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Assessing NAFTA - Part I

Trade Flows, Foreign Direct Investment, and Corporate Strategy

by

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ASSESSING NAFTA: PART I

**TRADE FLOWS, FOREIGN DIRECT INVESTMENT, AND
CORPORATE STRATEGY**

by

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and

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PREFACE

This paper is one of three Lubin Working Papers on “ASSESSING NAFTA.” These papers are part of a wider project to assess the impact of NAFTA that was carried out in the fall and winter of 1997-98 by the Institute of International Trade and Investment in Japan.

Opinion about NAFTA in the U.S. is deeply divided. Critiques of NAFTA, particularly in the U.S., reflect a reaction to excessive claims made earlier by NAFTA proponents. More importantly, however, they reflect a growing anxiety about the economic and social impact of trade on Americans — on their jobs, income, employment, and labor standards, for example. Many Americans wonder if trade is responsible for stagnating wages, the decline of U.S. workers employed in manufacturing, and rising levels of income inequality in American society. NAFTA has become a code word for a host of fearful and contentious issues that have little to do with the agreement, including globalization, economic dislocation, job insecurity, ethnic paranoia, and even the future of the American middle class.

In these papers we identify and assess recent research on the impact of NAFTA on trade, investment, jobs, income, and the environment. Our review led to these conclusions:

- NAFTA is an important agreement and, together with the Uruguay Round accord, will exert substantial influence over patterns of trade and investment in the future.
- However, to date, NAFTA has had only a modest direct impact on patterns of trade and investment in North America. The same holds true for employment and wages. The NAFTA side agreements have led to some change in environmental protection policy and in the protection and enhancement of labor rights. These results are also modest, and it is simply too early to evaluate the impact of the agreement in these areas.
- NAFTA, in our view, should be seen not as the beginning of the process of economic integration in North America, but as a response to powerful forces of change that began in the mid-1980s. These include changes in policy — particularly when the collapse of oil prices forced the Mexican and Canadian governments to abandon import-substitution economic development strategies and changes in markets — as rising levels of international competition forced firms to reduce excess capacity and to rationalize operations in North America.
- Changes in corporate structure and organization have been a more powerful force in driving the restructuring of the North American economy than NAFTA itself.
- NAFTA's greatest value has been its impact on government and business policies and decisions; factors that cannot be measured in economic terms. Most remarkable was Mexico's ability to maintain its commitment to trade liberalization during the peso crisis of December 1994 by reversing its trade policy of closing markets by imposing import restrictions.

One finding is both clear and ominous. Whereas four years ago, the United States took the leadership role in pressing for the implementation of a North American free trade agreement, today support for the agreement and for the expansion of NAFTA is stronger in Canada and Mexico (even after the peso crisis) than in the United States.

INTRODUCTION

Tremendous changes have taken place in North America over the past decade. Trade among the three North American nations has increased dramatically, and many firms now view North America as a single continental system. In key sectors of our economy — in gas and electricity, for example, or in transportation — a North American infrastructure is now emerging. In many ways, we can now speak of a North American economy. One of the signal events in the process of North American economic integration was the formation of the North American Free Trade Agreement (NAFTA).

NAFTA is a far reaching free trade agreement between two major industrial countries and a developing country. It has a close relationship with the Uruguay Round accord, and it has had important implications for investment. NAFTA has influenced North America in other ways as well by influencing the behavior of policy makers, and by increasing investor confidence that changes put in place by governments will continue.

THE NORTH AMERICAN FREE TRADE AGREEMENT ¹

Our view is that NAFTA can best be viewed as part — but not the beginning — of a wider movement towards economic integration in North America. NAFTA was a response to changes already underway in North America's economic infrastructure, changes driven by the restructuring of corporate strategy and organization, which was itself propelled by transformations in the global economy.

This is not to say that NAFTA was marginal to economic integration in North America. It is a powerful and in many ways unique trade agreement. NAFTA provided for immediate tariff reductions on 68 percent of U.S. exports to Mexico and 49 percent of U.S. imports from Mexico. It provided for reductions in nontariff barriers including import prohibitions, quantitative restrictions, and import licensing requirements. Trade in energy was to be liberalized, and numerous nontariff barriers on U.S.-Mexico agricultural trade were to be replaced by tariff-rate quotas that will be phased out by 2009. NAFTA aimed to establish rules that would govern the conduct of trade among the three NAFTA partners, which included such areas as the protection of direct investment, intellectual property, services trade, and governmental procurement. The agreement also included provisions for resolving disputes arising over trade issues, and was accompanied by "side agreements" on environmental and labor issues.

By 1997, much of NAFTA was in place. As the International Trade Commission (ITC) reported in the most comprehensive assessment of NAFTA yet undertaken, "most, but not all, of NAFTA's tariff provisions have been implemented, and nearly all of its 'rule making' obligations (in customs, standards, and investment, for example) are in force. The agreement represented a breakthrough in trade policy, and had the effect of

¹ Much of the material in this section is drawn from International Trade Commission documents and data.

liberalizing North American commerce and serving as a model for subsequent agreements in the Uruguay Round of trade negotiations and elsewhere.”²

The International Trade Commission estimated that slightly more than two-thirds of the value of U.S. imports from Mexico, and slightly under half of U.S. exports to Mexico were to be accorded duty-free entry upon NAFTA's enactment in 1994. An additional 8.5 percent for imports and 17.4 percent for exports were estimated to become duty free by 1998, with 20-percent annual reductions in tariffs beginning on January 1, 1994. Thus, based on these estimates, 76.2 percent of U.S. imports from Mexico and 66.3 percent of U.S. exports to Mexico were already well on their way to duty-free treatment by the end of 1996. Key U.S. sectors became eligible for duty free treatment on January 1, 1994 — notably aerospace equipment, semiconductors, computers, telecommunications and electronic equipment, medical devices, rail locomotives, most auto parts, machine tools, and paper products, all of which had previously faced Mexican tariffs in the 10-20 percent range. Furniture, steam turbines, light trucks, and beer are among the U.S. products whose Mexican tariffs were phased down by 60 percent as of January 1, 1996. With the implementation of the fourth annual round of NAFTA tariff cuts on January 1, 1997, Mexico's average tariff on NAFTA qualifying goods was reduced to an estimated 2.9 percent.

The average U.S. duty collected on all U.S. imports from Mexico, meanwhile, fell to 0.6 percent in 1996. Three-fourths of U.S. imports from Mexico were actually accorded duty-free treatment and U.S. duties on the remainder averaged 2.6 percent.

Nearly all of the "rulemaking" obligations of NAFTA came into effect immediately upon NAFTA's implementation or shortly thereafter. For example, NAFTA obligations on customs administration, standards, investment, most services, and intellectual property rights are now in effect. Other liberalization commitments are being phased in over time, notably, obligations found in the nontariff barrier provisions of NAFTA including automotive, textiles and apparel, agriculture, government procurement, telecommunications, transportation services, and financial services. Even so, considerable liberalization in these areas had already been attained under NAFTA provisions. For example, Mexico's import licensing requirements for agricultural products no longer apply to NAFTA partners, having been replaced with tariff-rate quotas that will become progressively more liberal until they are phased out by January 1, 2004.

² U.S. International Trade Commission, *The Impact of the North American Free Trade Agreement on the U.S. Economy and Industries: A Three -Year Review*; Investigation No. 332-381, 1997, p. 1-1.

For the most part, implementation of NAFTA's various liberalization and facilitation commitments continue to run smoothly. Mexico, in particular, has continued to make changes in its trade and investment regimes as a result of NAFTA disciplines. It has undertaken additional unilateral liberalization since NAFTA's inception, for example, in investment regulations.

The NAFTA partners have advanced the implementation of the agreement. At its March 20, 1997 meeting, for example, the NAFTA Free-Trade Commission announced that the elimination of tariffs under NAFTA on several dozen products would be accelerated, effective July 1, 1997.

Despite the smooth implementation of most joint policies, some irritants remain. The United States, for example, has expressed dissatisfaction with certain aspects of Mexico's implementation of the agreement, notably in the areas of standards, telecommunications, intellectual property, and small package delivery services. Canada's high post-Uruguay Round tariffs on agricultural goods, perceived subsidies for lumber and wheat, and protection of cultural industries remain sources of U.S. concern. Mexico and Canada, meanwhile, have their own frustrations, including delays in U.S. implementation of NAFTA trucking provisions, remaining animal and plant health restrictions, and aspects of the U.S. sugar policy.

NAFTA and the Uruguay Round

The phase-in of the Uruguay Round agreements negotiated prior to, during, and after NAFTA's negotiation makes it more difficult to evaluate NAFTA's impact on U.S. trade. To a significant degree, NAFTA disciplines were both modeled on, and served as models for, the final WTO agreements. Where the two agreements overlap, NAFTA generally goes further faster than the Uruguay Round, particularly in such areas as market access, investment, and most services. For example, NAFTA involves the complete elimination of tariffs. The Uruguay Round negotiations resulted in a 35 percent reduction in U.S. tariffs, with tariffs being lowered in stages starting January 1, 1995. In services, NAFTA disciplines and commitments were generally more extensive than those in the Uruguay Round General Agreement on Trade in Services (GATS). [NAFTA rules provide for unconditional Most Favored Nation (MFN) and national treatment and for the right of establishment, for example.] Some NAFTA innovations were ultimately incorporated into the final Uruguay Round accord, notably in intellectual property, where the final WTO provisions on Trade-Related Intellectual Property Rights (TRIPs) were much stronger than those discussed earlier.

TRADE

Trade among the NAFTA partners has increased dramatically since the agreement was signed, despite the peso crisis in 1995. However, it is difficult to isolate the impact of NAFTA on trade flows from other powerful factors, including the previous record of multilateral and national liberalization of trade and investment regulations, patterns of change in corporate strategy and organization in North America, the peso crisis, and a wide array of macroeconomic and political variables.

To assess these developments, we must first view North American trade in a broader context of all U.S. trade. Next, we will look at U.S. trade with Canada and Mexico in the period of North American trade liberalization before NAFTA (from 1985 to 1993), and then examine the same patterns of trade after NAFTA (1993-1996). We will finally place these changes in a global perspective.³

U.S. international trade increased remarkably in the past 25 years. Total trade (exports and imports) grew more than tenfold — from \$83,037 million in 1970 to \$889,072 million in 1990. Exports climbed from \$42,681 million in 1970 to \$394,030 million in 1990; imports rose from \$40,356 million in 1970 to \$495,042 million in 1990.

United States Exports and Imports 1970-1990

U.S. Trade (US\$ in million)	Exports	Imports
1970	\$42,681	\$40,356
1975	107,652	98,503
1980	220,626	244,871
1985	213,133	345,276
1990	394,030	495,042
1995	584,742	743,445

Source: Office of Trade & Economic Analysis, U.S. Dept of Commerce

Between 1985 and 1990, U.S. exports increased by 85 percent and imports by 43 percent. Between 1990 and 1995, the rate of U.S. export growth slowed a bit as exports rose by 48 percent; imports increased by 50 percent.

U.S. Trade with Canada and Mexico Before NAFTA (1985-1993)

U.S. trade with its North American neighbors increased between 1985 and 1993, especially after the critical shift in Canadian and Mexican development policies that followed the crash of oil prices in 1982.

During the mid-1980s, Mexico reversed long-standing import substitution development policies that had restrained imports and foreign investment opportunities. Austerity programs requested by the International Monetary Fund in the early 1980s in the wake of the 1982 debt crisis and the progressive dismantling of many trade and investment restrictions transformed Mexico into one of the world's fastest-growing markets. Inflation fell from an annual rate of 159 percent in 1987 to 11 percent in 1992.

³ To assess the impact of NAFTA on bilateral trade flows with Canada and Mexico, we draw on several reports prepared by the U.S. government, and by the International Trade Commission in particular.

Mexico's economic reforms included liberalizing foreign trade, easing rules on foreign investment, improving intellectual property rights protection, privatizing state enterprises, deregulating domestic economic activity, reforming agriculture, and strengthening infrastructure. Mexico joined the General Agreement on Tariffs and Trade (GATT) in 1986, and as part of its accession agreement, reduced and bound its tariffs and undertook additional trade-enhancing commitments. U.S.-Mexico trade ties were further strengthened by the implementation of a series of trade and investment agreements starting in 1987. These measures sparked a surge of foreign investment in Mexico and a return of capital that had fled the country following the debt crisis.

By 1992, U.S. trade with Mexico had doubled from its 1986 level. U.S. exports to Mexico were increasing faster than imports from Mexico, and the United States recorded a slight surplus in bilateral trade. Between 1978 and 1995, U.S. exports to Mexico grew by a substantially larger margin than the Mexican GDP in every year except 1982, 1983, 1986, and 1995.

The importance of U.S. trade to the Mexican economy increased markedly. Mexico was the leading beneficiary of the U.S. Generalized System of Preferences, and a growing proportion of Mexican exports entered the U.S. at reduced duties under so-called production-sharing provisions of the U.S. tariff schedule. By 1993, over half of U.S. imports from Mexico in terms of value entered the U.S. free of duty. The average U.S. tariffs on dutiable imports were just over 4 percent. Mexico became the third largest market in the world for U.S. exports, and Washington's response to the Mexican Government's initiative on free trade reflected a clear recognition of the substantial trade and investment reforms undertaken by Mexico since the mid-1980s.

U.S. trade with Canada also grew rapidly in this period. The key event was the Canada-U.S. Free Trade Agreement (CUSFTA), signed in 1989. CUSFTA was designed to bring political and regulatory environments in line with the rapidly expanding bilateral economic relationship and to ensure that unilateral actions by either party would not disrupt the interdependencies that had developed in the past years. U.S.-Canada trade increased rapidly, the largest bilateral trading relationship in the world.

Changes in U.S. Trade Patterns with Canada and Mexico After NAFTA (1993-1996)

The currently available data series for 1993-1996 is not long enough to establish firmly emerging patterns. However, North American trade clearly increased substantially in this period. Total U.S. trade with its NAFTA partners rose from \$1,014 million in 1993 to \$1,373 million in 1996. U.S. exports rose by 32.9 percent; U.S. imports were up by 37.5 percent — an increase in total U.S. trade of 35.3 percent.

North American Trade: U.S. Imports for Consumption and Exports of Domestic Merchandise (US\$ in millions)

U.S. Trade	1993	1994	1995	1996	Absolute Change 1993-96	Percent Change 1993-96
<i>Imports from</i>						
World	\$574,863	\$657,885	\$739,660	\$790,470	\$215,607	37.5%
Mexico	38,668	48,605	61,721	74,179	35,511	91.8
Canada	110,482	128,753	144,882	158,299	45,817	41.5
All Others	425,713	480,526	533,057	559,992	134,279	31.5
<i>Exports to</i>						
World	\$439,295	\$481,887	\$546,465	\$582,137	\$142,842	32.5%
Mexico	40,265	49,136	44,881	54,686	14,420	35.8
Canada	91,866	103,643	113,261	119,123	27,257	29.7
all others	307,164	329,108	388,323	408,328	101,165	32.9

Source: U.S. International Trade Commission

Exports to Mexico increased from \$40,265 million in 1993 to \$54,686 million in 1996 (35.8 percent), while imports from Mexico increased from \$38,668 million to \$74,179 million (91.8 percent) in the same three-year period. Exports to Canada were up from \$91,866 million in 1993 to \$119,123 million in 1996 (29.7 percent), and imports from Canada rose from \$110,482 million in 1993 to \$158,299 million in 1996 (41.5 percent). The U.S. merchandise trade deficit with Canada increased from \$18,796 million to \$39,176 million, while the merchandise trade balance with Mexico shifted from a surplus of \$1,597 million to a deficit of \$19,493 million. Between 1993 and 1996, the total U.S. merchandise trade deficit with Canada and Mexico increased by almost 350 percent, from \$17,199 million to \$58,669 million.

The Office of Trade & Economic Analysis in the U.S. Department of Commerce reported that U.S. exports to Mexico reached \$71.38 billion in 1997, and imports from Mexico rose to \$85.93 billion. Exports to Canada totaled \$151.77 billion and exports from Canada, \$168.2 billion. In September 1998, Mexico surpassed Japan as the United States' second-largest trading partner.

U.S. Trade with North America in Global Perspective

Despite this impressive increase in North American trade, the change in global perspective is fairly modest. North America's share of U.S. exports increased from 1993 to 1994 (from 30.5 percent to 32.2 percent), but fell back in 1995 after the peso crisis. In 1996, U.S. exports to North America regained their 1993 share of all U.S. exports. The change in the share of U.S. imports coming from North America is more noteworthy. Between 1993 and 1996, U.S. imports from North America increased from 26 percent to 29 percent of all U.S. imports.

North America's Share of U.S. Exports & Imports

Year	North America's Share of U.S. Exports	North America's Share of U.S. Imports
1993	30.5 %	26.0 %
1994	32.2	26.8
1995	29.7	27.9
1996	30.5	29.0

Trade with Mexico accounts for the growth in imports from North America. U.S. imports from Mexico rose from 6.73 percent of all U.S. imports in 1993 to 9.38 percent in 1996.

U.S. Trade: Imports from & Exports to

U.S. Trade	1993	1994	1995	1996
<i>U.S. imports from:</i>				
World	100.00%	100.00%	100.00%	100.00%
Mexico	6.73	7.39	8.34	9.38
Canada	19.22	19.57	19.58	19.77
All Others	74.05	73.04	72.07	70.84
<i>U.S. exports to</i>				
World	100.00%	100.00%	100.00%	100.00%
Mexico	9.17	10.20	8.21	9.39
Canada	20.91	21.51	20.73	20.46
All Others	69.92	68.30	71.06	70.14

Source: U.S. International Trade Commission

The Impact of NAFTA on U.S. Bilateral Trade Flows with Canada and Mexico

U.S. trade with its NAFTA partners rose substantially during the first three years of the agreement. However, trade had been increasing before NAFTA was put in place, and other factors, including the devaluation of the peso and the falling value of the Canadian dollar, have also influenced trade flows in North America.

Can we assess the direct impact that NAFTA has had on North American trade and identify the industrial sectors in which NAFTA has led to a significant trade diversion or creation? In an effort to answer these questions, the United States Trade Representative, on behalf of the President, asked the United States International Trade Commission (ITC) in April 1997 to analyze the actual impact of the first three years of NAFTA on the U.S. economy as a whole, and on industries particularly affected by the agreement.⁴ This would be part of a wider study on the operation and effect of NAFTA that had been mandated in the NAFTA Implementation Act. In response to this request, the ITC launched the broadest and most significant investigation yet undertaken of the impact of NAFTA on the United States.

⁴ U.S. International Trade Commission, *The Impact of the North American Free Trade Agreement on the U.S. Economy and Industries: A Three-Year Review*, p. 4-1.

What did the ITC investigation discover? It found, first, that NAFTA's overall impact on trade flows was modest. Second, where its impact was found to be statistically significant, the direction of change was usually positive. And, third, for a final group of industries, the investigation's results were inconclusive regarding a strong consistent relationship between the implementation of NAFTA and changes in trade volumes.

Using the ITC and other data, the White House prepared a second report on NAFTA's impact on trade flows in North America.⁵ This report was somewhat more positive in its evaluation. It found that U.S. exports had maintained or enhanced their domination in Mexico's import markets since NAFTA was implemented. In 1996, the U.S. share of Mexican imports exceeded 75 percent in 10 (of 22) broad sectors accounting for all U.S. bilateral goods trade with Mexico compared to just three sectors in 1993. In no segment of Mexican imports in 1996 did U.S. exports enjoy less than a 50 percent market share. Between 1993 and 1996, the overall U.S. share of Mexico's import market rose by 6.2 percentage points. In reaching these conclusions, the President's report relied on a fairly simple correlation between the decline of Mexican tariffs in NAFTA schedules and the increase of U.S. exports in these sectors. However, Mexican tariffs had been falling since the mid-1980s, and it would be difficult to claim that the NAFTA tariff changes had a more powerful overall impact on trade patterns than the prior changes in Mexican policy.

The ITC Survey

The ITC sought to evaluate changes in U.S. imports and exports at both individual sector and aggregate levels to determine if shifts in trade flows could be associated with NAFTA. Approximately 85 percent to 90 percent of U.S. bilateral trade with Canada and Mexico were included in the detailed analysis that focused on approximately 198 (45 percent) of the 4-digit SIC industries that contain commodity trade. The survey used monthly data spanning five years prior to the Agreement and three years following it to determine whether there were distinct shifts in actual trade flows that could be attributed to NAFTA. Econometric estimations controlled for changes in import prices, competing (domestic) goods prices, purchaser incomes, and exchange rates that could also have influenced trade flows.

As noted above, the ITC investigation found that NAFTA's cumulative impact was modest and that where the impact of NAFTA was found to be statistically significant, the direction of change was usually positive.

The ITC's analysis of aggregate bilateral trade flows showed that, as a result of NAFTA, after controlling for changes in income, prices, and exchange rates, the volume

⁵ Study on the Operations and Effects of the North American Free Trade Agreement as required by section 512 of the NAFTA Implementation Act (Public Law 103-182; 107 Stat. 2155; 19 U.S.C. 3462), Chapter 2.

of U.S. imports from Mexico increased by 1.0 percent in 1994, 5.7 percent in 1995, and 6.4 percent in 1996. The volume of U.S. exports to Mexico increased by 1.3 percent in 1994, 3.8 percent in 1995, and 3.2 percent in 1996 as a result of NAFTA.

The industry-level analysis focused on nearly 200 industries, accounting for over 85 percent of trade between the United States and its NAFTA partners. NAFTA was found to have exerted a modest impact on a number of industries, although for most of those industries analyzed, NAFTA had no consistent discernible impact on changes in the volume of bilateral trade between the U.S. and its NAFTA partners. The ITC found that none of the analyzed industries revealed a conclusive relationship between NAFTA and lower U.S. exports to Mexico, a major concern among NAFTA opponents. Finally, the number of industries that showed statistically significant increases in exports and imports was greater for bilateral trade with Mexico than with Canada.

The U.S. Trade Representative (USTR) instructed the ITC to examine the impact of NAFTA on those industries “in which U.S. exports to Mexico or Canada or imports into the United States from Mexico or Canada have increased significantly.” The ITC carried out a qualitative analysis of the impact of NAFTA on 68 individual sectors. The impact was defined as significant if the increase in U.S. trade flows from 1993 to 1996 were due in considerable measure to NAFTA, as compared with any other economic factor or industry development during the period. Otherwise, the impact was judged as negligible. The findings in the qualitative assessment were not necessarily the same as in the quantitative analysis described above.

NAFTA was found to have had only a negligible effect on 59 of the 68 sectors analyzed — most often due to the impact of other variables. These included the strong U.S. economy, the already relatively low trade-weighted average rates of duty on U.S. imports from Mexico, low most-favored-nation rates, eligibility under the Generalized System of Preference, duty-free treatment on the U.S. content of imports from Mexico’s maquiladora industry, and the impact of the peso devaluation, which reduced Mexico’s demand for U.S. exports in 1995. In about half the sectors examined, the major trade increases were with Canada, and were primarily due to non-NAFTA factors — in particular, CUSFTA, which had already removed many tariff and nontariff barriers that affected U.S. imports from Canada. The ITC survey found that nine sectors were significantly affected by NAFTA: grains and oilseeds, raw cotton, textile mill products, apparel, women’s footwear, leather tanning and finishing, household appliances, motor vehicles, and motor vehicle parts.

“DEEP INTEGRATION” AND THE IMPACT OF NAFTA ON DIRECT INVESTMENT

Even more important than increasing volumes of trade in North America was the changing nature of the relationship. Economists use the term “deep integration” to describe a relationship characterized by increased direct investment, new structural linkages, extensive cross-border networks, and rising levels of intra-company trade. Deep integration extends beyond “water’s edge” trading linkages between countries and rests

on extensive changes in national economic structures that link economies across borders. Patterns of investment and cross-border networks increasingly shape trade composition and trade flows. Deep integration intensifies the erosion of national borders; governments are less able to manage what are no longer “national” economies. Robert Lawrence discusses the factors that support new regional agreements like NAFTA:

They are motivated by the desire to facilitate international investment and the operations of multinational firms as much as the desire to promote trade. Although liberalization to permit trade requires the removal of trade barriers — a relatively shallow form of integration — the development of regional production systems requires deeper forms of international integration, for example, the elimination of differences in national production and product standards that make regionally integrated production costly. Investment also depends on credible and stable governance mechanisms and secure access to large foreign markets unhindered by customs officials or by domestic actions such as antidumping. Since much of the investment relates to the provision of services, the regulatory regimes governing establishment and operation become the focus of attention.⁶

Our sense is that in North America, changes in corporate strategy and organization drove the creation of new bilateral and regional agreements. In the 1980s, U.S. firms were forced by heightened international competition to reduce costs and overhead. Liberalization in Mexico and Canada provided the opportunity for firms to rationalize formerly autonomous and often less efficient branch plants into new continental networks. The two trade agreements, first between the U.S. and Canada and then NAFTA, both recognized this new situation. The agreements sought to stabilize these emerging arrangements, to ensure that they would not be undermined by unilateral actions, and to raise investor confidence in these emerging arrangements.

Estimating the impact of NAFTA on flows of foreign direct investment is even more problematic than measuring its impact on trade flows. Investment decisions are influenced by a wide array of macroeconomic factors that operate independently of trade agreements. These include overall economic growth and stability of home and host countries, currency values and trends, trends in savings, interest rates, inflation and wage rates. Moreover, corporate managers or investors rarely view these factors in a simple objective fashion. Subjective assessments — how investors interpret growth statistics, how they project future trends in currency values, and how they view political leaders — are critical data in determining investment flows. Investment strategies emerge in firm-specific situations in which corporate history, objectives, and managerial style are powerful influences.

⁶ Robert Z. Lawrence, *Regionalism, Multilateralism and Deeper Integration* (Washington, D.C.: The Brookings Institution), 1996, p. 17.

Finally, investment decisions are rarely made and executed in a single year. Since investment decisions may be made long before the flow of capital begins, tracking flows by year does not necessarily indicate investor attitudes. Nor does the measurement of capital flows provide a clear image of total new investment by foreign subsidiaries. Many subsidiaries meet capital needs by reinvesting local profits or by tapping local financial markets.

NAFTA followed extensive changes in Mexican and Canadian policies toward foreign investment. Integration and rationalization preceded NAFTA in many cases. Mexico reformed its policies with regard to incoming direct investment before NAFTA by widening the sectors eligible for Foreign Direct Investment (FDI) and loosening government regulation of FDI in other sectors. In the late 1980s, Canada, too, liberalized trade and investment policies, including the transformation of the Foreign Investment Review Agency into Investment Canada and entering the Canada-U.S. Free Trade Agreement. Liberalization in Mexico and Canada and heightened international competition in the mid-1980s led managers to create new strategies to reduce excess capacity in North America by integrating formerly autonomous Canadian and Mexican branch plants into U.S. or North American networks.⁷ Other factors influenced investment flows as well. The peso crisis led to a dramatic fall in Mexican asset prices, as has the decline in the value of the Canadian dollar. In each case, investment has been stimulated. Cross-border capital flows increased substantially following the free trade agreement. Some of this increase in foreign investment was due to the earlier reforms. Other investments were initiated in anticipation of NAFTA. Still others were undertaken when the signing of NAFTA raised investor confidence that these reforms had been “locked in.” Most specialists conclude that it would be difficult indeed to determine which of these factors was decisive in leading to a particular investment decision.

The Changing Relationship of Trade and Investment, Before and After NAFTA and the Peso Crisis

In this environment of deep integration, patterns of direct investment increasingly shape trade patterns. A brief case that focuses on the North American auto industry helps us comprehend the changing relationship of trade and investment.⁸

In 1993, GM sold 10 U.S.-made vehicles to Mexico; in 1996, it sold 31,000. GM export of vehicles from Mexico to the U.S. increased much more rapidly, however. In 1996, GM exported nearly seven times as many vehicles from Mexico to the United States as it exported from the U.S. to Mexico. NAFTA planners had viewed Mexico as a rapidly growing consumer market and anticipated a rapid growth in domestic sales of vehicles. However, the peso crisis revealed just how distant this dream really was.

⁷ On corporate strategies in North America, see Stephen Blank, Stephen Krajewski, and Henry Yu, *U.S. Firms in North America: Redefining Structure and Strategy*, North American Outlook (Washington, National Planning Association) Vol. 5, No. 2 (March 1995) and Stephen Blank and Jerry Haar, *Making NAFTA Work: U.S. Firms and the New North American Business Environment* (Boulder, CO: Lynne Reiner Publishers), 1998.

⁸ See Nancy Dunne and Daniel Dombey, “Peso Crisis Turbo-Charges Revolution in Motor Trade,” *Financial Times*, 11 June 1997.

Instead, Mexico has emerged as an export platform for cars, trucks, and parts far more swiftly and dramatically than anyone imagined.

Before NAFTA, the auto industry projected that sales of cars and trucks in Mexico would reach 1.3 million by 2002 and that exports would account for only a third of the national output of vehicles. In 1995, however, domestic sales were only 185,000 units and exports rose to 781,000 units. In 1996, domestic sales increased to 334,000 and exports jumped to 975,000 — almost all to the United States.

This remarkable transformation of the North American auto industry had a number of causes. NAFTA was one factor, but not the only one or even the most powerful according to Dunne and Dombey.

It could not have happened without Nafta, but it could not be put down to Nafta alone. What could be attributed to Nafta, however, were some of the other things that came the way of GM. The most important was that it greatly benefited from the phasing out of a variety of Mexican decrees that forced US companies to manufacture in Mexico if they wanted to sell there.⁹

The peso crisis dramatically forced Mexican leaders to reorient their trade policies from a model resting on the growth of the Mexican consumer market to one driven by export performance. The falling cost of production factors, including labor, led U.S. automakers to transfer production southwards. Continuing high levels of competition in the auto industry in the United States and the growing flexibility and efficiency of networks of automotive supplies and production were also crucial, as was Mexico's capacity to achieve U.S. required quality levels. Regulatory changes follow a longer trajectory that began in the mid-1980s and may well have been put in place even without NAFTA.

Flows and Volumes of Direct Investment

Canada, Mexico, and the U.S. were linked by an extensive structure of cross-border investment long before NAFTA. Canada had been the largest site for U.S. foreign direct investment since the Second World War, and American firms had created an elaborate system of branch plants there. In fact, the U.S. was the largest source of foreign direct investment in Canada and Mexico for most of the twentieth century.

NAFTA provisions that affect investment are evaluated very favorably by experts. They are viewed as more far-reaching than those found in the Uruguay Round accord and cover a wider range of matters affecting foreign direct investment than the more narrowly defined coverage of the Uruguay Round Agreement on Trade-Related Investment

⁹ Ibid.

Measures (TRIMs). The TRIMs agreement does not address such basic issues for investors as the right of establishment, the right to fair and just compensation for expropriation, and the expeditious handling of investor-state disputes. Moreover, NAFTA's premise is that all flows of investment will be free of restrictions unless specifically exempted. Gary Hufbauer and Jeff Schott observe, “The NAFTA negotiators produced a landmark agreement on investment that meets or exceeds our recommendations. Under the NAFTA, the three countries agreed to obligations more comprehensive than those contained in the Canada-U.S. FTA (or any other U.S. agreement, for that matter), and to new procedures that provide binding arbitration of investment disputes. In parallel, they negotiated a tax treaty that breaks new ground in a constructive direction.”¹⁰

The following tables show U.S. capital outflows to Mexico and Canada and stocks of U.S. FDI in Mexico and Canada in the post-NAFTA period.

U.S. FDI Outflows (US\$ in millions)				
	1989	1994	1995	1996
World	37,604	68,272	85,165	85,560
Canada	1,268	6,760	8,435	6,875
Mexico	1,652	3,674	2,955	2,747

Source: U.S. Department of Commerce, Survey of Current Business web site

U.S. FDI Stock on Historic Cost Basis (US\$ in millions)			
	1994	1995	1996
World	640,320	717,554	769,494
Canada	78,018	85,441	91,587
Mexico	16,169	15,980	18,747

Source: U.S. Department of Commerce, Survey of Current Business web site

From 1989 (when the Canada-U.S. Free Trade Agreement came into effect) to 1992, Canada attracted a total of \$19.8 billion of net FDI flows — about \$5.0 billion annually.¹¹ Almost 40 percent of the flow of FDI into Canada after CUSFTA originated in the United States. At year-end 1992, the stock of foreign direct investment in Canada was \$131.6 billion.

Total U.S. direct investment capital inflow into Canada during the first two years of NAFTA was \$14.1 billion, nearly triple the \$5.7 billion of inflows during 1992-93. The composition of this investment continued to be heavily weighted toward manufacturing, especially transportation equipment. In 1995, the U.S. direct investment position in Canada, on a historical-cost basis, amounted to \$85.4 billion. In 1996, U.S.

¹⁰ Gary Clude Hufbauer and Jeffrey Schott, *NAFTA; An Assessment* (Institute of International Economics: Washington, D.C.), 1993, p. 85.

¹¹ See John Knubley, Marc Legault, and Someshwar Rao, “Multinationals and Foreign Direct Investment in North America,” in Lorraine Eden, ed., *Multinationals in North America* (Calgary: University of Calgary Press), 1994.

investors increased their holdings in Canadian businesses by almost \$7 billion, bringing their total holdings to \$91.6 billion. This accounted for 68 percent of all Canada's stock of foreign direct investment, and constituted 11 percent of all U.S. FDI.

It can be noted that Canada's FDI position in the U.S. is also very large. Canada is the fifth largest source of direct investment in the United States and accounts for about 8.2 percent of all FDI in the country. Given that the U.S. economy is about 10 times larger than the Canadian economy, Canada's FDI position in the U.S. in 1996 of \$54 billion (roughly one-half of that of U.S. FDI in Canada) can be viewed as five times greater in scale than the U.S. position in Canada. Most Canadian FDI in the U.S. is in manufacturing, and Canada's investment into the U.S. in the first years of NAFTA was among the highest ever recorded.

Foreign Direct Investment in Mexico increased substantially in recent years. Flows of FDI to Mexico increased from \$1.7 billion in 1985 to \$3.6 billion in 1991. Direct investment inflows from all sources amounted to approximately \$2 to \$3 billion annually in 1991-93, and then doubled to \$11 billion in the first year of NAFTA. While FDI flows fell in 1995 to \$7 billion, this was still significantly more than historic trend levels. U.S. investment in Mexico began to increase sharply well before NAFTA. The stock of U.S. direct investment in Mexico on a historic cost basis was \$11.6 billion at the end of 1991, compared with \$4.9 billion at year-end 1987. Over the next three years, investment flows increased. In 1994, the first year of NAFTA, U.S. FDI flows to Mexico reached a record level of \$3.7 billion. While U.S. FDI inflows to Mexico declined in 1995 (to \$2.9 billion) and 1996 (to \$2.7 billion), the stock of U.S. direct investment reached \$18.747 billion in 1996.

Controversy over NAFTA produced several "myths" about foreign investment. The first myth is that U.S. investment in Mexico displaced investment at home. This is totally in error. While U.S. FDI flows to Mexico during the NAFTA years have increased, investment in Mexico is still a small proportion of all U.S. foreign direct investment and is a minute share of total U.S. gross private fixed investment. U.S. direct investment in Mexico amounts to only 2.6 percent of the total stock of U.S. direct investment overseas. (During the 1991-94 period, flows of equity capital to Mexico accounted for 6.7 percent of the U.S. overall total.)¹² Investment in Mexico scarcely constitutes a drain of U.S. investment capital southwards. Nor is there any indication that FDI in Mexico was withdrawn from other markets because of superior investment opportunities there.

The second myth is that Mexico deliberately set out to court portfolio capital while spurning long-term direct investment. Bill Orme observes that "to the contrary: the entire NAFTA enterprise was designed as an enticement for the kind of direct invest-

¹² Hufbauer and Schott, *NAFTA: An Assessment*, p. 79.

ors who think in terms of decades. Once it was clear that the Salinas government was serious and that NAFTA was likely to be approved, the strategy began to work. During the three years of the NAFTA negotiations, direct investment — most of it American — rose by nearly \$15 billion, double the inflow of the previous three years.”¹³

Orme says that portfolio investment poured in far faster than direct investment, however. Mexican officials, he says, were acutely aware of the volatile imbalance between highly liquid portfolio capital and long-term investment in fixed assets. They were reluctant to create mechanisms used by other countries such as Chile and some Asian nations to limit or control the flows of portfolio capital. Mexico’s 1994 crisis revealed what is now, in the wake of the Asian “meltdown,” common knowledge — that the balance of international capital flows was changing sharply, as more and more pension and mutual funds sought international markets. Flows of “hot” money — funds seeking short-term gains without being locked into long-term commitments — now dominate many financial markets and exert a highly uncertain impact on global economic performance and stability.

It can also be noted that North America’s share of world FDI inflows declined from the years before the Canada-U.S. trade agreement to the years following NAFTA. In the earlier period, 1984-88, North America accounted for 44 percent of all world FDI inflows, while in the later period, 1994-1995, North America accounted for only 26 percent of these flows. Mexico’s share increased (from 2 to 3 percent) and Canada’s declined (from 4 to 3 percent). However, the real change was that the U.S. share of world FDI flows fell sharply from 38 to 20 percent. These statistics moreover can mislead. Global capital was streaming into the U.S. in the early 1980s in the wake of the debt crisis and because the U.S. was enjoying much higher levels of domestic growth than the rest of the world. Later, in the early 1990s, a greater share of global capital was flowing into new Asian markets, especially China. However, the total amount of capital flows had increased enormously over this period.

CORPORATE STRATEGIES AND STRUCTURES

Corporate strategies and organizations in North America were recast in the mid-1980s. The result was the emergence of a true “North American economy.” Changes in corporate strategies and structures in North America have been driven by three key variables. One is the change in government policy — the movement toward liberalization of the national trade and investment barriers, both through multilateral agreements in GATT and unilaterally, as was carried out in Mexico from the mid-1980s. The second was the change in global markets with greatly heightened competition — competition in an environment of relatively slower growth and narrower profit margins. This forced firms to eliminate excess capacity and rationalize production processes. The third variable was new technology that reduced the impact of distance, even in complex production processes, altered the nature of control systems, and restructured financial markets.

¹³ William A. Orme, Jr., *Understanding NAFTA: Mexico, Free Trade and the New North America* (Austin: The University of Texas Press, 1996), p. xvii.

“Canada” and “Mexico” were key strategic and operational concepts for U.S. firms through the early 1980s. However, patterns of change were not the same in all sectors — the emergence of North American networks are particularly visible in manufacturing, with the restructuring of Canadian and Mexican branch plants into coherent continental systems. In financial services and media industries, the emergence of these new patterns has been slowed by various factors including the desire by Canadians and Mexicans to preserve national autonomy and culture.

In resource sectors in Canada and Mexico, U.S. mining and petroleum companies provided critical links between domestic resource production and global markets. In manufacturing industries, national import-substitution strategies compelled U.S. firms to establish branch plants. These branch operations enjoyed protected national markets for selling their goods and faced a wide range of pressures to increase benefits to the host economy by importing less, exporting more, hiring more local managers, enhancing local value-added activities, and carrying out more research and development. Each host country offered a particular mix of incentives to encourage foreign firms to meet national objectives.

In the 1970s, U.S. firms operating in Canada responded to growing regulatory and political pressures by increasing Canadian content in their own operations and raising levels of Canadian autonomy within corporate structures. This meant more Canadian inputs at all stages of the production process and a stronger role for Canadian managers in decision making.

At the same time, however, the global economy was undergoing profound structural changes. Falling levels of protection in the Canadian market on the one hand, and heightened global competition on the other, were altering the basic framework of bilateral relations and the foundation on which corporate structures and strategies in Canada and North America would stand. The result was that efforts to localize operations and be “good Canadian corporate citizens” were overwhelmed by the need to respond to intensified international competition in an environment in which national borders were less and less significant in defining economic boundaries. U.S. firms in an increasingly integrated U.S.-Canadian economy sought ways to reduce costs by rationalizing and integrating their sourcing, production, and distribution systems.

The response of U.S. multinational firms in Mexico to this emerging environment paralleled experiences of U.S. subsidiaries in Canada. As in the case of Canada, Mexican economic nationalism, long antipathetic toward U.S. direct investment, had intensified during the 1970s and resulted in new efforts to Mexicanize and localize operations. These were not abandoned but rather recast. With multinational companies and international agencies such as the World Bank providing the lion’s share of the capital Mexico needed to finance investment, Mexican nationalism was tempered in the 1980s with a new prag-

matism, ensuring the continued inflow of investment. Mexican demographics (a high population growth rate, an expansion of the economically active population, and an expanding middle class) fueled an ever-increasing demand for imported consumer goods, while Mexico's industrial growth created an even greater demand for capital and intermediate goods.

Liberalization was not a source of immediate benefits for all firms. U.S. firms operating in Mexico with sufficient market power to enable them to come to terms with Mexican regulations and to meet national needs in exchange for market reservations found themselves facing new competitors. Similarly, U.S. operations in Canada were often faced with excess capacity because of the emergence of continental strategies and the end of protected branch plants.

Many Canadians were fearful that the U.S. firms would dismantle their production operations in Canada. They worried that these firms would supply Canadian markets instead from U.S. production. On the eve of Canada-U.S. Free Trade Agreement, well-known Canadian scholars Joseph D'Cruz and James Fleck carried out an investigation of how American subsidiaries in Canada were responding to globalization and projected how they might react to the impending free trade agreement. They concluded that a Canada-U.S. Free Trade Agreement would intensify the pressure on U.S. firms to deploy their resources across the continent more efficiently, just as developments in Europe were driving forward pan-European integration and rationalization:

There can be little doubt that similar forces will be put into play when the Free Trade agreement between Canada and the U.S. is implemented. For one thing, intra-firm trade is already well established between the two countries. Thus, the administrative infrastructure for rationalization of production between the U.S. and Canadian operations already exists in many U.S. multinationals. For most, the next round of major capital projects is highly likely to involve more rationalization between production facilities in Canada and the U.S.¹⁴

In the past six years, a number of studies on emerging patterns of corporate organization and strategy have been carried out by The Conference Board of Canada (focused on managers of U.S. subsidiaries in Canada), the Americas Society (focused on senior headquarters managers of U.S. firms with operations in Canada and Mexico), and the North-South Center (focused on managers of U.S. subsidiaries in Mexico).¹⁵ The findings from all of these studies indicate clearly that D'Cruz and Fleck's projections were on target. The great majority of respondents in the surveys, all of whom were managers in U.S. firms with long-established operations in Mexico and Canada,

¹⁴ Joseph D'Cruz and James Fleck, *Yankee Canadians in the Global Economy: Strategic Management of U.S. Subsidiaries Under Free Trade* (London, Ontario: The National Centre for Management and Research, The University of Western Ontario), 1988, p.9.

¹⁵ See Blank and Krajewski and Blank and Haar op. cit.; Stephen Krajewski, *Multinational Firms Across the Canada-U.S. Border: An Investigation of Intrafirm Trade and Other Activities* (Ottawa: The Conference Board of Canada), 1992.

confirmed that few U.S. firms would abandoned Canada or Mexico (even after the peso crisis). They agreed instead that CUSFTA and NAFTA intensified trends already underway toward the development of continental-wide strategies and the creation of North American production, marketing, and sourcing networks.

In a 1995 article, journalist Greg Ip described changes in Black & Decker's strategy and operations in Canada:

The Brockville [Ontario] operation hasn't always been used for export. Since arriving in town in 1957, Black & Decker's Canadian subsidiary, like other foreign-owned branch plants, had made small quantities of many products strictly for the Canadian market. But beginning in 1984, B&D's head office in Towson, Maryland, began to restructure worldwide. Operations in Canada were rationalized. R&D reduced the number of products made in Brockville, but the plant now makes them for the world markets. The overhaul has transformed the Brockville plant from a sheltered, Canadian company selling 80 percent of its products in Canada to a globally competitive, integral unit of North American operations exporting 65 percent of its output.¹⁶

Ip's description of Black & Decker confirms what other firms in these studies carried out over the past several years have discovered about efforts to rationalize and integrate their North American operations. First and by far most important, rationalization and integration have been driven by the need to meet global competition. In an environment characterized by low growth, uncertain profit margins, and rapid technological change, competitive intensity soared.

Reducing overcapacity remains central to meeting competition. With technological change forcing the adoption of new forms of production and intensifying international competition, firms must shed excess production capacity if they are to survive in the new global economy. Protected by high tariff walls, many high-cost Canadian branch plants generated substantial profits for their corporate parents. However, without protection, and in an increasingly competitive environment, these plants are painful liabilities. As the Campbell Soup Company's *Annual Report* stated in 1990: "We are closing high cost plants, carrying on a program begun last year. This restructuring will increase our capacity utilization, productivity, controls, and quality...The company's worldwide portfolio of business has been sharply refocused. Non-strategic and low-return businesses are being divested." A respondent in a Canadian subsidiary commented in a similar fashion: "The current recession and greater competition have forced us to reassess our

¹⁶ Greg Ip, "Free Canada," *The Financial Post* 500/1995 (Toronto: The Financial Post).

manufacturing capability, reduce costs, shrink production time, and most importantly, to improve the overall quality of our business.”¹⁷

“We are facing these new realities squarely. To operate profitably in today’s conditions, we have cut our operating expenses, consolidated overlapping operations and made our organization more flexible and responsive,” observed Frank Popoff, chairman and CEO of Dow Chemical Company, one of the largest U.S. chemical firms. The firm’s aim, he said, was to create “...a more streamlined, horizontally integrated organization . . . that is geared to strengthen and accelerate implementation of global strategies.”¹⁸ One step in this direction was to combine the firm’s North American core businesses into a single organization with a good strategy and alignment of goals.

Asea Brown Boveri Ltd. (ABB), a Swiss-Swedish electrical engineering group, reorganized its global structure “to give business areas more responsibility when dealing with customers and to reduce overhead costs.” A sluggish global economy and rising costs forced ABB to reorganize its “fragmented national managements into three economic regions: Europe, the Americas and Asia-Pacific.” According to ABB CEO Percy Barnevik, “The opening-up of markets under the North American Free Trade Agreement made the establishment of one region for the Americas a logical step.”¹⁹

Efforts to enhance quality in design, production, delivery, and service drive integration as well. With growing emphasis on customer satisfaction and total quality management, higher levels of integration are necessary to achieve greater control over quality and inventory. For instance, Revlon has been implementing the latest production techniques in its Mexican operations. Its strategy in Mexico is to provide quicker customer service, and this approach — rather than tariffs that were lowered before NAFTA — was the determining factor for the company’s success.

Markets in North America are changing rapidly as well. Many have escaped entirely from national borders. Subsidiaries are becoming operations in Canada or Mexico rather than operations producing for Canada and Mexico. Distinct national markets have begun to blur, and branches with what once were national mandates now find themselves competing with other divisions in the firm. In this vein, another executive told how his company is “finding more overlap in what we once thought of as separate customer bases.”²⁰

As manufacturing firms restructure on a North American basis, other firms, suppliers for example, will do so as well. The president of IBM Canada, William Etherington, observed, “As a response to the increasing number of customers that have been demanding cross-border services,” our company intends to become “as seamless as

¹⁷ Quoted in Stephen Krajewski, “Adjusting to the New North American Competitive Dynamic: The Experience of U.S. Subsidiaries in Canada,” *Working Paper # 2* (New York: The Americas Society), 1993.

¹⁸ Frank Popoff quoted in Dow Chemical Corporation, Annual Report 1992 and *Dow Today*, no. 138, December 4, 1992.

¹⁹ Quoted in Margaret Snyder, “ABB to Reorganize Its Global Structure,” *Wall Street Journal* (25 August 1993).

²⁰ Quoted in Krajewski, *Working Paper # 2*.

possible across North America. If our customers are going to organize along North American lines, then our company will do the same.”²¹

Markets can sometimes be serviced better by regional than by national sites. There is often no reason, it is observed, for a Quebec-based subsidiary of a U.S. firm to supply Canadian buyers in Vancouver. Firms are working out more rational, less expensive sourcing and marketing networks in North America. Xerox, for example, was beginning to ship products to Canadian customers directly from U.S. production sites in the early 1990s, rather than through a system of warehouses in Canada.

Several cases provide important insights into why firms sought to rationalize and integrate their U.S., Canadian, and Mexican operations. Siemens AG, the German industrial group, decided to opt for a North American organization well before NAFTA was finally signed. It created a special task force charged with regionalizing production, with the objective of cutting replication. At the end of 1993, a *Wall Street Journal* article reported, “All small-motor production is overseen by Siemen’s Mexican operation, while large and medium-size motors are overseen by the U.S. unit. Cement-making equipment is controlled by Mexico, but engineering for steel is handled out of Atlanta. Shipbuilding equipment and some software operations belong to Canada. Some products, notably those controlled by things such as local building codes, will remain locally produced, but Siemens expects the vast majority of its production to be regional.”²²

The Dow Chemical Corporation is another example. Until 1991, Dow had no North American focus or unit specifically devoted to serving a North American market. During the last half of 1990 and early 1991, the company was active in developing joint ventures through its well-established Canadian subsidiary to take advantage of opportunities generated by CUSFTA. More important, however, Dow’s customers were already conducting business on a North American basis. As the president of Dow of Canada stated in 1992, “As a customer-driven company, we need to adapt to changes affecting our customers that are brought about by the globalization of the chemical industry, free trade and the escalating changes in the North American marketplace...We really need a common approach to the increasing number of customers doing business on a North American basis.”²³

Faced with this new business reality of rising global competition, continuing margin pressures, and a lagging economy, Dow Chemical assembled a task team of senior managers from Dow Canada and Dow USA to identify opportunities in North America that would match Dow’s core businesses. The team concluded, “A significant competitive advantage can be achieved by bringing together the two Areas with a common North American strategy. The new framework will mean one Area — Dow North America — with an overarching management structure built on the strengths of the

²¹ Quoted in Carolyn Leitch, “IBM building North American bloc,” *The Globe and Mail*, 7 May 1992.

²² E. S. Browning, “Nafta or not, Many Foreign Companies View North America as One Market,” *Wall Street Journal*, 15 November 1993.

²³ Dennis Wolcock, quoted in *Dow Today*, 8 July 1992.

two countries and single business teams for each of the core businesses. The core businesses will operate with a single strategy and scorecard for North America.”²⁴

The magnitude of change within corporate networks, along the lines suggested in the above examples, is still surprising to most observers. These trends toward greater integration are not new; they were well underway before the CUSFTA or NAFTA, but they seem to have accelerated over the past few years.

The drive to integrate Mexican operations with those in Canada and the United States is not a strategy that works for everyone. Existing corporate organization was an issue in some cases. In several companies such as CPC and Kodak, the Mexican subsidiary reported to the firm’s Latin American division rather than to the North American corporate office. Strong personal feelings as well as organizational concerns inhibited major changes in structure. Motorola found that it benefited from keeping Mexican operations under its Latin American umbrella. Mexican management in this case believed that its Latin American customers appreciated a strong Latin orientation. The firm was reluctant, therefore, to integrate its Mexican operations into a North American operation. Here, and in other firms as well, the direction of cross-border integration might be southward, from Mexico. All of these reasons have made integration into a North American business unit more difficult in practical terms, however desirable in theory.

Gillette responded to these same pressures in a much different fashion. Until 1988, the company was structured on North American lines. It managed its Canadian and U.S. operations under a unified North American division, although each country had its own separate production facilities. The North American division oversaw marketing and advertising in the two countries. In 1989, the North American division was subsumed into a North Atlantic Group in order to gain efficiencies in marketing, advertising, and promotions. Gillette felt that its products were global and could be sold in different markets using essentially the same advertising and marketing strategies. At the same time, Gillette began to supply the entire Canadian and U.S. markets from a single U.S.-based plant, closing its higher-costing Canadian production facility.

For many firms, continental integration and rationalization will continue, expand, and intensify. For the North American multinational corporation, business policy responses will be based not on choice but on the necessity to survive and compete successfully in this dynamic new environment.

The Competition for Mandates and Intra-Firm Trade

When Canadian, Mexican, and U.S. managers talk about corporate organization in this era of strategic and organizational change, they seem to have a number of different models in mind. One model focuses more on efforts to capture efficiencies and synergies through centralized control of key activities. In this model, the actions of subsidiaries are

²⁴ *Dow Today*, 8 July 1992.

tightly linked or integrated across national borders. As a result, subsidiaries perform only those activities that leverage location-specific advantages or those in which the subsidiary has a distinctive capacity.

This kind of centralization worries local subsidiary managers who fear that corporate headquarters will pull back key functions from their operations. This has happened most severely, however, when there has been a decentralization of authority from corporate headquarters to strategic business units or operating companies. In this case, these units have often centralized their control over local operations. When Canadian corporate headquarters lacked a single overall perspective on their company and its subsidiaries, individual product lines have reduced Canadian autonomy or the scale of operations. In this case, a Canadian headquarters that formerly ran a wide range of corporate activities now would have no direct responsibilities and no one unit at headquarters with which to deal. In these situations, subsidiary morale, output, and productivity can all deteriorate together.

An alternative model envisages a different dynamic at the core of global organizational change. Instead of being driven by centralized efforts to capture efficiencies by allocating functions from the center, subsidiaries are driven by competition among themselves for mandates to carry out whatever activities each feels it can handle. In this model, the problem is not a lack of centralized direction by corporate headquarters but entrepreneurial competition among operations in a more decentralized and networked firm.

Variations of both of these models exist today in North America. Canadian and Mexican operations that recently produced a wide range of their parents' products now focus on single products or even components, typically with a continental or even global mandate. The CEO of the Canadian subsidiary of a major U.S. consumer-goods products manufacturer observed: "Canada has no choice. We either win big and have big factories that supply at least North America, if not the world, or we're not going to have any factories at all."²⁵

This new specialization accounts for rapidly rising levels of intra-firm trade in North America and for new investment that seeks to capture and deepen specialized skills and resources. At the same time, levels of competition for mandates among operations are increasing within many firms in North America.

In companies like Hewlett Packard Canada, Canadian operations report directly to U.S.-based business units. However, the Canadian managers collaborate to maintain a high level of Canadian identity and to identify possible production, research, or sales mandates that can be carried out in Canada. In a lighting fixture and controls company, for example, a product was identified as "an area where we saw potential for significant growth. The product line is technically very complex, and at the time of the pitch, did not represent significant production for the larger US facility. Our goal is to do a major re-design on this product offering in an effort to reduce costs...and to win the mandate and

²⁵ Quoted in John Southerst, "There Goes the Future," *Canadian Business*, October 1992.

service the entire North American market.”²⁶ The same holds true for many subsidiaries in Mexico. One executive observes that “Black and Decker’s main competitor is Black and Decker USA. NAFTA brought certainty and with it transborder shipments that are hurting us. We previously enjoyed a protected market locally, but thanks to NAFTA, we have benefited, nevertheless, by being forced to become more competitive. Our output has tripled. With trade liberalization, markets open throughout the Americas, competitive pressure will increase. We expect to source from and sell into many different markets to stay ahead.”²⁷

The change in corporate strategy and structure suggests why an increasing share of cross-border trade in North America takes place within corporations. In 1990, intra-company shipments between U.S. parents and their Canadian subsidiaries accounted for approximately 40 percent of all U.S.-Canada trade. Trade between U.S. parents and their Mexican subsidiaries accounted for a lower share of total U.S.-Mexico trade — about 25 percent.²⁸ However, this figure was expected to increase rapidly after NAFTA. These projections turned out to be quite accurate: In 1994, approximately 33 percent (about \$16.2 billion) of all U.S. exports to Mexico and 34 percent (about \$16.4 billion) of all Mexican exports to the U.S. were intra-firm.²⁹

New Investment or the Purchase of Existing Assets?

Foreign investors seek a variety of objectives. Some invest in highly liquid financial instruments, some in a wide range of fixed assets. But even direct investment can have a variety of purposes. Some investments are made to create new assets, some to acquire existing assets.

Much of the foreign capital that flowed into Mexico after the peso crisis and its devaluation went to acquire Mexican assets. One result has been a wave of acquisitions of Mexican assets by foreign firms. The *Wall Street Journal* reported in the fall of 1997 that “foreign multinationals have spent more than \$7 billion in the past two years buying up stakes in everything from a maker of tequila bottles to Mexico’s most famous baker.”³⁰

Acquisition may take the form of buying back shares in U.S. companies held by foreigners. In Canada, gaining wider Canadian equity participation in U.S. subsidiaries was a key element in becoming a “good Canadian corporate citizen” in the 1970s. This trend has been weakened if not reversed in the 1990s, and various Canadian subsidiaries have reported that they have been bought out by their U.S. parents. GE, for example, in 1989 purchased the shares of its Canadian operation that had been held by Canadians. In

²⁶ “Lightolier Canada: Taking Advantage of a Niche Strategy to Win a North American Mandate,” in Department of Foreign Affairs and International Trade, *Attracting World Mandates* (Ottawa, 1995).

²⁷ Interview with Jose Marie Gonzalez, President, Latin American Group, Black & Decker.

²⁸ See Dennis Encarnation, “Intra-firm Trade in North America and the European Community, in Eden, ed., *Multinationals in North America*.

²⁹ ITC survey, pp. 3-36.

³⁰ Craig Torres, “Foreigners Snap Up Mexican Companies; Impact is Enormous,” *Wall Street Journal*, 30 September 1997.

a survey of foreign-owned subsidiaries conducted in 1994 by The Conference Board of Canada, about 16 percent of the responding firms said that Canadian ownership had decreased. Of these, three-quarters were bought back by the parent company.

These patterns generate concern among Canadians and Mexicans. Mel Hurtig, a leading economic nationalist in Canada, observed recently that in 1997, the total of new foreign investment, C\$21.2 billion, was the second highest on record. He states that 97.7 percent of this amount went for acquisitions of Canadian assets, and only 2.5 percent for new business investment. He states, further, that of the C\$183.6 billion in new foreign investment that came into Canada from 1985 to the end of 1997, 93.4 percent was for takeovers and only 6.6 percent for new business development.³¹ Similarly, the director of international affairs for Mexico's largest left-wing political party has complained that "the economy has lost its national meaning. Wealth and economic strength and the existence of well-established firms are just being siphoned off to globalization."³²

In many cases, this is not a meaningful debate. A foreign takeover may save an ailing domestic company or may provide a critical opportunity for growth for a Canadian or Mexican firm that is too small to survive in international competition on its own. Ralston Purina, the U.S. pet food producer, reacquired nearly 100 percent of the shares in its Mexican subsidiary that had been delisted in 1990. Previously, when the 1973 Foreign Investment Law limited foreign ownership to 49 percent, the firm had sold its majority interest to Mexican investors. Regaining ownership permitted it to embark on a strategy that fit the Mexican operations into the company's global strategy and involved standardizing brands, packaging, and ingredients. Ralston Purina reorganized its production in Mexico: some products were phased out, some were imported from the United States, and some product lines were kept in Mexico to take advantage of lower costs and new economies of scale. This same scenario has been played out in many U.S. firms with operations in Canada and Mexico.

Our conclusion here is quite clear. Tracking flows and volumes of foreign direct investment across the borders of NAFTA partners does not get to the heart of the changes now underway in the infrastructure of the North American economy. Changes in corporate structure and organization are not clearly identified by the movement of capital. The profound restructuring of U.S. branch plants in Mexico and Canada and the creation of cross-border supply, production, and marketing networks are, we believe, the main themes of the story of the emergence of a true North American economy.

³¹ Mel Hurtig, "How much of Canada do we want to sell?" *The Globe and Mail*, 5 February 1998.

³² Torres, op. cit.

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Appendix A: ITC Sector-By-Sector Qualitative Findings

The ITC sector-by-sector qualitative findings are summarized as follows:

Agriculture

ITC Group No.1: Grains and oilseeds — Mexican tariff reductions on grains and the conversion of import licensing to a tariff-rate quota were largely responsible for the increased U.S. exports of grains to Mexico. Despite increased exports due to NAFTA, employment on U.S. farms continued a long-term decline.

ITC Group No. 2: Raw cotton — The growth in U.S. exports of raw cotton to Mexico partly reflected increased Mexican demand for the fiber used in the production of textile mill products (such as fabrics) for shipment to the United States under NAFTA. Data on changes in employment were not available, nor were investment data other than acreage planted in cotton, which increased by 24.6 percent between 1993 and 1996.

Manufactured Products

ITC Group No. 18: Textile mill products — NAFTA rules of origin stimulated demand in both Mexico and Canada for fabrics produced by U.S. textile mills to make apparel for the U.S. market. Job losses, possibly attributable to increased imports, have been at least partly offset by gains due to increased exports.

ITC Group No. 19: Apparel and other finished textile products — Increased U.S. apparel imports from Mexico were primarily due to NAFTA provisions that enable duty-free and quota-free entry for apparel (and other made-up textile goods) assembled in Mexico solely from fabric that was both formed and cut in the United States. The increase likely came at the expense of imports from Asian and Caribbean Basin Initiative countries. Employment in U.S. apparel manufacturing has declined since NAFTA, most likely reflecting, in part, a shift of some operations to Mexico.

ITC Group No. 34: Leather tanning and finishing — The increase in U.S. exports of leather (principally for use in motor vehicle seats) resulted, in part, from NAFTA changes in rules of origin related to motor vehicle export performance requirements and changes in Mexico's Maquiladora Decree that allowed shipments of car seats and/or car seat covers directly from maquiladora operations to vehicle assembly plants in Mexico. Employment in the leather tanning and finishing industry has declined despite increased exports as a result of the cyclical nature of the cattle/beef industry, closures in the face of stricter environmental standards, and relocation of some facilities to low wage-rate countries.

ITC Group No. 35: Women's footwear, except athletic — Increases in women's footwear imports from Mexico, mostly under production-sharing provisions,

largely reflected uncertainty over MFN renewal for China, as well as preferential U.S. tariffs under NAFTA. U.S. employment decreased from 1993 to 1996.

ITC Group No. 48: Household appliances — Some leading U.S. appliance producers chose to expand production in Mexico to supply the growing Latin American market, with increased U.S. imports from Mexico reflecting rationalized production. Changes in Mexican investment laws made it attractive to expand U.S.-Mexican joint ventures producing household appliances, and changes in the Maquiladora Decree enabled a phased-in increase in shipments from maquiladoras to the Mexican domestic market. Since employment grew in this sector, it is difficult to qualitatively discern a negative employment effect.

ITC Group No. 54: Motor vehicles — U.S. exports of motor vehicles to Mexico increased as a result of NAFTA-related reductions in trade balancing requirements and tariffs. NAFTA has had a positive effect on the increase in industry employment.

ITC Group No. 55: Motor vehicle parts — The sustained growth of the U.S. and Canadian motor vehicle markets, and investments in new plants and capacity, have supported employment growth in the U.S. auto parts industry. U.S. imports of motor vehicle parts from Mexico rose in part because of NAFTA rules of origin requirements and a more liberalized foreign investment climate.

Appendix B: The Impact of NAFTA on Trade in the Maquiladora Industry

The maquiladora industry is a critical element in Mexico's export earnings and employment. In 1996, the industry was the source of approximately 70 percent of Mexico's total exports of manufactured goods and 37 percent of Mexico's exports of all products to the United States. NAFTA and the peso crisis have accelerated the growth in the maquiladora sector over the past three years and have led to many changes in the industry.³³

By the close of 1996, 2,465 maquiladoras employing 811,376 persons were established in Mexico. The maquiladora sector accounted for one-third of the total manufacturing employment in the country. The ITC estimates that U.S. firms owned 37 percent of the maquiladora plants; another 42 percent were owned by Mexicans under service contracts, almost exclusively with U.S. customers; 13 percent were owned by Japanese companies; and 6 percent by owners in other countries.

The maquiladora industry expanded rapidly in the 1980s following Mexico's debt crisis and subsequent peso devaluations. Growth in the industry slowed, however, in 1992 and 1993 as the gap between wages in the U.S. and in Mexico narrowed. The rate of expansion increased again in 1994-95 following the implementation of NAFTA and the devaluation of the peso and continued in 1996. Between 1993 and 1996, maquiladora employment grew by 50 percent, while exports from the maquiladora sector rose by some 54 percent.

The International Trade Commission concluded that despite the maquiladora program's impending termination, as agreed to under NAFTA, certain aspects of NAFTA have provided incentives for investment in the sector:

- Duty- and quota-free treatment of apparel and other textile products sewn in Mexico from U.S.-formed-and-cut fabric encouraged the expansion of sewing operations in Mexico. U.S. apparel firms with sewing operations in the maquiladora industry saw them as a favorable alternative to importing these goods from Asia. This regulatory change also benefited U.S. textile producers who supply fabric to U.S. apparel firms with assembly plants in Mexico, but who were essentially shut out of the apparel-production markets in Asia by regional fabric suppliers.
- NAFTA rules of origin requirements have encouraged a number of Asian producers of consumer electronics and related products to set up or expand facilities in Mexico to assemble goods for the North American market and to increase their use of U.S.-made parts in order to minimize the customs portion of their total costs of bringing their products to the U.S. market. Many of the rules for specific electronic articles require that products imported into the United States from Mexico or Canada contain

³³ This section of the report is drawn largely from the U.S. International Trade Commission, "Production Sharing: Use of U.S. Components in Foreign Assembly Operations, 1992-1995" (U.S. Imports Under Production-Sharing Provisions of Harmonized Tariff Schedule Heading 9802), USITC Publication 3032, April 1997 (Investigation 332-237).

North American-origin content, accounting for a specific proportion of the products' value. Other rules specify that certain critical components or subassemblies be of North American origin to qualify for preferential treatment under NAFTA. Some of these companies have moved their production of components from Asia to the United States, purchased existing U.S. parts manufacturers, or insisted that their Asian suppliers establish production facilities in North America.

- The expiration of the maquiladora program on January 1, 2001, as agreed to under NAFTA, has also provided an incentive for Asian and European-owned maquiladoras to encourage their non-North American suppliers to shift production from Asia to the United States and Mexico. Components for Mexico's export-assembly that currently enter Mexico duty free will become dutiable upon entry into Mexico if they are made elsewhere than Canada or the United States.
- The stages of products access from the maquiladora industry into the Mexican domestic market, as agreed to in NAFTA, has permitted companies with maquiladora operations to sell directly into the Mexican market and to other maquiladora operations instead of shipping products to the United States for export back to Mexico. The revised Maquiladora Decree, which implements this part of NAFTA, will also bolster U.S. exports of components used in the assembly of auto parts in Mexico. Under the revised Decree, maquiladoras that supply the Mexican motor vehicle sector will be considered Mexican suppliers for purposes of complying with local content regulations. In addition, principal automotive producers with assembly plants in Mexico are likely to encourage parts suppliers located in the Far East and Europe to move to Mexico and be recognized as domestic suppliers to the Mexican industry.

The impact of NAFTA on the maquiladora sector may be less important, however, than the impact of the peso crisis. Prior to the peso devaluation, the number of maquiladora establishments had decreased by 2.4 percent over the previous year, while hourly compensation in the industry had risen to record heights. There was substantial uncertainty in the industry, particularly with regard to investing in new manufacturing facilities. But the 50 percent drop in the value of the peso greatly improved the price competitiveness of maquiladora exports in the United States and elsewhere. Maquiladora exports increased by 18 percent in 1995 and by 15 percent in the first half of 1996, compared with the first half of 1995. By the end of 1996, employment in the maquiladora industries had increased by almost one-quarter since December 1994, and 224 new maquila plants had been opened.

This change in cost structure, produced by the peso devaluation, seemed to have intensified a shift from reliance on component production and assembly operations in

Asia to North America. In 1995, a substantial number of Asian, European, and Canadian maquiladoras had opened, particularly in Mexico's northern border states. U.S. subsidiaries of several large Korean and Japanese firms were responsible for a large amount of the foreign direct investment entering Mexico.

Lower labor costs in Mexico have led some companies to shift production from the United States to Mexico. The French-owned Thomson Consumer Electronics announced that it would close its television assembly plant in Bloomington, Indiana, and consolidate all of its television assembly for North American markets into Juarez, Mexico.

This influx of Asian and EU manufacturers and their suppliers into border states has coincided with the modernization of maquiladora production methods and a shift from lower-skilled, labor-intensive assembly to production methods that require more highly skilled workers. Efforts to achieve just in time connections between suppliers and assemblers, particularly among automotive producers and suppliers, has reinforced the creation of cross-border networks along the Rio Grande. The maquiladora industry is also in the midst of change in the sources of its suppliers. In Northern Mexico, the "cluster" concept is being developed by Asian and European maquilas who build manufacturing facilities and then invite their suppliers to establish independent subsidiaries or joint ventures nearby.