong as it could be. Canadian enterprises could control more aspects of sales and sourcing — more nodes of the supply chain — through investment and location in Mexico and the United States. Without these ownership benefits, Canada remains a spoke with low market power within the NAFTA relationship.

Canada's strength in Mexico's mining, aerospace and financial-services sectors is indicative of Canada's ability to expand further. Canadian entrepreneurs who have expanded to Mexico note that diversification has helped to counterbalance currency and demand fluctuations.<sup>44</sup>

Closer engagement with Mexico will also help Canada to strengthen its bargaining position with the United States; the two countries can form an effective counterbalance against the United States on matters of joint interest. Exploratory discussions on regulatory co-operation and border measures are a logical first step and, in October 2014, a Mexican observer was sent to the annual meeting of the Canada-U.S. Regulatory Cooperation Council.

A strengthened relationship with Mexico will also help Canadian small and medium-sized enterprises (SMEs). With the growing presence of larger Canadian firms in Mexico, Canadian SMEs can expand their business to Mexico, docking onto established supply chains to mitigate risk.<sup>45</sup> In an interesting variation of this strategy, Canadian high-tech companies are locating in southern California in order to reap the dual benefits of U.S. know-how and venture capital as well as lower-risk access to Mexican markets and skills.<sup>46</sup> A foothold in Mexico also provides Canadian firms with business acumen to help in expanding into other parts of Latin America.

Low levels of migration between Mexico and Canada are an impediment to the relationship. But while permanent migration from Mexico to Canada remains flat, Canada's temporary foreign worker program has helped to facilitate the movement of Mexican workers to Canadian regions experiencing skills shortages (see Figure 2). In the other direction, Mexico's friendly climate continues to be a draw for Canadians. More than 1.5 million Canadians visit Mexico annually for tourism and unofficial estimates

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<sup>43</sup> Baldwin, "WTO 2.0," 12.

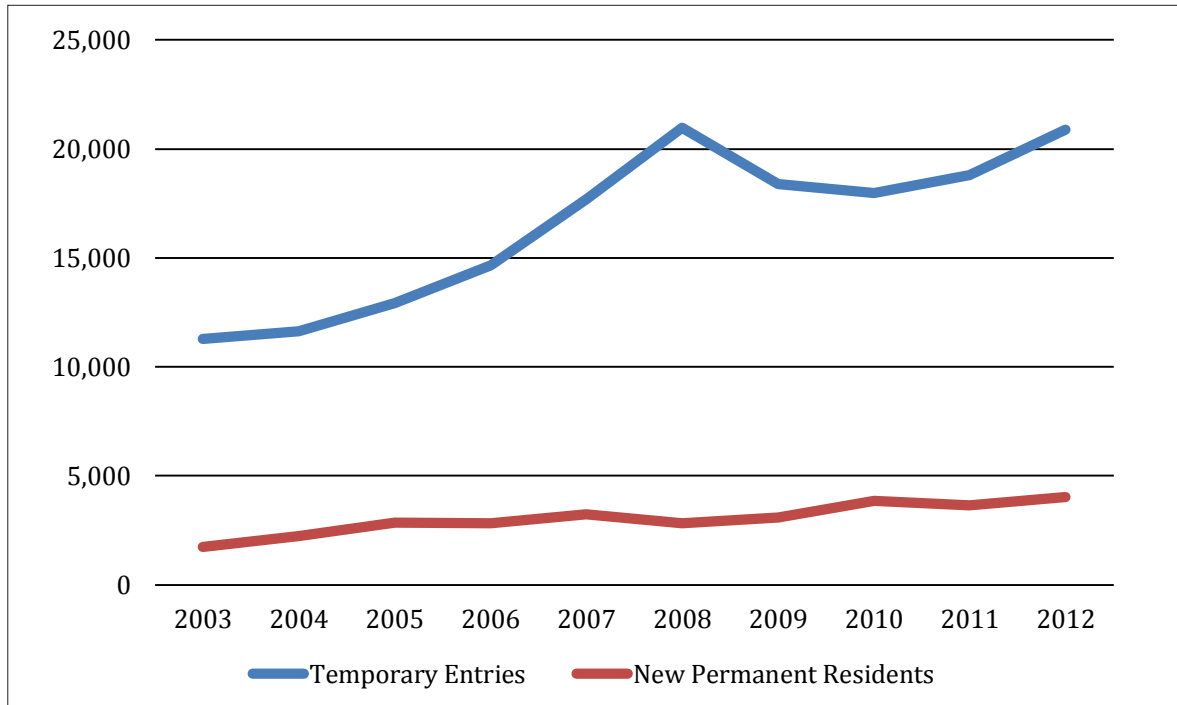
<sup>44</sup> Communications with Art deFehr, CEO of Palliser Furniture.

<sup>45</sup> Export Development Canada promotes protocol agreements to encourage foreign multinationals to include Canadian firms in global supply chains. Such agreements have helped Canadian firms enter Mexico.

<sup>46</sup> The San Diego-Tijuana mega-region is one area where this phenomenon is taking place.

from the respective embassies suggest that there are about 100,000 continuing Mexican residents of Canadian origin and the same number of Canadian residents of Mexican origin.

**FIGURE 2** MIGRATION FROM MEXICO TO CANADA (FLOW)



Source: Citizenship and Immigration Canada, 2012.

## MEXICO'S REFORM AGENDA

In 2013 Mexican President Peña Nieto launched a far-reaching reform agenda covering energy, telecommunications, finance, fiscal policy, education and labour. If successful, the reforms will increase economic opportunities for Mexicans and build the country's stock of social capital. As a trading partner, Mexico will become more stable and prosperous and some of the reforms will provide new opportunities for Canadian entrepreneurs and investors as well.<sup>47</sup>

Of particular interest to Canada are the energy reforms that will grant foreign companies exploration and extraction rights, effectively ending Mexico's national energy monopoly. The state corporation *Petróleos Mexicanos* (Pemex) will become just one competitor among many. There are currently 80 to 85 Canadian companies active in the Mexican oil and gas sector. If the reforms are successful, there may be considerable opening for foreign participation in upstream, midstream, and downstream activities. Of particular interest to Mexico are foreign investments in fracking and deep-water activities.

Even though Mexico has agreed to the constitutional changes necessary to carry out the reforms, passage of secondary laws to establish a new contracting regime will not be easy and administrative details are beyond challenging. But in the end, a more open and vibrant energy sector should provide opportunities to Canadian companies, particularly service companies, although increased Mexican crude oil output could also compete with Canadian exports in the future.

<sup>47</sup> While many of these reforms have passed initial congressional hurdles, the bigger challenges of secondary legislation and reform implementation remain.

## Fiscal Reforms

Mexico's fiscal reforms are intended to help alleviate poverty and income inequality by increasing tax revenues. At around 10 per cent of GDP, Mexico has one of the lowest tax-revenue levels in Latin America and the government depends on energy returns from Pemex for a third of its revenue.<sup>48</sup> While Mexico's reforms run the gamut of new revenue schemes, including a junk food levy, new taxes on mining profits are of major concern to Canadian investors. If successful, the new laws will impose a 7.5 per cent mining royalty on earnings before interest, taxes, depreciation and amortization. Other reforms that may affect Canadians are new value-added taxes in the *maquiladora* (contract manufacturing) sector and new taxes on stock market profits and dividends.

## Banking and Financial Services Reforms

Mexico's January 2014 financial-services reforms seek to increase competition and lower the cost of borrowing by businesses and consumers. This is especially important for Mexico's SMEs, which make up 35 per cent of the GDP and contribute seven out of 10 jobs to the formal economy.<sup>49</sup> Overhauls to the banking legislation will make it easier for commercial banks such as Scotiabank Inverlat to offer more secure low-interest loans to a broader range of borrowers.

## CONCLUSIONS

The clear option for Canada is to put its greatest focus on North America. We cannot be equally competitive everywhere and North America provides the greatest rewards for the least investment at the lowest risk. As a long-term strategy, Canada should continue to be involved in negotiations in Asia, Africa and elsewhere in the world to take advantage of new opportunities as they arise, but in the immediate term Canada must focus on NAFTA.

During the current lull in U.S. political attention and capacity, there is not much more that Canada can do to cultivate and promote bilateral trade with the United States until after the 2016 presidential election. Even with a Republican majority in Congress — traditionally the party more amenable to cross-border trade — the lame-duck session will offer few antidotes for bilateral ills. Meanwhile, 2014 has seen a number of important reports setting out recommendations to improve the relationship, ranging from the establishment of a North American bank to study and prioritize regional infrastructure projects,<sup>50</sup> to strengthening the U.S. appetite for economic co-operation by linking it to American security, energy, and resource interests.<sup>51</sup>

There is, however, much that can be done with Mexico.

The natural linkages between Canada and Mexico were not strong during the formation of NAFTA. Changes to global production technologies, emerging market competition, and Mexico's own efforts at stabilization and reform have reshuffled the deck. Canada and Mexico now share a number of important

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<sup>48</sup> Council of the Americas website, "Explainer: Mexico's 2013 Reforms" (December 17, 2013), <http://www.as-coa.org/articles/explainer-mexicos-2013-reforms>.

<sup>49</sup> Secretaría de Economía, "SME's: The Growth of Small Giants in Mexico" (November 2011).

<sup>50</sup> Eric Miller, John Dillon and Colin Robertson, *Made in North America: A New Agenda to Sharpen Our Competitive Edge* (Canadian Council of Chief Executives, November 2014).

<sup>51</sup> David Patraeus, Robert Zoellick and Shannon O'Neill, *North America: Time For a New Focus* (Council on Foreign Relations, October 2014).

interests and opportunities, but they are so used to looking elsewhere that they are not paying enough attention to the NAFTA neighbourhood. (Granted, the sightline between Ottawa and Mexico City contains many obstructions.)

Mexico's growth prospects, strong sectoral supply chains, and the shared trade governance regime created by 20 years of NAFTA integration make it the best option for Canada's emerging-market expansion and investment plans. There is no other emerging market with which Canada is so closely aligned. This translates to relatively lower transaction costs and levels of market risk.

Mexico provides opportunities to create specialized, high-quality products than can be shipped to North American customers faster and more reliably than from Asian suppliers. Mexico also provides a hemispheric trading partner with strong growth prospects and access to markets around the world.

Both Canada and Mexico benefit from the fact that they have already aligned their commercial and trade policies with those of the United States. Thus, any benefits that the United States may secure in the TTIP and TPP should accrue to Canada and Mexico as well.

But there are obstacles to building a closer relationship. Canadian concerns about Mexican security, and Mexican frustration with Canadian visas are high on the list, but the lack of political will is the biggest impediment to overcoming those issues. The NAFTA institutions are weak and do not provide a viable space for continuing engagement. And many in Canada have made a habit of either underestimating Mexico's prospects or holding onto the outdated idea that closer relations with Mexico would undermine the putative "special relationship" between Canada and the United States.

From a strategic perspective, closer relations with Mexico will help the smaller parties in NAFTA to counter U.S. influence on matters of shared interest. Joint efforts to launch a WTO challenge against U.S. country-of-origin rules for meat products are a good example of how Canada and Mexico can work together to exert regional leverage.

Another important challenge for Canada is to move from a spoke to a hub in North American value chains, providing more control over innovation, production and distribution. Not only will this improve Canada's access to high-value-added jobs, more ownership and control will also keep companies and key projects in Canada.

A regional value chain is not a zero-sum game. Thus, helping to build Mexico's capacity to innovate through training and research partnerships is good for Canadian business. A prosperous and stable Mexico is a better customer for Canada.

Within the Canada-Mexico sphere, businesses are talking to businesses about joint ventures, educators are talking to educators and student and faculty exchanges, but without political leadership and formal mechanisms for collaboration, those aspects of the relationship that the private sector cannot manage on its own will fail to thrive.

## About the Author

**Laura Dawson** is the incoming Director of the Canada Institute at the Woodrow Wilson International Center for Scholars in Washington DC. Named one of Canada's Top 100 foreign policy influencers by the *Hill Times* in 2014, Dawson is a speaker, writer, and thought leader on Canada-U.S., NAFTA and international trade issues. Previously, she served as senior advisor on economic affairs at the United States Embassy in Ottawa and taught international trade and Canada-U.S. relations at the Norman Paterson School of International Affairs. Dawson continues to serve as Emeritus Advisor at Dawson Strategic, which provides advice to business on cross-border trade, market access and regulatory issues. She is a Fellow at the Canadian Defence and Foreign Affairs Institute and serves on the board of the Council of the Great Lakes Region. Dawson holds a PhD in political science.



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